



REPUBLIC OF SOUTH AFRICA

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**Ninth Interim Report  
of the  
Commission of Inquiry  
into certain Aspects of the  
Tax Structure of South Africa**

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*Fiscal Issues Affecting  
Non-Profit Organisations*

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NINTH INTERIM REPORT OF THE COMMISSION OF INQUIRY  
INTO CERTAIN ASPECTS OF THE TAX STRUCTURE OF  
SOUTH AFRICA

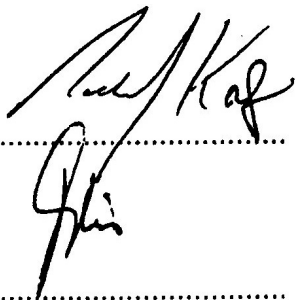
TO THE PRESIDENT

MAY IT PLEASE YOU MR PRESIDENT:

WE HAVE THE HONOUR TO SUBMIT HEREWITH THE NINTH INTERIM  
REPORT OF THE COMMISSION.

SIGNED AT JOHANNESBURG, THIS 12<sup>TH</sup> DAY OF FEBRUARY 1999.

M M KATZ (CHAIRMAN)




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D M DAVIS

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P L E R D U T O I T



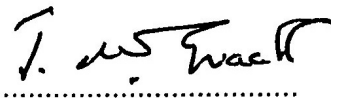
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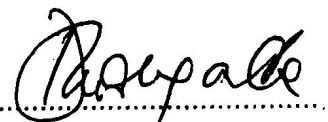
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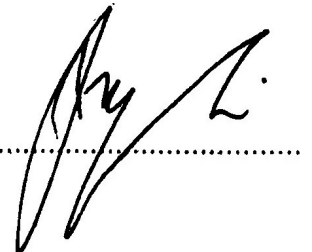
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# FISCAL ISSUES AFFECTING NON-PROFIT ORGANISATIONS (NPOs)

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# FISCAL ISSUES AFFECTING NON-PROFIT ORGANISATIONS

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## 1. INTRODUCTION

1.1 The Commission appointed a Sub-Committee to review existing fiscal legislation affecting Non-Profit Organisations (NPOs), and to advise with reference to possible changes therein with a view to achieving a more supportive fiscal environment. There are two broad themes which constitute the particular focus of the enquiry, namely:

1.1.1 The principal exempting provisions are contained within section 10 of the Income Tax Act No. 58 of 1962, as amended, ("the Act"), namely sub-sections 10(1)(f) and 10(1)(fA), which respectively deal with:

1.1.1.1 religious, charitable and educational institutions of a public character [s.10(1)(f)]; and

1.1.1.2 any fund the sole object of which is to provide funds for any religious, charitable or educational institution contemplated in paragraph (f) [s.10(1)(fA)].

1.1.2 The provisions of the Act (s.18A) restrict the benefits of donor deductibility to:

1.1.2.1 universities, colleges and educational funds (as defined); and

1.1.2.2 a deduction from taxable income, not exceeding:

(i) in the case of individuals, five hundred rand (R500,00) or two per cent (2%) of taxable income; and

(ii) in the case of companies, five per cent (5%) of taxable income.

1.2 Although the investigation does not purport to address comprehensively the other provisions of the Act which have reference to NPOs, including the remaining provisions of section 10, which contain a lengthy categorisation of activities that may be eligible for tax exemption, subject to compliance with various qualifying conditions, it does make certain recommendations about donations tax, estate duty and value added tax.

1.3 Organisations which are exempt from income tax in terms of the provisions of section 10, are generally also eligible for a range of other fiscal benefits, including those relating to stamp duties<sup>1</sup>, marketable securities tax<sup>2</sup>, transfer duty<sup>3</sup>, estate duty<sup>4</sup>, donations tax<sup>5</sup>, value added tax<sup>6</sup> (VAT), and

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<sup>1</sup>Stamp Duties Act, No. 77 of 1968, as amended (section 4).

<sup>2</sup>Marketable Securities Tax Act, No. 32 of 1948, as amended (section 3).

<sup>3</sup>Transfer Duty Act, No. 40 of 1949, as amended (section 9).

<sup>4</sup>Estate Duty Act No. 45 of 1955, as amended (section 4).

<sup>5</sup>Income Tax Act No. 58 of 1962, as amended (sections 54 - 64).

<sup>6</sup>Value Added Tax Act, No. 89 of 1991, as amended (sections 12 - 13).

Regional Services levies<sup>7</sup>. Certain fiscal privileges are also contemplated in respect of customs duty and excise for restricted purposes, as specified by the statute<sup>8</sup>. To a lesser degree, this report canvasses certain amendments to some of this legislation.

## **2. MOTIVATION FOR BENEFICIAL TAX TREATMENT OF NPOs**

2.1 The Sub-Committee received and considered a large number of motivated submissions made on behalf of individual NPOs, and from certain umbrella bodies and organisations representative of the NPO sector (e.g. the South African National NGO Coalition [SANGOCO]); and of the Grantmaking sector (e.g. the South African Grantmakers' Association [SAGA]). A schedule of the submissions received is attached (Annexure A). In addition, the Sub-Committee had the benefit of several written submissions from international agencies and authorities, including the United States International Center for Non-for-Profit Law (ICNL); the Charities Division of Revenue Canada; the Australian Association of Philanthropy; and a variety of religious organisations.<sup>9</sup>

2.2 Whereas these sources and submissions differ in their emphasis upon particular needs and objectives, there is virtual unanimity of opinion and authority regarding the importance and justification for retaining the privileged tax status of NPOs and extending the ambit and reach thereof.

2.3 Cognisance was also taken of the extremely difficult financial conditions that are currently being experienced by NPOs, many of which are compelled to seek alternative funding sources and means of generating donation and "earned" income. These circumstances can be attributed not only to prevailing economic conditions, but also to a certain measure of defection by overseas donors who, ironically, are less motivated to support a post-apartheid society than they were in respect of the beleaguered NPO sector prior to South Africa's transition to democracy. These circumstances have exacerbated fiscal anomalies and have sharply focused the restrictive nature of present fiscal legislation with particular reference to so-called "trading income", and other endeavours by NPOs to secure the survival of their operations.

2.4 It is apparent that a great many countries recognise the desirability of supporting NPOs by granting them some degree of preferential tax treatment and donor incentives, although the eligibility criteria, the benefits available, and the fiscal methodology differ in many instances. However, there is a broad consensus in the international community regarding the justification for such beneficial treatment. Factors which are most frequently cited include the following:

- (i) NPOs are seen to be a relatively cost-effective means of delivering social and developmental services in a manner which relieves the financial burden which otherwise falls upon the State;
- (ii) as civil society initiatives, NPOs are seen to promote important values in society, including voluntarism, self-responsibility, and participative democracy; and

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<sup>7</sup>Regional Services Council Act, No. 109 of 1985, as amended (Section 12(1A)d).

<sup>8</sup>The Customs and Excise Act, No. 91 of 1964, as amended.

<sup>9</sup>Acknowledgement is also made for the summary of comparative law and practice in a number of other countries, which are derived from a publication by Johns Hopkins University in association with John Wiley Inc. entitled, "The International Guide to Non Profit Law" (Lester M. Salamon: 1997).

- (iii) in societies such as South Africa where there exist gross disparities of income and wealth, NPOs represent an important mechanism for encouraging philanthropy and promoting greater equity and redistributive policies.

### 3. PROBLEMS WITH THE EXISTING LEGISLATIVE FRAMEWORK

3.1 Attention has been directed by a number of bodies to deficiencies in fiscal legislation, including the existing statutory formulations and the manner in which these are currently being implemented in practice. The following seem to be of the greatest significance.

3.1.1 Much of the antiquated language of these provisions is derived from old English law with its ancient formulations originating in the Preamble to the Charitable Uses Act of 1601. In terms of these archaic Anglo-Saxon formulations, a purpose is considered "charitable" only if it falls "within the spirit and intendment" of the Preamble. This refers *inter alia* to:

"the relief of aged, impotent and poor people, maintenance of sick and maimed soldiers and mariners, schools of learning, pre-schools, and scholars in universities, repair of bridges, ports, havens, churches, seabanks and highways, education and preferment of orphans, relief, stock or maintenance for house of correction, marriages of poor maids, aid or ease of any poor inhabitants . . . setting out of soldiers and other taxes . . .".

It is self-evident that such terminology is a product of its time, and no longer reflects a contemporary understanding of development, altruism, or public benefit.

3.1.2 As a result of the application of this medieval language, and in the absence of any statutory definitions, the interpretation and implementation of these provisions has imposed a substantial interpretative burden upon the Commissioner.

3.1.3 The difficulties facing both applicants and the Commissioner are compounded by the negligible litigation and hence judicial interpretation of these provisions.

3.1.4 It is recognised that the taxation of NPOs poses particular problems, not only because of limited resources of the South African Revenue Service, but also because of the special character of the organisations and their activities. Any attempt to levy taxation on such organisations is faced with difficulties in defining "income", "expenditure", and "trading", and in distinguishing accruals of a capital nature (such as donations) from accruals of a revenue nature. There exists an inherent difficulty in placing value upon, and bringing to account, goods, services and products which derive from donations, or that are secured and provided at less than actual cost.

3.1.5 The legislation stipulates that eligibility for tax benefits is conditional upon compliance with a range of enumerated criteria and disciplines, which are set out at length in section 10(1)(fA), involving long lists of what may be termed "public interest", rather than "fiscal" qualifying conditions. This leads to considerable uncertainty of application.

3.1.6 A particular area of concern involves the treatment of earned or so-called "trading" income, which is both prohibited by Statute (*vide* section 10(1)(fA)(ii)(ee)) in respect of "Funds", and, where permitted, then subject to tax. For reasons already indicated, it is considered that NPOs should be encouraged to become more financially self-sufficient therefore such prohibitions and constraints seem inappropriate and incongruous. However, it is recognised that there are legitimate concerns about "unfair competition", and the potential abuse of any tax-exempt status.

3.1.7 There exists a widely-held view that tax deductibility for the benefit of donors represents an important incentive to philanthropy and would be a valuable benefit for hard-pressed NPOs. At present, donor deductibility is permitted only within the very narrow confines delineated by section 18A. It has been cogently argued that the ambit of these provisions should be substantially enlarged. In reality, such arguments are only valid in the event that donor deductibility leads to greater munificence by donors, a result which is difficult to assess. The research is largely of an anecdotal variety, to the effect that greater donor deductibility results in greater philanthropy. The fiscal argument for granting such benefits rests upon the notion that donations support important public needs, thereby relieving Government of financial burdens it would otherwise bear. Professor Lester M. Salamon, in his landmark review of international NPO tax practice, has commented:

"In a sense, such special tax advantages reduce the "cost" or "price" of the gift by reducing the tax liabilities that the donor would otherwise bear. Whether such tax incentives actually induce taxpayers to make charitable contributions or merely influence the timing and amount of such gifts is open to debate, but there appears to be compelling evidence that they have some effect at least on the timing and amount of gifts."<sup>10</sup>

However, Salamon qualifies this observation by noting that:

"Critics charge, by contrast, that such incentives are undemocratic since they vest in the hands of private persons, decisions over how to allocate revenues that would otherwise come to the government in the form of taxes."<sup>11</sup>

## **4. CURRENT PRACTICE**

4.1 As indicated, there has been extremely little litigation challenging the refusal of privileged tax status, despite the large numbers of disappointed applicants. Apart from the cost of litigation, many NPOs discover that the amount of "net income" which would be subject to tax (after excluding donations which are considered of a capital nature) after making provision for operating expenses, is not sufficient to warrant the cost and risk of instituting review proceedings to challenge the Commissioner's decisions.

4.2 The Commissioner's office frequently provides extensive reasons for its decision, in conformity with the precepts of section 33 of the Constitution. However, such stated reasons often serve to illustrate the difficulty inherent in the present legislative provisions.

4.3 Examples of anomalous decisions, to which the Committee's attention has been drawn, include the following.

### **4.3.1 First Example**

4.3.1.1 The Commissioner refused to categorise an organisation as tax-exempt, whose main object was "to train and educate young people to become qualified artisans, to create work opportunities for unemployed people, and to promote cultural aspects in the community and family of the people of the Catholic faith". The Commissioner explained that in the light of the criteria employed, the organisation could not be regarded as either "religious", "charitable" or "educational" within the meaning contemplated by section 10(1)(f) of the Act.

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<sup>10</sup>The International Guide to Nonprofit Law, Lester M. Salamon (1997).

<sup>11</sup>The International Guide to Nonprofit Law, (1997), at 24.



#### 4.3.1.2 The Commissioner recorded the basis for this decision, as follows.

"Section 10(1)(f) of the Income Tax Act (the Act) provides for an exemption from income tax in respect of the receipts and accruals of a religious, charitable or educational institution of a public character.

1. "The term "religious" is not defined in the Act and there have been no South African Income Tax judgments in this regard. However, in considering what is religious, the Commissioner takes factors such as the following into consideration:
  - 1.1 The organisation's purpose.
  - 1.2 The actual operations of the organisation.
  - 1.3 Regular religious services conducted. This would entail a system of faith, a creed and form of worship.
  - 1.4 A regular congregation, the members of which contribute by way of voluntary gifts.
  - 1.5 A complete organisation of ordained ministers.
  - 1.6 A distinct and definite ecclesiastical government.
  - 1.7 Public character - the organisation must be managed and controlled by a body of members who hold their position by virtue of election. There must be no autonomous control by certain members. The whole beneficial interest, including administration and control, must vest in the members who are the public.
2. If the organisation's sole or at least main purpose or activity is to provide education, the following principles must be complied with:
  - 2.1 Acquisition of knowledge in a formal institution of learning.
  - 2.2 Systematic instruction, schooling or training, a formal course of study, instruction or training. The concept of education envisaged in section 10(1)(f) of the Act requires at least an element of systematic or formal instruction, schooling or training.
3. The word "charitable" is not defined in the Act and consequently it is difficult to lay down hard and fast rules. However, some definitions do provide guidelines and criteria, such as relief of poverty, protection and care of the sick, helping the helpless and almsgiving.

The main object of the organisation is to train and educate young people to become qualified artisans, to create work opportunities for unemployed people and to promote cultural aspects in the community and family of the people of the catholic faith.

The nature of the objects and activities of the organisation has been considered in the light of the aforementioned criteria and I am of the opinion that the organisation cannot be regarded as either a religious, charitable or educational institution of a public character as contemplated in section 10(1)(f) of the Act."

#### 4.3.2 **Second Example**

4.3.2.1 A section 21 company was refused tax exemption, notwithstanding that its main purpose was "to alleviate poverty, and promote enterprise development in marginalised Southern Africa, by developing and marketing educational and training materials and services, as an institution of a public character". The specific focus of this organisation was to develop innovative training materials and computer-based methodologies to advance entrepreneurship as a strategy for addressing conditions of poverty and unemployment. Its contribution over the initial years of its activity involved enabling more than 7 000 previously-unemployed persons to start their own small businesses. In submitting its

application to the Commissioner, attention was drawn to the statement of the Minister of Finance in the 1998 budget speech indicating the creation of the Government's "Umsobomvu Trust", to the effect that the Government, in establishing this Trust, was "responding to the key objective of the presidential job summit, which is to convert the challenge of unemployment into the opportunity for job creation". In refusing this application, the Commissioner advised as follows:

"Section 10(1)(f) of the Income Tax Act provides for an exemption in respect of the receipts and accruals of religious, educational, and charitable institutions of a public character.

The Courts have, in the past, held that an educational institution of a public character, as contemplated in section 10(1)(f) of the Act, is regarded as a formal institution of learning where a formal course of study, instruction or training is imparted.

In a recent appeal case heard overseas, the High Court held that the word "education" connotes the process of training and development of the knowledge, skill, mind and character of students by normal schooling. It is not used in the wide sense according to which every acquisition of further knowledge constitutes education.

Furthermore, it must be noted that the Income Tax Act does not define "charitable". Under common law it has an extensive meaning. It has, however, been held that the fact that the Legislature has specified each category separately in section 10(1)(f), "charitable" is to be used in a narrower sense. This has also been confirmed in the judgment delivered in 56 SATC 18 (on page 25).

In approving an exemption from income tax in terms of section 10(1)(f) of the Income Tax Act, this Department has always interpreted "charitable" in the strict and narrow sense of relief of the needs of the poor.

The nature of the objects and activities of the company has been considered in the light of the aforementioned criteria and I am unable to agree that the company can be regarded as either a charitable or educational institution of a public character, as envisaged by section 10(1)(f) of the Income Tax Act."

## **5. CRITICAL POLICY ISSUES**

In reviewing and formulating appropriate fiscal legislation with respect to NPOs, a number of critical issues need to be addressed. These include the following.

### **5.1 The two distinct South African tax benefits**

5.1.1 As in most countries which have devised fiscal regimes favourable to NPOs, South African law recognises two distinct benefits which are available, viz:

- (i) an exemption available to the NPO itself in respect of its liability for income tax, and other fiscal levies; and
- (ii) a right available to donors to deduct from their taxable income, limited amounts representing philanthropic contributions for the benefit of eligible institutions.

### **5.2 Problem of defining eligibility criteria**

5.2.1 A key problem which becomes evident in most countries surveyed, is the matter of defining eligibility criteria and identifying activities and organisations which qualify for beneficial tax treatment. A summary of the survey appears in Appendix 1.

5.2.2 Each country has sought to grapple with these problems and achieve a tax regime which is certain, equitable and administratively practical. Of particular interest is the United Kingdom which has devised a novel solution to the problem of donor tax deductibility by stipulating minimal amounts and requiring a written "covenant" for a period which may exceed three years. The mechanism for conferring such benefits is to afford the charity the right to reclaim from the fiscus, the amount of tax attributable to the donation in the hands of the donor. By contrast, South Africa permits the donor to deduct eligible donations from taxable income. The United Kingdom method is administratively-sophisticated in that it limits the need for fiscal oversight to the relatively small number of charitable institutions reclaiming tax, rather than requiring oversight over a multitude of tax-paying donors.

### **5.3 Drafting Considerations**

5.3.1 It is necessary to devise formulations which are clear, flexible, and have reference to objective criteria, which do not rely upon arbitrary or subjective discretions. Wording such as "activities which the Commissioner is satisfied are of a cultural nature" (s.10(1)(cB)i(dd)) need to be avoided. Moreover, section 18A - which itself contains three pages of definitions, including definitions within definitions - must be reduced to plain language. Philanthropic needs and methodology change over time. Accordingly, the legislation should have a degree of flexibility, both as to eligibility criteria and as to the quantum and nature of fiscal benefits conferred. The legislation should make provision for the Government to focus its own fiscal priorities on particular social issues which may change with the passage of time.

5.3.2 It is undesirable to vest sweeping discretions in the Commissioner. Ideally, the legislation should provide clear objective criteria which can be uniformly applied by reference to jurisdictional facts, thereby removing concerns about subjectivity, inconsistency and perceived discrimination.

### **5.4 Administrative Simplicity**

5.4.1 Any system should recognise the severely limited resources available to the South African Revenue Service. The system should not place undue demands upon Revenue personnel to monitor and exercise oversight thereby preventing "tax leakage" and abuse. Accordingly, the provisions should, insofar as possible, be self-regulating and should be devised in a manner that limits the need for extensive audit.

### **5.5 Government Financial Co-option**

5.5.1 As Salamon has pointed out, in granting tax exemptions and other fiscal privileges, the fiscus is passively co-opted into benefiting eligible organisations and donors to the extent of tax waived or deductions permitted. Democratic governments are rightly jealous of their prerogative to order and determine their own fiscal priorities, with due regard to changing social needs. Accordingly, a system that is overly liberal as to eligibility and uniform as to benefits granted, would not only represent an indeterminate fiscal cost, but also in effect deprive Government of its ability to make its own choices and direct its own social spending, as it deems appropriate.

5.5.2 In particular, a recommendation to expand the range and scope of deductions for donations to NPOs beyond the present dispensation provided for in terms of section 18A raises the issue of whether the tax system is the appropriate mechanism for supporting the commendable work of such organisations. Two fundamental problems need to be addressed, namely:

- (i) the potential for the tax base to be eroded by means of incentives, introduced all too often as a result of special pleading that does not amount to rational justification for

the measure and, as a result of which, the Government's scope to reduce rates of tax to internationally-competitive levels is severely reduced; and

- (ii) a system of special exemptions and deductions raises the possibility of abuse, particularly in the form of tax-based schemes.

5.5.3 The Commission has taken careful cognisance of these concerns by attempting to frame its proposals in terms of the approach adopted by the Commission in its Interim (First) Report, namely:

"The Commission's policy is that the range of incentives should be narrowed as far as possible and that those which exist should all be justified in terms of the objectives in the Reconstruction and Development Programme. If this approach is adopted it will assist in preventing tax leakage and in promoting the closure of the gap between effective and nominal rates of taxation."<sup>12</sup>

5.5.4 For the same reason, the Commission considers that the selection of categories of activities within the NPO sector that should be eligible to benefit from a beneficial dispensation should be decided upon by Government in terms of its own developmental priorities.

## 5.6 Trading Activities

5.6.1 In recent years, NPOs have been obliged to contend with a shrinkage of donor funding (particularly from foreign sources) and they have faced an imperative to narrow their focus, and explore income-generating products and services. Such "trading" or "service" activities present a number of fiscal problems, including:

- (i) an issue of "equity", in particular where non-profit (tax-exempt) organisations trade and compete in the market place with profit-making (taxpaying) entities; and
- (ii) the erosion of the tax base and the creation of opportunity for abuse, particularly in relation to joint-venture or "hybrid" organisations which seek to combine taxable (profit-making) activities with non-taxable (philanthropic) objects, especially where such "hybridisation" occurs within the context of shared costs and infrastructure.

5.6.2 The Commission has taken note of various foreign tax regimes which have drawn a distinction between "related" and "unrelated" trading activities. The notion of "relatedness" refers to the nature of the trading activity as having some substantive relationship with the philanthropic purpose of the organisation. One concern has been to ensure that "trading" activity does not become the *de facto raison-d'etre* of a tax-exempt organisation, providing more private inurement than public benefit. Thus, overly generous remuneration packages, consultancy fees, rentals, administration charges and other devices can be used as the conduit for personal benefit.

5.6.3 Apart from the test of "relatedness", suggestions have been made that the fiscus needs first to determine the fiscal cost in terms of lost revenue or, alternatively, that some absolute ceiling or limitation be placed upon the amount of "trading" income that may be treated as tax-exempt.

5.6.4 It is the Commission's view that the present constraints on trading activities are unduly restrictive and tend to discourage NPOs from becoming financially independent. Accordingly, it is

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<sup>12</sup>At paragraph 13.5.12.

proposed that trading by NPOs should henceforth be permitted, albeit within a carefully structured fiscal regime which facilitates oversight by the Commissioner and limits the opportunity for abuse.

5.6.5 The distinction between "related" and "unrelated" trading does, in fact, find some precedent in our own law. To the extent that trading forms part of the core activities of an NPO and provided that the promotion of the organisation's objectives rather than the pursuit of profit is the primary aim of the activity, it is deemed a "related activity".<sup>13</sup>

5.6.6 In considering comparative law, it is noteworthy that the United States' federal tax law exempts profits derived from a business which is "substantially related" to a NPOs tax-exempt purposes. Where profits are derived from an activity that is carried on with profit-making as the dominant purpose, the mere fact that the organisation tends to apply the income derived to further its charitable purposes will not qualify it for exemption from income tax. Salamon states:

"Substantially related in this context means that the conduct of the business activity must have a significant causal relationship to the achievement of a tax-exempt purpose. Thus, for the conduct of a trade or business from which a particular amount of gross income is derived to be exempt from taxation, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of the organisations' exempt purposes."<sup>14</sup>

5.6.7 Similarly, in the United Kingdom trading income derived by charities from "trades which are a primary purpose of the charity" are tax-exempt and the exemption extends to include ancillary activities "exercised in the course of the actual carrying out of a primary purpose". This exemption has been clarified in a Revenue Practice booklet CS2 entitled "Trading by Charities" which cites as examples of qualifying ancillary trades:

- (i) the provision of accommodation to students by schools or colleges; and
- (ii) the sale of food and drink in a cafeteria to visitors to an art gallery or museum or to visitors to a hospital.

5.6.8 Apparently, United Kingdom Revenue Practice is to accept ancillary trades provided they are "small in absolute terms and the turnover of that part of the trade is less than 10 per cent of the turnover of the whole trade". However, unrelated trading by charities on a tax-exempt basis can be achieved in the United Kingdom by the simple mechanism of locating these activities in a separate trading company, which enters into a covenant in favour of a registered charity, in terms of which it donates the amount of its net profits.<sup>15</sup>

## 5.7 Public Policy

5.7.1 Section 10 of the Income Tax Act seeks to impose (for example, in relation to "funds" as envisaged by section 10(1)(fA)) a number of constraints which are really "piggy-backed" onto fiscal legislation in order to address a broad sweep of public policy objectives. Whilst this use of fiscal regulation to promote broader public goals is not unique to South Africa, it does seem anomalous that the Commissioner should be charged with monitoring and promoting such matters which have little

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<sup>13</sup>See ITC 1565, 56 SATC 18 at 31-32.

<sup>14</sup>See Lester M. Salamon. 1997. *The International Guide to Non Profit Law*. Johns Hopkins. University in association with John Wiley Inc., par. 25.7.

<sup>15</sup>See "The Charity Law and Practice Review", Volume III at pages 149 - 156.

or no bearing upon normal fiscal criteria - and which require some philosophical base or technical competency that may not be readily available to the Commissioner. Thus, for example the Commissioner is:

- (i) required to regulate "prudent investment" by NPOs to the extent that an NPO may wish to place investment funds otherwise than in "listed securities" (quoted on a licensed Stock Exchange) or with a "financial institution" (as defined in the Financial Institutions (Investment of Funds) Act, No. 39 of 1984);
- (ii) charged with adjudicating the merits of reasons advanced for the retention of revenue by a tax-exempt organisation that wishes to expend in any particular year less than 75 per cent of its net revenue earned in the preceding fiscal year;
- (iii) required to grant or refuse consent (without any indication as to criteria) for the carrying on by an NPO of any business; and
- (iv) required to approve expenditures for philanthropic purposes where the beneficiary is outside the Republic.

## **5.8 Public Accountability**

5.8.1 Through the newly-enacted Non-Profit Organisations Act, No. 71 of 1997, an attempt is to be made to promote the value of "transparency", or public accountability, on the part of NPOs. To the extent that such organisations are encouraged to choose voluntarily to register, such registration renders them bound to disclose certain statutory information, which is then publicly accessible. As an incentive, registered organisations are promised eligibility for (as yet unspecified) benefits, which will no doubt include eligibility for beneficial tax status.

5.8.2 Once again, it is proposed to use fiscal legislation to promote other social values - i.e. in this instance, the merit of NPOs making public financial information and details of their constitution, management, office bearers and auditors.

5.8.3 However, voluntary registration is hardly an adequate "stand-alone" criterion to justify fiscal benefits without some further qualifying conditions. As the evidence placed before the Commission has indicated, the newly-fledged Directorate of Non-Profit Organisations has limited resources and person power.

## **5.9 Conflicts of Interest**

5.9.1 There exists a common law obligation upon directors, trustees and other officers of NPOs to avoid "conflicts of interest" and the abuse of their fiduciary responsibility in self-benefiting ways, e.g. through excessive remuneration. This important fiduciary duty is not presently provided for in legislation and depends upon the somewhat diffuse and inaccessible common law. In the absence of any other available oversight body, the regulation of NPOs in this respect is also likely to become the responsibility of the Commissioner, notwithstanding that it is a problematic area.

## **5.10 Unfair Competition**

5.10.1 In granting privileged tax status to particular organisations, the fiscus needs to have regard to the issue of "unfair competition" between bodies which are subject to tax and those which are tax-exempt. The broad issue of fairness or equity within a free-market economy is a fundamental one that warrants some degree of vigilance. However, the Commission is of the view that this value

should not be elevated to the status of a "*summum bonum*" and needs to be counter-balanced with other important values in society, including the need for a strong, independent, and viable NPO sector.<sup>16</sup>

5.10.2 It is possible that, over time, resourceful NPOs may operate at a scale and with such zeal that might threaten the profitability and viability of competing tax-paying enterprises. In such circumstances, it is possible that some form of constraint or "ceiling" will be necessary upon the scale of trading activity by NPOs that would qualify for privileged tax treatment. A related concern is to ensure that NPOs do not invest a disproportionate amount of their human and financial resources in the generation of income at the expense of their core, altruistic, purposes.

5.10.3 Various mechanisms for controlling "unfair competition" have been considered, including:

- (i) a test directed to:
  - (a) "scale", as would be addressed by an absolute limit upon turnover per annum; or
  - (b) "character", as would be addressed by stipulating that not more than a fixed percentage (say 50 per cent) of gross receipts should derive from "trading income"; and
- (ii) in the final analysis, having taken account of the existing case law in South Africa and the comparative international position, it is considered that the primary contention for a statutory exemption for trading income should be that the trade is exercised in the course of the actual carrying out of a primary purpose of the charity.<sup>17</sup>

## 5.11 Prudent Investment

5.11.1 In some jurisdictions (e.g. the United Kingdom), specific legislation exists to prescribe prudent investments that are permitted by charities and tax-exempt endowment funds. In some measure, the South African Income Tax Act makes similar provision to the extent that organisations seeking exemption are precluded, in terms of section 10(1)(fA), from investing funds in any manner,

- "(A) with a financial institution as defined in section 1 of the Financial Institutions (Investment of Funds) Act, 1984 (Act 39 of 1984);
- (B) in securities listed on a licensed stock exchange as defined in section 1 of the Stock Exchanges Control Act, 1985 (Act 1 of 1985); or
- (C) in such other financial instruments as the Commissioner may approve."

5.11.2 A number of difficulties arise with reference to the application of these formulations, which must also be read in conjunction with related prohibitions on "the carrying on of any business" (save to the extent that the Commissioner may permit). It should be mentioned that the

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<sup>16</sup>There is compelling argument that exemption from income tax does not create a comparative advantage. See, for example, S. Rose-Ackerman "Unfair Competition and Corporate Income Taxations" (1982) 34 *Stanford Law Review* 1017.

<sup>17</sup>This provision would accord with both the position in the UK and the USA where an unrelated trade or business is one that is not substantially related to the exercise or performance of the exempt purpose or function.

Commissioner has been in the practice of administratively imposing further conditions which frequently include restrictions on:

- (i) the granting of loans; and
- (ii) the making of investments in private companies.

5.11.3 An exception is made in respect of "any asset or business undertaking acquired by such funds by way of donation, inheritance or bequest, [which] may be retained or continued as the case may be in the form so acquired".

5.11.4 There was evidence placed before the Commission that problems have arisen in recent years when NPOs have been precluded, as a result of these constraints, from benefiting from "empowerment" investment opportunities targeted to benefit the previously disadvantaged. In view of the existing statutory restrictions on permissible investments, NPOs have been prevented from taking up such investment opportunities. Thus far, the Commissioner has refused to sanction investment in unlisted equities within the rubric referred to in (C) above.

## **5.12 Community-based and Informal Organisations (CBOs)**

5.12.1 A particular problem relates to the arbitrary disqualification of smaller, informal, community-based organisations which are prevented from benefiting from grants by funding institutions that are themselves exempt from income tax in terms of sub-section 10(1)(fA). The reason for their ineligibility relates to the fact that the present formulation of this Sub-section prohibits the granting of benefits by a tax-exempt fund to any beneficiary organisation, unless that beneficiary organisation is itself exempt from income tax in terms of section 10(1)(f), viz. a "religious, charitable or educational institution of a public character".

5.12.2 There are no reliable statistics available regarding the numbers of non-profit and public-benefit organisations presently operating in South Africa. Only a limited number of more formally structured organisations have brought themselves within the purview of official registers maintained respectively in respect of Trusts and section 21 Companies and an even more limited number within the purview of the Tax Authorities.

5.12.3 However, by far the largest percentage of NPOs and CBOs are in fact constituted as Voluntary Associations, for which there exists no public office of registry. The newly established Directorate of NPOs will, over time, build records on the basis of voluntary registration only, as presently envisaged. Accordingly there are no relevant records available. It is the experience of most large funding institutions that they are often frustrated in their wish to support commendable local initiatives because they lack the necessary legal and financial expertise to present successful application to the fiscus for tax exemption. In many instances they are in fact probably unaware of the requirements of the legislation.

5.12.4 Accordingly, it is the opinion of the Commission that tax-exempt funding institutions should be permitted to devote their funds to any eligible purpose without prescription in respect of eligible organisations. Further the beneficiary organisations should not be required first to secure formal tax exemption, as presently required. As a matter of public policy, it may well be that registration in terms of the new Non-Profit Organisations Act should become a prescribed requirement; particularly in the light of the intention that the Directorate is mandated to assist organisations and to provide resources, where necessary, to facilitate registration under the Act.



## **5.13 Land Restitution Bodies and Membership Organisations**

5.13.1 Representations were received with regard to a special genre of organisation, falling somewhere between a "philanthropy" and a "members' co-operative". Legislation makes provision for a number of special-type organisations (for example, Communal Property Organisations) which are to be constituted as vehicles to facilitate restitution and redistribution, and which envisage communal or group ownership, and the collective administration of compensation awards. These situations are characterised by the disadvantaged nature and indigence of the beneficiary community, and represent evidence of our society's commitment to assist "the poorest of the poor", to enable them to establish reasonable conditions of life, including security of tenure, rudimentary housing, employment opportunities, and access to basic amenities.

5.13.2 It has been argued that such institutions should be accorded limited tax relief as part of a "package" of social assistance for which they are eligible, notwithstanding that they are characteristically constituted with broad objects and intended to benefit community members - who also serve on their Boards of Trustees. The Commission is persuaded that some form of tax relief could be considered in such cases, which would, for example, render these institutions exempt from transfer duty on the acquisition of land and would enable them to function without the incidence of income tax for an initial "entry period" of, perhaps, five to ten years. Thereafter, the continued eligibility of such organisations for tax-exempt status might be subject to review and would depend on their level of need and deprivation. Obviously it would not be desirable to create a "tax haven" extending beyond the ambit of assistance to the poor and which might create the spectre of an affluent community enjoying a favoured tax shelter indefinitely.

5.13.3 A related problem concerns organisations which devote their efforts to creating small-scale business opportunities and encouraging entrepreneurial activity as a strategy for alleviating poverty, unemployment, and crime. Frequently such organisations directly, or in partnership with others, engage in some measure of "trading" or in establishing small enterprises as a strategy to facilitate "the escape from poverty and unemployment". Once again, it is the Commission's view that such organisations should be accorded tax relief, notwithstanding that their activities may be technically entrepreneurial in character. A fiscal precedent exists in the United Kingdom in respect of the so-called "beneficiary worker exemption" which exempts charity trading income from tax, provided it derives from trades whose work is carried out by beneficiaries of the charity.

## **5.14 Donor Deductibility**

5.14.1 For reasons indicated above, the Commission has sought to identify a means of enlarging the present scope of donor deductibility as envisaged by section 18A. In its deliberations, the Commission has been careful that, in extending the scope of section 18A, it should not create a new incentive. Its recommendations must fall within its own philosophy as outlined in previous reports and as supported by comparative experience. It has also taken account of the persuasive argument that such deductions, proceeding as they must from disinterested benevolence, do not constitute personal consumption and hence should be allowed.<sup>18</sup> Whilst recognising a number of practical constraints, including:

- (i) the limited resources and oversight capacity of the South African Revenue Service;
- (ii) the absence of reliable data upon which reasonable estimates of fiscal cost can be made. (The Commission is advised that a new database is in the process of being established, which will in due course facilitate the calculation of the effect of future

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<sup>18</sup>See W.D. Andrews "Personal Deductions in an Ideal Income Tax" (1972) 86 *Harvard Law Review*, 309.

fiscal concessions. This is vital for the assessment of all deductions and their impact on the Budget); and

- (iii) the absence of any statutory authority (other than the Commissioner) which can assume the responsibility for effective administration of any such wider dispensation. (The Commission has been informed that, the newly-established Non-Profit Organisations Directorate has neither the resources and skills nor powers to enable it to exercise effective fiscal oversight.)

5.14.2 Notwithstanding these practical constraints, the Commission has attempted to define a dispensation which would serve to promote a culture of philanthropy and would be administratively feasible and cost-efficient.

5.14.3 A number of theoretical options were considered and rejected, including:

- (i) leaving section 18A unchanged;
- (ii) repealing section 18A to eliminate donor deductibility in its entirety; or
- (iii) expanding section 18A to permit each and every tax-exempt organisation to enjoy the same benefits.

5.14.4 It would have been the Commission's first preference to suggest a system analogous to that currently operating in the United Kingdom, where tax-exempt organisations are entitled to claim back from the fiscus the tax paid by donors in respect of eligible and "covenanted" donations. The administrative burden which such a system imposes, dictates otherwise.

5.14.5 Accordingly, the Commission proposes, as an interim measure, a broadening of the provisions of the existing section 18A to permit a broader category of eligible organisations that would be entitled to grant-donor benefits similar to those presently reserved for educational institutions and funds.

5.14.6 However, if the necessary resources could be made available to SARS, consideration could be given to a system devised on the following lines:

- (i) in each budget, the State might appropriate a fixed amount available for appropriation amongst tax-exempt organisations, in respect of the tax attributed to tax-paying donors.
- (ii) any tax-exempt organisation would then be entitled to apply for a pro rata allocation of the budgeted amount, on condition that its claim, duly vouched, was filed with the fiscus by no later than a stated date.

5.14.7 The pro rata amount attributable in respect of any given donation would be calculated as follows:

$$\frac{X \times Z}{Y}$$

Where:

- X = The amount of the donation actually paid by a registered taxpayer during the relevant fiscal year, duly supported by appropriate documentation.
- Y = The aggregate amount of all such documented claims timeously received by the fiscus by the specified date.
- Z = The amount budgeted and appropriated by Parliament in respect of the relevant year.

5.14.8 Such a system could incorporate a degree of "politico-fiscal" flexibility in that it might allow for certain high priority activities to be accorded a greater share or proportion of the budgeted amount.

5.14.9 The system would be relatively simple and cheap to administer because of the relatively small number of organisations to be audited and assessed, as compared with a system that necessitated oversight being exercised in respect of large numbers of individual taxpayers. Moreover, as in the United Kingdom, consideration might be given to excluding minor claims, and excluding claims not represented by a multi-year "covenant".

5.14.10 A disadvantage of the proposed system is that it would involve retrospective determination of each individual organisation's share (X/Y) of the fixed amount (Z), because no organisation would be in a position to estimate Y (the aggregate of donations) in advance with any degree of accuracy. An alternative suggestion, involving a departure from the current practice of allowing full deductibility of any donation that qualified under section 18A, would be to move to a system of partial deductibility.

5.14.11 Under partial deductibility a figure would be proposed in each year's budget indicating the percentage of any donation that would qualify for deduction from taxable income in the ensuing year, provided of course that it met all the other requirements of the amended section 18A. If, for example, the figure were to be set at 80 per cent, a donation of R1 000 would entitle the donor to a deduction of R800 from income subject to tax.

5.14.12 Partial deductibility would provide a welcome measure of flexibility in countering revenue loss as the scope of section 18A was gradually broadened to accommodate a wider range of institutions. The sensitive use of this measure on an incremental basis requires on-going information on the actual revenue losses being incurred, but that is a pre-requisite for any reform of the NPO tax regime.

5.14.13 Two "caps", one for individuals and another for companies, are currently in place to limit revenue loss. They restrict the extent to which section 18A donations may be deducted by any taxpayer to a maximum of 2 per cent of taxable income for an individual and 5 per cent for a company. The Commission can find no justification for this form of differentiation and for this reason recommends that "one cap" be introduced for all taxpayers.

5.14.14 The introduction of partial deductibility would enable the two "caps" to be lifted. The lifting of the caps is a separate issue from their standardisation to eliminate discrimination between

individuals and companies but would not, in the opinion of the Commission, pose any significant risk of revenue loss if a system of partial deductibility were in place.

## **6. SPECIFIC PROPOSALS**

### **6.1 General recommendations**

After reviewing current legislation and practice, and in the light of international precedent and experience, the Commission thus recommends.

6.1.1 That the law should provide for a simple, generic definition of tax-exempt organisations, which might be characterised as "exempt public-benefit organisations".

6.1.2 That the subjectivity of the present system should be replaced by one which is objective and clearly defined as to eligibility criteria.

6.1.3 That the defining characteristics of "exempt public-benefit organisations" should include the following:

- (i) a "public-benefit" purpose or activity, falling within a schedule of such activities; or involving a further category prescribed by Ministerial Notice in the Gazette. (As social needs and priorities change over time, it may be appropriate to permit the addition by Ministerial Notice of further categories, albeit on an interim basis, say not exceeding 24 months, unless the Act is amended by Parliament);
- (ii) formal registration in terms of the Non-Profit Organisations Act, No. 71 of 1997; and continued compliance with its conditions and disciplines;
- (iii) a formal written Constitution in terms of which the organisation is constituted as either a Voluntary Association, as a Trust, or a section 21 Company;
- (iv) a minimum number of members (to be prescribed);
- (v) the application of the major portion of "gross receipts" for philanthropic purposes; and not merely to benefit members or staff, or for some limited sub-category of beneficiary/ies;
- (vi) a prohibition on the payment of remuneration to employees in excess of levels which, in the opinion of the Commissioner, are excessive, having regard to norms and standards applicable to NPOs from time to time;
- (vii) an obligation to expend in any particular year at least seventy-five per cent (75%) of net revenue accruing in the previous tax year, save insofar as the Commissioner may approve the expenditure of a lesser percentage for reasons and purposes approved by the Commissioner; and
- (viii) the avoidance of conflicts of interest or self-dealing for the benefit of Trustees, members or other persons associated with the organisations.

6.1.4 That the legislation should contain a schedule listing eligible public-benefit activities, which might include:

- charity and altruism;
- upliftment and development of indigent and disadvantaged communities;
- welfare and social services;
- religion, philosophy and belief;
- politics, public policy and advocacy;
- education, including adult, civic and public education;
- job training, skills transfer, and the promotion of entrepreneurial skills for the benefit of unemployed and indigent persons;
- recreation and sport;
- culture and arts;
- physical, mental and psychological health (including prevention, treatment, rehabilitation and support);
- environmental concerns, animal protection and wildlife conservation;
- the provision of legal, medical and other professional services for the benefit of indigent persons, either free of charge or at a charge which is significantly less than that normally levied;
- international organisations directed to the promotion of peace, friendship, cultural exchange and other beneficial purposes;
- museums of a scientific, cultural and historical nature; and
- institutions for the advancement of science.

6.1.5 Consideration could also be given to those ancillary taxes and levies, apart from income tax, for which a Registered Public Benefit Organisation might be exempt.

6.1.6 That any organisation aggrieved by the refusal of the Commissioner to recognise it as eligible in terms of the relevant scheduled categories, should have a right of objection and appeal to the Special Income Tax Court. It is suggested that in any such proceedings involving an NPO, one of the assessors should be a person having particular knowledge and experience of the sector.

6.1.7 That the ambit of the benefit of donor deductibility (from pre-taxed income) which, in terms of section 18A is presently restricted to educational institutions, be substantially enlarged by reference to a scheduled listing of organisations and categories of activity which would qualify for this benefit. The system could allow for some differentiation as to the scale or quantum of benefits on the basis that Government may wish to give differential and preferred encouragement to particular social priorities at different times. Recognising concerns expressed with regard to the difficulty of

anticipating the likely impact this concession might have on future tax receipts, it is proposed that specific limits be established at this stage, which could be reviewed from budget year to year. Should there be concern that this recommendation would involve too great a loss of revenue, the proposal in respect of partial deductibility contained in paragraph 5.14.11 could be considered.

6.1.8 Having regard to the State's prerogative to determine its own fiscal priorities in the area of social and developmental spending, in addition to the general tax deductibility ceilings envisaged above, the State could also designate from time to time particular categories of social activity which could be eligible for more generous tax deductibility. Thus, for example, education, health, or housing (or some other category of social activity) could be designated as eligible, at a particular time, for more generous limits than those applicable to section 18A. The major drawback with this proposal however is that it will create much difficulty in determining into which category an organisation should be considered.

6.1.9 That an efficient computer system be introduced so as to calculate the cost of such deductions to the fiscus (i.e. tax expenditures). Such cost must be tabled in the annual Budget in the form of a "tax-expenditure budget".

6.1.10 That existing restrictions upon categories of permissible investments by tax-exempt organisations be rescinded for the reason that the common law itself requires prudent (and non-speculative) investment by persons holding fiduciary positions. If a need is perceived to further regulate this matter further, then the Income Tax Act is not regarded as the appropriate mechanism to achieve this purpose.

6.1.11 With respect to "trading" activities by registered public-benefit organisations, it is proposed that such activities be permitted within the following parameters. That:

- (i) on the basis of the *de minimis* rule, no tax implication should arise in respect of such "trading income" up to a limit of say R100 000,00 per annum, or five per cent of "gross receipts", whichever is the greater;
- (ii) income derived from "related" trading- or fee-generation be exempt from tax, to the extent that the gross receipts derived from such income-generating activities do not exceed one-half of the gross receipts (including donations) of the organisation concerned. The balance would be subject to normal principles of taxation;
- (iii) "unrelated" trading activity or fee generation would be permitted without restriction, but only if conducted within the structure of a separate wholly-owned or controlled subsidiary, which is duly constituted for this purpose. The income derived from such "unrelated" trading activities would be subject to normal tax, save to the extent envisaged by clause 6.1.11(i);
- (iv) related trading be defined along the lines set out in clause 5.10.3(i) and (ii); and
- (v) these provisions must be reinforced by substantial penalties for fiscal fraud or evasion.

## **6.2 Donations Tax**

6.2.1 Donation is defined, for the purposes of donations tax, as meaning any gratuitous disposal of property including any gratuitous waiver or renunciation of a right.<sup>19</sup> This definition is

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<sup>19</sup>Section 55(1) of the Income Tax Act, No. 58 of 1962, as amended.

incongruous with that of the common law in which a donation is defined as a transaction *inter vivos* between donor and donee whereby the donee is enriched and the donor correspondingly impoverished, such transaction being accompanied by an intention of the donor to enrich the donee at his or her expense.<sup>20</sup> The different definitions have given rise to confusion in practice and there is no need to maintain the difference.

6.2.2 The Commission recommends that the statutory definition be amended to accord with that of the common law. Donation should thus be defined as a transaction, whereby one person without any legal obligation to do so, undertakes out of disinterested benevolence to give property to another person without receiving anything in return.<sup>21</sup>

6.2.3 In the light of the recommendations made in this report, it is further recommended that section 56(1)(i) (donations by and to charitable and other institutions) and section 56(1)(j) (donations of property for charitable and other purposes) of the Income Tax Act, No 58 of 1962 should be deleted and that a new section 56(1)(i) should be inserted to exempt from donations tax, any donation of property to an institution which enjoys an exemption from income tax in terms of section 10(1)(f) (as amended in terms of the recommendations of this report). This will bring about consistency of treatment in respect of institutions classified as tax exempt.

### 6.3 Estate Duty

6.3.1 In its 4th Report, the Commission made a set of recommendations regarding incentives to encourage socially and economically beneficial bequests. As the Commission considers this set of recommendations to be highly appropriate to the objectives of the report, the relevant passages are cited in full.

12.1 Evidence submitted to the Commission suggests that there is meaningful support for the estate duty regime to be modified to encourage socially and economically beneficial bequests.

12.2 Certain non-Governmental organisations would be identified on a periodic basis by Government preferably after consultation with provincial governments. The organisations so identified would be referred to in a Proclamation issued from time to time in terms of the Estate Duty Act. Although the Commission can clearly not be prescriptive in this regard, it would naturally be important for the attainment of the objectives sought to be achieved by this recommendation that the organisations so identified must be such that the testator can meaningfully identify with them.

12.3 Any bequest made to an organisation proclaimed as aforesaid:

- (a) would continue to form part of the dutiable value of the estate; and
- (b) the amount of the bequest would be a deemed discharge to that extent of the estate duty payable by that estate.

12.4 The purpose of the foregoing is to encourage bequests by wealthy individuals to promote causes which Government identifies as being important to the public good. As set out above, the Commission cannot be prescriptive in the determination of the causes which should qualify for the foregoing treatment, as these must be determined by Government.

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<sup>20</sup>Avis v Verseput 1943 AD 331 at 348.

<sup>21</sup>See D. Hutchison et al, Wille's Principles of South African Law (8th ed) at 624.

12.5 In order to qualify, the bequest must represent an outright divestment of control of the amount in question. There must be no retention of any interest whatsoever by the estate in the amount or asset in question."

6.3.2 Unfortunately no action has been taken to implement this proposal. The Commission is of the opinion that the revenue from estate duty which will be lost pursuant to this recommendation is somewhat illusory in that the practical choice open to an estate owner is either to engage in more sophisticated estate planning or make the bequest as proposed. In short, the revenue channeled to the NPO sector though this proposal is unlikely to result in a significant erosion of the estate-duty base.

6.3.3 Within this context, the Commission considers its proposal to be particularly viable to the promotion of a healthy NPO sector.

6.3.4 The Commission does not consider that there is any case for altering the other taxes levied, such as VAT, to benefit the NPO sector. Such amendments would erode these tax bases and cause far greater harm than benefit.

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## APPENDIX 1

### VARIATIONS IN INTERNATIONAL TAX TREATMENT OF NPOS<sup>22</sup>

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#### 1. Australia

1.1 The key subsection is section 23(e) of the Income Tax Assessment Act of 1936, which exempts the income of a religious, scientific, charitable or public-educational institution. However, the term charity is not defined in legislation and relies on case law for its meaning. The Australian courts recognise as charitable any NPO whose purpose falls within one of the four heads of charity set out in nineteenth-century English case law: relief of poverty, advancement of education, advancement of religion, and other purposes beneficial to a community. The fourth head of charity, namely other purposes beneficial to a community, has generally been given a wide interpretation by the Australian Tax Office and the courts. Other purposes that qualify a NPO for a tax exemption, such as promoting the development of aviation or encouraging music, art, science, or literature, have subsequently been added.

#### 2. Canada

2.1 Under the incorporating statute, the purposes that a society or non-share capital corporation may pursue must in the broadest possible terms be for some charitable, educational, patriotic, community, or public-benefit purposes. The only restriction is that the primary purpose must not be to operate some business, professional, or other for-profit activity.

2.2 All charities that have applied to Revenue Canada and been registered as charitable organisations, public foundations, or private foundations are completely exempt from all tax on income whether the income is from donations; earned by way of interest, dividends, or capital gains from passive investments; or earned from active businesses carried on by the charity. There is no excise tax payable by private foundations on earned income. There is also a wide range of exemptions on consumption, land, and import taxes, but these vary according to Provinces and even Municipalities.

#### 3. Egypt

3.1 There are five main types of NPOs in Egypt:

- (i) associations;
- (ii) foundations;
- (iii) professional groups;
- (iv) business associations; and
- (v) clubs and youth centers.

3.2 Associations and foundations are both governed by Law No. 32 of 1964. In fact, this law treats foundations as a sub-group of associations. An association is any organised group composed of individual or legal persons operating for a certain period of time with an aim other than achieving

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<sup>22</sup>They are taken from Salamon, *op. cit.*

profit. A private foundation, on the other hand, is a type of association that is established by the dedication of an amount of money (either by individual or legal persons) for an unspecified period of time to pursue religious, scientific, social-welfare, or public-benefit goals. The principal difference between foundations and associations is that foundations operate on the basis of an endowment, like the historic Islamic *waqf*, whereas associations depend on current income from membership fees, donations, and grants.

#### **4. France**

4.1 Although a wide array of objectives is open to NPOs in France, only organisations that serve public-interest purposes are eligible for special treatment. This special treatment takes the form of tax advantages for both the organisations and their donors and eligibility for government funding. Eligible for such treatment are organisations that serve the broader public rather than their members alone or that take on tasks that would otherwise fall within the responsibility of the state. This generally includes organisations working in the fields of education and research, health and social services, environment, development and housing, advocacy, philanthropy, international activities, or professional and business associations. Such organisations are often designated by state authorities as “organismes exercent des activités d'intérêt général” or “dont la gestion est désintéressée” to indicate the public-benefit aim and non-profit character of the organisation, respectively.

#### **5. Germany**

5.1 Tax exemption is generally granted to those NPOs that pursue public-benefit activities “Gemeinnützigkeit”, regardless of the type of organisation or its legal status. The rules relating to public-benefit status are spelled out in sections 51 through 68 of the “Abgabenordnung” (AO), or General Tax Code of March 16, 1976. The Act distinguishes three categories of tax-privileged purposes:

- (i) charitable or public benefit purposes, “gemeinnützige Zwecke”;
- (ii) benevolent purposes, “mildtätige Zwecke”; and
- (iii) church-related purposes, “kirchliche Zwecke”.

5.2 According to section 52 AO, public-benefit purposes are those purposes that materially, spiritually, or morally promote the well-being of the public at large, as opposed to small and exclusive groups such as a family, company employees, or the members of a social club. The section includes the following purposes in this category:

- (i) the support of science and research, education, arts and culture, religion, international understanding, development aid, preservation of the environment, nature and monuments, local and regional history, and lore;
- (ii) support of youth activities, the aged, public health, welfare, and amateur sports;
- (iii) support of civic activities; and
- (iv) support of animal breeding, plant cultivation, hobby gardening, carnival activities and local folklore, care of servicemen, amateur broadcasting, miniature airplane building and flying, and dog walking and guiding.

5.3 In terms of section 53 of the AO, an organisation pursues charitable work, if its activities are singularly focused on supporting persons in an altruistic fashion. These are only charitable activities if:

- (i) the beneficiaries of these actions or deeds primarily depend on these contributions because of their bodily, mental or emotional and/or psychic disabilities or conditions; and
- (ii) the payments received by way of the charitable relief measures do not exceed four times the amount of the prescribed income or contribution received by way of social insurance benefits in terms of the German Social Insurance Legislation. This proviso does not apply in cases where these people with disabilities have at their disposal sufficient financial resources and could thereby contribute to their own well-being. There are certain other stipulations that mandate bigger charitable contributions but which relate closely to German social security legislation and, hence, are not relevant for the South African situation.

5.4 In terms of section 54(1) of the AO, an organisation pursues religious or ecclesiastical work if its activities support in an altruistic manner a religious community but which is at the same time an entity that is governed in terms of public laws. Included under this category are all financial support measures aimed at the erection/construction, the decoration and maintenance of places of worship, churches or buildings or facilities for a parish, the financial support of religious activities or services; the training of clergymen, priests or parsons; the financing of religious instructions in schools, funerals and remembering the deceased; the administration of churches' or parishes' assets; the salaries of clergymen and religious support staff; and the old-age care of clergymen, their support staff, inclusive of the caring for their widows and orphans.

5.5 The support or promotion of charitable or non-profit activities only takes place if one's economic self-interest is not primarily advanced through this activity. Hence, any commercial or business-related activities must per definition rule out altruism. In short, this pursuit of publicly-minded activities in terms of German tax-preferential treatment is only present if no group benefits exclusively therefrom. Furthermore, the following conditions or prerequisites must be met:

- (i) funds of the NPOs may only be utilised for purposes as stipulated in its founding documents;
- (ii) members, partners or associates of the NPOs and those who are members on the basis of the non-profit's constitution are not allowed to receive any share, percentage of the profits of such NPOs and may not be the recipients of any other allocations, allowances, gratuities or gratification, advances of funds or gifts from such organisation due to their membership;
- (iii) the non-profits are explicitly prohibited from using their funds or resources for the direct and/or indirect support of advancement of political parties;
- (iv) members or associates of the NPO may, on leaving or at the dissolution of the organisation, receive not more than their originally paid-in share of capital or ownership interest and the agreed value of their assets in-kind brought into the NPOs;

- (v) the NPO may not incur expenses which are not in line with the objects as embodied in the founding documents or that seek to benefit a person through a disproportionately high remuneration or emoluments or allowances; and
- (vi) at the dissolution or abolition of the non-profit character or the annulment or scrapping of its original objects the NPOs accumulated resources or funds as far as they exceed the originally paid-in shares of capital or interest shares or the agreed value of their assets in-kind brought into the NPO, may only be utilised or distributed in favour of another tax-exempt non-profit or charitable organisation as this was the very basis for the creation and accumulation of such capital assets.

## **6. Hungary**

6.1 Only selected types of voluntary associations are exempt from corporate income tax under Hungarian law; namely those engaged in scientific and technical research, culture, environmental protection, sports, health care, social help, and child and youth care:

## **7. India**

7.1 Sections 10 through 13 of the Income Tax Act of 1961 define organisations eligible for tax-exempt status generally as religious and charitable organisations. These religious and charitable organisations fall into two groups:

- (i) organisations that are totally exempt from taxation due to their non-profit status, and
- (ii) organisations that can acquire income tax exemptions if they satisfy certain requirements.

7.2 The first group includes:

- (i) scientific and research associations;
- (ii) universities, colleges, or other educational institutions pursuing exclusively educational purposes;
- (iii) hospitals or medical institutes that are not profit making and exist solely for the provision of medical care to suffering persons;
- (iv) organisations exclusively promoting sports like cricket, hockey, football, etc.; and
- (v) organisations existing solely for the protection or encouragement of Khadi and village industries registered with the Khadi and Village Industries Commission.

7.3 These organisations are fully exempt from income tax as long as they continuously pursue their objectives and apply all of their income to these objects.

7.4 Organisations that are charitable in nature but not included in this list can still acquire tax exemptions. According to section 2(15) of the Income Tax Act of 1961, the term charitable purpose includes relief for the poor, education, medical relief and advancement of any other object of public utility not involving the carrying on of any activity for profit.

## **8. Republic of Ireland**

8.1 Some types of NPOs are specifically exempt from various taxes. These include credit unions, bodies promoting human rights which have consultative status with the United Nations or Council of Europe, athletic and amateur sporting bodies, and certain Friendly Societies. In addition, organisations that pursue charitable purposes are eligible to receive charitable exemptions from the Revenue Commissioners, the body responsible for the implementation of tax legislation in Ireland.

8.2 **The Treatment of Organisations.** With respect to direct taxation, only charitable organisations in the legal sense of the term and those organisations listed in the previous paragraph are eligible for exemption.

8.3 **Charitable Status.** In order to be recognised as having charitable status, the objects of the organisation must be entirely "charitable" as defined through years of case law. Since there is no official register of charities in Ireland, organisations must apply to the Revenue Commissioners for exemption from certain taxes. In order to be recognised by the Revenue Commissioners, an organisation must already have some form of constitution and must be the subject of a binding trust for charitable purposes only.

## **9. Israel**

9.1 The Income Tax Ordinance exempts the income of any public institution from tax on its income (defined as corporation tax) insofar as such income is not derived from any trade or business carried on by the organisation or by another association that it fully controls. For tax purposes, a public institution is defined as either an association of at least seven persons, the majority of whom are not related to each other, and that exists and operates exclusively for a public purpose.

## **10. Italy**

10.1 Under Italian tax law, the absence of a profit motive has never been a rationale for granting tax exemption to organisations. NPOs, therefore, do not automatically enjoy a privileged position as far as liability for Italian taxation is concerned. Rather, the key to whether an organisation is liable for tax is whether it carries out commercial activities, as defined in article 2195 of the Civil Code.

## **11. Japan**

11.1 NPOs that engage in activities for the benefit of society as a whole, rather than the pursuit of profits, are given favoured treatment in tax law in Japan. Most significantly, such corporations are exempt from corporate income tax, except for income derived from profit-making activities.

## **12. Mexico**

12.1 By law, private-assistance institutions are automatically granted exemption from corporate income taxation. However, in the case of civil associations, the application for tax-exempt status is handled separately from the registration for legal personality. In particular, institutions wishing to obtain tax-exempt status must apply in writing to the Ministry of the Treasury, Undersecretary of Revenues, Area of Donations or, alternatively, to the Local Legal Administration of Revenues of the same Ministry. This application must include:

- (i) the section of the law declaring the proposed activities to be eligible for tax exemption;

- (ii) a copy of the institution's by-laws with all the requisites mentioned above;
- (iii) evidence of the activities performed; and
- (iv) a copy of the registry in the Science and Technology Registry or in the Education Ministry, if applicable. The Treasury Authorities publish an annual list in the Official Gazette of all the institutions that have obtained this benefit and that are currently in compliance with their obligations. The tax exemption is granted permanently and there is no need for periodic re-applications.

### **13. Poland**

13.1 The general principle of Polish law is that all legal actors, including associations and foundations, are treated equally in matters of taxation. Accordingly, tax exemption is not granted to specific types of organisations *per se*, but is rather related to the pursuit of specific eligible activities. All legal entities are therefore formally obliged to pay income tax, commodities and services tax, tax on real property, and so on.

13.2 An exception to this general legal principle was introduced by the Law on Foundations of 1984, which originally exempted bequests or gifts of cash and other movable property or property rights made to foundations from inheritance and gift taxation. Although this exemption was annulled in 1989, the Law of January 31, 1989 granted exemptions from income taxation for all legal personalities, including associations and foundations, whose statutory aims are scientific and scientific-technical activities, education, culture, sports and recreation, the protection of the environment, charity, health protection, social assistance, occupational and social rehabilitation of the handicapped, and religious practice.

### **14. The Russian Federation**

14.1 NPOs are generally exempt from the profit tax on all income except that received from entrepreneurial activity. This includes income received in the form of designated gifts, foreign grants, membership dues, and participants' deposits designated for the NPOs use. By contrast, revenue from an NPOs entrepreneurial activity is subject to taxation, as is revenue received through partnerships or joint ventures with commercial organisations. In addition, the government has the right to confiscate from the NPO the amount of income from foreign grants or designated gifts not used according to the designated purposes.

14.2 Religious organisations and public organisations for the disabled are generally exempt from the profit tax. Moreover, the taxable profit of enterprises owned by artistic unions is reduced by the amount applied to fulfilling the parent organisation's chartered activity.

14.3 Generally, inasmuch as the law does not sanction entrepreneurial activity that does not correspond to the NPOs chartered purpose, it does not provide for an unrelated business income tax (UBIT).

## **15. Spain**

15.1 Although the system is generally favourable, eligibility for beneficial tax treatment is fairly narrowly defined. According to article 42 of the Law on Foundations, to be eligible, foundations and associations of public utility must:

- (i) pursue aims of a general interest;
- (ii) earmark at least 70 per cent of net income and other earnings to the pursuit of these aims;
- (iii) testify that any majority interests held in commercial companies serve the pursuit of the aims while not infringing on the non-profit character of the organisation;
- (iv) render accounts to the Public Administration; and
- (v) in the case of dissolution, apply their assets to other organisations pursuing similar aims of a general interest.

## **16. Sweden**

16.1 The tax treatment of organisations is as follows.

- (i) Associations. Non-profit associations are generally subject to taxation at the regular corporation tax rate of 28 per cent. However, organisations of several kinds serving a public benefit are exempt from tax on their income under the condition that they use at least 80 per cent of their income for their public-benefit purposes. The VAT basically follows the income tax. Furthermore, exempt organisations do not have to pay the 0.15 per cent net wealth tax and are also exempt from inheritance and gift taxes. The exemption does not normally apply to their unrelated business income. However, capital gains are tax exempt, even if related to property used in the generation of unrelated business income. The definition of public benefit, as spelled out in section 7 of the Act of State Income Tax, or “Lagen om statlig inkomstskatt”, is very wide. It encompasses any activity for the public good, provided it is of a general character and principally addressed to an unlimited number of persons, and not orientated to certain family members or to an otherwise limited circle. Any religious, charitable, social, political, artistic, and cultural purpose would be acceptable in so far as that particular purpose is the principal purpose of the association and the activities are geared to fulfilling that purpose. Under such circumstances, all income that arises from the activities of the association is exempt from taxes, provided that such activities have a natural connection to the public-benefit purpose. However, income earned from businesses unrelated to the principal public-benefit purpose of the association is still subject to taxation if it amounts to more than 15 to 20 per cent of the association's total business income. If such income exceeds this percentage, the whole of the business income will be taxed.
- (ii) Foundations. A vast number of foundations are also exempt from taxes, especially those foundations that serve the public good, such as foundations pursuing charitable, scientific, educational, religious, welfare, and other public or commonwealth purposes. To enjoy such tax exemption, a foundation must pursue these purposes exclusively or principally in its daily activities, and at least 80 per

cent of the proceeds or returns received by the foundation from its property or assets must be used for the same purposes. Family foundations, on the other hand, do not enjoy any particular tax exemptions.

## **17. United Kingdom**

17.1 In 1891, the mass of case law was classified by Lord Macnaghten in *Pemsel's Case* into four categories: the relief of poverty; the advancement of education; the advancement of religion; and other purposes beneficial to the community not falling under any of the preceding categories. Although it is a classification of convenience only, it has constantly been referred to in later cases. Although courts have recognised that the law of charities may have evolved since Lord Macnaghten's classification, it remains the case that purposes which are neither enumerated in the preamble nor, by analogy, deemed to be within its spirit and intendment are not charitable, even though such purposes are beneficial to the public.

## **18. United States**

18.1 Federal Law. The federal law in the United States provides income tax exemption for many types of organisations. These organisations are, in order of their listing in the Internal Revenue code:

- (i) Instrumentalities of the United States;
- (ii) Title-holding corporations;
- (iii) Charitable (including religious, educational, and scientific) organisations;
- (iv) Social welfare organisations (sometimes termed civic leagues);
- (v) Local associations of employees;
- (vi) Labour organisations;
- (vii) Agricultural organisations;
- (viii) Horticultural organisations;
- (ix) Business leagues;
- (x) Chambers of commerce;
- (xi) Real estate boards;
- (xii) Boards of trade;
- (xiii) Professional football leagues;
- (xiv) Social clubs;
- (xv) Fraternal beneficiary societies;
- (xvi) Voluntary employees' beneficiary associations;
- (xvii) Domestic fraternal societies;
- (xviii) Teachers' retirement fund associations;
- (xix) Benevolent life insurance associations;
- (xx) Mutual ditch or irrigation companies;
- (xxi) Mutual or co-operative telephone companies;
- (xxii) Cemetery companies;
- (xxiii) Credit unions;
- (xxiv) Certain insurance companies or associations;
- (xxv) Crop operations financing companies;
- (xxvi) Supplemental unemployment benefit trusts;
- (xxvii) Veterans' organisations;
- (xxviii) Group legal services organisations;
- (xxix) Black lung benefit trusts;
- (xxx) Farmers' co-operatives;
- (xxxi) Political organisations; or



- (xxxii) The states, political subdivisions of them, and a variety of organisations that are closely associated with the states or their political subdivisions.

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**ANNEXURE A**  
**SCHEDULE OF SUBMISSIONS**

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1. Charities Aid Foundation Southern Africa
2. Cluny Farm
3. Community Action Company
4. Community Chest
5. Department of Welfare
6. Gauteng Legislature
7. IDASA
8. National Coalition for Social Services (NACOSS)
9. National Welfare Social Service & Development Forum
10. Organisation Development Training
11. Society for the Advancement of Independent Living
12. South African National NGO Coalition
13. South African Revenue Service
14. Southern African Catholic Bishop's Conference
15. Southern African Institute of Fundraising
16. Southern African Association of Homes for the Aged
17. The South African Institute of Chartered Accountants
18. Western Cape Cerebral Palsy Association