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Funding ‘third country NPO’s’ and the reform of German Non-Profit Tax Law

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The peculiarities of German Tax Law and its potential exemptions concerning Non-Profit-Organizations (NPO’s) are only rarely of interest to a wider audience, even among lawyers, tax professionals and academics. However, a recent reform by the German legislator may have the potential to be somewhat of an exemption hereto. The transferal of funds in compliance with the legislative framework governing the status of tax exemptions of NPO’s has just become easier as well as partially impossible – both at the same time. Additionally, the new regulations may give cause for considerable concern regarding its compatibility with EU law.

Introduction

The most recent reform of German Non-Profit Tax Law took effect on January 1st 2021. In course of the same, the legal framework enabling German NPO’s to pass funds (tax-free) to other tax-exempt entities, without endangering its own status as a tax-exempt organization, was adjusted. The general reasoning for the restriction of such financial flows is rather obvious and omnipresent in most legal orders – if the legislator exempts funds from taxation in the first place, those have to be actually used for the tax exempt purposes set out in the national legal (tax) order – otherwise one may open the door for an array of tax avoidance strategies.

For context: Tax-free in the context of this article is limited to the status of non-taxation within Germany. Whether or not a transfer of funds is taxed in the recipient country may differ and is subject to the national tax law in the respective country. Moreover, whenever this article refers to NPO’s, the same legal conclusions apply to legal persons under public law in Germany (entities which, as legal persons under public law, perform tasks on behalf of the state, e.g. Public Universities,) and tax-exempt corporations in general.

General conditions for a tax-exemption under German Law

Basic precondition for any qualification of an entity as tax-exempt under German Law is its compliance with the German Fiscal Code (*Abgabenordnung*), in particular Sections 51 to 68 (*Third Chapter of the German Fiscal Code – Tax-privileged purposes*). Therefore, such organizations must comply with the following principles:

- The corporation must serve – directly and exclusively – public-benefit, charitable or religious

purposes (so called ‘*tax-privileged purposes*’). A corporation shall be understood to mean a corporation, an association or a pool of assets as defined in the German Corporation Tax Act. Functional subdivisions (departments) of corporations shall not be treated as independent taxable entities.

- These tax-privileged purposes must correspond to at least one of the twenty-five purposes recognized as advancement of the general public according to Section 52 Subsection 2 of the German Fiscal Code.
- The purpose must be pursued altruistically, and the statutes / articles of association need to specify how the relevant tax-exempt purpose is to be achieved.
- Furthermore, the purpose must be pursued exclusively and directly, and the actual management activity must conform to the statutes / articles of association of the tax-exempt organization.
- The statutes / articles of association must contain a provision that the assets of the corporation will continue to be used for tax-privileged purposes in the future, e.g. in the event of dissolution or discontinuation of the tax-privileged purposes or the organization as a whole.

Operational activity and transfer of funds

Generally tax-exempt organizations may pursue operational activities on their own or transfer funds to finance other (charitable) organizations, foreign and/or domestic, as stipulated in Section 58 of the German Fiscal Code.

1. Previous legal situation

Before the reform, Section 58 of the German Fiscal Code distinguished between so-called ‘fund-raising entities’ (“*Förderkörperschaften*”) whose purpose was limited to the transfer of funds and other tax-exempt entities, which in addition to the transfer of funds to other entities, pursued their own tax-privileged purposes through some form of operational activity.

For such ‘fund-raising entities’ the transfer of funds had to be an explicit statutory purpose. Furthermore at least one of the twenty-five tax-privileged purposes had to be the explicit purpose of both the (German) donating/ transferring entity and of the recipient entity.

In case of entities which pursued their own tax-privileged purposes through some form of operational activity the passing of funds did not have to constitute a statutory purpose. However, the transfer of funds was restricted in terms of its relative amount, as it was not allowed to be a predominant activity for such entities.

2. Current legal situation

This differentiation no longer exists. As a consequence, Section 58 of the German Fiscal Code now permits the transfer of funds to other tax-privileged entities, for tax-privileged purposes, without differentiation as to its predominant activity being a ‘fund raising entity’ or not.

However, there is one additional restriction with regard to the requirements to be satisfied by the statutes / articles of association of the transferring (German) entity: If the purpose of the corporation is limited to the transfer of funds to other tax-privileged corporations, meaning there is no operational activity by the German entity itself, this (sole) purpose of transferring funds needs to be specifically stated in the articles of association / statutes.

Furthermore, the new law presupposes, that the receiving entity is itself tax-privileged under German Law – independent of whether the entity is subject to limited or unlimited tax liability in Germany. Herein lies a considerable difficulty in the case of a transfer of funds to ‘foreign’ entities.

Previously, only recipients with unlimited tax liability had to be tax-privileged under German Law. For other entities, the German entity only needed to prove that the funds were used for tax-privileged purposes. This means, that If a foreign corporation generates domestic income and is subject to limited tax liability in Germany, it must now fulfill the same requirements as a recipient corporation with unlimited tax liability (*domestic entity*).

While entities from EU/EEA member states may qualify as non-profit entities under German law, the high formal requirements which their statutes / articles of association need to comply with means, that only few foreign corporations will be able to prove the required status as adequate recipient.

Moreover, transfers of funds to entities in third countries, which are subject to limited tax liability are consequently no longer possible within the sphere of tax exemption for German tax-exempt entities.

While this may be untenable from a EU law point of view, especially with regard to the free movement of capital (Article 63 TFEU), German tax-exempt entities should not (from a tax compliance perspective) transfer funds to foreign corporations that are subject to limited tax liability in Germany, until the compatibility of this domestic tax law with EU law is clarified conclusively.

The absurdity of this is demonstrated by the following fact: In the case of corporations, which are not subject to any tax liability in Germany, it is sufficient to prove that the funds were used (abroad) for tax-privileged purposes.

Conclusion

To sum it up, that means a transfer of funds by a domestic tax-exempt entity will now be factually prohibited if the recipient entity is subject to limited tax liability in Germany. While there are several ways to address the issue, German entities will need to be careful to not endanger their status as tax-exempt, which will most certainly affect the outbound transfer of funds to recipients all around the globe.

On a side note: Even though the new legislation likely conveys a selective (tax) advantage in the sense of Article 107 TFEU, it wasn't notified with the European Commission.

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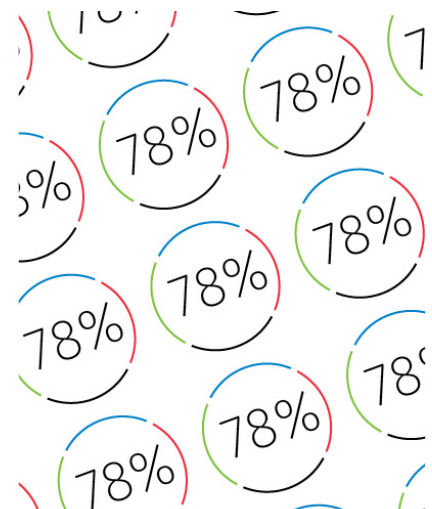
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