



Nonprofit
Enterprise and
Self-sustainability
Team (NESST)



The Legal and Regulatory Framework for CSO Self-Financing in Croatia

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This guide examines the legal and regulatory framework that governs the use of "self-financing" (i.e., income-generating, commercial) activities of civil society organizations (CSOs) in Croatia and provides an assessment of the relevant law and its practical effects in order to identify areas where the law might be improved. In Chapter 1, the guide explains the importance of understanding the regulatory environment as it relates to self-financing, defines the concept of CSO self-financing, and explains the methodology used by NESST in researching and assessing the legal framework in Croatia. Chapter 2 outlines a generally-accepted typology initially developed by the International Center for Not-for-Profit Law (ICNL) for evaluating the legal framework that regulates CSO self-financing. Chapter 3 presents the current regulatory framework and its application in Croatia. The chapter illustrates that although some CSO self-financing activities are permitted in Croatia, legal and tax regulations vary based on the type of organization and the level and relatedness of the activity to the overall mission and purpose of the organization. Finally, in Chapter 4, five criteria are applied to critique the Croatian legal framework, assess its current strengths and weaknesses, and make recommendations for improvement.

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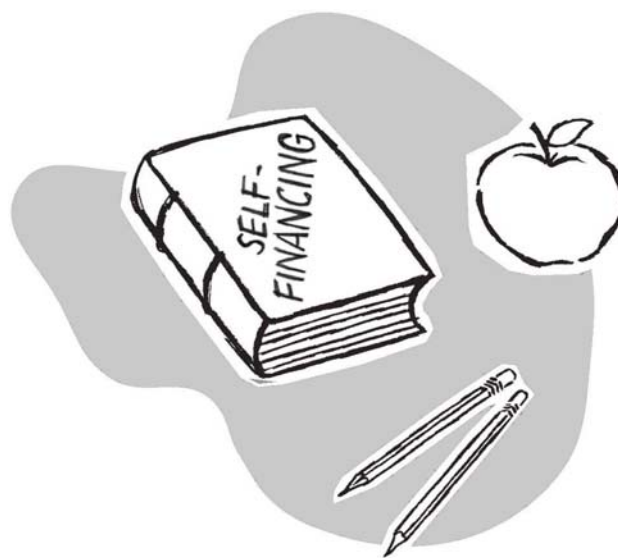
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Setting the Stage: Purpose and Methodology



The term "civil society organization"¹ (CSO) encompasses the wide diversity of not-for-profit, non-state organizations as well as community-based associations and groups that fall outside the realm of the government and business sectors. Given the limited philanthropic and government assistance, many CSOs undertake self-financing to generate revenues in support of their mission and programs.

NESST has documented hundreds of CSOs in Latin America and Central Europe that engage in these types of activities and has analyzed the impact of these strategies on the organizations' performance and sustainability. An important factor that emerged from these investigations is the need for a clear and supportive legal and regulatory framework to foster the adoption of self-financing strategies among CSOs. This framework defines whether CSOs can or cannot engage in self-financing activities and influences the circumstances under which and degree to which they will do so. In addition, the tax structure, the level of bureaucracy, and the clarity of the applicable legal rules have a direct bearing on the use of self-financing activities. CSOs are often unaware of

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These organizations are often also referred to as nonprofit organizations (NPOs), nongovernmental organizations (NGOs), charities, or voluntary organizations. The term "CSO" is a broadly encompassing term that includes all of these subgroups.



these rules. Many believe that they cannot practice self-financing; others feel that if they do, it will damage their public image or their relations with donors. Even when CSOs are aware of the relevant legislation, they often do not understand what taxes they need to pay, what forms to file, or what procedures to follow. In Croatia, self-financing activities by CSOs remain a rare practice, partly because of the lack of capacity and entrepreneurial spirit on the part of the CSOs, but in part also because of the lack of a clear interpretation of the legal framework which, in principle, allows CSOs to engage in commercial activities.

Croatian legislation encompasses a variety of types of CSOs engaging in activities aiming to achieve general or common interest. They include associations, institutions, foundations, funds and non-profit commercial companies. This guide will attempt to clarify the legal framework faced by Croatian associations, non-governmental organizations which constitute the bulk of Croatian civil society. The guide will, then, assess the degree to which this framework provides an enabling environment for these organizations to pursue self-financing strategies.

1.1 What is Self-financing and Why is it Important?

Self-financing strategies are used by CSOs to generate revenues in support of their missions. The use of self-financing is a response to the current funding paradigm in which CSOs compete for a limited pie of existing government and philanthropic resources from both national and international sources. This reality makes many CSOs heavily dependent on short-term, project-based funding and prevents them from focusing attention on the long-term, strategic development of their organizations. Through the self-financing, CSOs may be able to increase their long-term viability and independence by generating some of their own resources to supplement support from public and private donors.

Self-financing need not lead to the commercialization of CSOs. Rather, self-financing can provide CSOs with a greater level of independence and sustainability without compromising their mission objectives or values. Self-financing income can be one alternative for CSOs to support work that is often difficult to finance through traditional sources of funding (e.g., core operating expenses, new programs, advocacy efforts). NESST does not argue that CSOs should entirely replace their traditional sources of funding with self-financing, but instead posits that self-financing can provide a powerful complement to government and philanthropic support. Through self-financing, many CSOs are not only financially strengthened, but also institutionally empowered by their ability to generate new revenues and to determine the course of their work with fewer constraints from funders.

Furthermore, when pursued in a socially and environmentally responsible manner, the enterprise activities of CSOs can help create an "alternative economy" more responsive to the needs of local communities, small producers and low-income people. By purchasing products and services sold by CSOs, consumers are simultaneously promoting the mission of CSOs and contributing to a more equitable and sustainable world.

Types of self-financing activities include the following:

- **Membership fees:** raising income through dues from members or constituents of the organization which is not considered a fee for some kind of product, service, or other benefit provided by the CSO to its membership.
- **Fees for services:** capitalizing on some existing skill or expertise of the organization by contracting work to paying clients in the public or private sector (e.g., a CSO provides consultation services to businesses or local government).



- **Product sales:** selling, rather than giving away, the products of CSO projects (e.g., books or other publications); reselling products (e.g., in-kind donated items) with a mark-up; or producing and selling new products (e.g., T-shirts, mugs).
- **Use of “hard” assets:** renting out CSO real estate, space/facilities, equipment, etc. when not in use for mission-related activities.
- **Use of “soft” assets:** for example, generating income from license of CSO-held patents or other intellectual property, or by endorsing products with the CSO name/reputation.
- **Investment dividends:** passive investments such as savings accounts and mutual funds, or other more sophisticated financial transactions (e.g., active trading on the stock market).

CSOs engage in self-financing activities primarily to strengthen their financial resources, to advance their social mission, or both. On the one hand, a CSO may be purely interested in generating profits that it can use to fund its core mission programs. In these instances, the organization is not concerned with advancing its social mission directly through the self-financing activity, but rather indirectly by applying the revenues from the activity to further its social mission. An example of this is a health education organization that starts a printing press and uses the revenues to fund the organization's research projects. This activity would be considered non-mission-related.

On the other hand, a CSO may be primarily interested in using a self-financing strategy to advance its social mission. For example, a CSO whose social mission is to offer carpentry training and job placements to recovering substance abusers may begin selling the furniture that the trainees produce in order to pay for the costs of materials and the salaries of the trainees. This activity would be considered mission-related.

Yet these examples are not mutually exclusive - and neither are the financial and social goals that motivate CSOs engaging in self-financing activities. Many times, CSOs aim to achieve financial and social goals simultaneously through a self-financing activity. The health organization may be better positioned to disseminate the findings from its research by publishing its own materials, and the job training organization may be able to apply surpluses from its furniture sales to fund other programs of the organizations or its core operating expenses. In each of these scenarios, the objectives of CSO self-financing activities and the relation of these activities to the organization's primary mission strongly influence the success of the activities and may play a role in determining the legal treatment of these activities, as this guide will illustrate.

1.2 Purpose and Contents of this Guide

In an attempt to diversify their funding base, a number of Croatian CSOs have initiated self-financing strategies. For the most part, however, they have done so with little know-how, capital or other forms of support. NESST research on the use of self-financing among CSOs in Croatia demonstrates that many of them have limited internal capacity (i.e. staff skills and time, adequate financial resources, business plans) or the external support (i.e. financing, consulting support, favorable legal/regulatory environment) to engage in self-financing activities. When such organizations nevertheless attempt to pursue self-financing strategies, they have to deal with a range of legal, financial, management and organizational issues for which support is not readily available. If CSOs decide to pursue self-financing activities, it is important that they do so with the appropriate types and levels of technical and financial assistance and within an enabling external environment

The pressures and demands faced by CSOs engag-



ing in self-financing activities highlight the need to understand the legal environment affecting them in Croatia. In this context, the purpose of this guide is twofold:

1. To outline key laws, regulations and procedures governing the use of self-financing by CSOs in Croatia. Chapter 3 explains what the Croatian law says about the use of self-financing and discusses the administrative and tax regulations that apply to CSOs engaging in such activities. It also explains the procedures - forms that must be completed and fees that must be paid - required to initiate such activities. It offers a general overview of the relevant laws and regulations, so that Croatian CSOs have an idea of where they fit within the legal system and what they have to do if they wish to undertake self-financing.
2. To assess the relevant laws governing CSO self-financing in Croatia, to evaluate their practical effects and to identify areas where the law might be improved. This guide identifies the strengths and weaknesses of Croatian laws - whether they help or hinder the use of self-financing, and whether they foster the development of the sector as a whole. The legislation is considered within a tax treatment typology that makes it easier to understand and assess.

The typology was first developed by the International Center for Not-for-Profit Law² (ICNL) to examine the legal treatment of CSO economic/commercial activities in Central and Eastern European countries; it has now become a widely accepted typology for understanding and assessing the tax treatments of such activities. The ICNL typology is presented in Chapter 2; Croatia's legislation is analyzed in the context of this typology in Chapter 3; and

the five criteria of the typology are used as a basis for the assessments and recommendations offered in Chapter 4.

1.3 Background and Methodology

This guide is a component of NESST's efforts to foster self-financing among CSOs in Croatia. In 1997, NESST began conducting applied research on CSO self-financing in Central Europe in order to identify the typical challenges and needs in the region. The objectives of the applied research were as follows:

- To assess the current use of self-financing activities among CSOs in Central Europe. NESST completed case studies documenting successes and obstacles in CSO self-financing activity in four Central European countries: Hungary, Slovakia, Czech Republic and Slovenia.
- To examine the current legal environment for CSO self-financing in the region overall, including the regulatory and tax framework in place at local and national levels that affects the self-financing activities of CSOs.
- To disseminate lessons from the research - by publishing case studies and legal guides and by organizing local workshops - for stakeholders from all sectors in an effort to develop strategies for assisting CSOs in the use of self-financing.

In 2005, such research was conducted in Croatia. It was conducted using a methodology developed by NESST to evaluate the legal environment for CSO self-financing activity in a particular country. The following four areas were considered:

1. **What the law states.** What is the current legal treatment of CSO self-financing activities (including current legislation, legal provisions,

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ICNL is an international organization whose mission is to facilitate and support the development of civil society and the freedom of association on a global basis. ICNL, in cooperation with other international, national, and local organizations, provides technical assistance for the creation and improvement of laws and regulatory systems that permit, encourage, and regulate the not-for-profit, non-

governmental sector in countries around the world. ICNL maintains a documentation center for laws, regulations, self-regulatory materials, and other relevant documents; provides training and education; and conducts research relevant to strengthening and improving laws affecting the nonprofit sector. For more information on ICNL, see www.icnl.org.



history of the law, revisions of the law, regulatory approach, tax rates, reporting requirements, other laws or regulations, legal cases, and organizations or lawyers providing advice or assistance)?

2. How the law is understood. Are the regulations of CSO self-financing activities understood by CSOs?
3. Effects of the law. What is the effect of current regulations on CSO self-financing activities?
4. Recommendations for the law. What are the most important recommendations for addressing current regulatory problems?

NESST contracted a consultant on civil society in Croatia who conducted primary and secondary research for the purposes of this guide. The research encompassed extensive interviews with 15 Croatian CSOs engaging in commercial activities, analysis of relevant laws and a review of related literature. The guide was then reviewed by nonprofit lawyers with extensive expertise of the Croatian regulatory framework for CSOs.



NESsT

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for Self-Financing in Croatia

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Chapter 1



Presenting a Typology for Assessing the Legal and Regulatory Framework



This chapter presents a typology for analyzing the legal rules that govern CSO self-financing activities. The typology was developed by the International Center for Not-for-Profit Law³ (ICNL). NESST has expanded and modified it to make it more applicable. The following section presents four key areas that are vital for understanding the legal structure for CSO self-financing before assessing the specifics of Croatia: 1) the legal characteristics of CSOs, 2) the legal definition of self-financing, 3) the criteria for permitting self-financing, and 4) the taxation of self-financing activities.

It is important to note that in its texts, ICNL uses the term "nonprofit organizations" or "NPOs," which refers to a subgroup of the broader classification of "CSOs," the term used by NESST. This guide uses the term "CSO," except in parts that specifically draw upon the ICNL typology, where it maintains the original ICNL terminology. Croatian laws make reference to the term "association" (udruga) which is consistent with the broad scope of organizations encompassed by the term "CSO."⁴

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The overall typology presented in this chapter was adapted, with permission, from the paper *Regulating Economic Activities of Not-for-Profit Organizations* that was first prepared by ICNL for the "Regulating Civil Society" Conference in Budapest, Hungary, in May 1996 (copyright ICNL, 1997) and from the *Handbook on Good Practices Relating to Non-Governmental Organizations, Appendix I: Economic Activities and Taxation* (copyright ICNL, 2000).

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Foundations, funds and other forms of CSOs in Croatia, are not encompassed by this guide.



2.1 Legal Characteristics of Nonprofit Organizations

These characteristics highlight the key differences between nonprofit and for-profit organizations and therefore provide a context for understanding how NPOs engage in self-financing or commercial activities. The discussion that follows in this chapter and the rest of the guide addresses a subgroup of all NPOs - those whose not-for-profit purposes are intended to promote the public benefit. It is important to recognize that some NPOs, such as mutual associations of stamp collectors or chess players, may not pursue these goals. These organizations are still considered NGOs and generally the same regulations apply, but this guide will address only those NGOs that pursue the public benefit. There is no fixed way of determining what constitutes the public benefit, and Croatian laws do not distinguish between NPOs on this basis as the concept of public benefit is non-existent in this context.⁵ ICNL, however, does make this distinction, and its typology accordingly identifies two basic legal assumptions that distinguish public benefit NPOs from for-profit entities:

1. **Non-distribution constraint.** Although NPOs are not prohibited from generating profits, these profits may not be distributed to private parties who might be in a position to control them for personal gain, such as founders, members, officers, directors, agents, employees, or any related party.
2. **Public-benefit purpose.** By definition, this class of NPOs is organized and operated primarily to provide a public benefit.

These characteristics are not primarily dependent on the particular legal form of the NPO. Accordingly, this discussion addresses NPOs of various legal forms as long as they provide a public benefit and uphold the principle of non-distribution.

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Although the public benefit status is not defined in Croatian legislation, Article 17 of the Law on Foundations and Funds, for instance, obliges the state to promote foundations and their activity whereby such organizations are inexplicitly and effectively treated as public benefit organizations.

2.2 Legal Definition of Self-financing

There are many terms and definitions, both legal and non-legal, currently in use to describe activities that generate revenues for CSOs (e.g. commercial activity, economic activity, nonprofit enterprise, social enterprise, social-purpose business, earned income, income-generating activity). ICNL uses the term "economic activity" to refer to self-financing activity. ICNL defines economic activities as "regularly pursued trade or business activities," with the exception of those that have traditionally been excluded (i.e., ticket sales for cultural events, tuition fees at educational institutions, and patient fees at nonprofit hospitals). NESsT, on the other hand, uses the term "self-financing" to refer to activities that generate revenues for the CSO, including the six types of activities described in the previous chapter. In Croatia, the terms "self-financing," "economic activities," and "commercial activities" are used interchangeably to indicate both mission related and non-mission related activities undertaken by CSOs for revenue-generating purposes.

2.3 Criteria for Permitting Self-financing

According to ICNL, "a threshold issue is the extent to which NPOs should be permitted to engage in economic or commercial activities without losing their not-for-profit status."⁶ At this stage of the analysis, the question is not whether such activities should be tax-exempt, but under what circumstances they should be permitted at all.

There are two typical tests used by governments around the world for determining whether economic activities are "nonprofit" or "for-profit":

1. **Principal-purpose test.** The principal-purpose test provides one legal model for regulating NPO self-financing. It does not prohibit the use of self-financing activities, but rather emphasizes that the NPO is established and operated

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Regulating Economic Activities of Not-for-Profit Organizations, (copyright ICNL, 1997).



primarily for not-for-profit purposes and not for private gain. The test implies that self-financing would be for mission-related, not-for-profit purposes and/or would not be the principal activity of the organization.

2. **Destination-of-income test.** Contrary to the principal-purpose test, the destination-of-income test, in its pure form, ignores the economic or commercial nature of the activity in question and focuses exclusively on the purposes for which profits from the activity are used. Under this test, an organization must devote all of its income to its not-for-profit purposes in order to qualify as an NPO. Accordingly, an organization that spends 99% of its time pursuing commercial endeavors, spends 1% of its time undertaking public-benefit activities, and devotes all of its profits to these public-benefit activities could still qualify as an NPO.

Under either test, an NPO is permitted to engage in economic activities that further the not-for-profit purposes for which it is organized. But what justification is there for governments to permit NPOs to conduct self-financing activities? There are two main public policy rationales for permitting NPOs to engage in such activities:

a. Self-financing applies non-public resources to the public good. Income from economic activities is a primary source of funds for NPOs (particularly in countries in transition, where there is an absence of private capital and philanthropic tradition) and enables them to do their public-benefit work with less dependence on governmental support and charitable donations.

b. Self-financing accomplishes public-good objectives. Certain economic and commercial activities directly accomplish public-benefit purposes. For example, although the selling of a book on teaching techniques by an educational organization is an economic activity, the distribution of the book directly serves the public-benefit purpose of pro-

moting education. Preventing NPOs from using such commercial and economic means to attain their goals could directly impair their ability to serve public-benefit purposes.

Preventing NPOs from using commercial and economic means to attain their goals could directly impair their ability to serve public-benefit purposes.

2.4 Taxation on Self-financing Activities

While the legal treatment of CSO self-financing varies on a practical level from country to country, most have ruled out polar extremes (i.e., a complete prohibition against economic activities or allowing economic activities to be the principal activity of the organization). Beyond this decision, the issue becomes the tax treatment of such activities. Governments have typically employed four approaches, singly or in combination, to determine the tax treatment for CSO self-financing activities:

1. **Blanket tax.** A blanket tax policy taxes income from all economic activities, regardless of the source or destination of the income. Under this approach, the organization is not limited by level or type of activity, but is taxed for all revenues generated through these activities regardless of how those revenues are used.
2. **Destination-of-income tax.** A destination-of-income tax policy exempts income from economic activities that is used for public-benefit purposes. Under this approach, the organization is not limited by level or type of economic activity, but is taxed on all income that is not used to further its public-benefit purposes. The destination-of-income tax should not be confused with the destination-of-income test. The test is used to establish that CSOs may conduct economic activities without compromising their nonprofit legal status as long as any revenues



are destined to the organization's mission. The destination-of-income tax, on the other hand, focuses purely on the tax treatment of non-profit organizations.

3. **Source-of-income tax (or relatedness test).** A source-of-income tax policy focuses on the source of the income, granting a tax exemption only when the income results from activities that are related to the public-benefit purposes of the organization. Under this approach, the organization is taxed for all income generated from non-mission-related activity even if the income is used to support mission-related activities.

4. **Mechanical tax.** A mechanical tax policy makes a rigid distinction based on fixed criteria in order to determine the difference between economic activities that are taxed and those that are not. An example of a mechanical test is an exemption ceiling (i.e., an income level below which economic activities are tax-exempt and above which they are taxable).

Some governments have created hybrid tax policies that are based on two or more of these approaches. For example, it is possible to allow net income from economic activity to be tax-exempt below a specified threshold and to apply a mission-relatedness mechanical test to determine whether net income above that threshold should be taxed.

CSOs in Croatia are explicitly permitted to engage in commercial activities, in line with the non-distribution constraint. They are allowed to engage in both mission and non-mission related activities, with the obligation of allocating all of

the earned income for organizational purposes. As the following chapter will discuss, in Croatia, CSOs are exempt from taxes on income generated from their economic activities. If, however, under procedures which are not entirely clear, the competent tax authority establishes that a CSO has gained an "unjustified privilege on the market," the CSO's income will be taxed at the regular corporate income tax rate. In this respect, CSOs would be taxed for income from their economic activities along the lines of the blanket tax treatment presented above. In practice, however, there have been no such rulings and no case law is available which would assist in the interpretation of the criterion.



There is no consensus on which of these tax approaches is best, since each entails certain benefits and costs and defines a different public policy objective. ICNL applies five criteria to shed light on the practical

implications of each approach.

a. Simplicity or complexity of administration.

Blanket taxation of all economic activity is the simplest approach to administer—once economic activities are defined, NPOs are treated the same way as for-profit organizations. The destination-of-income rule is slightly more complex to administer. The main difficulty is establishing and enforcing criteria for what constitutes an expenditure in furtherance of public-benefit purposes. A relatedness test is the most complicated to apply because it is difficult to specify the necessary connection between the economic activity and the public-benefit purposes.

b. Effects on revenue collection. Assuming the tax rates under the various treatments are equal, the largest potential tax revenue is generated using

Governments have typically employed four public policy approaches, singly or in combination, to determine the tax treatment for CSO self-financing activities.



the blanket taxation approach, since it subjects the greatest number of NPO self-financing activities to taxation. However, empirically, it is unclear how much tax would in fact be collected, because, other things equal, the level of commercial activity by NPOs will presumably be lower under this rule than under the others (because taxation provides a disincentive for NPOs to initiate commercial activities).

In its purest form, the destination-of-income rule has the lowest potential to produce tax revenue because all income from whatever source is free from tax if it is applied to performance of public-benefit purposes. In practice, many countries impose limits upon the amount of income that is exempt under the destination-of-income rule, thus limiting potential losses to the state's revenue base. The mission-relatedness test also potentially reduces the size of the tax base, but probably less so than the destination-of-income test, because the former has the effect of channeling NPO economic activity into specific areas that produce public benefit.

c. Effects on the commercial sector. The blanket taxation approach to NPO income from economic activities is most favorable for the commercial sector, since there is no possibility of "unfair" or prejudicial competition (i.e., NPOs do not receive preferential tax treatment compared with their for-profit peers). The destination-of-income rule, in its purest form, does nothing to prevent claims of unfair competition, since the nature of the use of income may give NPOs a tax advantage that their for-profit competitors do not share. Naturally, a limit on this benefit reduces the comparative advantage for NPOs. The mission-relatedness test minimizes unfair competition by encouraging NPOs to focus on activities that produce a public benefit and by applying the standard tax treatment used for for-profit enterprises when NPO activities are conducted purely for profit. The difficulty in implementing this mission-relatedness

rule lies in establishing which economic activities advance the public benefit and which do not (or which do not advance it enough).

d. Effects on the development of the NPO sector.

The blanket taxation approach reduces resources for the nonprofit sector, essentially transferring money away from NPOs and into the governmental sector. It is generally accepted that NPOs devoted to public-benefit purposes, if not eligible for state subsidies, should at the very least not be required to transfer resources to the state (in the same fashion as for-profit enterprises). Blanket taxation of all NPO income from economic activities eliminates the incentive to engage in income-generating, public-benefit activities and is most unfavorable to the nonprofit sector. At the very least, NPO proponents claim, such taxes should be at a lower, preferential rate than taxes for for-profit enterprises.

The destination-of-income rule provides the greatest potential revenue to NPOs, since virtually any income can be made tax-exempt if channeled into public-benefit activities. The mission-relatedness test is less favorable to NPOs because activities that are undertaken purely to obtain revenue enjoy no tax exemption. However, the mission-relatedness test still provides significant tax benefits for NPOs, particularly when they focus on activities associated with public-benefit purposes. Moreover, the relatedness test channels NPO economic activities into more socially beneficial directions than the destination-of-income test, which encourages NPOs to engage in economic activities that can earn the greatest potential financial return.

e. Practical implementation issues. The blanket taxation approach is the easiest approach to implement, since there are uniform rules for NPOs and for-profit organizations alike. The destination-of-income rule uses a mechanical approach that is relatively easy to administer, although it is necessary to define what constitutes



an expenditure in furtherance of public-benefit purposes and to supervise the actual use of profits. Nonetheless, it is still necessary to monitor NPOs and their use of funds, and this “policing” function may prove to be administratively difficult. Moreover, this approach creates a greater potential for abuse by unscrupulous individuals seeking to use NPOs as vehicles for tax evasion. The relatedness test is relatively difficult to implement, since a precise definition and application of this concept is elusive, and tends to work best when developed over time through administrative practice. On the other hand, this relatedness approach is the most likely to keep NPOs focused on economic activities that also benefit the public good.



The Croatian Legal and Regulatory Framework



The Croatian legal framework is favorable toward the commercial activities of CSOs to the extent that such activities are explicitly permitted by law and they are not taxed. CSOs are exempt from paying corporate income tax on income generated through commercial activities unless such exemption has led to the acquisition of "unjustified privilege on the market." Should the competent tax authority reach such a finding, which has not happened in practice thus far, a blanket tax is levied on the CSOs income resulting in the same obligations as those incurred by for-profit entities. Although such legal framework is nominally favorable, a number of open issues remain, not the least the definition of the unjustified market privilege criterion. Moreover, Croatian legislation does not recognize the concept of public benefit which would greatly aid in the establishment of an enabling environment for the civil sector.

3.1 General Regulations for CSOs

CSOs in Croatia are governed by the Law on Associations, NN 88/01, adopted in October 2001 (Zakon o udrugama, NN 88/01)⁷. The amendments included in this Law, compared to its 1997

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Zakon o udrugama - Law on Associations, NN 88/01, available at www.nn.hr/clanci/sluzbeno/2001/1496.htm.



version, resulted in the decrease of the number of founders, the equalization of the status of Croatian and foreign founders, regulation of informal and foreign associations, change in the competent registration bodies, explicit permission for NGOs to conduct commercial activities as well as more precise regulation of state financial support.⁸ The 1997 Law on Associations replaced the earlier Law on Social Organizations and Associations of Citizens,⁹ adopted and amended in the 1980s, which was inherited from the previous system.

In its Article 2, the Law defines the association as "any form of free and voluntary association of private or legal persons who subject themselves to the rules determining the constitution and activities of such type of association for the purpose of protecting their wellbeing or undertaking to protect human rights and liberties, as well as environmental, humanitarian, information, cultural, national, pro-birth, educational, social, professional, sports, technical, health, scientific or other convictions and aims, all without the intention of acquiring profits."¹⁰ This Law is not applicable on political parties, religious communities, unions and associations of employers.

In addition to defining an association, the Law prescribes its membership, scope of activities, management and its bodies. The Law also provides for associations which are not incorporated as legal entities, and allows for the incorporation of foreign NGOs. Moreover, it specifies the assets and liabilities of the association, the supervisory authority and procedures for its termination as well as prohibition of activity. Finally, it contains punitive provisions in cases of misdemeanor

The Law requires that each association have an assembly, as the highest body of the association, and one or more legal representatives. The remaining bodies of the association, such as a management board, executive board, supervisory

board or presidency, are determined by the association's statute.¹¹ The statute, moreover, must define the name of the NGO, its seat, and the conditions for membership in the association, as well as for its termination. It specifies the manner in which the publicity of its operations is ensured. The statute must contain provisions on the aims of the association and the activities it undertakes which must be in accordance with the aims.

The term for CSO used in Croatian legislation is "association" (*udruga*), which is generally understood to be a nonprofit entity operating to further its aims, as prescribed in its statute, for the benefit of its membership, the public at large or certain sectors thereof.

3.2 CSOs and Commercial Activities

Although the Law is clear in that the purpose of the establishment of an association may not be the acquisition of profits, but rather the promotion of wellbeing of certain interest groups, such as the founders or members, the promotion of public interest or the protection of certain convictions and aims,¹² NGOs are not prohibited from undertaking revenue-generating activities. The not-for-profit status of an association, in fact, implies that its mission-related or revenue-generating activities, as determined by its statute, may not be performed for the purpose of acquisition of profits for its members or other private or legal entities.¹³ Nevertheless, in Article 5, the Law is explicit that in addition to its basic activity, an association may engage in revenue-generating activities, in which case any profit earned must be allocated exclusively for the implementation and promotion of mission related activities, as determined by the NGO's statute. According to expert legal opinion, the Law is not entirely clear on whether the mandatory content of the statute should also include provisions on the NGO's self-financing activities. It is thus recommended that the statute should cite in broad terms the com-

8

Q&A from the ICNL Workshop on the New Law on Associations held in Zagreb on 5 April 2002. Document available at www.zamirnet.hr/icnl/pdf/brosura.doc.

9

Zakon o društvenim organizacijama i udruženjima građana - Law on Social Organizations and Associations of Citizens, NN 7/82, 5/85, 47/89 and 2/90.

10

Zakon o udrugama - Law on Associations, NN 88/01, Article 2.

11

Ivanovic, Mladen. *Kako registrirati udrugu u Republici Hrvatskoj*. ICNL, Budapest and B.a.B.e. Zagreb, 2002.

12

Ibid., p.9.

13

Ivanovic, M. and Marija Zuber. *Priručnik o pravnom, poreznom i carinskom sustavu za nevladine organizacije u Republici Hrvatskoj*. ICNL, Budapest, 2001, p.6.



mercial activities which the CSO wishes to undertake in order to achieve its aims. Such income may not be distributed to founders, members, and officers of the organization. The revenue-generating activity may be both mission-related and non-mission-related.

The amount of revenue which may be earned this way is not limited. By the same token, the range of revenue-generating commercial activities which an NGO may undertake is not restricted. In principle, an NGO may engage in any activity which has been prescribed by its statute, with the exception of those which have been explicitly prohibited by law. Moreover, different kinds of commercial activities are regulated by specific laws which must be considered when determining the future course of action. The most common are the Law on Trade, the Law on the Publishing Activity, the Law on Social Welfare, The Law on the Catering Activity, etc.¹⁴

Associations may undertake commercial activities both within the framework of the existing not-for-profit legal entity or through a separate for-profit commercial company established by the NGO. In the latter case, Company Law applies on the firm which enjoys no special status but is treated as any other for-profit entity.

3.3 Taxes on Commercial Activities

3.3.1 Income Tax

1. Corporate Income Tax

If an NGO has established a for-profit company for the conduct of commercial activities, such activities are taxed at the regular corporate tax rate of 20%. The basis of the tax assessment is the profit determined in accordance with the accounting regulation as the difference between the revenue and the expenditures before tax, with additions or deductions in accordance with the

provisions of the Law on Corporate Income Tax.¹⁵

If, on the other hand, the commercial activity is conducted within the framework of the not-for-profit entity, such income is not subject to taxation. Pursuant to Article 2 of the Law, NGOs, along with a number of other state institutions, political parties, associations, boards, clubs and foundations, are exempt from the corporate income tax. Exceptionally, if such tax exemption would lead to the acquisition of unjustified market privileges, the Tax Administration may rule that such entities must comply with the corporate tax liability. In the case of such a finding, an NGO will be taxed at the rate of 20% for the income earned from commercial activity. Such a motion may be initiated by the Tax Administration or any other taxpayer or interested party. In practice, however, it is not clear how the Tax Administration interprets the term "unjustified privilege on the market." To avoid misunderstandings, an NGO may apply to the tax authority for an official interpretation of the term in its specific case. If the Tax Administration has issued a decision that an NGO has incurred the corporate tax liability, all of its revenues, including income from non-commercial activities, are subject to taxation. To date, apparently, the Tax Administration has not issued a single such decision. Most CSOs would not turn to the Tax Authority for such ruling; they try to avoid paying tax in a different way: they might prefer to receive their commercial revenue in the form of donations from clients (be it corporate or individual customers) and thus make sure that they don't show high revenues from commercial activities on their financial statements.

2. Personal Income Tax

A progressive personal income tax rate is applied in the following manner:

¹⁴

ibid, p.6.

¹⁵

Law on Corporate Tax, NN 177/04, available at www.nn.hr/clanci/sluzbeno/2004/3067.htm.



- the rate of 15% is assessed on the base not exceeding the amount equal to the double of the basic personal deduction;
- the rate of 25% is assessed on the difference between the double and quintuple basic personal deduction;
- the rate of 35% is assessed on the difference between the quintuple and fourteenfold basic personal deduction, while
- the rate of 45% is assessed to the base exceeding fourteenfold personal deduction.¹⁶

This personal income tax is assessed on all work-related income earned by individuals. It is not levied on NGOs, however, if an NGO employs either full-time employees or external consultants, it has the obligation to deduct the amount of the personal income tax from any wages and pay out only the net amount. Any employer is also liable for employer's contributions which include social security, healthcare, and employment contributions.

3.3.2 Value-Added Tax¹⁷

Pursuant to the Law on Value Added Tax,¹⁸ an NGO acquires the VAT registration liability if the annual value of its goods and services sold exceeds HRK 85,000 (approximately USD 14,000). Grants, donations and membership fees do not constitute the basis for the VAT liability. The exception are membership fees which are in fact fixed fees for services provided to beneficiaries, in which case the VAT rate may be applicable. The VAT rate, charged on virtually all goods and services, amounts to 22%. The obligation to become VAT registered is incurred at the beginning of the financial year following the year in which the income from commercial activities has

exceeded the VAT threshold. If the income from commercial activities earned by an NGO in a financial year does not reach HRK 85,000, the NGO may, if so wishes, request VAT registration. Such option may be reasonable if the nature of the commercial activity is such that it involves significant purchase of goods and services for which VAT is paid. VAT registration allows the NGO to deduct the paid amount from its obligation making it eligible for potential tax return. In this case, the NGO has the obligation to remain VAT registered for a period of five years, regardless of the amount of income from commercial activities earned in that period.

If an NGO is VAT registered, it may reclaim only the amount of VAT paid for goods and services used in the commercial activity. If the goods and services are used for both mission-related activities and commercial activities, the NGO may reclaim only a share of the VAT, in proportion with the use of the goods and services in the commercial activity. This share can be determined on the basis of the physical indicators of use, or, if this is not feasible, on the basis of the most acceptable proportion given the actual use of the goods and services in question. Such an NGO also has the obligation of charging the VAT for all goods and services it delivers to its clients.

Until April 2004, NGOs whose projects were funded by foreign grants were exempt from paying VAT on goods and services acquired for the implementation of these projects. The regulation, however, was changed, becoming effective on 8 May 2004 and NGOs no longer may enjoy this

16

Zakon o osobnom dohotku - Law on Personal Income Tax, NN 177/04, available at www.nn.hr/clanci/sluzbeno/2004/3066.htm.

17

Udruge u poreznom sustavu Republike Hrvatske, IJF, August 2002, available at www.pu.mfin.hr/contentData/PDF%20Datoteke/Brošure/PROSPEKT_05.pdf

18

Zakon o porezu na dodanu vrijednost - Law on Value Added Tax, NN 47/95, 104/98, 105/99, 54/00 and 73/00, available at www.nn.hr.

19

Pravilnik o izmjeni pravilnika o porezu na dodanu vrijednost - Regulation on the Amendment of the Regulation on Value Added Tax, NN 55/04, available at www.nn.hr/clanci/sluzbeno/2004/1247.htm.

20

http://zaklada.civilnodrustvo.hr/casopis/sadrzaj/broj_1/pitate_odgovaramo/



exemption.¹⁹ Nevertheless, this VAT exemption remains in effect for projects funded by the grants from the European Commission and the United States Government.²⁰

3.3.3 Other Taxes

Several other taxes apply to CSOs conducting commercial activities or irrespectively of it. They are the consumption tax, the trade of real estate tax and the inheritance and gift tax. A number of other taxes may be applicable, depending on the types of commercial activities carried out by CSOs.

1. Consumption Tax

The consumption tax is a municipal tax levied on the consumption of alcoholic and non-alcoholic beverages in restaurants, bars and other venues. The tax may amount to up to 3% of the product's sales price net of the VAT. The applicable rate is set by the municipal council.²¹

2. Trade of Real Estate Tax

The trade of real estate tax is a joint tax paid to the unit of local self-government by the acquirer of real estate. The tax is applicable also in the case of exchange of real estate. The tax, however, is not levied on the acquisition of newly built real estate in which case the VAT is charged.²²

3. Inheritance and Gift Tax

The inheritance and gift tax is a county tax levied on legal and private entities that have inherited

certain assets or received them as a gift. The tax amounts to 5% and is charged on cash, financial claims and securities, as well as movable property the value of which exceeds HRK 50,000 respectively.²³ If the gift is made by the government of the Republic of Croatia or a unit of local self-government in relation to the Homeland War, the tax is not levied. Moreover, CSOs are exempt from the obligation to pay the inheritance and gift tax if the donation is received for purposes established by special regulation.²⁴

3.4 Tax Filings

Accounting obligations

The bookkeeping and financial reporting procedures applicable to CSOs are specified by the Law on Accounting,²⁵ the Decree on the Accounting for Non-profit Organizations²⁶ and the Regulation on Bookkeeping and Accounts for Non-profit Organizations.²⁷ According to the legal stipulation, CSOs whose revenue and assets did not exceed the value of DEM 5,000 (approximately USD 3,000) in the course of the previous financial year, are not obliged to fulfil all the accounting and reporting requirements. Such CSOs must keep only the book of revenues and expenditures and the book of cash receipts and disbursements. CSOs whose assets and revenue exceed the DEM 5,000 threshold, are required by law to keep their books in line with double-entry recording requirements. The books include the journal, the ledger and auxiliary books such as the book of cash receipts and disbursements, book of inventory, book of supplies, book of purchase and sales invoices, etc. If an organization is VAT registered, it must, moreover, keep the book

19

Pravilnik o izmjeni pravilnika o porezu na dodanu vrijednost - Regulation on the Amendment of the Regulation on Value Added Tax, NN 55/04, available at www.nn.hr/clanci/sluzbeno/2004/1247.htm.

20

http://zaklada.civilnodrustvo.hr/casopis/sadrzaj/broj_1/pitate_odgovaramo/

21

www.pu.mfin.hr/porezi/v_poreza16.asp?id=b02d1

22

www.pu.mfin.hr/porezi/v_poreza25.asp?id=b02d1

23

www.pu.mfin.hr/porezi/v_poreza11.asp?id=b02d1

24

Udruge u poreznom sustavu Republike Hrvatske, p. 16.

25

Zakon o racunovodstvu - Law on Accounting, NN 90/92, available at www.nn.hr/clanci/sluzbeno/1992/2331.htm.

26

Uredba o racunovodstvu neprofitnih organizacija - Decree on the Accounting for Non-profit Associations, NN 112/93, available at [/www.nn.hr/clanci/sluzbeno/1993/2140.htm](http://www.nn.hr/clanci/sluzbeno/1993/2140.htm).

27

Pravilnik o knjigovodstvu i računskom planu neprofitnih organizacija - Regulation on Bookkeeping and Accounts for Non-profit Organizations, NN 20/94, available at www.nn.hr/clanci/sluzbeno/1994/0351.htm.



of purchase and sales invoices in line with the VAT regulation. If an organization has the obligation to pay the corporate income tax, it must keep its books in line with the Law on Accounting as applicable to for-profit companies.²⁸

Reporting obligations

A CSO keeping its books in line with double-entry accounting, must twice a year submit the following financial reports: balance sheet, statement of revenues and expenditures, and notes on financial reports. The reports are compiled on prescribed forms available in stationary shops, or created by accounting firms or the organization itself. The reports are submitted to the local branch of the State Auditing Office. Moreover, CSOs are obliged to submit quarterly and annual statistical reports to the Payment Transactions Institute. Non-profit organizations whose assets and revenues do not exceed DEM 5,000 are not obliged to submit any reports.²⁹

CSOs which are VAT registered must file the VAT return on a monthly basis or quarterly if their annual revenue does not exceed HRK 300,000. The return must be filed before the end of the month following the expiration of the reporting period, within which period any due balance must be settled as well. In addition, CSOs must file the annual return, and settle any due balance, before the end of April of the following financial year.³⁰

3.5 Miscellaneous Reporting Obligations

CSOs engaging in commercial activities must keep additional registers depending on the type and volume of commercial activities, as prescribed by relevant laws. In addition to the above mentioned, this includes the book on the inflow and outflow of foreign currency in case the organizations receive payments from abroad. CSOs with permanently employed staff must keep an employment register, a payroll register and other related books.³¹

List of Laws Concerning CSOs

Zakon o udrugama - Law on Associations, NN 88/01
Zakon o ustanovama - Law on Institutions, NN 76/93 and 29/97
Zakon o zakladama i fondacijama - Law on Foundations, NN 36/95

List of Laws Concerning CSO Operations and Commercial Activities³²

Opci porezni zakon - General Tax Law, NN 127/00
Zakon o porezu na dodanu vrijednost - Law on Value Added Tax, NN 47/95, 104/98, 105/99, 54/00, 73/00
Zakon o porezu na dobit - Law on Corporate Income Tax, NN 127/00
Zakon o porezu na dohodak - Law on Personal Income Tax, NN 127/00
Zakon o porezu na promet nekretnina - Law on Trade of Real Estate Tax, NN 69/97
Carinski zakon - Customs Law, NN 78/99, 73/00
Zakon o sportu - Law on Sports, NN 111/97, 13/98, 127/00
Zakon o stopama doprinosa za zdravstveno osiguranje - Law on the Rate of Healthcare Contributions, NN 54/00
Zakon o radu - Labor Law, NN 38/95, 54/95, 65/95, 17/01, 82/01
Zakon o zapošljavanju - Law on Employment, NN 59/96
Zakon o platnom prometu u zemlji - Law on In-country Payment Transactions, NN 27/93, 97/00
Zakon o osnovama deviznog sustava, deviznog poslovanja i prometu zlata - Law on the Fundamentals of the Foreign Currency System, Foreign Currency Operations and Trade of Gold, NN 91A/93, 32/01
Zakon o racunovodstvu - Law on Accounting, NN 90/92
Zakon o državnoj reviziji - Law on State Audit, NN

²⁸ Udruge u poreznom sustavu RH, pp. 3-4, Zuber, pp. 66-67.

²⁹ Zuber, p. 68.

³⁰ Udruge u poreznom sustavu RH, p. 7.

³¹ Zuber, pp. 68.

³² Taken from Zuber, pp. 68-70.



70/93

Zakon o humanitarnoj pomoci - Law on Humanitarian Aid, NN 83/92

Zakon o tehnickoj kulturi - Law on Technical Culture, NN 76/93, 11/94

Zakon o financiranju jedinica lokalne samouprave i uprave - Law on the Financing of Units of Local and Regional Self-Government, NN 117/93, 117/01

Zakon o trgovackim društima - Law on Commercial Companies, NN 111/93, 34/99, 52/00, 118/2003

3.6 Expertise Needed to Manage Commercial Activities

The civil society sector in Croatia has grown significantly over the past decade and a half both as regards the number of active CSOs as well as the quality of the services they provide and activities they implement. This growth has been accompanied by an increasing need for legal, accounting, management and financial expertise crucial for the sustainability of CSOs. Although a small number of organizations provide capacity building services in these fields, either for a fee or as part of their program activities, CSOs still lack sufficient access to such services. For CSOs conducting commercial activities, the problem is compounded both by the unclear interpretation of the legal framework regulating CSO commercial activity and the limited practice of CSO self-financing activities.

In addition to legal and accounting firms providing technical assistance for a fee, clarifications of relevant legal, taxation or related issues can be sought from the competent authorities. This procedure, however, is time consuming and provides no guarantees that the reply will offer satisfactory clarifications.

List of organizations providing support to NGO sector:

CERANEO - Centar za razvoj neprofitnih organizacija

Nazorova 51

10000 ZAGREB,

Tel. 48 95 829

Tel/fax 48 12 384

E-mail: ceraneo@zg.t-com.hr

Website: www.ceraneo.hr

Government Office for Cooperation with NGOs

Ulica grada Vukovara 78

10000 Zagreb

Tel: 01/610-6500

Fax: 01/610-9972

E-mail: ured.za.udruge@zg.htnet.hr

Website: www.uzuvrh.hr

Institut za javne financije

Katanciceva 5

10000 Zagreb

Tel (+385 1) 4886 444, 4819 363

Fax: (+385 1) 4819 365

E-mail: ured@ijf.hr

Website: www.ijf.hr

International Center for Non-profit Law

Apaczai Csere Janos u. 17

1st Floor, Budapest 1052

Tel. 361-318-6923

Fax 361-266.1479

E-mail: Judit@icnl.org.h

Website: www.icnl.org

National Foundation for the Development of Civil Society

Adresa: Zagreb, Kušlanova 27

Tel: 01/23 99 100

Fax: 01/23 99 111

E-mail: zaklada@civilnodrustvo.hr

Website: http://zaklada.civilnodrustvo.hr/

Slap

Neumanova 2a

31000 Osijek

Tel: +385 31 213 556



NESsT

Tel: +385 31 213 556
Fax: +385 31 213 557
E-mail: slap@mail.inet.hr
Website: www.pomak.hr

SMART

Blaža Polica 2/4
51000 Rijeka
Tel: (051) 332-750
Fax: (051) 320-792
E-mail: smart@smart.hr
Website: www.smart.hr



Fax: +385 31 213 557
E-mail: slap@mail.inet.hr
Website: www.pomak.hr

SMART
Blaža Polića 2/4
51000 Rijeka
Tel: (051) 332-750
Fax: (051) 320-792
E-mail: smart@smart.hr
Website: www.smart.hr



CSOs should take special note of the tax laws pertaining to donations. These laws enable for-profit entities or private individuals to receive tax deductions on donations made to certain types of CSOs and thus encourage donations to CSOs that fall into these various groups based on their missions.

Tax laws relating to donations

- Law No. 18,681 of 1987 (Article 69 provides a tax incentive for donations to universities and public or private professional institutes)
- Law No. 19,895 of 1990 (Article 8 contains the “law on donations for cultural purposes” amended by Law No. 19,721 of 2001)
- Law No. 19,712 of 2001 (Articles 62 and following enumerate special tax treatment on donations for sports clubs)
- Law No. 19,247 of 1993 on donations for educational purposes. Under this provision, a for-profit juridical person that makes capital donations for projects that are in collaboration with SENAME and other educational institutions can deduct up to 50% of the donation from its taxes and another 50% from its expenses—a total tax reduction of 42.5%.
- Law Decree No. 3,063 on Municipal Rents (Article 47 provides a tax incentive on donations to private nonprofit institutions engaged in education, creation and dissemination of art and science, or conducting social action programs for the benefit of the neediest populations). This provision states that a for-profit juridical person with accounting systems in place that makes a cash

donation of no more than 10% of its profit can classify the donation as an expense and deduct it from its income, thereby reducing its tax burden.

Civil and commercial laws

- Law on Money Credit Operations (Law No. 18,010 of 1981)
- Civil Code (assets and other property issues, juridical acts, contracts, etc.)
- Code of Commerce and supplementary laws (Bankruptcy Law, Law on the Securities Market, Law on Bills of Exchange and Notes, Law on Checks, General Bank Law, Law on Investment Funds, etc.)
- Supreme Decree No. 110 of 1979, issued by the Ministry of Justice, contains regulations on granting legal status to corporations and foundations
- Supreme Decree No. 292 of 1993, issued by the Ministry of Justice, approves the model bylaws to which “nongovernmental development organizations” may adhere.

Nevertheless, the Ministry has broad powers to act autonomously in overseeing CSOs and their activities.

Public-law legislation

- Penal Code (enacted in 1874) and subsequent amendments and supplementary laws (defines, among other things, the crime of “illicit association”)



Box 3c SPECIFIC LAWS CONCERNING CSO COMMERCIAL ACTIVITIES

- Law No. 18,603 of 1987, Constitutional Organic Law on Political Parties (sets special objectives reserved for this kind of organization, which are incompatible with and exclusive of the objectives of any trade, neighborhood, student, charitable, or other type of organization)
- Annual Budget Law for the Public Sector (reproduces each year a provision that subjects nongovernmental organizations receiving funds contemplated in the items of such Budget Law to oversight of such funds by the Office of the Comptroller-General of the Republic)
- Law No. 18,593 of 1987 on Regional Electoral Courts (regulates elections in certain intermediate bodies described in the law), and subsequent amendments thereto
- Law 18,695 of 1988, Constitutional Organic Law on Municipalities, and successive amendments thereto
- Law 18,962 of 1990, Constitutional Organic Law on Teaching
- Municipal ordinances on payment of licenses, rates, and duties (regarding payment of patents, duties, and concessions, and, from another angle, citizen participation at the local or municipal level)

Labor, social security, and social laws

- Labor Code and subsequent amendments (the consolidated text is contained in Law Decree No. 1 of 1994, issued by the Ministry of Labor and Social Security)
- Law on Pension Funds (Law Decree No. 3,500 of 1980 and successive amendments thereto)
- Law on Social Security HealthCare Institutions (Isapres) (Law No. 19,833 of 1997)
- Law on Occupational Accidents and Professional Diseases
- Law on the National HealthCare System (Law No. 18,496 of 1986)

Special laws on certain organizations

- Law Decree No. 2,757 of 1979 and Law Decree No. 4,163 of 1980, both on Trade Associations
- Law on Homeowners' Associations and other Community Organizations (Law No. 18,418 of 1996)
- Law No. 19,638 of 1999 on Churches, Creeds, and Religious Institutions
- General Law on Universities, Law Decree No. 1 issued by the Ministry of Education, of 1980
- General Law on Cooperatives, whose consolidated text is contained in Supreme Decree No. 502 issued by the Ministry of Economic Affairs, of 1978
- Law No. 19,233 of 1993, on Agricultural Communities (reformed from Law Decree No. 5 of the Ministry of Agricultural of 1968)
- Law No. 19,253 of 1993, on Protection and Development of Indigenous Peoples
- Water Code (contains specific provisions applicable to communities and water and canal associations)

3.7 Expertise Needed to Manage Commercial Activities

The growth of CSOs in Chile over the past fifteen years has generated an increasing need for legal, accounting, management, and other technical expertise not traditionally associated with the sector. While Chilean professionals specializing in these areas are not in short supply, CSOs lack the financial resources to pay for this assistance. Making high quality technical expertise affordable and accessible to CSOs is a pressing need for strengthening the sector in general. This need is



even greater for CSOs conducting commercial activities, which by their very nature entail a level of financial risk that must be managed by personnel with experience and expertise.

Unfortunately, there is currently a large gap between the small supply and the large and growing demand for affordable technical expertise from CSOs. Some government assistance is available from municipalities, each of which is mandated by Chilean law to have a Directory of Community Development (commonly known as a “Dideco”) that is intended to support nonprofit and community groups in their formation and capacity building. However, this aid tends to be more in the form of advice than action and is offered unevenly throughout the country based on the resources and priorities of each local office. Various individual professionals with expertise in legal, accounting, or other areas offer assistance free of charge or at discounted rates to CSOs. Often, these professionals do not specifically publicize their willingness to assist CSOs, but accept solicitations from individual organizations referred by personal connections or through word of mouth within the sector. More importantly, an expanding group of nonprofit organizations offer assistance to CSOs in various areas:

Access S.A. was created in 1988 with the mission

of providing technical, professional, and training services in a private and independent manner to development organizations. The organization is made up of professionals from diverse disciplines—consulting and auditing, law, finance, administration and human resources, accounting and tax systems—who share common characteristics: 1) extensive work experience and 2) commitment to the challenge of social and economic development in the country. Currently, it is working from Arica to Punta Arenas in partnership with small, medium-sized, and large social development organizations. For more information about Access S.A. contact:

Access S.A.
Avda. Ramón Freire 7051
Pudahuel, Santiago, Chile
Fono: (56-2) 7476309 / Fax: (56-2) 7487174
Email: access1@terra.cl

Corporación Simón de Cirene is a nonprofit organization whose mission is to provide nonprofit entities with organizational capacity building and leadership support. It offers workshops and intensive consulting in these areas, attracts volunteers from the for-profit sector, and distributes a manual that explains its methodology. The Corporation offers a workshop and information on the process for legally establishing a nonprofit organization. For more information about Corporación Simón de Cirene:

Corporación Simón de Cirene
El Bosque Norte 0440, Piso 8
Las Condes, Santiago, Chile



Fono: (56-2) 2035202 / Fax: (56-2) 2035270
 Email: scirene@entelchile.net
 Internet: www.simondecirene.cl

Fundación Pro Bono is a nonprofit organization with a mission to promote social responsibility in the legal profession by offering legal services on a *pro bono* basis. It provides support 1) to nonprofit organizations that channel legal assistance needs to low-income persons and 2) to individuals, groups, and organizations that safeguard and protect civil liberties or rights in the public interest. In order to pursue its objectives, Fundación Pro Bono receives solicitations for *pro bono* assistance from nonprofit organizations and it refers these groups to law firms and attorneys that are members of the Pro Bono Project. For more information about Fundación Pro Bono contact:

Fundación Pro Bono
 (No address at the time of publication)
 Phone: (56-2) 6324554 / Fax: (56-2) 6325759
 Email: probono@probono.cl
 Internet: www.probono.cl

Fundación Valora is a nonprofit organization whose mission is to generate changes in the leadership and administration styles of nonprofit organizations with the objective of optimizing their resources and impact. To pursue this goal, the foundation offers tailored consulting services in areas of leadership and volunteerism; participatory workshops in Santiago and throughout the country; and trainings in legal, accounting, and administrative aspects of managing a nonprofit. It also promotes partnerships between foundation or not benefit CSOs in their commercial activities. Yet this situation has not prevented CSOs currently engaging in commercial activities from adopting strategies, some of which are commonly used by for-profit entities, to reduce their tax burdens. For example, in some cases where there is not a significant volume of activity, CSOs do not charge for the sale of a product or service, but rather ask for a donation, which is not taxable either to the

consumer (there is no VAT) or to the CSO. Sometimes this donation is for a suggested amount and therefore strongly resembles a sale. In another example, when CSOs set up separate, for-profit companies to generate revenues for their nonprofit missions, they often apply as many costs as possible to their businesses in order to reduce taxable income, much in the same way that for-profit businesses do. In some cases, for example, the CSO rents services to its own for-profit company, thereby increasing the for-profit company's costs and decreasing the taxable portion of the income. A third strategy adopted by many CSOs is to report incoming funds as nontaxable donations, rather than as taxable fees-for-services. All of the strategies mentioned above are perfectly legal as long as the activities are conducted at low levels. A CSO engaging in one of these strategies at a high volume might arise suspicion in the Ministry of Justice or the SII, with possible penalties ranging from the payment of taxes to the nullification of the organization's legal status. In order to avoid problems with the government institutions that oversee CSOs, it is prudent for CSOs to have two distinct legal entities: one for their nonprofit activities and the other for the commercial or self-financing activities that are intended to generate revenues for the organization. This separation allows for accounting that more accurately reflects the particular nature of the nonprofit or for-profit activities that each entity conducts.

The following case studies present the experiences of two CSOs that engage in commercial activities. The first is Fundación Hogar de Cristo, the largest welfare institution in Chile, which is headquartered in Santiago but operates throughout the country. Hogar de Cristo, which is the beneficiary of presidential recognition that accords it an income tax exemption, engages in commercial activities at relatively high levels for a CSO. The second is Corporación CIEM, a community development corporation of moderate size that is located in the town of San Felipe, north of Santiago, and that is not a beneficiary of presiden-



tial recognition. These case studies present two CSOs in distinct situations operating under different rules to illustrate some of the diversity of CSO experiences with respect to commercial activities.

Corporación CIEM Aconcagua is an organization that supports community development efforts in the Aconcagua subregion located 80 Km. north of Santiago in Region V. From its base in the town of San Felipe, CIEM's wide-ranging programs emphasize small business development, conservation and dissemination of the local cultural heritage and the arts, education, environmental protection, and capacity building among young people and artisans in traditional arts and trades.

Founded as an independent corporation in 1995, the organization has always received institutional and financial support from the local Roman Catholic diocese. For example, CIEM operates out of a physical space known as Centro El Almendral, which it occupies under a "gratuitous loan agreement" in which the diocese allows it to use the facilities free of charge for a term that is automatically renewable every ten years. At the same time, CIEM has attempted to develop financial independence through various initiatives to generate its own resources.

Some of these initiatives are organized specifically as commercial activities, although most are directly related to the organization's mission. CIEM has obtained licenses from the local municipality for each of its commercial activities, but this process is relatively easy and the costs are usually minimal (CIEM has not applied for an exemption from these license fees, for which it may be eligible under Article 27 of the Law of Municipal Taxes—see section 3.4.2). CIEM's commercial activities include operation of a printing press, which publishes both its own materials and those of small businesses and other CSOs in the region; a store that markets and sells products purchased from local artisans; a café that sells coffee and

homemade food; and rental of equipment and space. CIEM applied for presidential recognition as a welfare institution, but it was denied this status and therefore must pay first-category tax on income. All of CIEM's commercial activities are operated at low levels, so the organization makes provisional monthly payments of approximately 2% on all profit during the course of the year. CIEM can recoup these monthly payments at the end of the year if its balance sheet shows no surpluses, but it may be required to pay the full first category income tax of 17% if it has generated significant revenues. The organization must also make monthly VAT payments, the majority of which it can recoup as discussed in section 3.4.2.

The organization also charges fees for activities that are not deemed commercial as such. It charges for the training programs it offers to youths in arts and trades, but does not pay VAT since the programs are considered educational and are exempt from this tax. The organ
As presented in the previous chapter, the basic



Interpreting and Critiquing The Croatian Legal and Regulatory Framework



legal framework applicable to CSOs conducting commercial activities in Croatia differs from the framework governing the operations of for-profit entities in that CSOs undertaking commercial activities in line with their statute are exempt from the corporate income tax. Nevertheless, the caveat here is that CSOs remain exempt unless the competent tax authority establishes that such exemption has resulted in the CSO acquiring an "unjustified privilege on the market." To date, apparently, the tax authority has not found this privileged position in a single case. It would require further research to establish what exactly are the reasons for this: whether there had been no cases filed due to the modest level of commercial activities of CSOs or whether the tax authority simply overlooks this type of activities. What we know is that there is no data collected and published on the commercial activities of CSOs in Croatia today.

Chapter 4 evaluates the practical effects of Croatian laws on CSO commercial activities, discusses the strengths and weaknesses of the legal



framework, and offers recommendations for the reform of the system which would enhance the development of CSO commercial activities, and, in turn, increase and sustain the contributions of the sector to Croatian society as a whole.

4.1 Evaluating the Croatian Legal Framework for CSO Commercial Activities

A legal framework that is grounded in fair principles and applied accurately and consistently is essential to the social, political and economic stability of any country. In this respect, the Croatian legal system has a long way to go on the road towards the rule of law and judicial competence and independence. Indeed, Croatia's feeble judiciary remains a major obstacle in the country's process of accession to the European Union. In the more specific area of legal treatment of CSOs conducting commercial activities, the framework is seemingly favorable yet unclear. On the one hand, the law explicitly allows CSOs under certain conditions to engage in commercial activities granting them a preferential tax treatment. In practice, however, the benefits of it remain evasive as much of the interpretation is left to competent authorities, such as the tax office, still operating in a climate and espousing an outlook which are fairly hostile to CSOs. This section evaluates the Croatian legal framework with respect to the five analytical criteria established by the ICNL typology and presented in Chapter 2.

Simplicity or complexity of administration

Since CSO commercial activities are tax exempt, such a system is relatively simple to administer from the state point of view. In case, however, they should lose the exemption status because of the "unjustified privilege on the market", the blanket tax treatment would apply which, again, is the simplest system to administer. A practical difficulty is posed by the lack of definition of the unjusti-

fied market privilege criterion. In this respect, a more precise interpretation of the term would provide legal security and facilitate broader engagement in commercial activities by CSOs. Adherence to the non-distribution constraint by CSOs is ensured by the financial reporting system and occasional audits by competent authorities.

Effects on revenue collection

ICSOs enjoy the tax exemption and are not obligated to pay any taxes on the earned income. Thus this model yields no revenue to the state and, in this respect, is the least favorable for the state. If the unjustified market privilege criterion were to be invoked, then the blanket tax would apply, in which case the largest potential revenue would be created. In practice, however, this yields little revenue, as to date there have been no instances of the application of such criterion, and, moreover, the level of commercial activities undertaken by CSOs is low.

Effects on the commercial sector

Because of the tax exemption, CSOs are, de jure, in a privileged position in comparison to the commercial sector. This could give rise to unfair competition claims by for-profit businesses. In practice, however, given the volume and type of activities undertaken by CSOs, there has been no cause for complaint from the for-profit sector, and no such claims have been recorded.

Effects on the development of the NPO sector

While the effects of such system on the development of the NPO sector would appear positive at the first glance, in reality its impact has been limited. At issue here is not the fiscal framework, which at least in terms of taxation remains posi-



	Good	Moderate	Poor
Simplicity or complexity of administration		☐	<p>Since CSO commercial activities, with the exception of those conducted by CSOs classified as exempt from paying income tax by the President of the Republic, are uniformly regulated not only within the sector but also in line with the for-profit sector, the system is relatively simple to administer. The same rules apply to all persons or entities engaging in commercial activities with respect to registration, reporting, and tax filing. Under the ICNL typology, this system would be classified as "blanket tax treatment," which is the most simple of the various systems to administer.</p> <p>The income tax exemption for CSOs classified as welfare institutions by the President represents a form of mechanical test, although it is more qualitative in nature than quantitative. The ruling is not related to amount of income generated, which is the classical mechanical test. Instead, it is determined by whether the organization is classified as a welfare institution. Once an organization is exempted, then it falls under the "source of income" ruling that exempts all revenues generated from mission-related commercial activities as long as that income is destined for the mission. This exemption applies only to income tax and does little to complicate the administration of the overall system.</p> <p>From the perspective of CSO proponents, the simplicity of the system underscores its problems, for the uniform treatment of commercial activities conducted by CSOs and for-profit businesses fails to recognize and specifically promote the public benefits achieved by CSOs. The authors of this guide therefore believe that even though administering the system would be necessarily complicated as a result of the reforms proposed later in this chapter, such complications are small sacrifices in return for the greater benefits that would be produced from these reforms.</p>
Effects on revenue collection	☐		<p>The Chilean tax system is one of the most modern and effective systems in Latin America, and the collection of taxes with respect to CSO commercial activities is no exception. To the degree that Chilean CSOs conduct commercial activities that are recognized as such, the process of revenue collection is successful.</p> <p>Yet aspects of the system, particularly the absence of tax discounts for CSOs engaging in commercial activities, have an impact on the level of revenue collection in two specific areas. First, many CSOs are discouraged from initiating commercial activities because they perceive that the incumbent tax burden makes it difficult or impossible to yield a profit. Thus, CSOs under the current system are conducting commercial activities at lower levels than they might be within a</p>



OVERALL CRITIQUE: COLOMBIAN LEGAL FRAMEWORK FOR CSO COMMERCIAL ACTIVITIES

	Good	Moderate	Poor
Effects on the commercial sector			<p>□ more supportive regulatory environment. At the same time, those that are conducting such activities are also paying the full income tax. It is unclear whether this revenue base would increase or decrease with a higher level of CSO commercial activity but a lower rate of taxation. Granting CSOs full tax exemptions would obviously decrease revenue collections.</p> <p>Second, CSOs that currently engage in commercial activities have adopted many of the strategies used by for-profit entities to reduce their tax burdens. These practices, which will be discussed in section 4.2, have primarily emerged because of the absence of tax breaks for CSO commercial activities. Tax discounts for CSO commercial activities would probably help decrease such practices, though it is unlikely that they would entirely disappear unless CSOs were fully exempt from paying income tax. Full tax exemption, of course, would eliminate revenue collection from CSO commercial activities rather than increase it.</p> <p>Because CSOs receive the same legal and regulatory treatment as for-profit businesses, there is no "unfair competition" between the two sectors. Each individual commercial activity competes in the marketplace under the same rules, so there has been no cause for complaint from the for-profit sector. Taxing CSOs at the same level as their for-profit counterparts is considered strongly favorable to the commercial sector.</p> <p>While some CSOs receive income tax exemptions based on their recognition by the President as welfare institutions, these organizations do not generally conduct commercial activities at high levels and have therefore not provoked criticisms of unfair competition from the for-profit sector.</p>
Effects on the development of the NPO sector	□		<p>The flip side of the "good" effects of the current system on the commercial sector is its undeniably "poor" effects on the development of civil society. On the whole, it is fair to say that CSOs tend to enter the commercial arena at a disadvantage relative to their for-profit counterparts because of the priorities expressed in their missions and values, the experience and skills of their staffs,</p>



tive for CSOs, but the overall environment in which CSOs operate in Croatia. The government sector remains largely distrustful towards the civil sector, while the business sector, by and large, still has not developed an appreciation for the civil society, the work it does and the role it plays.

Practical implementation issues

In practical terms, the implementation of the system is easy, as long as no party raises the issue of "unjustified privilege on the market." As there is no case law to rely on, it is unclear in which direction authorities will rule should such a claim be brought forward and which implications this would have on the system's practical implementation.

4.2 Working within the System

Although the legal framework is clear inasmuch it explicitly allows CSOs to undertake commercial activities, this practice is not very common in Croatia. CSO representatives cite a variety of reasons ranging from the lack of capacity and initiative among the civil sector to unclear interpretation of the legal framework by the relevant authorities. CSOs are thus hesitant to engage in commercial activity, fearing that that may be subject to adverse actions from the tax authorities should their operations be deemed in breach of regulations. Many of them have thus devised strategies which allow them to collect proceeds which are not automatically classified as revenue. Thus in some cases CSOs may not charge for the sale of a product or service but rather accept donations which are not recorded as revenue. Moreover, instead of issuing invoices for the sale of services, CSOs may sign contracts on cooperation with prospective partners.

In order to avoid accounting complications and risk being in breach of regulations, CSOs may choose to set up a separate for-profit entity,

owned by the CSO, which conducts the income-generating activity on its behalf. Any profits earned this way are directed towards the CSO in the form of a donation or similar. It is important to bear in mind that such an entity is treated as any other business and enjoys no preferential treatment or tax breaks. There have been some examples of CSOs in Croatia resorting to this solution; however, these occurrences are very rare.

4.3 Competition with the For-Profit Sector

In spite of the seemingly favorable fiscal framework which puts CSOs conducting commercial activities in a privileged position in comparison to their for-profit counterparts, to date there has been no record of complaints of for-profit entities on the account of unfair competition. The main reason for this probably lies in the fact that the number of CSOs engaging in self-financing is relatively limited, as is the volume and type of commercial activities they undertake. As a matter of fact, the competent tax authority has to date received no complaints from any interested party on the ground of a CSO having acquired an "unjustified privilege on the market."

4.4 Perception of CSOs

Although forms of civil engagement and association have existed prior to 1990, civil society in Croatia started gaining ground only with the change of the regime. It is unfortunate that this process coincided with the war in Croatia, which created a very hostile environment in which the civil sector ultimately emerged. As Croatia's independence from former Yugoslavia was accompanied by fierce state nationalism, centralization and corruption, any dissenting views on the course of events were automatically perceived by the authorities as subversive and anti-state. Since a major impetus for the development of civil society was provided by foreign actors, largely donors



Box 4a. CASE STUDY: FUNDACIÓN HOGAR DE CRISTO



Hogar de Cristo was founded in 1944 by the Jesuit priest Father Alberto Hurtado and is currently the largest operating and grantmaking foundation in Chile. It provides assistance to the marginal poor, with projects focused in six key areas: 1) children and youth; 2) community centers; 3) senior citizens; 4) hospices; 5) health; and 6) social risks. Among its various programs, Hogar de Cristo operates shelters, hospices, and homes for children and the elderly; provides funeral services to those who cannot afford them; offers scholarships to children and youth to attend schools; extends credit to unemployed individuals to start their own businesses; and provides housing support.

Hogar de Cristo is an extremely large and far-reaching organization with over 2,000 staff members and fifty affiliate offices throughout the country. It has been specially recognized by the President of the Republic as a welfare institution and is therefore exempt from paying taxes on income generated from commercial activities, as long as these activities are related to the organization's mission and the levels of income are not disproportionately high.

Most of Hogar de Cristo's activities are either classified as donations or considered mission-related, so the foundation does not pay tax on income generated by these activities. Income received from membership dues, Padre Hurtado products, announcements made on behalf of family and friends at religious services, and advertisements in *Noticias* magazine, which is distributed to the organization's members, are all treated as donations and are therefore exempt from income tax. Contract fees paid to the foundation by the government and voluntary fees for services paid by clients are all tax-exempt, since they are considered directly related to the foundation's mission and are treated as a subsidy.

Hogar de Cristo has also established a private business, the Hogar de Cristo Funeral Homes, which is set up to generate profit and therefore pays income taxes. Frequently these profits are low because Hogar de Cristo owns the funeral limousines and rents them to the Funeral Homes, an arrangement that raises the costs of the business and thus reduces its taxable profit. All profits after taxes are donated to Hogar de Cristo for mission-related purposes. In this way, Hogar de Cristo collects tax-free rents from its business on money that would otherwise be taxed as income.

Hogar does sell services and products, but it treats most of these sales as donations and does not provide a bill or charge VAT. For example, the majority of the products from Hogar's gift shops are offered to customers with a suggested donation. Although this exchange strongly resembles a sale, it is legally treated as a donation and therefore is not taxed. The only exception to this is for the sale of Christmas cards, which Hogar sells to customers with the 18% VAT included in the price. Like for-profit businesses, Hogar is also able to recoup the VAT that it pays in purchasing the materials necessary to produce the cards.

Hogar de Cristo conducts a range of activities that generate income for the organization. Some, like the funeral home and the sale of Christmas cards, are specifically organized as for-profit ventures and are therefore taxed, while others, like the sale of gift shop items, membership dues, and advertisements in *Noticias* magazine, are treated as donations and are thus tax-exempt. These activities are vital to both the financial sustainability of Hogar de Cristo and the promotion of its social mission, and they do not in any way reflect the commercialization of the organization.



providing humanitarian aid and funding for human rights and anti-war initiatives, CSOs were often accused of being agents of international agendas and interests. Although the environment has changed significantly since the 1990s, a general distrust toward the civil sector has persisted to date. Against this backdrop, it becomes especially important that CSOs engage in self-financing activities and social enterprise in a transparent and ethical manner, being very clear about how the self-financing activities can potentially enhance their mission goals.³³

4.5 Reforming the System

Thus far, this guide has provided an overview of the legal framework regulating CSO commercial activities in Croatia and a review of its practical implications. This section presents a critique of the existing system and offers recommendations for improvement of the current situation. It is hoped that these ideas will inform the debate on how CSO commercial activities are regulated with the ultimate objective of promoting such activities, strengthening the organizations that conduct them and enhancing their abilities to contribute to Croatian society. Emphasis is placed on three aspects of the system which could be improved to create a more favorable environment for CSOs and their commercial activities.

1. The interpretation of the unjustified market privilege criterion is lacking. As reviewed in section 3.3.1, CSOs are exempt from taxation on income generated through commercial activity. Nevertheless, CSOs may lose the exemption status if the competent tax authority finds that the CSOs as a result of this activity have acquired an "unjustified position on the market." The interpretation of the criterion is not provided by the law and, to date, none has been offered by the competent authorities. This allows much room for arbitrariness as the interpretation is left to officials generally lacking an understanding of the significance

and role of the civil society and operating in an environment which is still hostile to CSO activity.

2. Enabling environment for CSOs to engage in commercial activities is lacking. Although CSOs are by law allowed to engage in commercial activities, their scope and volume have not been defined. In practice, therefore, CSOs may be denied registration if their statutes include references to commercial activities. Moreover, excessive bureaucracy of the state administration poses additional burdens on CSOs planning to or engaging in commercial activities. This implies that in effect, the legal and administrative frameworks are not truly conducive to the engagement of CSOs in commercial activity which is vital for the sector's sustainability in Croatia.

3. The law does not recognize the concept of public benefit status. Croatian regulatory framework is not familiar with the concept of CSOs whose not-for-profit purpose is intended to promote a public good. This is a serious shortcoming as various types of associations pursuing various goals are placed on the same standing, effectively disadvantaging CSOs operated to provide a public benefit.

In response to the three criticisms presented above, the following recommendations are offered:

1. Clarify the criteria for allowing CSOs to engage in commercial activities so that no undue obstacles arise during the registration process.

2. Provide a solid and unequivocal interpretation of the unjust market privilege criterion within the context of the CSO commercial activity.

3. Consider introducing the concept of public benefit organizations in legislation regulating civil society specifying the criteria, rights and obligations of organizations receiving such status. A more particular legal framework taking into



account the subtleties and varied needs of CSOs would be more conducive to the development of civil society in Croatia.³⁴

- As the experience of countries in which the concept of public benefit organization (PBO) exists has shown, such legislation would also tend to have a positive impact on commercial activities undertaken by CSOs through the breaks PBOs may receive on various local taxes and customs duties that could be imposed on profits of their commercial activities. Those PBOs whose mission activity coincides with their commercial activity can even receive complete exemption from corporate income tax.

4. Implement these recommendations in a participatory manner, involving a broad base of CSOs in the process.

Conclusion

As indicated in the previous chapters of this guide, the Croatian legal framework allows CSOs to engage in commercial activity under circumstances which are nominally more favorable than those regulating the activity of for-profit entities. Although under the present systems CSO commercial activity is tax exempt, the practice of self-financing is not widespread among Croatian CSOs. The reason for this partly lies in the lack of capacity and entrepreneurship on the part of the CSOs and partly is due to the shortcomings of the system as it is vulnerable to potential arbitrariness by tax and registration authorities.

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Public benefit status is constantly on the agenda of nonprofit professionals in Croatia. The latest development is a workshop organized by ECNL and the National Foundation for Civil Society Development in Zagreb, in December 2005. The goal of the workshop was to compare the current regulatory framework affecting public benefit status in Croatia with European regulatory practices. Analysis concluded that there was a need to adopt a more coherent policy on the issue. The key recommendation was to introduce a uniform public benefit organization concept and clearly define the criteria that each legal entity must meet, should they wish to obtain this status and the corresponding tax benefits. This way, public benefit would not be a function of legal entity type or field of activity and would not allow for discrimination based on these.