DISCRIMINATION AGAINST FOREIGN CHARITIES: RELIEF IN SIGHT?

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In 1996, a Belgian resident, Mr Raymond Ditmar, bequeathed his entire estate to a British charity. In doing so, he had no inkling of the legal and political stirrings this act of generosity would cause. At the time Mr Ditmar made his will, Belgian law provided that charitable bequests to Belgian charities would incur inheritance tax of less than 8%. By contrast, bequests to non-Belgian charities incurred inheritance tax of 80%. As surprising, and to some shocking, as this discriminatory treatment is, it is by no means unique. In a recent survey of cross-border charitable philanthropy, spanning 20 EU Member States, it was found that only two States (Slovakia and Sweden) provide equal tax treatment to charities which are based in Member States other than the donor country[2]. This discrimination was found to occur in a number of areas affecting charities: income tax deductibility, gift taxes and inheritance taxes.

In the *Ditmar* matter, which is presently before the Belgian national Appeal Court, the European Commission took up the complaint and, in response to its Reasoned Opinion[3], the four regions of Belgium amended their discriminatory laws to bring them into compliance with the EU Treaty. One region, Walloon, has not amended its laws satisfactorily and the European Commission has instituted proceedings against Walloon[4]. In addition, the European Commission has sent Reasoned Opinions requesting an end to discriminatory treatment of foreign charities to

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2 Source: www.givingineurope.org

3 Commission Press Release dated 21 December 2006 "*Direct Taxation: Commission requests Belgium to end discrimination against foreign charities*", IP/06/1879.

4 Commission Press Release dated 14 July 2005 "*Direct Taxation: Commission decides to refer Belgium to Court of Justice over Walloon inheritance and gift tax laws*", IP/05/936.

Ireland, Poland and the UK[5]. The European Commission has also let it be known that it would entertain complaints concerning other national discriminatory tax provisions.

The EC Treaty enshrines a number of cardinal free movement principles including the freedom of establishment, free movement of goods and services and the free movement of capital. As noted above, the discriminatory tax treatment of foreign charities can arise in relation to a number of sources of revenue, such as deductibility of income tax, gift taxes, inheritance taxes and also taxation of investment income.

The two principles of the EC Treaty which have been deployed in particular in the battle over discriminatory tax treatment have been Article 43, which prohibits restrictions on the freedom of establishment of nationals of one Member State in the territory of another Member State; and Article 56 which prohibits all restrictions on the movement of capital between Member States and between Member States and third countries.

The *Ditmar* matter, which concerned discriminatory inheritance tax treatment, raised issues under Article 56 of the EC Treaty. A "movement of capital" is not defined in the Treaty but in relation to the idea of 'capital', the European Court of Justice (ECJ) has approved a reference to a Directive (which has since been repealed) which set out a non-exhaustive list of personal capital movements which were regarded as falling within the scope of the EC Treaty[6]. Directive 88/361/EEC (which was concerned with the implementation of Article 67 of the EC Treaty) provided that the concept of "capital" under EC law included gifts, endowments, inheritances, legacies and real estate investments. The ECJ confirmed this approach to the definition of capital, whilst noting that the list in the Directive was not exhaustive and thereby leaving open the possibility that the list could be broadened.

The Article 56 principle of free movement of capital is not absolute. It is subject to a number of exceptions. As a starting point, the ECJ has confirmed that direct taxation is not within EU competence and remains within the Member States' competence[7]. However, Member States in exercising such competence must not discriminate on grounds of nationality (which is covered by Article 12 of the EC

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5 Commission Press Release dated 10 July 2006 "*Commission requests the United Kingdom to end discrmination of foreign charities*", IP/06/944 and Commission Press Release dated 17 October 2006 "*Commission requests Ireland and Poland to end discrimination of foreign charities*, IP./06/1408.

6 See discussion of the *Stauffer* case below.

7 Case C-251/98 Baars v Inspecteur de Belastingen Particulieren/Ondernemingen Gorichem.

Treaty) and must not take steps or enact measures which constitute a disguised restriction on the free movement principles. Article 56 may be excluded if:

- there is an objective distinction between taxpayers who are not in the same situation with regard to their place of residence or the place where the capital is invested; and

- the measures taken by the Member States are meant to prevent infringements of national law and regulations (an example of this might be money laundering).

As is the case with all exceptions to fundamental treaty principles, exceptions must be interpreted strictly and the ECJ has set conditions for relying on these exceptions. Whilst there have been a number of cases interpreting claimed exceptions to the application of Article 56, there has been a paucity of jurisprudence on the application of Article 56 to discriminatory tax treatment of charities and charitable foundations.

One of the issues in the *Ditmar* case was the difference in the way charities are constituted and regulated in the UK as compared with Belgium (and by analogy with a number of other EU jurisdictions). In the UK, a charity does not have to take a particular constitutional form: it can be incorporated as a charitable trust, a company, by Royal Charter (e.g. the British Museum), or as an unincorporated club having charitable purposes. In the *Ditmar* case, the beneficiary is an unincorporated English charity in which the assets and liabilities are vested in the trustees, who have fiduciary duties under common law to pursue the charitable objects of the trusts and who have potential personal liability for their actions. Trusts, charitable or otherwise, do not exist under Belgian national law. The difficulty was therefore for the Belgian judge to understand an entity which has no legal existence in Belgium and try to assimilate it to a legal entity which exists under Belgian law. Such assimilation could only establish what a trust is and how it is settled. One of the key issues is the fact that the assets and liabilities of unincorporated trusts are vested in the trustees and are not the property of the 'trust' itself. This goes against the continental law concept of the "*unité du patrimoine*" according to which an individual or a legal entity is the sole owner of all the assets and liabilities and such assets and liabilities cannot be transferred or assigned without at the same time changing ownership. This was one of the arguments used by the Belgian State. This underlines the difficulties faced by foreign courts in dealing with foreign entities which have no equivalence under their laws.

There are however moves for Belgium to give recognition to foreign trusts through recognition of The Hague Convention on the Law Applicable to Trusts and on their Recognition of July 1985.

The Belgian equivalent to an English charity is an *association sans but lucratif* ('ASBL') which is a statutory not-for-profit corporation. Assets are held in a company and deployed for its non-profitable purposes by the directors. Statutory duties are imposed on the directors to adhere to the non-profitable purposes of the ASBL.

This arose in the *Ditmar* case on the issue of the equivalence of an English unincorporated charitable trust to an ASBL. The Belgian State has argued that the two are not equivalent. If its arguments are upheld, then the differential tax treatment might be deemed to be justified on the basis that the taxpayers in Belgium are in objectively different situations from those in the UK – one of the two bases for escaping from Article 56 referred to above.

In a recent case involving cross-border discriminatory tax treatment of a charity, the ECJ has, for the first time, laid down some key principles in this area. The case of *Centro di Musicologia Walter Stauffer v Finanzamt München Für Körperschaften* (which will be referred here as the '*Stauffer*' case)[8] concerned the tax treatment of real estate investment income realised in one Member State by a charitable foundation established in a different Member State. The Stauffer Foundation enjoyed charitable status under Italian law and was established to award narrowly focussed scholarships, namely to young Swiss people, preferably from the city of Berne, for the purpose of studying in Cremona the classical methods of production of stringed instruments, the history of music and musicology in general. The Stauffer Foundation owned commercial premises in Munich, Germany from which it derived investment income. Had the Stauffer Foundation been established with charitable status in Germany, it would have been exempt from corporation tax and would not have been liable to tax on its income from the letting of the property. However, this tax exemption did not extend to the Stauffer Foundation since it was established outside Germany.

The Stauffer Foundation challenged the tax assessment in the Munich Finance Court and, on appeal, this issue was referred to the ECJ. At the outset, the ECJ reaffirmed the point concerning the concept of 'capital', namely that investments in real estate are to be considered forms of capital for the purposes of Article 56, as articulated in Article 1 of Directive 88/361. The ECJ went on to say that the list set out in the Directive is not exhaustive. As a consequence, the apparently discriminatory treatment of non-German charitable foundations was in breach of Article 56 unless it could be justified on one of the two grounds for exclusion.

8 Case C-386/04 Judgment dated 14th September 2006

In a key passage, the ECJ stated:

> "*… where a foundation recognised as having charitable status in one Member State also satisfies the requirements imposed for that purpose by the law of another Member State and where its object is to promote the very same interests of the general public, which it is a matter for the national authorities of that other State, including its courts, to determine, the authorities of that Member State cannot deny that foundation the right to equal treatment solely on the ground that it is not established in its territory.*"[9]

Thus, whilst it is not a Treaty requirement that Member States must automatically confer domestic charitable status on charities from other Member States, the discretion they have must be exercised in compliance with Community law. Where the objects of the foreign charity conform to principles of general public interest which are or would be recognised domestically, then it should be treated in the same way as a domestic charity. So, if the production and free distribution of an illegal drug such as heroin were recognised as being in the general public interest in one Member State, this would not mean that it would have to be recognised as such in another Member State where such purposes would not, on objective grounds, be so recognised domestically. In the *Stauffer* case, there was an issue as to whether a foundation with such a narrow pool of beneficiaries would have been afforded charitable status if it had been established under domestic German law. It is understood that the relevant German Ministries involved have agreed that it would and therefore the issue in this case is moot. However, it is an issue which is pertinent for Member States to consider on a case-by-case basis.

In what may prove to be a rehearsal of arguments in future battles between the European Commission and Member States, the ECJ went on to reject a number of arguments advanced by Germany (supported at least by the UK) as to why differential treatment of domestic and foreign charitable foundations is justified. In order to justify the differential tax treatment, arguments were advanced relating to: the promotion of culture; training and education; effective fiscal supervision; the need to ensure the cohesion of the national tax system; the need to protect the basis of tax revenue; and the fight against crime. All of these arguments were rejected.

Whilst the *Stauffer* case arose out of the tax treatment of German property investment income derived by an Italian charitable foundation, the striking down by the ECJ of the national provision which dis-applied the exemption solely on the basis of the foreign status of the charitable body, is an important milestone in the

9 Paragraph 40, ibid.

development of the law on the broader treatment of charities across Europe. As individuals and organisations move around Europe and exploit their Treaty-enshrined rights of establishment, it is inevitable that the principle of free movement of capital will be tested against Member States' rights of national taxation, as people seek to support charities in their own 'home' states. The development of a consistent and predictable body of rules to support this, would be an important and welcome outcome for benefactors and charities alike…if not perhaps for Member State treasuries.

The *Ditmar* case could therefore be a precedent in this area and the long awaited decision of the Court of Appeal is expected to be made within the next two years.