



**Nonprofit
Enterprise and
Self-sustainability
Team (NESST)**



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

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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 Chile 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 Chile. 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 Chile. The chapter illustrates that although some CSO self-financing activities are permitted in Chile, 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 Chilean legal framework, assess its current strengths and weaknesses, and make recommendations for improvement.

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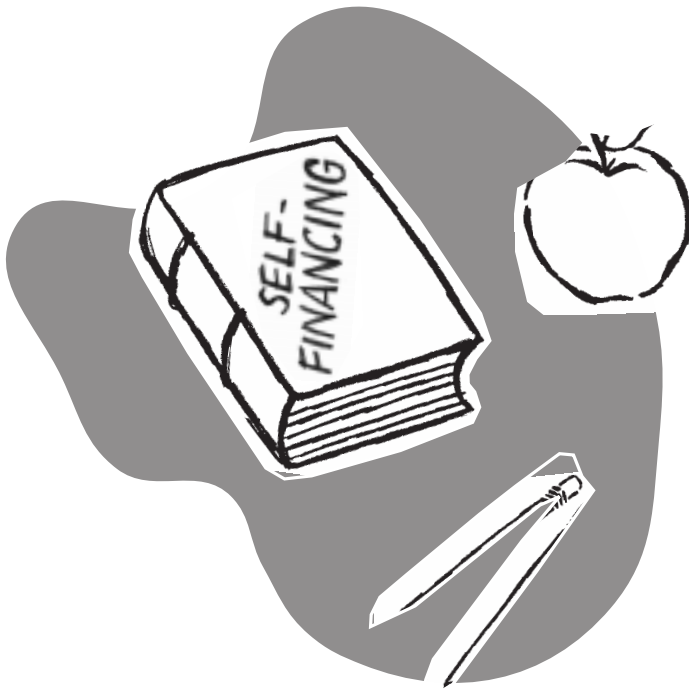
Felipe Viveros conducted the legal research and provided all of the legal information related to the guide. Mr. Viveros is a leading expert on Chilean nonprofit law and is currently a professor and researcher at the Law Faculties of Diego Portales University and Bolivariana University and a mediator for the of Conflict Resolution Program within the Ministry of Justice. **Cristina de Molina**, Development Director of CDI Chile, coordinated the initial research, including the adaptation of NESsT's legal research questionnaire. **María Isabel García-Reyes**, a Chilean lawyer, professionally translated the guide from English to Spanish. **Cy Hersch**, NESsT Entrepreneur-in-Residence, offered clear and thoughtful feedback on the various drafts. The **International Center for Not-for-Profit Law (ICNL)** provided the typology for classifying the use of economic or commercial activities among CSOs and the framework for assessing the Chilean legislation. **Piera Lombardi** and **Jose Neira** of Tesis provided the design and layout of the guide. **Janis Foster** professionally edited the final document. **María de la Luz Melo Fuentealba** shared her legal expertise during the research and writing process. **Verónica Moggia**, Executive Director of Fundación Valora, offered helpful comments on a draft of the document. **María Angélica Ponce** provided expert advise on accounting issues relevant to the guide. **Jorge Razeto**, Director of Corporación CIEM, provided the information for the case study of the Corporación. **Julio Viveros**, Director of the Legal Unit for Hogar de Cristo, provided the information for the case study of the Fundación.

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Setting the Stage: Purpose and Methodology



The term “civil society organization” (CSO)¹ 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 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.

The purpose of this guide is to clarify the legal framework faced by Chilean CSOs and to 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 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 in exchange for some kind of product, service, or other benefit (e.g., a CSO provides a newsletter or magazine to its members and/or discounts on CSO products or services).
- **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 the 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 active and 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 missions, 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 placement 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 organization 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, many Chilean 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 Latin America in general, and in Chile in particular, demonstrates that many of them do not have the internal capacity (i.e., staff skills and time, adequate financial systems, stakeholder support, 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, a great deal of stress is put directly on their staff and indirectly on their other programs and their underlying missions. 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 engaging in self-financing activities highlight the need to understand the legal environment affecting them in Chile. In this context, the purpose of this legal guide is twofold:

1. **To outline the key laws, regulations, and procedures governing the use of self-financing by CSOs in Chile.** Chapter 3 explains what Chilean law says about the use of self-financing and dis-

cusses 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 and maintain such activities. The chapter does not provide a step-by-step description of how to navigate the law, because there is no one approach applicable to all CSOs. However, it does offer a general overview of these laws and regulations, so that Chilean 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.

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2. **To assess the relevant laws governing CSO self-financing activities in Chile, to evaluate their practical effects, and to identify areas where the law might be improved.** This guide identifies the strengths and weaknesses of Chilean laws—whether they help or hinder the use of self-financing, whether they allow for transparent 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 to assess.

The typology was first developed by the International Center for Not-for-Profit Law (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.² The ICNL typology is presented in Chapter 2; Chile'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 Latin America. In 1999, NESsT began conducting applied research on CSO self-financing in Latin America, particularly in Chile and Colombia, 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 Latin America. NESsT completed case studies documenting successes and obstacles in CSO self-financing activity in seven Latin American countries.
- To examine the current legal environment for CSO self-financing in the region overall, and particularly in Chile and Colombia, 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.

The research for this guide was conducted using a methodology developed by NESsT to evaluate the legal environment for CSO self-financing activity in a particular country. NESsT uses an extensive questionnaire that includes sets of questions in four key areas:

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

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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 <http://www.icnl.org>.

ry 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 Felipe Viveros, a leading nonprofit lawyer and academic in Chile with extensive experience in analyzing the Chilean legal framework governing CSOs, to adapt and respond to the questionnaire. His research drew upon his own knowledge of Chilean legislation, as well as on consultations and interviews with an array of individuals and institutions including lawyers with nonprofit law expertise, CSOs, and other experts familiar with nonprofit law and/or involved in drafting or lobbying for changes in the law regarding tax treatment of CSOs, etc.

NESsT and Mr. Viveros also convened a focus group consisting of sixteen lawyers and representatives from Chilean CSOs to respond to a series of more open-ended questions regarding the use of self-financing among CSOs and the legal framework governing this use. Interestingly, the focus group participants spent most of their time on the first part of the discussion and very little on the second. Perhaps the fact that the invited groups were chosen based upon their overall experience as CSOs and not specifically upon their knowledge or use of self-financing, explains why they were keen to discuss the broader issue and not as interested in the issues specifically related to legislation. However, the discussion generated a great deal of debate around whether

CSOs should or should not use self-financing activities as a form of financial sustainability and, if so, on whether they should be treated like for-profit entities when they do. This discussion confirmed the underlying need for the guide as a tool that could be helpful in clarifying the legal framework for self-financing activities in Chile and introducing new perspectives from which to assess this framework.

The data from the questionnaire and the focus group were collected and assessed by Mr. Viveros and then used by NESsT in preparing the guide. NESsT drew upon its case study research as well as interviews with several CSOs using self-financing to develop illustrative examples of how the legislation plays out in reality. The guide was reviewed by other nonprofit lawyers as well as by CSO representatives for accuracy and clarity.



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 Law (ICNL).³ NESsT has expanded and modified it to be more applicable to the Chilean legal system. The following section presents four key areas that are vital for understanding the legal structure for CSO self-financing before assessing the specifics of Chile: 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. Chilean laws are consistent with the broad scope of organizations encompassed by the term “CSO.”

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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).

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 NPOs and generally the same regulations apply, *but this guide will address only those NPOs that pursue the public benefit*. There is no fixed way of determining what constitutes the public benefit, and Chilean laws do not distinguish between NPOs on this basis. 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.

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

[Organizations are considered NPOs] as long as they provide a public benefit and uphold the principle of non-distribution.

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. However, “self-financing” is not a term commonly used in Chile, so, for purposes of clarity to the readers, this guide refers to “commercial activities” as the practices that CSOs adopt to generate their own resources. While this term includes both mission-related and non-mission-related activities (as discussed in section 1.1) and does not distinguish between activities conducted by CSOs and for-profit entities, these differences are central to the discussion of Chilean laws that follows in Chapters 3 and 4.

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.”⁴ 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 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 (particular-

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

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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 nonprofit organizations.



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.

As the following chapter will discuss, Chile taxes most CSOs on income from all of their economic activities, along the lines of the blanket tax treatment presented above. However, those CSOs that are considered welfare institutions because they work to alleviate poverty are eligible to apply for a full exemption

from income tax from the President of the Republic. Only CSOs that meet the criteria of welfare institutions—which generally do not include those that focus on issues related to health, education, culture, human rights, or the environment—are considered for this exemption. This represents a form of mechanical test treatment since the end result is to categorize

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.

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

CSOs as either welfare institutions or not. However, this “mechanical test” is not based on a set of fixed criteria that is well-known to the public, but is rather made internally by the Ministry of Finance as will be discussed in section 3.4.1. Once an organization is classified under this category, the tax treatment is determined by the source-of-income test where revenues generated by mission-related commercial activities are exempt from income tax.

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

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 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.

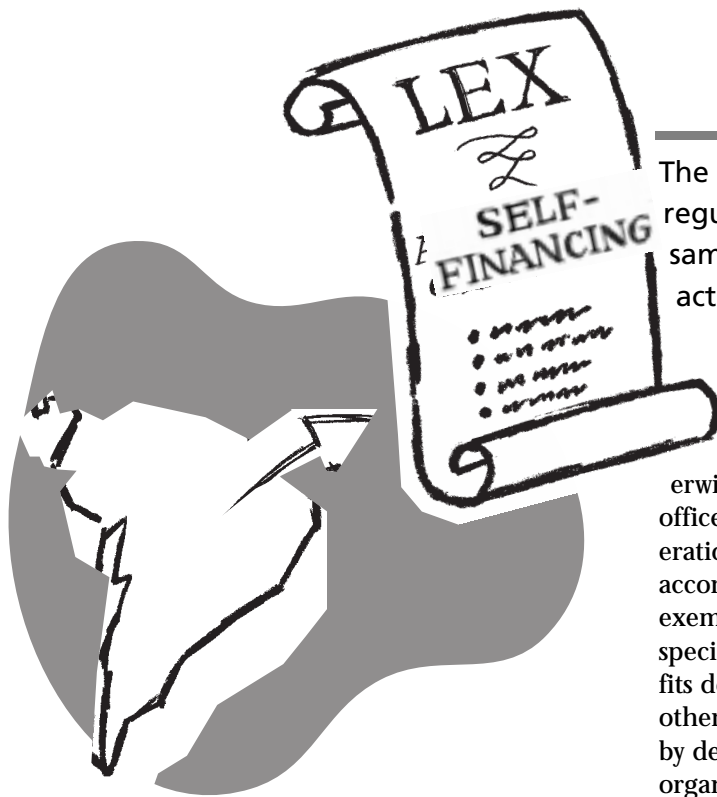
The destination-of-income rule provides the greatest potential revenue to NPOs, since virtually any income can be made tax-exempt if channeled into public-benefit activities. The mission-relatedness test is less favorable to NPOs because activities that are undertaken purely to obtain revenue enjoy no 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.

Chapter 1 presented a background for understanding CSO commercial activities; Chapter 2 established the analytical typology for assessing the legal framework that governs such activities. Chapter 3 discusses the Chilean laws and regulations that are relevant to CSO commercial activities. Chapter 4 evaluates the existing Chilean legislation using the typology presented in Chapter 2.



The Chilean Legal and Regulatory Framework



The Chilean legal framework generally regulates CSO commercial activities in the same way that it treats commercial activities conducted by for-profit entities.

The same taxes are charged at the same rates and the same filing reports are required for both types of entities. There is, however, a notable exception to this otherwise blanket treatment. CSOs may apply to the office of the President of the Republic for consideration as welfare institutions, a status that accords an exemption on income tax. This exemption represents a significant benefit in the specific area of income taxation, but these benefits do not extend to eligible organizations in other tax areas. Furthermore, these benefits are by definition limited to welfare institutions, and organizations working in the areas of health, education, culture, human rights, or the environment are generally not granted this favorable classification. In this sense, although the Chilean legal system does promote some CSOs through special, albeit limited, tax treatment, it does not extend this benefit to support the overall development of civil society.

3.1 General Regulations for CSOs

CSOs in Chile are governed by Articles 545 through 564, which are contained in Book I, Title XXXIII of the Civil Code. The Civil Code was enacted in 1855 and specifically reformed with respect to organizations now considered CSOs in 1931 and 1943. It is worth noting that Book I, Title XXXIII of the Civil Code does not refer to “civil society organizations,” but is titled “Juridical Persons.” This term includes both nonprofit and for-profit entities, but Title XXXIII only addresses nonprofit entities. Nonprofit entities may be organized as either corporations or foundations; the principal difference between these two legal statuses is that corporations are formed as an association of individuals, while foundations are formed with an endowment of financial or physical resources by one or more founders.⁵

Regulations contained in the Civil Code deal with general aspects of such organizations. These include, among other matters, the way organizations are organized, their administration and assets, the liability of partners or members, government supervision, the bylaws and their reform, and dissolution and the effects thereof. Commercial, tax, labor, health, urban development, and other specific regulations that may apply to CSOs are covered under various laws that make no distinctions among the juridical subjects of the regulation. In other words, such regulations do not have separate clauses that define a distinct treatment for CSOs. Rather, these regulations apply generally to CSOs, just as they do to for-profit entities, based on their actions or situations as employers, taxpayers, economic subjects, etc.

A CSO with legal status may perform all manner of juridical acts. There are no restrictions or limitations on the clause of the bylaws empowering

the board of directors to represent and manage the CSO with full powers. A CSO may, among other things, operate in or out of court, perform acts, and execute civil, mercantile, labor, and administrative contracts. The provisions of Book I, Title XXXIII of the Civil Code that deal specifically with CSOs are supplemented and developed in detail under Supreme Decree 110 of 1979, which contains regulations for granting juridical status to corporations and foundations.

3.2 Pending Amendments to the Current Law

In recent years, particularly since the beginning of President Ricardo Lagos’ term of office in 2000, public discourse has evolved on the need for a more appropriate legal environment to regulate the operation and development of CSOs. Lagos initiated this dialogue with a specific commitment to support CSOs during his 1999 presidential campaign. In the course of 2000, the policy-making responsibilities for strengthening civil society and civil society organizations were lodged by order of the President in the Division of Social Organizations under the purview of the Ministry of the Government Secretariat (previously it had operated in the Ministry of Development and Planning).

Various initiatives stemmed from this effort. In 2000, President Lagos summoned representatives of CSOs to participate in the Citizen Council for Strengthening Civil Society, which, after meeting for several months, produced a final report with proposals to the President. President Lagos responded with a Plan for Strengthening Civil Society, a set of Presidential Instructions for Citizen Participation and, more recently, a Program to Strengthen Alliances between Civil

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⁵ For specific definitions of corporations and foundations, see Title XXXIII of Book I of the Civil Code and Supreme Decree No. 110 of the Ministry of Justice (1979).

Society and the State. This latter program is conceived as a frame agreement between the Chilean government and the Inter-American Development Bank. It features a substantial “loan for innovation” to initiate both investigations and concrete action designed to assist CSOs in areas such as legal frameworks, training needs, perceptions of their role in Chilean society, and volunteerism.

The Division of Social Organizations has created a series of public initiatives to implement the commitments of the state to the civil society sector. One such line of action features diagnosis and criticism of legislation applicable to CSOs, including proposals to amend the law and regulations. While these efforts reflect a government commitment to civil society in general, there has been little discussion of CSO commercial activities or the regulations that govern them.

3.3 CSOs and Commercial Activities

The Civil Code contains no special provisions regarding economic or commercial activities by CSOs. In principle, the general rules of private law apply; that is, CSOs, in their capacity as private-law juridical persons, are subject to the common provisions that govern the commercial activities of any person understood as a subject of law. This means that the law does not specifically restrict or promote the acts and contracts in which CSOs may engage.

In general, CSOs may pursue their missions “by all available means.”⁶ With regard to assets, CSOs have equally broad capability: “Foundations and corporations may acquire assets of any kind for any reason.”⁷ CSOs may pursue commercial activi-

ties as long as they are not principal activities, but rather are incidental or supplementary operations of the organization or assist in promoting its mission. However, there are no strict definitions for determining whether CSOs’ commercial activities are conducted at acceptably low levels; the Ministry of Justice has oversight of CSOs in general

CSOs may pursue commercial activities as long as they are not principal activities, but rather are incidental or supplementary operations of the organization or assist in promoting its mission.

matters and may act according to its judgment, as discussed in section 3.6. When a CSO does engage in commercial activities, the surplus income generated must be applied to the mis-

sion of the organization as described in its bylaws, and any commercial activities should not alter the moral, ideal, or social purpose of the CSO (this is an example of the destination-of-income test).

3.4 Taxes on Commercial Activities

Like their for-profit counterparts, CSOs engaging in commercial activities are required to pay several taxes related to their enterprises. This section enumerates these various taxes.⁸

3.4.1 Income Tax

Article 2(1) of the Income Tax Law provides that income is understood to be “earnings that are profits or benefits yielded by a thing or an activity, and all benefits, profits, and increments of property received or accrued, of whatever nature, origin, or denomination.” What determines whether a tax must be paid is the generating of “income,” which in legal terms corresponds to the earnings that arise from any profession, trade, or activity.

The same Income Tax Law provides that taxpayers are any persons resident in Chile, whether natural or juridical persons, including communities

⁶ Supreme Decree No. 110, Article 6, paragraph 2 of the Regulations for Juridical Persons (1979).

⁷ Article 556 of the Civil Code.

⁸ For complete information on taxes, including the actual texts of relevant laws, consult <http://www.sii.cl>, which is the website for the Chilean internal revenue service, known as the Servicio de Impuestos Internos (SII).



and temporary associations, that pay taxes on their income from whatever origin and whether the source of income is located inside or outside the country. Persons not resident in Chile shall be taxed on their income originating inside the country.⁹

The structure of income tax in Chile is twofold:

1. Category tax, which has a fixed rate and breaks down into

a. first-category tax, which taxes profit (income minus expenses) from capital (real property, securities, and income from business). Under the reform in law 19,750, the tax rate will increase gradually during a transitional period until 2004, after which the full rate of 17% will apply;¹⁰ and

b. second-category tax, which taxes income from work (employment, lucrative professions, and other activities where personal effort predominates, as well as professional partnerships choosing this system). Its rate is 10%, but this tax does not apply to CSOs.

2. Supplementary tax, which is a personal tax and is assessed on all income received by the taxpayer and arising from any source or activity inside Chilean territory (withdrawals or profits from business, rents, interest, compensation for dependent or independent work). Its rate is progressive and ranges from 0% on monthly incomes of 13.5 UTM (monthly tax units) or less to 40% on incomes greater than 150 UTM. There are intermediate brackets taxable in a similar way.¹¹ This tax applies only to natural persons and does not affect CSOs.

For-profit businesses as well as nonprofit organizations that have commercial activities must pay first-category tax. This is an annual tax that is paid for any profit generated by the business or organization; in the month of April of each year all profits earned during the prior calendar year must be declared and are subject to the 17% rate (see footnote on page 10). Taxpayers should make a provisional monthly payment (PMP) on gross income based on estimated annual taxes. If this amount exceeds the final tax owed in April of the following year, the taxpayer receives the difference; if the amount is less, then the taxpayer pays what is owed. The PMP is calculated using a variable rate that is determined and adjusted annually based on the relationship between the total monthly PMP and the annual income tax rate. This means that if the PMP is higher than the established tax rate, the rate will decrease proportionally; if it is lower, the rate will increase during the subsequent period; and if there are losses no PMP is paid (the idea is that the PMP amount will be more or less equal to the final tax owed). Since most CSO operate commercial activities at low levels, they usually are returned most of the PMP.

The category tax paid by a for-profit entity is generally considered a tax credit in favor of the natural taxpaying persons—such as owners, partners, or shareholders—that are bound to pay supplementary tax. Since CSOs, by legal definition, have no partners in the commercial sense, PMP cannot be credited. This does not directly affect CSOs, since all entities pay the flat 17% tax, but it does provide a substantial tax benefit to investors in for-profit entities, who are not “double-taxed” on their earnings in Chile as they would be in many other countries. CSOs receive no comparable tax advantage.

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Articles 3, 5, and 6 of the Income Tax Law.

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The first-category tax rate was 15% in 2001 and is scheduled to increase by 0.5% annually until it is fully phased in at 17% in 2004. When referring to the first-category tax, this guide uses the full rate of 17% even though this rate is not scheduled to take effect until after the guide's publication.

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The rates described were set by Law No. 19,753 (Diario Oficial, September 28, 2001), which reduced income tax applicable to natural persons. As will be seen in the text, this rebate applies to second-category tax and supplementary tax. The new rates, however, will enter into full force as of calendar year 2004.

Although the majority of CSOs are required to pay the first-category tax on income generated from commercial activities, some CSOs are eligible for an exemption from this tax. Article 40(4) of the Income Tax Law provides an exemption from first-category tax for those welfare institutions recognized as such by the President of the Republic; these organizations may receive the income tax exemption only when their commercial activities are mission-related. The law states that this benefit applies only to non-profit-making institutions whose main purpose under their bylaws is to render material or other assistance to low-income individuals.

The authority to determine this exemption is officially a power of the President of the Republic, but in effect the decision is made within the Ministry of Finance by the Servicio de Impuestos Internos (SII). Eligible CSOs may apply free of charge for the exemption from the Ministry of Finance. Applicants must submit basic legal documents, their most recent balance sheets and accounting status, and a declaration of which activities are currently producing or expected to produce income related to the exemption. There are no fixed criteria for classifying CSOs and the SII has the legal authority to interpret the tax laws and to apply judgment based on internally-established criteria that are not available to the public. Generally, these exemptions tend to exclude community-based CSOs and those that work in areas such as health, education, culture, human rights, or the environment, although the Ministry of Finance may consider some of the organizations welfare institutions if they operate in low-income communities. In cases where the Ministry rules in favor of the exemption for a CSO, it issues a specific decree that is published in the Diario Oficial (Official Gazette). Once an entity has obtained the benefit, it must continue to submit monthly income declarations, year-end profit statements, and monthly payments under the VAT law discussed below in section 3.4.2.

In summary, CSOs conducting commercial activities are dealt with in principle as though they were for-profit entities. The Income Tax Law treats all entities engaging in commercial activities as taxpayers, and any organization seeking an exemption must demonstrate its special status as a welfare institution to the Ministry of Finance as described above. While it is possible for some CSOs to obtain exemptions under the law, current practices often limit the granting of exemptions to deserving organizations, and other organizations—including those working in culture, human rights, and the environment—are usually ineligible to apply.

Box 3a PARTIAL LIST OF INSTITUTIONS EXEMPT FROM INCOME TAX

The following is a partial list of CSOs recognized by the President of the Republic under Article 40 (4) of the Income Tax Law and exempt from paying tax on income generated from commercial activities:

- Fundación San José de La Dehesa
 - Fundación Doctor Alfredo Gantz Mann
 - Fundación Instituto Chileno de Medicina Reproductiva
 - Fundación Hogar de Cristo
 - Corporación para el Desarrollo Integral de la Octava Región
 - Corporación Demos una Oportunidad al Menor
 - Corporación CEAFIT
 - Fundación Techo para Cristo
 - Fundación Gente para un Amor Nuevo
 - Congregación Religiosa Purísimo Corazón de María
 - Fundación Paicavi
 - Corporación Obispo Enrique Alvear Urrutia
 - Fundación de Desarrollo Social INVICA
 - Fundación para la Promoción y Desarrollo de la Mujer (PRODEMU)
 - Fundación Hogar de Ancianos de la Santa Cruz
 - Fundación Metropolitana Central de Desarrollo Social y Salud
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3.4.2 Value-Added Tax

Another important tax in Chile is the value-added tax (VAT) of 18% on sales and services. “Value-added” refers to the greater value added to an item at each stage in its production or commercialization process. The tax is determined by adding all of the value added tax charged on receipts and invoices for sale of goods and services; and subtracting from this amount, the sum of the vat paid on all invoices from suppliers. In addition to sales and services, items subject to VAT include imports and exports, contributions, assignments, withdrawal of personal property, and all other assets related to the line of business as described under Article 8 of the VAT Law (Law Decree 825 of 1974). The seller or supplier of services collects VAT from consumers and then makes monthly payments to the Treasury. VAT is built into the price of the good, so the VAT on a good that sells for CLP (Chilean pesos) 1,000 would be CLP 180 and the seller would be required to submit this amount to the Treasury.

Taxpayers liable to this tax include anyone having the status of “habitual seller” or “supplier of services whether habitual or otherwise.” A CSO seeking to open a commercial line of business of any kind must necessarily be considered a VAT taxpayer. It is worth noting that welfare institutions may apply to the President for an exemption on income generated from their commercial activities, but they do not have the possibility of obtaining an exemption from the VAT they pay when purchasing goods unrelated to these for-profit activities. For example, a soup kitchen must pay VAT on the food it purchases and then provides free of charge to its clients.

There are a few very special exemptions from VAT that apply to certain payments and services that may be related to the CSO’s mission or activity.

These exemptions are enumerated in Law Decree 825, Articles 12 and 13, and apply, among other things, to the sale of tickets to artistic, scientific, or cultural events sponsored by the Ministry of Education; tickets to sports and games; and tickets to performances benefiting the Fire Brigades, the Red Cross, the National Kindergarten Commission, CEMA/CHILE, and charity institutions with legal status.

Similarly, exemption from VAT applies to radio stations and TV channel concession holders on income received from their line of business, except advertising of any kind. Exemptions are also extended to educational establishments on income received for their teaching activities. It is worth nothing that courses or other capacity-building activities offered by CSOs fall under this category and are therefore exempt from VAT. Hospitals owned and operated by the state or by state-recognized universities are exempt, but health care units belonging to a CSO are subject to VAT.

With the exception of the exemptions listed above, all entities—for-profit or nonprofit alike—engaging in commercial activities collect VAT on their sales and pass along these revenues to the Treasury. At the same time, all entities may recoup the VAT they paid on purchases related to the products they sell by submitting receipts to the Treasury. For example, an organization or business that buys CLP 10,000 in raw wood materials would pay VAT of 18% or CLP 1,800, which is included in the price of its purchase. If it sells the furniture it makes from these raw materials for CLP 15,000, 18% of this sum (CLP 2,700) represents the VAT that must be paid to the Treasury. However, of the CLP 2,700 that it must pay to the Treasury, the entity can recoup the full CLP 1,800 that it paid in VAT when it bought the raw wood materials. In this way, the entity is taxed only 18% (in this case, CLP 900) on the value it added to

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Article 12(e)(1), VAT Law (Law Decree 825 of 1974).

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Article 13(1) and 13(4), VAT Law (Law Decree 825 of 1974)).

the price of the raw materials (in this case, a value of CLP 5,000 was added—the organization bought the raw materials for CLP 10,000 and sold the finished products for CLP 15,000). Since this amount is included in the price of the good, the tax is passed on to the consumer. With respect to VAT, uniform treatment applies to both CSOs and for-profit entities.

3.4.3 Other Taxes

Several other taxes apply to CSOs conducting commercial activities, as described below.

1. **Estate tax, assignments, and donations.** This issue may concern CSOs benefiting from legacies or receiving donations in money or property in substantial amounts. Article 18 of Law No. 16,271 provides that exemption from this tax applies to organizations whose sole purpose is charity, dissemination of instruction, or the progress of science in the country. The President of the Republic may also declare an exemption for a CSO exclusively devoted to a purpose in the public good.
2. **Municipal tax.** Any entity—for-profit or non-profit—must apply for a municipal license and pay the associated fee in order to receive legal permission to conduct a commercial activity. These licenses are generally relatively easy to acquire and the related fees are usually minimal (though the costs may be significant for a low-level commercial activity). Often there is no fixed fee so the municipality where the commercial activity is located has the discretion to determine this amount, within certain parameters established by the Law of Municipal Taxes.

CSOs are exempt from paying the municipal license fee as established under Article 27 of the Law of Municipal Taxes, but in practice many CSOs pay these fees, which suggests that this provision is not widely known within the sector. This exemption applies to legally constituted nonprofit organizations (nonprofit juridical persons) that engage in welfare, religion, culture, the arts, amateur sports, or the promotion of community interests.

3. **Land tax.** This tax is regulated by Law No. 17,235 of 1969 and is a tax or assessment on real property partly for fiscal benefit and partly for municipal benefit, including a portion that goes to a so-called municipal common fund.

The land tax must be paid by the owner or occupant of the property (who is under the liability of the owner). The tax also applies to any occupant or concessionaire of a fiscal, municipal, or national property for public use. Under the law, real property is submitted to fiscal appraisal from time to time and is taxed based on this assessment. For this purpose, properties are divided into agricultural and non-agricultural properties.

Under the land tax law, the real properties listed in Annex No. 1 of Law No. 17,235 are exempt from this tax. The annex lists over 200 special cases of total or partial exemption from this tax, but there is no general exemption for the benefit of “nonprofit juridical persons.”¹⁴

4. **Stamp tax.** The stamp tax is regulated by Law Decree No. 3,475 of 1980 and applies to certain legal proceedings and documents, such as bills

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The beneficiaries of tax exemption listed in the annex to Law No. 17,235 include, among other public and private bodies, the fire brigades, the Mutualist Confederation of Chile, the municipalities, the traditional universities, the Diego Echeverría Castro Foundation in Quillota, the Foundation for the Historical Commemoration of Bernardo O’Higgins, the Pedro Montt Foundation, and the Salomón Sack Foundation. Also exempt are the Chilean Bar Association and other professional colleges created by law in respect of their permanent headquarters; the indigenous communities as long as they

remain undivided; mutual assistance societies; the Society of Primary Instruction; establishments devoted to education or sports and recreation; privately owned properties leased or turned over to the state for educational purposes; museums, archives, libraries, stadiums, and other properties in the purview of the Ministry of Education; landmark buildings; hospitals, hospices, orphanages, and other establishments that provide assistance or free accommodation to the destitute or homeless; and churches or temples of religious worship and ancillary facilities occupied by their staff, to the extent that they are exclusively devoted to such services and produce no rents.

Box 3b OTHER NOTEWORTHY LAWS

Aside from general provisions contained in the tax laws proper, other laws provide for certain exemptions for specific promotion and development purposes. Some of these exemptions follow:

1. Neighborhood councils, indigenous associations, and other community organizations

Article 4 of Law 19,418 (1995) on Neighborhood Councils and other Community Organizations provides that neighborhood councils and other community organizations shall be exempt from all assessments, taxes, and fiscal and municipal dues except as provided under Law Decree No. 825 of 1974 (the VAT Law). In turn, donations or testamentary assignments instituted for the benefit of such community organizations shall be exempt from any and all taxes and from judicial permit procedure.

The above benefits also apply to indigenous associations, pursuant to Article 37 of Law No. 19,253 (1993) on Protection and Development of Indigenous Groups.

2. Cooperatives

Article 54 of the General Law on Cooperatives (Supreme Decree No. 502 issued by the Ministry of Economic Affairs) provides that cooperatives shall be exempt from the following encumbrances:

- a. 50% of all assessments, taxes, charges, and other tax encumbrances for fiscal benefit. They shall nonetheless be subject to VAT pursuant to Law Decree 825 of 1974. Nor may they benefit from customs privileges under Supreme Decree No. 1 of 1979 issued by the Ministry of Finance.
- b. All taxes provided under the stamp law on legal proceedings, conventions, and other procedures listed therein, on all documents associated with their organizations, registration, internal operation, and judicial proceedings.
- c. 50% of all municipal assessments, duties, taxes, and patents, except those referring to manufacture and sale of alcoholic beverages and tobacco. Notwithstanding, consumption and service cooperatives must pay all applicable taxes on operations associated with their specific mission conducted with non-members.

3. Disabled persons

Article 39 of Law 19,284 (1994) on Provisions for Full

Integration of Disabled Persons into the Society provides that nonprofit juridical persons may apply for the benefits of exemption from customs duties provided under Law No. 17,238 and amended under Law No. 18,349 on import of vehicles for transport of disabled persons served by such organizations in the pursuit of their missions. Exemption applies to a cost free on board equivalent to USD 15,000, aside from special devices as may be necessary for the disabled persons.¹⁵ Such vehicles shall remain devoted to this use for at least five years.

Article 41 of this law provides that nonprofit juridical persons acting under their legal purposes in the field of disability and importing items in compliance with their mission or for the use or benefit of disabled persons served by them, may apply to the Treasury for reimbursement of customs charges paid on import of technical aids for disabled persons, such as prostheses, equipment, drugs, machinery, and working, teaching, and other tools necessary for their mobility, personal care, and communication.

4. Churches and religious organizations

Article 19 (6) of the Constitution, on freedom of conscience and worship, provides that churches, creeds, and religious institutions shall enjoy the rights granted and recognized under prevailing legislation in respect of their property. Temples and their ancillary buildings, if devoted exclusively to serve a form of worship, shall be exempt from all forms of assessment.

Law No. 19,638 (1999) enumerates Norms for Juridical Constitution of Churches and Religious Organizations and developed the above constitutional principles. Under Article 17 of this law, the juridical persons of religious organizations governed by such law shall enjoy the same rights, exemptions, and tax benefits that the Constitution and prevailing laws and regulations grant and recognize in respect of other churches, creeds, and religious institutions existing in Chile.

Article 16 of the above law provides that donations received by the juridical persons referred to under the law shall be exempt from judicial permit procedure if and when the amount does not exceed 25 UTM. In addition, the Land Tax Law, discussed above, contains exemptions on real property devoted to worship or related activities.

of exchange, notes, checks, mutual contracts, and other credit operations. There is no specific exemption from this tax for CSOs.¹⁵

3.5 Tax Filings

With the exception of those organizations officially recognized as welfare institutions, CSOs must comply with the same tax filing requirements in their commercial activities as any for-profit entity. In this context, the commercial laws (contained in the Code of Commerce and its supplementary laws), tax laws, labor laws, and certain administrative or municipal laws apply, together with other special laws applicable to each case according to the specific activity in which the CSO engages.

The SII oversees tax laws that require taxpayers to

- (1) register in the tax registry (RUT) and declare the start of activities before the Servicio de Impuestos Internos (SII);
- (2) issue sales slips, invoices, and waybills associated with the line of business or activity and registered with SII;
- (3) carry complete accounting and issue a balance sheet in accordance with generally accepted accounting principles;
- (4) file an annual income tax return;
- (5) file a monthly statement of sales and services including, as appropriate, payment of VAT, and make mandatory monthly provisional payments against annual taxes;
- (6) file other monthly statements, including tax withholdings made for employees or contracted consultants;
- (7) issue certificates to substantiate payments and receipts (such as tax withholdings made for

- third parties, receipt of donations, etc.);
- (8) keep accounting statements and supporting documents available to SII for a specified period (three to six years, which is the maximum term for extinction of tax obligations).

The need for an accountant or other specialist to assist in these processes depends on the complexity of the commercial activities pursued by the CSO. CSOs must expend their own resources to obtain such services, since they are not provided by any public mechanism or agency.

3.6 Legal Reports

There are two reporting requirements for CSOs:

- (1) to report from time to time to the authorities overseeing the organizations concerned; and
- (2) to file returns as required by tax legislation applicable to all taxpayers under the guidelines discussed above.

Regarding item (1), CSOs organized as private-law corporations and foundations must submit a report on their activities every six months to the Ministry of Justice or the appropriate Regional Secretary of Justice, as well as a balance sheet (this obligation is commonly performed on an annual basis). This obligation stems from the powers of oversight vested in the Ministry of Justice in respect of such juridical persons (Law Decree 1,183 and 1,382, and Supreme Decree 110, described above).

Reports submitted to the Ministry of Justice are not invested with any special formality, except that they must include certain essential information designed to identify the organization and update the Ministry's data. Such

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The term "free on board" means that the cost does not include insurance or freight charges.

¹⁶

Specific exemptions listed in this law include municipalities, universities belonging to the Council of Rectors, fire brigades, cooperatives, institutions with legal status devoted to worship, and certain charity institutions such as Fundación Niño y Patria, Instituto de Viviendas Populares (INVICA), Consejo Nacional de Protección a la Ancianidad (CONAPRAN), Corporación de Ayuda al Menor (CORDAM), and Corporación de Ayuda al Niño Limitado (COANIL).

information includes the legal name of the organization, the number and date of the decree granting it legal status, the date of publication in the Daily official, the address of the organization's main office, and a list of board members currently in office. This last requirement is designed to force CSOs that have failed to hold assemblies or board meetings to comply with this obligation.

Report contents tend to vary by organization. Some organizations submit extensive reports or narratives, whereas others are very succinct. Regarding financial data, the law requires an annual balance sheet in accordance with reliable accounting. Often, however, in the case of CSOs whose size and activity level are small, the authorities will accept a simplified income and expenditure account.

By virtue of its powers, the relevant authority may require that the information submitted be clarified, revised, or supplemented by other data. The penalty for omitting or submitting erroneous information to the Ministry of Justice is usually the Ministry's refusal to certify the effective status of the juridical person concerned, which, in practice, will considerably hamper the organization's day-to-day activities. This is a temporary penalty and is lifted as soon as the breaching organization corrects, clarifies, or completes the required reports to the satisfaction of the Ministry.

As a general rule, the Ministry acts as a passive or virtual controller and receives, registers, and files from time to time the information submitted by the organizations under its supervision. Nevertheless, the Ministry has broad powers to act autonomously in overseeing CSOs and their activities. It may conduct selective investigations or take up any irregularities it detects. Such investigations and audits are performed through accounting or legal inspectors. Although the Ministry rarely exercises its full powers, it is authorized to dissolve an organization that it deems has breached the law by canceling its legal status.

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

The Ministry of Justice carries a register of CSOs that submit reports. This register serves as a file or history of each organization. No estimation has been made of the amounts collected by the Treasury in the past few years from tax payments made by CSOs conducting commercial activities. SII makes no distinction between for-profit businesses and CSOs, but instead records all taxpaying entities under the same general category. Data exist on CSOs declared to be exempt from payment of first-category tax; however, such data are not systematized, nor is there any indication of the overall amount of untaxed income by virtue of this exemption.

Box 3c SPECIFIC LAWS CONCERNING CSO COMMERCIAL ACTIVITIES

CSOs conducting commercial activities should be aware of all laws that may apply to them. The following list groups these laws by legal type:

Tax laws

- Tax Code (contains general rules, obligations binding on all taxpayers, procedures for complaints, application of penalties, collection of taxes in arrears, among other important matters)
- Income Tax Law (Law Decree No. 824 of 1974 and successive amendments thereto)
- Value-Added Tax Law (Law Decree No. 825 of 1974 and successive amendments thereto)
- Land Tax Law (Law No. 17, 235 of 1969)
- Law on Estate Tax and Tax on Assignments and Donations (Law No. 16,271 of 1965)
- Stamp Tax Law (Law Decree No. 3,475 of 1980)

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.

Public-law legislation

- Penal Code (enacted in 1874) and subsequent amendments and supplementary laws (defines, among other things, the crime of “illicit association”)
- 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 Corporación 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 and the for-profit sector. In order to receive more information about Fundación Valora contact:

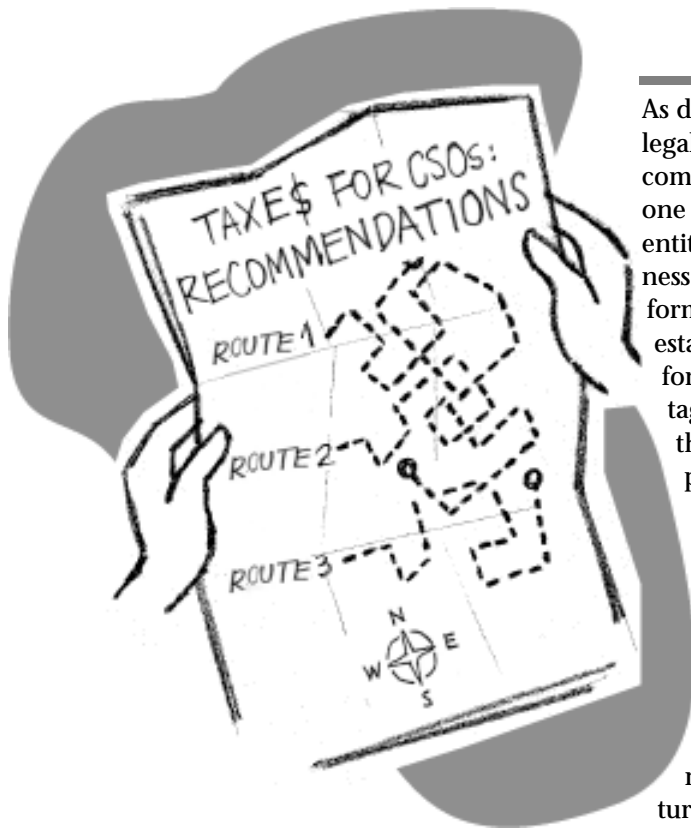
Fundación Valora
Callao 2975, oficina 101
Las Condes, Santiago, Chile
Phone (56-2) 2517201 /
Fax: (56-2) 2517186
Email: fundacionvalora@entelchile.net

While the organizations mentioned above do not provide services specifically related to commercial activities, their expertise may be useful to CSOs seeking assistance in this area.

Nonprofit Enterprise and Self-sustainability Team (NESsT) is dedicated to supporting CSOs in their self-financing and commercial activities. It offers workshops and trainings designed to guide CSOs through the process of establishing a commercial activity and provides technical and financial assistance to CSOs through its NESsT Venture Fund for the development of their social enterprises. More information about NESsT contact:

NESsT
Jose Arrieta 89
Providencia, Santiago, Chile
Phone: (56-2) 2225190 / Fax: (56-2) 6342599
Email: nesst@igc.apc.org
Internet: www.nesst.org

Interpreting and Critiquing The Chilean Legal and Regulatory Framework



As discussed in the previous chapter, the basic legal framework applicable to CSOs conducting commercial activities in Chile is identical to the one governing similar activities by any private entity, with one important exception. Many business and government leaders believe that this uniform legislation is justifiably neutral and that establishing different sets of rules for CSOs and for-profit businesses would give unfair advantages to CSOs. The authors of this guide argue that this perspective fails to acknowledge and promote the social benefits that CSOs contribute to Chilean society.

Chapter 4 evaluates the practical effects of Chilean laws on CSO commercial activities, presents and discusses the overall strengths and weaknesses of the legal framework, and offers recommendations for reforming the system in ways that will enhance the development of CSO commercial activities and, in turn, increase and sustain the contributions of the sector to Chilean society as a whole.

4.1 Evaluating the Chilean 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 Chilean legal system is regarded as highly functional, particularly in relation to other countries in Latin America. However, in the more specific area of

the legal treatment of CSOs conducting commercial activities, the Chilean system receives mixed reviews. On the one hand, the system establishes relatively clear rules and the laws are properly enforced, with minimal corruption. Yet on the other hand, the system does little, if anything, to promote CSO commercial activities, and in this sense it fails to capitalize on the initiative of CSOs to improve Chilean society. This section evaluates the Chilean legal framework with respect to the five analytical criteria established by the ICNL typology and presented in Chapter 2.

OVERALL CRITIQUE: COLOMBIAN LEGAL FRAMEWORK FOR CSO COMMERCIAL ACTIVITIES

	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>

	Good	Moderate	Poor
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 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>
Effects on the commercial sector	◎		<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>

OVERALL CRITIQUE: COLOMBIAN LEGAL FRAMEWORK FOR CSO COMMERCIAL ACTIVITIES

	Good	Moderate	Poor
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, their access to capital from banks, their target clientele, etc. Yet these challenges do not mean that CSOs should not engage in commercial activities. As this guide has discussed, such activities can have positive effects for CSOs in advancing their missions and strengthening and sustaining their finances. For this reason, governments should consider measures that promote, rather than deter, CSO commercial activities.</p> <p>But beyond offering a significant income tax exemption to the subsector of CSOs that qualify for this benefit, the current framework governing commercial activities does little to promote the efforts of CSOs to become more self-sufficient. Organizations not classified as welfare institutions do not receive benefits, and even welfare institutions receive benefits only in the area of income taxation. This failure to capitalize on the initiative of CSOs is curious, considering the powerful trend of privatization in Chile that has reduced the government's role in social areas such as education, health, and social security. To some extent, CSOs have filled the void created by the government's withdrawal, but their influence is limited by scant resources and a lack of public recognition. The Chilean government could help to solve both problems—and support the development of a sector that has much to contribute to Chilean society—by reforming the current legislation, which stifles, rather than promotes, CSO commercial activities.</p>
Practical implementation issues			<p>Since Chile follows the easiest implementation route in applying a blanket tax treatment that is identical for CSO and for-profit commercial activities (with the exception of CSOs exempt from paying income tax), and since the Chilean revenue collection system is well organized and well operated, the practical implementation of the legal framework is highly effective.</p>



4.2 Working Within the System

With the exception of the income tax exemption for some CSOs, Chilean laws do 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 presidential 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.

**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.

Box 4b. CASE STUDY: CORPORACION CIEM ACONCAGUA


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 organization also sells tickets to cultural events at the Centro El Almendral but does not pay VAT or first-category tax on income from these sales because these activities are conducted irregularly and at low levels.

CIEM conducts a range of activities that generate revenues for the organization. Many of these activities—like the publication and sale of its materials, the sale of handmade products, and the training programs—are directly related to CIEM's mission, while some—including the café and the rental of equipment and space—are not. While none of these activities are conducted at a high level, taken together they constitute an essential component of the organization's social mission and financial sustainability.

4.3 Competition with the For-Profit Sector

As the presentation of Chilean laws for CSO commercial activities and the evaluation of their effects on the for-profit sector reveal, there has been little reason for complaints from for-profit entities of unfair competition with CSOs. In fact, the only conceivable area for criticism in this respect would be of those CSOs specifically recognized by the President of the Republic to receive tax exemptions on mission-related activities. Yet this group is relatively small, comprising only a subsector of CSOs in the country, and their commercial activities are generally conducted at low levels. For this reason, CSOs have not incurred significant criticism from the for-profit sector for their commercial activities to date.

Overall, the for-profit sector in Chile benefits from a favorable regulatory environment. The income tax of 17% is significantly lower than the rate in most countries in the region,¹⁸ the right of entities selling goods and services to recoup VAT on purchases related to sales (see section 3.4.2) puts this tax burden on consumers, and, as discussed in section 3.4.1, Chile does not apply a “double tax” on income from dividends.

4.4 Perception of CSOs

Under the military regime that governed Chile from 1973 to 1990, many nonprofit and community-based organizations, particularly those working in human rights or in communities identified with leftist political groups, were the subjects of state scrutiny. During this period, the government carefully monitored such organizations for suspected insurgency. General distrust of CSOs was not limited to the military regime or its strongest

supporters. Many sectors of society, including those identifying more with center and even center-left politics, viewed CSOs as protest organizations that would undermine a peaceful transition to democracy.

Government policies toward CSOs have changed significantly in recent years. The government formed by the center-left coalition that assumed power in 1990 discontinued the military regime’s policy of surveilling CSOs. Subsequent governments have moved slowly toward recognizing CSOs and supporting their role in Chilean society. Yet large segments of Chilean society—not only military officers, right-wing politicians, and many business leaders, but also many Chileans identifying with the political center and center-left—still associate these organizations with the leftist, protest politics of the 1960s, 1970s, and 1980s. In this context, passing legislation that promotes CSOs and creating a favorable public perception of civil society is a long and difficult process.

Ironically, some CSOs are viewed with distrust from the other side as well. Many leaders of smaller or community-based organizations operating with few funds and little public recognition believe that the larger and more well-established CSOs siphon off the majority of public funds designated to support social development while contributing little to communities in need. To those operating on the margins, these CSOs have “sold out” to the government by mainstreaming their ideals in order to receive funding. On the other hand, there is a growing group of CSOs founded upon conservative social and political ideals. In this sense, the various organizations that constitute Chile’s civil society are far from a homogeneous group—politically, ideologically, or financially. This diversity of viewpoints, missions, and strategies promotes a vibrant and pluralistic socie-

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Both Colombia and Argentina, for example, charge 35% tax to for-profit entities on income generated, as compared with the 17% rate that applies in Chile. Of course, comparisons between tax systems in different countries are extremely complicated, but it is significant that the tax rate in Chile is substantially lower than in other countries in the region.

ty, but it also presents great challenges to the sector's attempts to unite behind common interests and lobby for more favorable legislation and public recognition.

4.5 Reforming the System

This guide has examined Chilean laws and regulations covering CSO commercial activities and reviewed their practical effects. This section distills the strengths and weaknesses of the system into three primary criticisms and a corresponding set of recommendations. These ideas are intended to 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 Chilean society. All three criticisms are targeted at aspects of the system that could be improved to create a more favorable environment for CSOs and their commercial activities.

1. Special status and benefits for a subsector of CSOs exclude the majority of the sector. As discussed in section 3.4.1, CSOs that apply for and are granted status as welfare institutions receive a significant benefit in the form of an income tax exemption that is categorically denied to all other CSOs. This special status privileges CSOs that are undoubtedly working in an area of need—direct material assistance—but the benefits are withheld from CSOs working in other important areas of need: culture, education, environment, health, human rights, and domestic violence. Although there is no one reason to explain this differential treatment among CSOs, it is clearly significant that the group of welfare institutions recognized as such tend to engage in apolitical work and are often associated with traditional religious institutions.

This differential status provides benefits to welfare institutions over all other CSOs, with the implication that this subgroup is doing more

valuable work than the rest of the sector. While assisting persons living in situations of poverty is certainly a worthy priority, other activities for social change, such as providing access to information about sexually transmitted diseases, providing proper sanitation to communities, or providing services that enable an abused partner to leave a violent domestic situation, are just as vital. And yet the very organizations that provide these services—in this case, in the areas of health, environment, and domestic violence—are often denied a benefit that would enhance their ability to pursue this work. Applying rules inconsistently within the sector based on each organization's principal activity stifles both the development of a diverse and vibrant civil society and all of the benefits to the larger Chilean society that would accrue from this process.

2. The legal framework does not promote commercial activities for the entire sector. A second criticism—interrelated with the first—is the absence of laws that promote CSO commercial activities. Since Chilean laws do protect the right of CSOs to conduct commercial activities, this criticism is levied at the tax regulations. The uniform application of these regulations to CSOs and for-profit entities (with the exception of the exemption on income tax extended to welfare institutions) fails to acknowledge the public benefits produced both directly and indirectly by CSO commercial activities. This is particularly problematic with respect not only to income tax, as discussed above, but also to VAT. Unlike income tax, from which some CSOs are eligible for an exemption, all CSOs, like their for-profit counterparts, are required to charge VAT on sales. Although CSOs themselves can later recoup the VAT payments they make in purchasing raw materials, this tax is passed on to the consumer, who, in the case of CSOs, often is low-income. For many CSOs, including the 18% VAT in the price of goods significantly diminishes their customer base and reflects an additional challenge to the



already difficult task of making a profit in a low-income community. When the commercial activity is mission-related, the presence of VAT undermines the CSO's ability to achieve its public-benefit purpose.

Another issue related to VAT, but not directly related to commercial activities, is that CSOs, even those recognized as welfare institutions by the President, must pay VAT on purchases related to the goods and services they provide. For example, a soup kitchen must pay VAT on the food it purchases and then provides free to its clients. The organization could recoup this expenditure by selling the food and thus passing along the tax to its clients, but this would go against its mission of feeding those in need. If a CSO must purchase materials to fulfill its public-benefit mission, why should it pay the 18% VAT on these purchases?

3. Information necessary to initiate and sustain CSO commercial activities is not accessible. Self-financing is still not a dominant issue in discussions of the third sector, and many CSO leaders are unaware that this is a feasible way to help finance their organizations. In fact, many organizations believe that because they are "nonprofit," they cannot generate their own income even if the income is designated for their mission activities. In addition, there are no services for nonprofits that want to engage in commercial activities. While there are agencies in Chile that provide small-scale businesses with support such as loans and training, there is nothing similar for the civil society sector. The challenge of managing the legal, accounting, and management aspects of an enterprise without any technical support is often prohibitively daunting for CSO staff whose expertise lies in other areas. Given this general lack of support, CSOs often shy away from initiating commercial activities and continue to pursue exclusively traditional funding despite its limitations.

The following recommendations are offered in response to the three criticisms presented above:

1 and 2. Establish favorable legislation for CSO commercial activities that applies to the entire civil society sector.

Criticisms 1 and 2 are interrelated and the accompanying recommendations are even more so. The current legislation that establishes preferential treatment for a subgroup of CSOs, welfare institutions, is a remnant of other times in Chilean history—initially, a time when welfare institutions were the principal actors in a social sector that was closely tied to the Catholic Church, and later, a time when organizations associated with any type of social or political dissent were marginalized and often oppressed. In the last twenty years, Chile's adoption of a free market economy and the parallel retreat of the state in the social sector have not been accompanied by strong legislative or financial support to develop civil society. But Chile has entered another phase in its history, a phase in which diversity of ideas and actions contributes to a more democratic society. This diversity should be promoted, rather than stifled, through laws that support CSO commercial activities when these activities directly provide a public benefit.

The tax exemption enjoyed by welfare institutions applies only to commercial activities that are mission-related; thus, a welfare institution is ineligible for a tax exemption on income generated from a restaurant, even if this income is used to advance the organization's core mission. This is a reasonable rule because it promotes commercial activities that specifically produce a public benefit (because these commercial activities are related to the organization's mission). This tax exemption on mission-related commercial activities should be extended to all CSOs in line with the consistent application of rules as discussed above.

True, these laws would be more difficult to administer than current laws. It would be necessary to establish criteria for determining mission-relatedness and then to assess each commercial activity of every CSO in Chile to determine whether or not the activity was related to the CSO's mission (the SII currently does this for organizations classified as welfare institutions that conduct commercial activities). Such laws would also lead to a slight decrease in the tax revenue collected by the SII. But the benefits to CSOs, and in turn to Chilean society, would far outweigh these costs.

With respect to VAT, CSOs should be exempt from VAT payments on purchases related to their missions, even if not related to a commercial activity. The soup kitchen should not have to pay 18% VAT on the bread that it provides free of charge to its hungry clients. Finally, another proposal that should be considered is eliminating the VAT on mission-related CSO sales in general, or at least those to low-income clients. VAT is a direct impediment to CSOs in their efforts to fulfill their public-benefit objectives.

3. Develop resources to support CSO commercial activities.

In order to initiate and sustain commercial activities, CSOs need access to general information as well as legal, accounting, and other technical expertise. With the exception of those organizations listed in section 3.7 and a small group of socially-active professionals, such expertise is generally not available in Chile at prices affordable to most CSOs. When this expertise is available, often it is not specific to the needs of CSOs. Developing these resources will require the efforts not only of government and CSO actors, but also of universities, professionals, and for-profit entities.

The biggest challenges CSOs face in conducting commercial activities lie in knowing where to go

for help and being able to pay for it. The government has recently become more involved in civil society, but there is still little policy or financial support specifically in the area of CSO commercial activities. There are some nonprofit organizations, as already mentioned, that provide legal support to CSOs, but there is little specific organizational support for CSO commercial activities. Many lawyers or accountants volunteer their services on a *pro bono* basis or charge minimal fees to CSO clients, but once again, there are insufficient resources to connect CSOs in need of assistance with professionals willing to provide it. The first step in developing institutionalized resources for supporting CSO commercial activities is the creation of a new nonprofit or government institution—or the expansion of an existing one—to direct CSOs to professionals with expertise in law, accounting, marketing, and other areas needed to create and manage their commercial activities.

Yet while the creation of an institution to connect CSOs to the existing pool of available resources is vital, it is far from enough. It is also necessary to expand this pool of resources to serve the size and diversity of the civil society sector. Universities could develop programs to link students and faculty from various fields to CSOs; this would help not only CSOs, but also the students and faculty, who would gain valuable practical experience by working with CSOs. Ideally, more lawyers, accountants, and other professionals with relevant skills would contribute their time to assist CSOs. Providing incentives to promote such contributions is the shared task of the government, CSOs, and for-profit entities interested in participating more fully in Chilean society. The expertise that CSOs need to conduct commercial activities successfully already exists in Chile, but it will require the concerted efforts of a diverse range of public, private, and nonprofit actors to make these resources available to CSOs.

Conclusion

As emphasized in Chapters 3 and 4, a single legal framework is applied to both CSO and for-profit commercial activities in Chile. This uniform treatment fails to promote the beneficial effects that CSO commercial activities can produce for Chilean society. The current system offers an exemption on income tax to a subgroup of CSOs that are classified as welfare institutions, but there are no additional tax benefits for these organizations, nor are there any tax benefits for CSOs that do not qualify for this classification.

In practice, many CSOs within Chile conduct commercial activities, but the payments they make to the tax authority tend to be small, both because they usually conduct commercial activities at low levels and because standard accounting practices significantly reduce or eliminate their taxable income. For these reasons, CSO tax payments represent a minuscule portion of the revenues collected by the Chilean tax authority. Creating favorable legislation for CSO mission-related commercial activities, particularly in the area of taxation, would not significantly reduce this overall revenue, but it would create meaningful incentives for CSOs to initiate commercial activities and hence enable them to pursue their missions more effectively and more sustainably. Such reforms would go far in promoting CSOs and in strengthening their ability to contribute to Chilean society.