

INTERNATIONAL DATELINE

Russia in Transition

by Milton Cerny and Vitaly Timokhov
Caplin & Drysdale, Chartered

Milton Cerny is a partner in the firm Caplin & Drysdale, Washington, and a former official in the IRS Exempt Organizations Division. He is a regular contributor of the International Dateline column and has written extensively on charitable activities in foreign countries. Vitaly Timokhov earned an LL.B. from Queen's University at Kingston, Canada, as a recipient of Canada's National Tax Award, and an LL.M. (International Taxation) at New York University's School of Law. Currently, he is a Visiting Foreign Attorney at Caplin & Drysdale.

This is the first of a two-part series that examines the current state of the law of charitable organizations in the Russian Federation "Russia." The second article will discuss specific recommendations for modifying the charitable tax law.

The primary legal framework for nongovernmental organizations (NGOs) is in the form of public organizations, foundations, institutions, partnerships, and other types of noncommercial organizations. Under the general federal law, we find public associations, mass movements, public foundations, and institutions. Foundations, and public institutions can be created under either the Law on Public Associations or the non-commercial organization law. Eighty-nine separate territorial jurisdictions also provide certain benefits and restrictions on NGOs.

Under the existing Russian federal tax laws, which are undergoing revisions, NGOs are exempt from income tax on grants, donations or other funding used to support their activities. However, NGOs 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 NGOs that support the organizations statutory goals (Article 3a(3)(3)) of the Russian Tax Code (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 NGOs. (See Article 149(3) of the Tax Code.)

With respect to contributions, legal entities do not receive the benefit of any tax deductions for contributions to NGOs 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, it should be noted that certain restrictions apply to 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 healthcare providers. Third, the donations must be made directly to the beneficiary organization and cannot be passed through a regrating 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 NGOs 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. The United States has entered into a double-tax treaty with the Russian Federation but there is no provision for recognizing reciprocal cross-border or charitable contribution deductions by donors.

I. Introduction

The Russian Constitution guarantees its citizens a constitutional right of assembly and the right to form associations to affect their political and other goals. Further, the Constitution encourages its citizenry to engage "voluntary social insurance," development of additional forms of social security, and charity.¹ Although the right to engage in voluntary charitable activities, either individually or in the form of associations, is constitutionally guaranteed and encouraged, the current law governing charitable and nonprofit activities in Russia is in a state of flux. Much has been done since the dissolution of the Soviet Union more than 10 years ago to improve the Russian legal system, including the introduction in the mid-1990s of legislation governing nonprofit organizations and charitable activities. However, the charitable sector remains an orphan of Russian legal reform and therefore requires significant revamping in order to make it friendlier for both benefactors and to recipients of charitable aid in Russia.

¹Art. 39(3) of the Constitution of the Russian Federation (as adopted at National Voting on December 12, 1993), available at Lexis, LEXSEE Garant 10003000.

Generally speaking, although Russia had a thriving charitable sector before the 1917 revolution,² a nonprofit sector did not exist in Russia under the Soviet system (or for that matter in the rest of the former Soviet republics forming the Soviet Union) until the Soviet Union's collapse in 1990. Although some nonprofit organizations, (e.g., women's organizations, organizations of veterans of the Great Patriotic War, etc.) existed during the Soviet period, these organizations were state-sponsored and lacked true independence, both financial and political. Some of these organizations, such as the Union of Afghan War Veterans or Blind People Society, were involved in commercial activities to support their memberships and received significant tax and other incentives, including reduced tax rates.

In the post-Soviet period, tax-exempt organizations often served as a shelter for taxable and unrelated commercial activities. Therefore, they were viewed as not truly nonprofit, which resulted in a suspicious attitude toward the nonprofit sector from both the Russian government, which often overreacted and cancelled much of these tax and nontax privileges in the 2001 tax reform, and the Russian people, who perceived the nonprofit sector as a tax shelter for business operations or as a tool of Russian business tycoons pursuing their own political aspirations and agendas.

The arrival of foreign charitable assistance in the early '90s did not change this perception much because all the funds were raised overseas and most of the activities of foreign based organizations were localized in Moscow and other major industrial centers. Not surprisingly, the Russian population does not appear to be very supportive of charitable causes. The surveys conducted by international organizations indicate that charitable giving in Russia significantly lags behind that in the developed countries. According to one survey, only 25 percent of Russian households contributed to charity compared to 75 percent in the United States.³ The amount of charitable contributions of the Russian households is also significantly smaller than in the United States. Those households that contribute to charity have donated on average only 0.6 percent of their annual after tax income to charity, compared to almost 3 percent in the United States.⁴

With the fall of the Soviet system, international philanthropy recognizing the needs of the Russian society that could no longer be supported by the government provided significant humanitarian and educational assistance through financial and logistical activities that supported the creation and funding of local charities. Today, as international philan-

thropy finds other objects of its charity, the continued sustainability of the Russian nonprofit sector will depend on charitable giving by domestic Russian sources. The importance of this major shift from the reliance on government and foreign aid to increased contributions from the Russian population is underscored by the reported scaling down of funding by large international charities, many of which, such as George Soros' Open Society Institute in Moscow, became important players in Russian society and influenced and advanced the democratic and legal process. This potential void now needs to be funded and encouraged through increased contributions from Russian businesses and individual donations.

The increase in local charitable giving will depend not only on changing the perception of the Russian nonprofit sector but on the transparency of the noncommercial sector and its activities. It will also depend on the support of the Russian government, which needs to enact incentives for giving and provide assurance to its citizens and foreign grant-makers that the NGO sector meets certain standards of accountability to encourage them to participate and contribute financially and personally to the emerging Russian charities.

II. Basic Legal Framework of the Nonprofit Sector in Russia

The major difference between western and Russian legal traditions when it comes to charities is the difference in understanding what charitable activities are. The common law approach exemplified by the United States or United Kingdom (U.K.) charity law is that it is very flexible and allows the charitable sector and government regulators to adapt to ever changing societal needs in finding certain activities charitable.

In contrast to the very flexible western approach,⁵ the legal meaning of charitable activities in Russia is defined in a number of legislative enactments. The list of charitable activities is enumerated in the Law on the Charitable Activity and Charitable Organizations⁶ and is not open to the broad interpretation used by the western regulatory authorities.

To illustrate, in the United States, the health care facilities and hospitals are usually nonprofit entities exempted from the federal taxation while Russian hospitals, many of which are still owned by the state, are taxed on their business income even if it is expended for healthcare. The second notional problem is the continued inconsistency between various leg-

²The first charitable organization in Russia has been reported to have been founded in 1551. In 1775, the Russian government issued the first decree on regulating private and public charitable organizations. In 1992 there were 11040 charitable organizations including 4762 charitable societies and 6278 charitable institutions. See Abrosimova, *History of the Regulation of the Establishment and Activities of the Russian Charitable Organizations*, 6 JURISPRUDENCE (1992).

³For more information on charitable giving in Russia, see Arthur Brooks, *Charitable Giving in Transition Economies: Evidence from Russia*, 55 NATIONAL TAX JOURNAL 743 (December 2002).

⁴*Ibid.*

⁵The legal definition of charitable activities generally adopted in the common law jurisdictions throughout the world has been derived from the seminal English case *Income Tax Special Purposes Commissioners v. Pemsel* (1891) AC 531 which defined charitable activity purposes as activities aimed at (i) the relief of poverty; (ii) the advancement of education, or increase of knowledge; (iii) the advancement of religion; and (iv) other purposes beneficial to the community.

⁶Federal Law No. 135-FZ of August 11, 1995 on the Charitable Activity and Charitable Organizations (with the Amendments and Additions of March 21, July 25, 2002), available at Lexis, Economic Laws of Russia, GARANT 4232 (Charities Law).

islative enactments that may interpret similar terms differently for purposes of tax and nonprofit law. The problem may in some cases be exacerbated by conflicting regional law or local practice. Although many of these problems can usually be overcome by large foreign and Russian charities, they still may pose a significant threat to smaller local charities and foreign donors.

Nonprofit organizations can be created under the registration process generally applicable to all other organizations. Since July 2002, the registration of all legal entities, including nonprofit entities, is processed by a local office of the Russian Ministry of Taxation under a newly implemented "one window" policy. However, in addition to the Ministry of Taxation, regulatory functions over the charities are retained by both local authorities (i.e., the Charities Council in Moscow) and various federal bodies such as the Ministry of Justice.

Although the concentration of the regulatory power in the hands of the revenue authorities is similar to the U.S. approach, the retention of broad administrative and regulatory powers also resides with other federal and regional authorities, which complicates compliance.⁷ This is especially true at the level of grass-root local organizations that are not as sophisticated and often may not have access to legal services to maintain their exempt status. The problem is exacerbated by the lack of legal information and plain language instructions explaining the regulatory requirements for setting up and maintaining a nonprofit organization.

Many observers of the Russian scene believe that centralizing the regulatory process and concentrating powers in one centralized body, along with more active dissemination of information and advisory materials related to all aspects of the nonprofit law is required for the successful revival of the Russian charitable sector.

Russian charities, similar to western nonprofit organizations, enjoy significant tax benefits. Under Russian federal tax laws, NGOs are exempt from income tax on grants, donations, or other funding used to support their activities. However, NGOs must pay an income tax on business activities to the same degree and manner as commercial entities even though their profits are used to support charitable activities. In addition to exemption from income tax, Russian NGOs benefit from exemption from the value added tax (VAT) on the transfer of goods and funds to NGOs that support the organizations' statutory goals. A similar exemption is granted from VAT on the distribution of goods and services that are provided free of charge and for charitable purposes and activities undertaken by the NGO. These fiscal benefits are extended to the Russian NGOs by federal legislation. However, further fiscal and other incentives, such as local or property tax exemptions, may be extended by regional and local legislation.

With respect to the deductibility of contributions, legal entities, including commercial organizations, do not receive the benefit of any tax deductions for contributions to NGOs. However, individuals may deduct up to 25 percent of their taxable income for monetary but not-in-kind gift contributions, but it should be noted that 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 healthcare providers. Third, the donations must be made directly to the beneficiary organization and cannot be passed through a regrantee organization. Contributions from foreign individuals and organizations may receive additional tax benefits.

In 1999, the Law on Gratuities Assistance exempted from the VAT, customs, and other duties certain humanitarian assistance and technical aid certified by the Russian government and provided free of charge through foreign governments and foreign charitable organizations to Russian NGOs and individuals.

U.S. citizens and entities that wish to make tax deductible contributions to Russian charities for federal income tax purposes must make such donations through a recognized tax-exempt U.S. charity. Although a donation can be made directly to a Russian charity and such contribution will be fully recognized under the Russian law, it will not receive the tax deductible benefits provided under U.S. law because there is no provision for recognizing reciprocal cross-border deductibility by donors under the double tax treaty entered into between the United States and Russia.

III. Charitable Giving in the Russian Federation

A. Legal Environment for Russian Tax-Exempt and Charitable Organizations

The legal environment for charitable and other tax-exempt organizations in Russia is based on the Russian Constitution, the Civil Code, and a number of recently adopted laws regulating various aspects of activities of nongovernmental organizations in the Russian Federation.

Although activities of charitable organizations are significantly affected by the relevant provisions of other legislative enactments, such as the Law on Nonprofit Organizations⁸ or the Law on Religious Associations,⁹ the Charities Law is a fundamental federal law directly regulating activities of charitable organizations in Russia. Any other legislation pertaining to the regulation of charitable activities, implemented at the federal or local level, has to comply with the provisions of the Charities Law. With the notable exception of the international obligations of the Russian Federation that would ordinarily prevail over the domestic law, any inconsistent law, including the law and regulations issued by the branches of

⁷See for instance, the City of Moscow Law N11-46 on Charitable Activities, of July 5, 1995 (as amended on June 10, 1998 and December 14, 2002).

⁸Federal Law No. 82-FZ (May 19, 1995).

⁹Federal Law No. 125-FC (Sept. 26, 1997).