

Russia — A ‘Virtual’ Democracy?

The second of a two part series on the Russian nonprofit tax law

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President Vladimir Putin’s Address to the Federal Assembly of the Russian Federation on May 26, 2004.

“I would like to say a few words about the role of nonpolitical public organizations. In our country, there are thousands of public associations and unions that work constructively. But not all of them are oriented toward standing up for people’s real interests. For some of these organizations, the priority is to receive financing from influential foreign foundations. Others serve dubious group and commercial interests. And the most serious problems of the country and its citizens remain unnoticed.

“I must say that when violations of fundamental and basic human rights are concerned, when people’s real interests are infringed on, the voice of such organizations is often not even heard. And this is not surprising; they simply cannot bite the hand that feeds them. Of course, such examples cannot be grounds for us to make accusations against civil groups as a whole. I think that these problems are unavoidable, and of a temporary nature.

“To reduce these problems and stimulate the further growth of institutions of civil society, we do not need to invent anything new. Our own experience and international experience has already proved the productiveness of an entire range of approaches. It is necessary to gradually transfer functions to the nongovernmental sector which the state should not or is unable to perform effectively.”

In his State of the Union address, President Vladimir Putin broke from the tradition of discussing macro socio-economic issues and concentrated instead on practical problems of vital importance to “every citizen, every Russian family.” He emphasized the need to (1) create a more competitive housing construction market and mortgage system; (2) provide an education system that educates the poor in specialties needed in the labor market; and (3) develop a modern health system. Putin made clear that improvements in housing, health care, and education would be necessary,

not only for raising the Russian standard of living and economic growth in the new global economy but also for the development of a civil society based on the rule of law. At the same time the government proposed dropping certain social welfare entitlements in lieu of cash payments to individuals.

President Putin’s approach of turning over functions to nonprofit organizations (NPOs) would appear to be a ready made blueprint call to action for the philanthropic community — perhaps! Winston Churchill once referred to Russia as “a riddle wrapped in an enigma,” a cogent description that is as true today as it was then because Putin also devoted some time during his address to the question of democracy in Russia, citing his commitment to democracy and the development of a civil society on the one hand but sending a clear warning to certain NPOs to refrain from criticizing the Kremlin by expressing concerns that Russia was becoming increasingly undemocratic by the selective prosecution and jailing of Mikhail Khordokovsky, the president of Yukos Oil Company, accused of tax evasion and corruption and who also happens to be the largest benefactor of NPOs for opposing Putin’s style of democracy.

The question is what is happening in Russia today and what impact do these events have on the Russian nonprofit laws and their administration? I recently returned from Moscow following consultations with NPOs and the Duma Committee on Public Unions and Religious Organizations, which is responsible for drafting the current Russian laws on NPOs. It was an eventful week with the passing of former President Ronald Reagan, the national holiday of the New Russia created after 1990, President Putin’s remarks on NPOs, and his return from the G8 Summit in Georgia with the leaders of the world’s richest nations.

Before you can understand what is transpiring in Russia, you have to see what has happened to Russia since the beginning of the 1990s and the efforts to westernize and reform Russia into a full-fledged member of Europe and the west. Many in the west thought that if only enough human, financial, political, and technical resources were given to the right reformers in Russia, they would create a broad base of support for liberal values among the population to anchor democratic and market principles.

This paradigm was effectively used in transforming the Central European countries into democratic states after the collapse of the Berlin Wall and the disintegration of the Soviet system. This optimistic paradigm, generally referred to as the Liberal Project, never took root in Russia because of Russia’s lack of democratic tradition and the Yeltsin attempts at reform that brought on the catastrophic drop in



Milton Cerny meets at the Duma with Sergey A. Popov (at Cerny's left), chairman of the Committee of Public Unions and Religious Organizations, to discuss nonprofit tax laws.

living standards, monetary crisis, the trauma of Chechnya, and the ushering in of the powerful oligarchs who gained control of important economic enterprises and undermined the liberal reform movement and its leaders.

A new paradigm has emerged with the administration of President Putin. Some describe it as tsarist but it may be better seen as managed democracy. Here, the state is the central organizing force of political and economic life. Under this paradigm, the state has the power to annul many basic human rights of citizens to gain economic growth, restore Russian dignity, and bring order to society. This paradigm is built on nationalism, the strict enforcement of law, and limited democracy permitted by the state.

Practically speaking, a liberal paradigm may never have worked in either the new or old Russia under a Jeffersonian system of democracy as we know it. However, NPOs operating under a more authoritarian form of democracy might still be an effective force if they engage the leadership of President Putin's united Russia on his own terms. The dynamic in governing has changed because the Duma is no longer a deliberative body based on the plurality of ideas but rather it has become the implementer of President Putin's policies of economic nationalism. However, it still can become the catalyst to create a new civil society.

What does this all mean for the NPO sector in Russia and its supporters in the west? First, the reformist model that has been the historic basis for western assistance to Russia

in the past decade must now be changed so that assistance is given to those elements of the NPO community who are rebuilding the civil society based on the programs the government has identified as of primary concern — health, education, housing, and relief for the poor. By doing so, bridges can be built with institutions and networks in Russia that serve as incubators for the development of future leaders of the civil society and establishment of opportunities for engagement that provide the future hope that Russia will one day join the nations of the western democracies as a full-fledged partner. Historical parallels of change can be drawn from the U.S. experience.

The 1960s in the United States ushered in great reforms of the civil society through the War on Poverty when nonprofits were created to partner with and carry out the Kennedy and Johnson administrations' efforts to seek the broader benefits of the civil society for all citizens through programs leading to a better life by eliminating pockets of poverty, providing educational opportunities, development of affordable housing, and health care initiatives for the elderly and the poor. It was a time when Head Start programs brought children early learning opportunities and the Peace Corp encouraged young people to enlist in community service and fueled the volunteer movement to reach out to communities all over the world just as Habitat for Humanity does today. Community development organiza-

tions brought new hope to economically depressed areas and revitalized communities.

Without an effective nonprofit sector government initiatives could not have been accomplished because it was the local communities and its volunteers that made them work. The U.S. government became a grant maker and not a deliverer of services needed by the community at costs that were much less than if the government carried on the programs directly. These volunteers were people who saw the need and took action through federal programs to make their community a better place to live.

Universities and community colleges were made affordable for every student. Scholarship funds were made available through federal and state aid and private assistance through nonprofit organizations. Private initiatives carried out by commercial corporations who became more socially responsible in their dealings with their local communities sought to eliminate pollution and promoted conservation practices and provided retraining of employees as technologies changed the workplace. Of course, not enough was done as America lost jobs to foreign markets. But in their place sprung new service industries manned by a more educated and productive workforce. Greater opportunities were afforded women in the areas of law, medicine, and business. How does that experience relate to Russia today?

Economically, Russia is doing well as GDP grew by more than 7 percent in 2003. In October, Moody's raised Russian debt to investment grade. Fixed income of individuals grew by more than 12 percent in 2003 and productivity is on the rise. It is estimated that the number of Russians who are classified as poor has fallen by 1/3 in the last four years. Not only does this good news apply to Moscow but also to the regions whose futures were bleak only a few years ago. What has changed in Russia in the past four years is that economic stability has been fueled by the oil boom and investment. What is needed is a more inclusive civil society to sustain Russia's democratic process. Russia now stands at a crossroads of its development. The United States and the west can either be engaged with the new Russia or stand aside as a spectator to an unfolding world drama.

What can be learned from the American and the world experience?

The relief of poverty by nonprofit organizations has taken many forms. Examples that could be utilized in Russia include nonprofit organizations that provide markets for products and micro-financing for small entrepreneurs, community centers for the elderly and the poor with food and medical assistance, low-income and affordable housing, vacations for the elderly poor at rural rest homes, and transportation services. Other organizations could provide alternative service for youth and rescue and disaster relief assistance and health care to the elderly and the poor through clinics.

Great opportunities for nonprofit organizations are present in the area of advancement of education that include the direct education of students by nonprofit educational institutions, promotion of scientific research, and dissemination of knowledge. Nonprofits could assist state and private universities through low-interest student loans and publication of scientific journals. University-affiliated nonprofit organizations could be utilized to promote scientific research and serve as coordinators for establishing economic

enterprises that result from the basic research at universities through incubator projects that manage the new organization until it is viable and then release it to operate in areas in need of economic development. Nonprofits could assist in applied research development through the management of university basic research to applied uses.

Local economic development corporations, organized as nonprofit organizations, could engage in a number of supporting activities such as training workers, promotion of business opportunities for commercial businesses to locate in economically depressed areas, and management of low-income housing projects. All of these activities in one way or another relieve the government of a burden to perform the activities directly and permit the nonprofit sector, utilizing in part its resources and voluntary assistance, to carry these out in the public interest. Revenue income streams from such activities would not be taxed, making these programs self-funded from tax-exempt sources and contributions. These opportunities are available if the tax regime could be structured in a manner to encourage the types of activities that President Putin has identified as priorities for the coming years.

I. Background

The primary legal framework for NPOs in Russia is found in the form of public organizations, foundations, institutions, partnerships, and other types of noncommercial organizations. Under the general federal law, organizations, including public associations, mass movements, and public foundations and institutions are established as juridical entities. Foundations and public institutions can also be created under either the Law on Public Associations or the noncommercial organization law. Eighty-nine separate territorial jurisdictions also provide certain tax benefits to and restrictions on NPOs.

Under the existing Russian federal tax laws, NPOs are exempt from income tax on grants, donations, or other funding used to support their activities. However, NPOs must pay an income tax on business activities to the same degree and manner as commercial entities. There are exemptions from the value added tax (VAT) on the transfer of goods and funds to NPOs that support the organizations' statutory goals (Article 3a(3)(3) of the Tax Code). A similar exemption is granted from VAT on the distribution of goods and services that are provided free of charge for charitable purposes and activities undertaken by NPOs. See Article 149(3) of the Tax Code.

With respect to contributions, commercial corporations do not receive the benefit of any tax deductions for contributions to NPOs. But individuals may deduct up to 25 percent of their taxable income for monetary but not in-kind gift contributions. Article 219(1) Tax Code. However, certain restrictions apply to these donations. First, the beneficiary organization must be either a state-subsidized or state-owned organization. Second, the donations do not apply to private schools, museums, or health care providers. Third, the donations must be made directly to the beneficiary organization and cannot be passed through a regrantee organization.

In 1999, Federal Law No. 95-F2 was enacted to provide exemption from tax for gratuitous assistance provided to the Russian Federation through legal entities conducting humanitarian assistance and technical aid. Foreign contributions to Russian NPOs are allowed under a certification process that confirms the nature of the funds, goods, work, and services provided. Exemption from tax and custom duties for such aid assistance was also granted. There are no provisions for recognizing reciprocal cross-border or charitable contributions deductions by donors.

II. Present Legislative System

The Russian Civil Code provides for various forms of NPOs. Pursuant to the Civil Code, these are consumer cooperatives, public and religious organizations (associations), foundations, institutions, unions (associations of legal entities), and other forms permitted by law. In addition to the Civil Code, a large number of other Russian laws regulate the establishment and operation of NPOs. They include the Law on Public Associations; the Law on Noncommercial Organizations; the Law on Charity and Charitable Organizations; the Law on Trade Unions; the Law on Consumer Cooperation; the Law on Education; the Law on Freedom of Conscience and Religious Associations; the Law on Private Noncommercial Associations of Owners of Gardens, Vegetable Gardens and Dachas; the Law on Ethnic and Cultural Autonomy; the Law on Housing Owners' Associations; and others.

The number of laws on nonprofit associations is growing, including the Draft Law on Noncommercial Associations, which passed three readings in the federal Duma, and the draft Law on Foundations is on the legislators' agenda. The resulting system of various types, subtypes, and subgroups of NPOs is very complicated for the NPO community to comprehend let alone follow. Accordingly, a restructuring of the various laws under the Tax Code would be highly desirable from the viewpoint of efficiency and administration of this sector.

III. Areas of Concern

A. Revenues earned by NPOs are taxed generally like commercial organizations whether or not the income earned is related to the organization's status as a nongovernmental organization.

B. Charitable donations are not generally tax deductible by corporations or individuals unless they support either a government-subsidized or state-owned organization. Moreover, there are no deductibles for supporting schools, museums, or health care organizations.

C. Social service organizations earning income from fees are subject to tax with the exception of organizations that are state-owned or state-supported.

D. Foreign contributions to Russian NPOs are allowed, for humanitarian purposes, but only if the NPO meets a strict certification process and even these donations may be subject to custom and VAT taxes.

IV. Recommendations

A. Exempt from taxation revenue streams income generated by fees from the general public that promote educational, religious, social welfare, health care, scientific research, and cultural activities that are conducted for the public benefit. Tax unrelated activities that are carried on for the sole purpose of producing income. Tax these activities at the same rate as commercial entities.

B. Develop tax exemptions for donations and grants from the profits, customs, and VAT taxes on services and goods that are related to charitable purposes that further the social welfare or public benefit.

C. Develop administrative rules that regulate and tax commercial income of NPOs engaged in nonrelated activities.

D. Develop a tax regime to tax and penalize individuals who use the NPO for their own private benefit through a system of taxes imposed on the insider or the management of the organization that approved the transaction.

E. Develop a system of applications and certifications under the Tax Administrator for the tax exemption of public benefit organizations that establishes periodic audits and penalties for organizations that fail to provide transparency of their activities.

F. Establish a uniform approach for international organizations and domestic charities that is exemption-based and conditioned on reciprocal rules and privileges granted by the governments concerned under appropriate treaties and protocols.

G. Establish a uniform system for the recognition and registration of all legal entities centralized in the local office of the Russian Ministry of Taxation or the local Tax Administrator administered under a systematic body of rules and regulations.

V. Proposed Changes to NPO Tax Laws

Chapter 3 of the Tax Code

Article 19.1. Taxpayers with a special status

1. Nonprofits are granted special tax-exempt status if their purpose, charter, and actual activities meet the criteria established by this article.

2. A nonprofit organization is recognized as operating for the public benefit if in compliance with its charter purposes it carries out activities exclusively in the following areas:

- (1) education;
- (2) scientific and research activity;
- (3) culture;
- (4) arts;
- (5) environmental protection;
- (6) social support to population, including psychological help;
- (7) health protection and prevention of diseases;

(8) support of territorial self-government and other forms of self-organization of citizens for solution of local problems;

(9) protection of economic and social rights and civil and human rights;

(10) rendering services to nonprofits;

(11) advancing family life through youth upbringing including support to children's and youth organizations;

(12) scientific research;

(13) collection and dissemination of information that improves the capabilities of the individual and educates the community in a beneficial way;

(14) physical and sport activities that improve the capabilities of the individual and provide recreational opportunities for the public; and

(15) promotion and conduct of religious activities.

A special status of NPO operating for the public benefit can also be applied to charitable organizations established under the federal law, "On Charity and Charitable Organizations," and on foundations financing one or several areas of nonprofit activities indicated in sub clauses 1-15.

3. The following organizations are recognized as nonprofits because they provide benefits for their membership rather than work for the public benefit:

(1) state-owned corporations;

(2) non-state pension funds;

(3) consumers' cooperatives;

(4) notarial chambers, law chambers, and bars;

(5) associations (unions) of commercial organizations; and

(6) political parties.

4. An NPO is recognized as operated for the public benefit if it carries on commercial activities and does not receive revenues from sales of goods, work, and services, except for:

(1) income from the sales of property at or below cost;

(2) income from the sales of gratuitous property, provided that such proceeds don't exceed 20 percent of all net revenues of the organization;

(3) income from the sale of goods and services below cost supported from other revenues of the organization and that do not exceed 20 percent of all revenues of the organization;

(4) income from sales of property that is created in the process of carrying out the NPO's activities, provided that the sales do not constitute more than 10 percent of all revenues of the organization;

(5) income received from the sale of goods or services whether or not gratuitously received will not be subject to tax if the following conditions are met:

(a) the sale event does not take place more than four times a year;

(b) direct costs of such events do not exceed 20 percent of the received revenues;

(c) gratuitous property or voluntary services are provided; and

(d) examples of the above-mentioned events include bazaars, lotteries, concerts, lunches, and other similar events, participation in which is connected with collection of funds for the chartered purposes of the organization.

5. An NPO operated for public benefit is entitled to receive tax-exempt revenues from the leasing or rental of its property; royalties or licenses from giving the right to use the results of intellectual property it has developed from patents, inventions, industrial designs, and other types of intellectual property.

6. An NPO operated for the public benefit is limited to expend for administrative expenses a maximum of 30 percent of all income within a fiscal year. Including administrative expenses for payroll, equipment, book-keeping and accounting services, travel and lodging for related business trips, representative costs, fund-raising campaigns, and mandatory publications of the organization's accounting statement.

Article 19.2. Establishment of procedures and conditions for receiving the status as a nonprofit organization operated for the public benefit

1. Status of an NPO operated for the public benefit is given for one calendar year.

2. An NPO wishing to establish a status as an NPO operated for the public benefit during the period from October 1 until November 30 of the preceding year, by submitting to the local tax body an application with the following documents:

(a) an extract from the organization's bylaws describing its activities; and

(b) a description of the actual operations of the organization during the preceding nine months describing its projects, programs, measures, and the groups for whose benefit the organization is operating.

3. The new organizations applying to receive the status of an NPO operating for the public benefit must submit an application for registration by the tax authorities. The application requires an extract from the organization's bylaws describing its activities. The organization will, if it meets the requirements of Article 19.2, be granted the special status during the current calendar year as of the date of establishment of the organization. A list of recognized organizations receiving such status will be published by the tax authorities.

4. An organization that receives the special status of an NPO operated for the public benefit has no right before the end of the calendar year to refuse this special status and start paying taxes under the conditions stipulated by the Tax Code for other organizations.

5. If during the calendar year an NPO violates the conditions of granting a special status, the organization will be deprived of the special status as of the beginning of the calendar year.

(a) The amount of taxes to be paid by the organization is calculated and paid under the procedure stipulated by the Russian Federation legislation on taxes and dues.

(b) An organization that has violated the conditions of its special status is subject to certain sanctions and penalties for violation of the tax legislation.

6. An organization that received the special status as operated for the public benefit can, if it wishes, pay taxes without taking into account the special status as of the beginning of the calendar years, having notified the tax authorities no later than January 15 when it plans to voluntarily give up the special status.

7. A taxpayer that has either been refused the status of a nonprofit organization operated for public benefit or has violated the conditions of granting a special status can submit an application for such a special status not earlier than three years after he has lost the right to pay taxes in compliance with the special status.

8. If an organization has been refused such special status by a government authority, it can appeal the decision and have that status determined by the courts.

Article 19.3. The accounting by nonprofit organizations working for the public benefit

1. An NPO operated for the public benefit in addition to tax accounts stipulated by this code must submit to the tax authorities annual reports:

(a) a report on compliance of the actual activities of the organization with the areas stated in clause 2 of Article 19.1;

(2) a report on the income of the organization with an indication of the share of that profit in the whole volume of all revenues including:

(a) a report on income received from fundraising events showing the nature and date of the events, amount of funds raised, and organizational expenses;

(b) a report on income from the sale of the property received gratuitously with an indication for the reason of the sale;

(c) a report on revenues from sales of non-gratuitously received property showing the purchase price, sales price, and the reason for the sale;

(d) a report on the sales of property that was created during the process of the NPO's activities with an indication of the type of property, purpose of the creation of the property, and its sales price;

(3) a report of the organization expenses, including the allocation of administrative ex-

penses, with the area of operation of the organization.

2. Value Added Tax

Article 146. Taxation

1. The following transactions are recognized as taxable:

(1) sales of goods and services in the Russian Federation including sales of collaterals and transfer of goods (results of fulfilled work, rendering services) under an agreement on indemnification or innovations, as well as assignation of property rights.

For the purpose of this chapter the assignment of property rights to goods, results of fulfilled work, or rendering services for free is recognized as the sales of goods except for the taxpayers shown in Article 19.1 of this code;

(2) transfer in the Russian Federation of goods (fulfillment of work, rendering services) for own needs, expenses for which are not deductible (including through depreciation charges) when profit tax for organizations is calculated, except for transfer of goods (fulfillment of work, rendering services) for taxpayers' own needs, indicated in Article 19.1 of this code; and

(3) fulfillment of building and assembly jobs for an organization's own needs;

(4) importation of goods into the customs territory of the Russian Federation.

2. For the purpose of this chapter the following transactions are not recognized as taxable:

(1) transactions shown in Clause 3 of Article 39 of the code;

(2) the free transfer of housing, kindergartens, clubs, sanatoria, and other social-cultural and communal objects, as well as roads, electric grids, substations, gas networks, water intake facilities, and other similar objects of the state power bodies and local government bodies (or by the decision of the indicated bodies, to specialized organizations using and maintaining the above facilities according to their function);

(3) transfers of property of state and municipal enterprises bought in the process of privatization;

(4) fulfillment of work (rendering services) by the bodies belonging to the state power and local self-government systems within the framework of fulfilling their exceptional powers in certain areas of activities, if the obligation of fulfilling that work (rendering services) is established by the legislation of the Russian Federation, subjects of the Russian Federation, or acts of local self-government bodies;

(5) free transfer of fixed assets to the state power and administrative bodies and to local self-government bodies, as well as to budgetary institutions and state and municipal unitary enterprises.

3. Tax on the profits of the following organizations that are additions to Article 246:

Article 246. Taxpayers

(1) The following are recognized as taxpayers on earned income:

- (a) Russian organizations; and
- (b) Foreign organizations conducting their activities in the Russian Federation through permanent rep offices and (or) receiving income from sources in the Russian Federation.

(2) Organizations described in Article 19.1 of this code are exempt from the payment of tax on earned income.

3. Chapter 23 — Tax on Individuals' Income

Article 217. Nontaxable additional activities to the current list

(8) welfare payments paid to individuals in the form of humanitarian aid (assistance), charity (cash or in-kind assistance), paid by recognized NPOs, operated for the public benefit;

(9) total or partial compensation for the cost of vouchers, paid by employers to their employees and (or) their families' members to sanatoria and resorts in the Russian Federation, paid from the employers' funds remaining at their disposal after payment of tax on profits or from the Russian Federation Social Security Fund; or at the expense of not-for-profit organizations, that have received the status of not-for-profit organizations working for public benefit; amounts paid for tourism are taxed.

(32) amounts of complete or partial payment for transportation and accommodation fees to participants at conferences and seminars, financed at the expense of recognized nonprofit organizations, that are necessary for the operation of the organization are not subject to tax.

(a) Non-cash payments for transportation fees and accommodation of participants of conferences and seminars, and cash given for those purposes, must be substantiated by expense documents.

(33) the cost of any winnings, prizes received as a result of competitions, games, and other related events conducted by organizations that have received the status of not-for-profit organizations working for public benefit.

4. Future chapters regarding property tax will exclude from tax NPOs operated for the public benefit.

5. Future chapters on advertisement tax will exclude from tax NPOs working for the public benefit.

Conclusion

As I left Russia, I saw a country transforming itself with a vibrant developing economy, confidence in the future, but with investor concerns about crime regarding whether the government was operating under the rule of law. Much work still remains to be done to establish a functioning and sustainable civil society that provides greater individual development and reduces poverty. The changes that I have suggested to the tax law will provide those opportunities for growth of the nonprofit sector and engagement. The inherent problems in Putin's managed democracy are obviously found in the areas of restricting free expression and criticism by individuals and the lack of an independent media that is the essence of a true democracy and that protects the right to disagree with those in power. These issues must still be part of the engagement process in developing a civil society based on democratic values and strengthening of the operation of the rule of law. However, President Putin has presented a blueprint of his vision for Russia and it is now up to the NPOs to decide whether they will follow a course of confrontation or engagement to build the type of civil society that they wish to see operate in Russia.