

In memoriam
Kari S. Tikka
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Civil law and tax law rules on distributions from public benefit foundations

Introduction

An area where Kari S. Tikka made valuable professional contributions outside his direct academic profession, was as chairman or member of the boards in charitable associations and foundations. In that position he was, like several colleagues, in a situation where application of law was not only an academic issue but the direct basis for his own decisions.

A number of civil and tax law questions are relevant for foundations. This article deals with some problems that are recurring in foundations. What amount of income may or must a charity distribute in pursuing its objective and are there minimum requirements for distributions in order to achieve or maintain tax exempt status? According to civil law rules laid down in statutes and bylaws there are normally limits for annual distributions from foundations. The tax law may on the other hand state a minimum level for distributions as a prerequisite for tax exempt status. In a number of cases the leeway for observing both sets of rules may be uncomfortably small. These rules are in focus for most foundations as the performance of the foundation needs to be monitored constantly to assure that they are fulfilled.

In this article I will primarily discuss reasons for the existence and formation of these rules. My comments are based on my previous writing in the field, most recently my participation in the project the European Foundation. The report from that project will be quoted as the European Foundation Report.¹

Civil law considerations

1. A basic feature of a foundation as a legal entity is its objective to pursue a stated purpose for a considerable time. Normally this is done by use of capital donated to the foundation by the

¹ The aim of the project was to present draft laws for a proposed European Foundation. The result is published in Hopt, Walz – von Hippel, Then (eds.): *The European Foundation*, Verlag Bertelsmann Stiftung, Gütersloh, 2006. I wrote the commentaries to the draft articles concerning Non-Distribution Constraints and Use of Funds and Timely Disbursement. However, the views expressed in the commentaries, taking into consideration of other team members, are not necessarily always exactly my personal views. The subjects of these commentaries coincides with the subjects of this article. The comparative sections of the European Foundation Report are not written by me.

founder. For these foundations a minimum restriction thus is that the capital not be fully consumed before the end of the intended period. Such a rule is probably implicitly or explicitly part of statutory civil law in most countries.

Besides this basic rule for a foundation there is normally little reason generally to regulate the timing of distributions from foundations in *statutory civil law*. In the European Foundation Report only one explicit statutory civil law distribution rule in Europe is mentioned. In Spain a foundation must pay out at least 70 percent of its net annual income for the furtherance of the foundation's public benefit purpose during a period of four years.² In other countries statutory civil law indirectly may impact distributions. In the report examples are given of such very vague rules. Some countries allow a foundation to accumulate its capital as long as that is not its principal purpose (e.g. Austria, Germany and Switzerland).³ In England and Wales a rather detailed rule applies to charities, stating among others that "unless the charity trustees have an explicit power to delay spending or to accumulate it as capital – – the trustees should not allow the charity's unspent income to keep on rising beyond a reasonable level of "free reserves" unless they have a specific future use for it in mind (e.g., a major spending project)."⁴

In Sweden and Finland no statutory rules exist in civil law.

2. There are few reasons for general statutory rules on distributions, but there is more reason for the foundation itself to design rules for distributions, and to establish how distributions should be done to pursue the aim of the foundation. There is a good reason for founders to state this in the charter or *bylaws*⁵ for the foundation. Otherwise the board/trustees must formulate a policy or make ad-hoc decisions.

In an *ex ante* situation, when designing bylaws or policy rules, a number of considerations for optimal distributions should be addressed. Some of the more basic and principal considerations will be discussed below in paragraphs 3–5. In an *ex post* situation, when applying more or less binding rules in bylaws etc., other considerations could be necessary to take. This could contain complicated interpretation of the rules. The problems of application will be discussed thereafter in paragraph 6.

3. A rule on distribution is part of the regulatory framework for achieving the purpose of the foundation. The optimal timing of distributions varies according to the purpose. Normally, public benefit foundations carry out continuous activities, usually in an eternal perspective, which makes a rather stable annual support necessary. Some foundations may be more focused

² The European Foundation Report p. 102.

³ Ibid p. 103.

⁴ Ibid p. 103.

⁵ "A *bylaw* (sometimes also spelt *by-law* or *byelaw*) was originally the Viking town law in the *Danelaw*. Contrary to popular etymology the element *by* has nothing to do with the preposition *by*. It is the *Old Norse* word for larger settlements as in *Whitby* and *Derby* (compare with the modern Danish-Norwegian word 'by' meaning town, or the modern Swedish word 'by', meaning village)." – [Http://en.wikipedia.org/wiki/Bylaw](http://en.wikipedia.org/wiki/Bylaw).

on special projects, which may motivate retaining income for some periods for later use. This article will be restricted to the first type of foundations.

The technical design of distribution rules also varies. As will be seen below a common design is to restrict distributions to a certain type or amount of income. However, in principle it would normally be more logical to start with rules for maintenance of the endowment. The first priority of perpetual foundations should be to maintain the real value of their capital. The amount of income derived from the capital would then be roughly the same – inflation-adjusted – year after year. A rule with this aim would state that the foundation should strive to keep the inflation-adjusted value of the endowment intact. Further restrictions could be motivated in order to build up reserves and to implement other precautionary measures, before income could be freely distributed.

4. Distribution rules for existing foundations are probably normally not designed as capital maintenance rules, but fundamentally the aim would normally be the same. The design is influenced by needs and aims in the specific case, practical considerations, tax law considerations etc. First *tax law considerations* will be discussed.

Exemption from income tax and other taxes is very important for most foundations and thus tax rules are important to consider in designing distribution rules in bylaws or general policies. In the articles of incorporation of Ford Foundation it is explicitly stated that "the corporation shall distribute its income for each taxable year at such time and in such manner as not to subject it to tax on undistributed income under Section 4942 of the Code."⁶ Some further examples from USA and Sweden could illustrate this.

As a prerequisite for exemption from income tax a foundation in USA should distribute at least 5 percent of the market value of the capital each year.⁷ The impact of this rule is obvious in a number of foundations.⁸

In the Annual Report of Rockefeller foundation it is stated:

"In providing oversight of the Rockefeller Foundation's endowment, the board of trustees strives to balance two long-term objectives – maximizing funds for current programs and maintaining generational neutrality – through policies on spending rate and asset allocation of the investment portfolio. The Foundation's long-term target for annual spending is 5.5 percent of the market value of the endowment."⁹

In the Annual Report of Gates Foundation the following is said:

"Our investments are designed to ensure that the foundation has a stable financial base with which to make grants and pursue its mission for the long term. Because they intend

⁶ [Http://www.fordfound.org/about/docs/charter.pdf](http://www.fordfound.org/about/docs/charter.pdf).

⁷ See further section "Timing rules for distributions".

⁸ The examples chosen are the most important foundations in USA. The distribution rules seem not to be stated in bylaws but in general policies.

⁹ Annual report 2005, p. 67.

to donate more of their own money to the foundation over time, Bill and Melinda feel that the endowment does not need to grow aggressively through investments. Therefore, they have asked BGI to manage it fairly conservatively, aiming for a 5 percent nominal return each year.”¹⁰

The final example is from the Annual Report of Carnegie Corporation:

”The Corporation’s spending policy supports a stable flow of funds for the foundation’s programs and offers a sense of security for our grantees. The policy, which calls for spending 5.5 percent of the average market value of the endowment during the prior 12 quarters, dampens large swings in valuation. This helps sustain the Corporation’s grant-making efforts in bad times as well as good, helping us fulfill Andrew Carnegie’s legacy of using private wealth for the public good in perpetuity.”¹¹

In *Sweden* the tax rule for tax exempt status has another form. It states that as a minimum 75–80 percent of the current income should be distributed for the charitable purpose. A dominant form of design of distribution rules in bylaws of Swedish foundations, at least in older versions, is to limit distributions to current income – dividends and interest. Such a rule presumably will give enough leeway for the foundation to fulfill the prerequisites for tax exemption, but not much more.

In the 1980’s it created serious alarm among foundations when a Government Committee proposed that not only a percentage of current income, but also of part of capital gains should be distributed as a prerequisite for tax exemption. In the following debate one powerful argument against the proposal was that existing bylaws would make it impossible for many foundations to fulfill such a prerequisite. The proposal was dropped.

A reasonable conclusion is that many distribution rules in bylaws are designed to fulfill requirements in tax laws for tax exempt status. Existing rules may, on the other hand, make it hard to reform tax rules in a way that would raise the threshold set in tax distribution rules.

5. Apart from tax considerations of the kind described above, practical reasons and traditional views affect the design of distribution rules.

There is a perception that *capital gains* per se are not suitable for consumption and distribution. This view was more widespread some decades ago and likely influenced those distribution rules that limit distributions to current income and prescribe that capital gains should be accumulated as capital. Today it is more obvious that the value of capital gains often could vastly exceed the most prudent rules for capital maintenance and reserves. Furthermore, modern financial instruments and corporate behaviour have diminished the difference between capital gains and current income. However, some persons still feel that the distinction has both practical and principal merits and thus favour the choice of such distribution rules even in new bylaws.

¹⁰ [Http://www.gatesfoundation.org/nr/public/media/annualreports/](http://www.gatesfoundation.org/nr/public/media/annualreports/).

¹¹ [Http://www.carnegie.org/sub/about/annual.html](http://www.carnegie.org/sub/about/annual.html).

6. *Application and interpretation.* It is common that bylaws lack distribution rules or that existing rules are not very comprehensive or easy to interpret. This could cause problems for the board to determine the limits of permissible distribution. In Sweden a discussion of principles for distributions and ways of interpretation of distribution rules in bylaws started after a new Act of Foundations came into force in 1996. In the preparatory works of the Act it is stated almost as a presumption that bylaws should normally be interpreted to mean that distributions are restricted to current income such as interest and dividends when another intention is not stated or follow from circumstances.¹² I think that this opinion in principle is stated too rigid. However, in practice it is probably realistic for the application of most older bylaws.¹³

The interpretation of bylaws may be complicated. In most countries interpretation norms imply that the will of the founder be established. This means that a phrase in one bylaw may have a meaning different from the meaning of the same phrase in another bylaw. According to circumstances it could be reasonable to establish that one founder had one intention but another founder intended something else, although the rule was phrased in the same arcane way in their respective bylaws. Nevertheless, there probably is a presumption that words such as yield, income, capital, land, etc. should be interpreted in the same way.

However, as was emphasized in the European Foundation Report, considering the many possible purposes of a foundation and the best ways of serving them, it is reasonable to allow a wide latitude in the interpretation of distribution rules in the bylaws of foundations. This presupposes that the directors of the foundation have the benefit of doubt in unclear situations.¹⁴ It further means that interpretative positions, as in the Swedish preparatory works, may be useful as factors to take into consideration, but should not be conclusive.

Tax law

The distribution norms in the bylaws of foundations and in general in civil law for foundations mainly deal with the question how much of a foundation's resources may be distributed within a specific period of time. There are good reasons for founders to establish fixed rules for distributions in the charter or bylaws for foundations. More general, the very institution of a foundation is based on some restrictions on the distribution of the capital of the foundation, which may be explicitly or implicitly stated in statutory law.

In tax law *two types of rules* often are labeled distribution rules. The first type includes rules that state that distributions should solely, or at least almost solely, serve the public benefit purpose. Such a rule is necessary but actually more a part of the rule that the foundation should serve a public benefit purpose. It will be briefly discussed below. The other type of distribution rules concerns the timing of distributions. In a way it regulates the same circumstances as the

¹² Government Bill 1993/94:9 p. 118.

¹³ My opinion on the real circumstances is not based on empirical material, rather on circumstantial observations.

¹⁴ The European Foundation Report p. 101.

civil law rules discussed above. Moreover, as described above many distribution rules in civil law are influenced by the existence and design of the tax rules. The need for tax rules is less obvious, which will be discussed in section "Timing rules for distributions".

Distribution only for the public benefit purpose

1. The basic prerequisite for being granted a tax-privileged status is that the foundation should carry out/support a public benefit purpose. The use or distribution of income should serve this purpose. In many foundations it would follow already from their bylaws that distributions could not be used for other purposes. However, a foundation may have multiple purposes or purposes may be phrased in a way that allows for support of a number of purposes. This motivates a special tax rule.

Normally the tax privilege is constructed as a binary rule, which means that foundations are either exempt from income taxation or not.¹⁵ Under such a tax regime a foundation supporting both a tax qualified public benefit purpose and another purpose would normally not be granted tax exempt status.¹⁶ Normally this would follow from a tax rule that explicitly or implicitly states that distributions should be made for the public benefit purpose only.

In principle such a rule should not allow any exceptions. An exception would mean that distributions for non privileged purposes could be made out of tax exempt income. However, in the real world such a strict rule could have unreasonable consequences, due to the binary character of the tax exemption. It is for instance not reasonable that occasional and insignificant distributions outside the public benefit purpose should result in the loss of tax privileges.¹⁷ It could for example sometimes be hard to decide whether a certain distribution will be considered as falling inside the public benefit purpose or not.

In the Swedish Income Tax Act a small leeway is given. The threshold to be met is that 90–95% of the distributions should be for the privileged purpose. That means that 5–10 % of the tax exempt income could be used for other purposes. In a large foundation this could represent very considerable amounts.

Apart from what obviously falls in one or the other category, there are sometimes problems of qualification of different expenses etc. Auxiliary costs are of course part of the cost for the distribution and should be classified according to the purpose they support. However, as some auxiliary costs could seem distant from carrying out the purpose this is an area where disputes could arise. This could be illustrated with an example. A foundation with the purpose of supporting medical science sends officers to courses in foundation law or participates in research projects into legal and administrative questions concerning foundations.¹⁸ Someone may

¹⁵ An alternative method employed in some countries is that all income is taxable and distributions for the public benefit purpose are deductible.

¹⁶ In practice there are examples of hybrid foundations. See the European Foundation Report, p. 94–95.

¹⁷ The European Foundation Report p. 323.

¹⁸ See European Foundation Report p. 323.

dispute that this is a cost for fulfilling the scientific purpose. However, it should not be a questionable case as the cost could have no other ultimate purpose than the purpose of the foundation and the functional link to this purpose could be established.

2. Most rules in *national tax laws* seem to be strict.¹⁹ In Germany, for example, the privileged purpose has to be pursued directly and exclusively. There is no *de minimis* rule as to other purposes. All disposable resources shall be used exclusively for the tax-privileged statutory purpose.²⁰ In the Swedish Income Tax Act there is such a rule, which was described above.

In the light of the problems outlined above one could expect that more *de minimis* rules would exist. However, in practice problems may be mitigated by a flexible application of the strict law rules.

Timing rules for distributions

1. Timing rules for distributions have the purpose of stating a minimum distribution of income for a certain period as a prerequisite for tax privileged status. The reasons for such rules are not of very basic nature but rather more pragmatic. Therefore such rules exist in some countries but not in others.

There are control reasons for timing rules in those tax laws where the tax-privilege is constructed as an exemption from income tax. The exemption is based on the assumption that exempt income will be used for the public benefit purpose. Without a timing rule it could be difficult to check that this will be the case. If the income would be used in contravention to the public benefit purposes it could pose considerable problems to rectify the taxation, if a long period would lapse between income realization and the use. First, there is a practical problem to keep track of undistributed income for a long time. Second, even if necessary information is gathered many tax laws may not provide the necessary means for a correction of the taxation. Tax law rules may prescribe that a correction, which means imposing tax on the income, should be decided or brought forward within strict time limits. When the income is used in contravention of the public benefit purpose this time limit may be exceeded, and the income could not be taxed.

2. *Two categories* of timing rules could be identified. The "Swedish" method prescribes that a reasonable portion of current income be distributed for the beneficial purpose. The "US" method prescribes for a deemed income, as a certain percentage of the market value of the foundation's net wealth, to be distributed. As assumed above both methods are designed in line with and/or have impacted distribution rules in bylaws.

¹⁹ Ibid p. 324.

²⁰ Ibid p. 324. However a major exception exists. Up to 30 percent may go to the founder or his family.

Timing rules could cause considerable problems for foundations if they are too rigidly designed. Therefore there are reasons to consider whether the fiscal need for a timing rule outweighs these problems.

Issues arise especially when a timing rule prescribes a level of distribution which could exceed or come close to the level of permissible distribution according to private law rules. Then there is little room for mistakes, creation of reserves etc. for the foundation. The design of the timing rule becomes more important in this situation than if the latitude is wider.

A timing rule will contain a number of components that could be designed in different ways and result in different problems of interpretation and application. Here only the most important problems will be listed.²¹ The problems are primarily valid with the "Swedish" type of timing rule, but comments are also given on the "US" method.

- *Income* should be computed. In the "Swedish" method the assessment is normally done in the same way as if the income had been taxable. It is only justifiable to include potentially taxable income. Income that is generally non-taxable should not be taxed irrespective of whether the income is spent within the time limits set by the tax law's timing rule or not. The calculation may be easier with the "US" method, where instead the market value of the net wealth is measured.
- A controversial question is whether or not the distribution requirements should include not only current income but also *capital gains*, because many foundations are not allowed to distribute out of capital gains or at least they interpret their bylaws as saying so. As described above, in Sweden a proposal some years ago to include half of the capital gains in the distribution requirement therefore caused strong opposition among foundations. The "US" method circumvents this problem by avoiding calculating real income.
- A foundation could only distribute what remains of income after costs for capital management, etc. Such costs should be deducted when computing income available for distribution. Rules should be symmetric, so when a distribution rule prescribes for instance that capital gains be included, capital losses should be deductible to the same extent. The "US" method avoids this problem.
- It is not only direct *distributions* that should be considered, but every cost which has a reasonable connection with these distributions and the fulfilment of the purpose. Another design of the timing rule may cause arbitrary results and make it harder to fulfil the requirements.
- A timing rule could not take income and distributions for only one year into account. Variations in income and distributions could make it very hard to fulfil the required distribution every year. The timing rule must be more flexible and take income and distributions for a longer period into account. This problem also exists with the "US" method.

3. The *comparative view* presented in the European Foundation Report p. 326–327 shows that a number of different tax timing rules are applied in the countries screened. Rigid tax timing

²¹ The European Foundation Report p. 325.

rules are in force in Germany, Spain, Sweden and United States (as to private foundations). More flexible requirements exist in United Kingdom, Austria, Switzerland and France.

Examples of more or less rigid rules are Sweden and United States and those rules have been described above. In Germany, as a matter of principle disposable resources are not to be retained beyond a short time-horizon. The rule is subject to restrictions, however, defining the nature of the disposable resources. Beyond that hurdle, there are a number of exceptions, mainly to allow reasonable retentions and the perpetuation of a foundation's endowment.

As an example of a more flexible regime the United Kingdom rules could be described. Here, the law does not impose a time limit, but the tax authorities generally require that this condition be met within a "reasonable" period of time. This is a flexible test that takes account of the fact that different charities will have differing expenditure profiles, e.g., the budget requirements of a charity established to meet short-term emergencies will be very different from a charity established to complete a major building project.

Finland has a flexible regime as no statutory tax rule exists. However, in case law there are examples where foundations have been considered no longer charitable when the charitable activities in reality have ceased.

Conclusions

To fulfil a purpose, in this article a public benefit purpose, is the ultimate object for a foundation. It is primarily a question of *what* to support or do. But *when* to support could also be an important question. As presented in this article the last question has not often been addressed in statutory civil law. It should be a question to be regulated by the founders or by the trustees/boards. It is not merely a question of sound financial management, but could have a profound importance for the generational timing of a foundations activities. However, such more principal fundamental aspects may not been given enough importance as it seems tax and practical considerations have been given considerable importance.

From a tax point of view there are more reasons to regulate distributions in statutory law. As a tax privileged status is only given to public benefit foundations it is a given rule that distributions should have that purpose. Statutory rules could be explicit or implicit on that. What have been discussed above is more if there should be given a small leeway for deviations from the this rule.

There are arguments both for and against timing rules in tax laws. A timing rule decrease the flexibility of the distribution decisions and the application of a rule could sometimes cause considerable problems. The reason for a timing rule is primarily that it makes it reasonably simple to check that tax exempt income is used for the public benefit purpose. Even if it is desirable that tax rules not impact decisions, in some cases a timing rule could be beneficial as a positive incentive for passive boards to start activities.

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