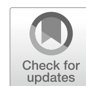
Social Enterprises and Tax: Living Apart Together?



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Contents

1 Introduction 78
2 The Public Finance Concept of Tax Incentives 79
3 State Aid Constraints in the EU 81
4 Taxation of Profits of Social Enterprises 82
4.1 Tax Exemptions for Charities May Apply to Certain Social Enterprises 82
4.2 Legal Forms Required for Charities May Not Meet the Needs of Social Enterprises 83
4.3 Specific Legal Forms for Social Enterprises Often Not Eligible for Tax Benefits 85
4.4 Specific Tax Benefits for Social Enterprises 85
4.5 Other Tax Benefits 86
5 Taxation and Funding of Social Enterprises 87
5.1 Donations 87
5.2 Tax Assignation Systems 88
5.3 Investments and Loans 89
6 Value-Added Tax Concerns of Social Enterprises 93
6.1 VAT Exemptions 94
6.2 The Problem of Irrecoverable Input VAT 95
6.3 Reduced VAT Rates 96
6.4 Alternatives 96
7 Conclusion 97
References 98

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1 Introduction

In general, tax legislation applies broadly. Companies that meet the requirements for corporate income tax are taxed, and so are transactions that meet the requirements of value-added tax (VAT). Most tax legislation predates the emergence of social enterprises. It does not always cater to the hybridity of social enterprises that pursue both a financial profit and a social benefit. Killian and O'Regan (2019) noted that for that reason, taxation can act as a, perhaps unintended, systematic constraint on social innovation within for-profit businesses. They define this hybridity as the combination of diverse elements. This includes combining goals of profit and of social value creation, elements that were traditionally housed in separate and separately taxed entities. In addition, social enterprises blur the lines between the public sector, the private for-profit sector and the charitable sector. Jurisdictions use different terms to address charities and the charitable sector, including philanthropic organizations, non-profit organizations, public benefit organizations and non-governmental organizations (NGOs). This chapter will use the term 'charities' to refer to these kinds of organizations without referring to a specific definition or legal context.

Some social enterprises may meet the definition of charity in certain jurisdictions and thus benefit from tax incentives for charities. Others might be able to benefit from specific, newly introduced, tax incentives especially adopted to further social enterprise models. The approach jurisdictions take is, as we often see in tax matters, quite diverse. [1] Many countries do not have specific tax benefits for social enterprises, but some do provide for such benefits. According to the European Commission (2020, p. 92), in the European Union (EU), the latter group includes Austria, Denmark, Estonia, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Poland, Portugal, Romania, Slovakia and Spain. Such incentives include corporate tax exemptions for retained profits, VAT exemptions or reduced rates and tax deductions granted to private or institutional donors. However, the European Commission (2020, p. 92) observed that in most countries, the fiscal framework within which social enterprises operate is rather complex and fragmented. According to the Commission, few countries have developed a clear policy providing specific and consistent fiscal incentives for social enterprises that are designed to address the specific needs of social enterprises and help them grow. In the Action plan for the social economy, the European Commission (2021, p. 6) acknowledged that taxation is an important policy for the social economy, and it repeated that few countries have developed a specific and consistent taxation framework for social enterprises. The Commission added that many provide incentives, ranging from corporate tax exemptions on retained profits to VAT exemptions or reduced rates, social insurance costs reduced/covered by subsidies or tax reductions for private and institutional donors, but that access to these incentives can be complex. In addition, the Commission mentioned that the different actions do not always benefit from appropriate coordination. The European Commission aims to

[1] European Commission (2020), p. 92.

publish guidance on relevant taxation frameworks for social economy entities based on available analysis and input provided by Member States' authorities and social economy stakeholders. [2] In addition, it wants to provide recommendations in relation to specific policies, such as taxation.

This chapter examines this complex relation between social enterprises and taxation and questions whether it can be characterized as living apart together. The focus is not on a specific country, although various examples will be mentioned. As specific tax measures for social enterprises are a form of tax incentives, Sect. 2 briefly discusses this public finance concept. Section 3 touches upon an important legal constraint on introducing such incentives for social enterprises in the European Union (EU): the prohibition of state aid. Section 4 focusses on the taxation of profits of social enterprises and Sect. 5 on the relevant tax aspects for their funders. Section 6 discusses value-added tax (VAT) issues social enterprises may encounter. The VAT that applies in the EU has been copied (with variations) by many non-EU Member States. For that reason, this chapter focusses on the EU VAT legislation as included in the VAT Directive [3] in relation to social enterprises. Section 7 concludes the chapter.

2 The Public Finance Concept of Tax Incentives

The primary function of tax legislation is to raise a budget for government expenditures. In addition, tax legislation can be used to promote policy goals such as fostering social enterprises. This is called a tax incentive. [4] The Organisation for Economic Co-operation and Development (OECD) (2010, p. 12) defined tax incentives as 'provisions of tax law, regulation or practices that reduce or postpone revenue for a comparatively narrow population of taxpayers relative to a benchmark tax'. Tax incentives can take various forms. Examples are exemptions from the tax base or from the definition of taxable subject, specific income deductions, tax credits and reduced rates.

Tax incentives may be perceived as free lunches, but they are not. A tax incentive reduces the tax income of the government, for which reason the government must increase the tax burden of other taxpayers, increase other taxes or reduce spending. Just as direct subsidies, tax incentives are a cost for the government. Government agencies sometimes prefer a tax incentive over a direct subsidy as these do not reduce their budget, but only the income of the Ministry of Finance. For the Ministry

[2] European Commission (2021), p. 8.

[3] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax as later amended (consolidated text as of 1 July 2021: http://data.europa.eu/eli/dir/2006/112/2021-07-01).

[4] One of the alternative terms is 'tax expenditure'. For a more elaborate discussion, I refer to Hemels (2017a).

of Economic Affairs, an ineffective tax incentive for social enterprises might, therefore, be more attractive than a more effective direct subsidy which reduces its budget. For the government as a whole, this is not desirable. Ideally, tax incentives are accounted for and controlled in the same way as direct subsidies to ensure efficient and effective use. This is often not the case.

Many tax experts are not in favour of tax incentives. Some of their arguments apply to direct subsidies as well, but others are more specific to tax incentives. The OECD (2010, pp. 25–34) identified the following theoretical and practical allegations against tax incentives:

- Fairness: lobby groups can have a strong political influence when pleading for tax incentives. The benefit of such an incentive is big for the small group that benefits, and the costs are borne by a large group of anonymous taxpayers.
- Efficiency and effectiveness: difficulty in evaluating existing tax incentives and weaknesses in reporting in the budget.
- Complexity: tax incentives can increase the complexity of the tax system.
- Revenue sufficiency: difficulty to estimate the costs of tax incentives.
- Growth of tax incentives: these tend to evade systematic and critical review. As a result, they can grow over time and avoid reform, reduction or repeal.

The OECD (2010, pp. 24–25) also identified conditions under which tax incentives are most likely to be successful policy tools to achieve their objectives:

- Administrative economies of scale and scope: tax incentives might lead to less administrative costs than direct subsidies.
- Limited probability of abuse or fraud: where detailed verification is not necessary, a tax benefit can be cost-effective, especially as information from third sources is available which can be used to check the claim of the taxpayer.
- A wide range of taxpayer choice: the distinctions among different activities that qualify for governmental support may not be considered important, in which case a simpler reporting and verification process through the tax system might be more efficient than a direct subsidy.

Tax incentives must be considered relative to alternative policy tools such as spending programmes, regulation, and information campaigns. They are not necessarily a better or worse policy instrument. Policy objects and fiscal policy considerations should determine the best instrument. In addition, tax incentives must be democratically controlled, accounted for and evaluated in the same way as direct subsidies. As this is currently not always the case, tax incentives are, in that respect, inferior to direct subsidies and should be used with care.

3 State Aid Constraints in the EU

EU Member States are not completely free to introduce support schemes for social enterprises. Among others, these must not infringe the state aid rules of Articles 107–109 of the Treaty on the Functioning of the European Union (TFEU). [5] Article 107 TFEU prohibits granting aid through state resources, which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods. Durand et al. characterize competition and state aid rules as important constraints for the regulation and application of public interests. [6]

Several forms of state aid are allowed. Examples are aid with a social character that is granted to individual consumers without discrimination related to the origin of the products concerned¸ [7] aid to make good the damage caused by natural disasters or exceptional occurrences [8] and aid not exceeding €200,000 over any period of 3 fiscal years per undertaking (de minimis). [9] The latter might be useful when incentives are specifically aimed at small-scale social enterprises. The state aid regime requires sufficient evidence of market failure and the necessity and proportionality of the intervention.

Certain forms of aid may be allowed where it does not affect trading conditions and competition in the EU to an extent that is contrary to the common interest. This includes several kinds of activities that might be conducted by social enterprises, such as aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment and of certain regions in view of their structural, economic and social situation; [10] aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest; [11] and aid to promote culture and heritage conservation, where such aid does not affect trading conditions and competition in the Union to an extent that is contrary to the common interest. [12] Notification and approval of the European Commission are necessary before Member States can introduce such aid.

In addition, the General Block Exemption Regulation (GBER) [13] provides that if certain requirements are met, several categories of aid are exempt from the notification obligation. This includes regional aid; aid to small and medium-sized enterprises

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[5] For an elaborate discussion of these state aid constraints, I refer to Luja (2017).

[6] Durand et al. (2021), p. 560.

[7] Article 107(2)(a) TFEU.

[8] article 107(2)(b) TFEU.

[9] Commission Regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the TFEU to de minimis aid.

[10] Article 107(3)(a) TFEU.

[11] Article 107(3)(c) TFEU.

[12] Article 107(3)(d) TFEU.

[13] Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of the Treaty.

(SMEs) in the form of investment aid, operating aid and access of SMEs to finance; aid for environmental protection; aid for research and development and innovation; training aid; recruitment and employment aid for disadvantaged workers and workers with disabilities; social aid for transport for the residents of remote regions; aid for broadband infrastructures; aid for culture and heritage conservation; aid for sport and multifunctional recreational infrastructure; and aid for local infrastructures. This might give EU Member States the possibility to support specific activities or specific social enterprises without breaching the state aid prohibition.

4 Taxation of Profits of Social Enterprises

Profit taxes tax profits. They do this by applying a certain tax rate on the taxable base. Both the definition of the taxable base—profits—and the tax rates vary widely between countries. Some countries apply one profit tax rate, while others apply a different (higher or lower) rate for higher or lower profits. Profit taxes levied from legal entities go under various names, such as corporate income tax and corporation tax. This chapter uses the term ‘corporate income tax’.

Liability to corporate income tax is often primarily based on the legal form of a company. For example, a limited liability company (LLC) will usually be liable to corporate income tax. The aim of the company, whether it pursues a profit for its shareholders, social objects or both, may not be relevant. If the company does not, in fact, make profits (which may not be the same as not pursuing a profit), there is no tax base and, hence, no taxation. Gifts, subsidies and grants received may, under certain circumstances and depending on the legislation in a specific jurisdiction, be regarded as profit and thus, in principle, be taxable.

The European Commission (2020, p. 94; 2021, p. 6) observed that few countries address tax measures only for social enterprises or design them specifically in coherence with the entrepreneurial nature of social enterprises. In some cases, a profitable social enterprise may benefit from tax incentives not specifically aimed at them to reduce their tax burden. As will be discussed in the remainder of this section, this may have serious drawbacks.

4.1 Tax Exemptions for Charities May Apply to Certain Social Enterprises

In several countries, carrying on a business does not necessarily lead to the loss of charitable status. Various jurisdictions even exempt charities from corporate income

tax. An example is Australia. [14] As countries use different definitions of (and terminology for) charities, exemptions might have a narrow or wide scope depending on the specific jurisdiction. Some social enterprises may benefit from such an exemption, but others will fall outside the definition of 'charity'.

A social enterprise that can meet the requirements and qualifies as a charity may make use of a corporate income tax exemption. This may not only entail that no tax is due, but it may also mean a liberation from administrative obligations. However, as specific administrative obligations may be in place for charities, this does not necessarily mean that such charities are completely free from administrative burdens.

In other jurisdictions, the business income of charities is taxed. For example, in the United States (US), this is taxable under the unrelated business income tax. [15]

As Gani (2021, p. 543) observes, the label of being tax exempt or of being a charity (which might, depending on the jurisdiction, coincide) indicates a recognition of the entity's utilitarian status by the state. It is a form of, in Gani's words, 'State stamp', which guarantees that the entity receiving it brings some kind of special utility through its activity. Not the tax benefits as such, but the label may be most relevant. According to Gani, this label is in Switzerland probably the most important reason to pursue a tax-exempt status. In the Netherlands, having a charitable status has a similar effect. For example, in the Netherlands, for both private and public (local authorities) funding, this status is often required to be eligible for grants. Both in Switzerland and the Netherlands, this might be problematic for social enterprises.

4.2 Legal Forms Required for Charities May Not Meet the Needs of Social Enterprises

Often, strict requirements are imposed on charities. These might not always suit social enterprises.

In Germany, the gemeinnützige GmbH (gGmbH), a non-profit company with limited liability under German law, is exempt from corporate income tax. However, the entity must pursue charitable purposes and promote the public benefit. [16] It is bound by many restrictions. For museums, hospitals and educational organizations, the gGmbH is an attractive legal form, [17] but for social enterprises with a more commercial character, it does not seem to be suitable.

[14] See for example the Australian High Court decision of Federal Commission of Taxation v Word Investments Limited [2008] HCA 55 as discussed in Martin (2021), pp. 525–526.

[15] Sections 511–514 Internal Revenue Code.

[16] § 52 AO and § 53 AO Abgabenordnung.

[17] Firma.de (2020).

Several jurisdictions restrict the exemption to legal forms traditionally used by charities. This may be problematic for innovative business models that do not use the traditional legal forms for charities, such as foundations, but instead use legal forms that were traditionally used by for-profit corporations, such as limited liability companies. Killian and O'Regan (2019) observed in the context of Ireland that it raises concern of social enterprises that tax benefits only apply to certain legal forms whereas social enterprises prefer legal forms traditionally used by regular for-profit enterprises, such as the limited corporation.

In some cases, this may lead to social enterprises exchanging their hybrid origins for a structure that fits tax legislation better, e.g. a charitable part and a business part with the matching legal forms, such as a foundation and a limited liability company. Vitello (2011, pp. 568, 578) discusses such structures that consist of a joint venture between a non-profit and a for-profit company, each owning a share in a for-profit company that pursues a socially beneficial purpose but may not generate substantial revenue and a foundation and another tax-exempt organization investing in a for-profit LLC having a charitable purpose for its primary goal. Martin (2021, pp. 529–531) describes three Australian case studies on how some social enterprises carry on their businesses through either a charity, a for-profit entity or a hybrid structure. She discusses the limitations social enterprises encounter when they have to operate within the constraints of the charitable status, which might induce them to opt for a for-profit legal form. This, however, has other drawbacks (including the lack of tax incentives). The third case study she describes is a social enterprise with charitable status that incorporated a limited company that ran the business. She observes that running such a structure can be expensive as there will be a range of legal obligations that need to be complied with. She points out that such costs may stop newly incorporated social enterprises from adopting this model but that it may be a realistic option once the social enterprise becomes successful. Durand et al. (2021, p. 559) describe similar problems in France using the case study of the Simplon project, which was forced to create three organizations: a simplified limited liability company, an endowment fund and an association This forced hybridization is perceived by the founder as the source of many complications in the management of the project, particularly in terms of governance and human resources.

Such workarounds may mean that tax barriers for social enterprises influence their legal structure, whereas the general idea is that the tax system should be neutral towards business decisions, such as on how an enterprise is legally structured. The European Commission (2020, p. 94) observed that tax benefits that only apply to certain legal forms may push social enterprises to choose legal forms that are not consistent with their aims.

4.3 Specific Legal Forms for Social Enterprises Often Not Eligible for Tax Benefits

Anheier (2021, p. 8) observed that most EU Member States were reluctant to propose policies that would address the shifting boundaries between public and private and between 'not for profit' and 'for profit'. As is discussed in Part III of this book, some countries developed specific legal forms for social enterprises. However, these are usually not granted a special tax status. In the EU, this can partly be explained by state aid concerns, but competition concerns also cause non-EU jurisdictions to be cautious in this respect.

For example, the US low-profit limited liability corporation (LLLC) for organizations whose mission is primarily social and the benefit corporation for enterprises that combine a profitable trade with a social focus are not tax exempt because they are still for-profit entities. An LLLC may elect to be treated as a tax transparent partnership, in which case it will not be taxed itself but the partners will (depending on their tax status). The treatment of non-transparent LLLCs and benefit corporations thus differs from the US tax treatment of charities, which can obtain a tax-exempt status. [18]

Similarly, the UK community interest company (CIC), which is designed for social enterprises that want to use their profits and assets for the public good, is liable to UK corporation tax as a company and, unlike charities, is not entitled to any specific corporation tax exemption. A CIC cannot obtain charitable status, but a charity may own a CIC and such CIC is allowed to pass on assets to the charity. [19] More in general, if a CIC donates surpluses to a charity, it may deduct the amount of such donations and thus reduce the taxable profit for corporation tax purposes.

The Netherlands is contemplating the introduction of a legal form for a limited liability company (BV in Dutch) with a societal purpose (*maatschappelijk doel* in Dutch), the BVm. [20] This would also not be given a special tax treatment and cannot obtain the Dutch charitable status.

4.4 Specific Tax Benefits for Social Enterprises

Some jurisdictions introduced specific corporate income tax exemptions for social enterprises that use the legal status developed for them. According to the European Commission (2020, p. 74), the tax breaks usually relate to exemptions for new social enterprises hiring (mainly disadvantaged) employees.

[18] Based on article 501(c)(3) Internal Revenue Code, which allows certain charitable organizations to be exempt from paying federal income taxes.

[19] Office of the Regulator of Community Interest Companies (2017), p. 8.

[20] Available at https://www.internetconsultatie.nl/bvm.

Work integration social enterprises in Belgium may benefit from a tax reduction when they put part of their profits into an asset lock scheme. [21] Italy exempts retained profits of entities with a social enterprise legal status from corporate income tax and applies corporate income tax on only 3% of the compulsory retained profits of social cooperatives. [22]

However, the European Commission (2020, p. 94) observed that linking fiscal benefits to specific legal forms creates an uneven landscape as social enterprises adopt different legal forms. In some countries, social enterprise legislation defining new legal status/qualifications has failed to introduce an advantageous fiscal treatment for all the entitled entities. According to the European Commission (2020, p. 94), these circumstances contribute to explaining the scarce number of associations, foundations and limited liability companies that have chosen to register as social enterprises in Belgium and Italy.

According to the European Commission (2020, p. 70), recognition via legal status seems to have been not fully effective, especially in those countries where, out of fear of creating unfair competition with conventional enterprises, tight burdens and administrative constraints and irrelevant tax breaks have been introduced for social enterprises.

4.5 Other Tax Benefits

In some circumstances, social enterprises may apply tax benefits not specifically designed for them. An example is an exemption for small companies. However, if such exemption is linked to specific legal forms without shareholders, such as foundations or associations (as is the case in the Netherlands), social enterprises that prefer a shareholder structure are not able to benefit from these incentives. The same applies to incentives for start-ups that do not apply to mature social enterprises.

Some social enterprises may make use of research and development (R & D) incentives many [23] jurisdictions include in their corporate income tax (or other taxes). However, such incentives, specifically those related to patents, may not always foster knowledge sharing, open access and open source and thus not cater to innovative, social business models and newcomers but instead protect the interests (and profits) of established companies. [24] The requirements of such incentives might, for that reason, not fit the social goal of social enterprises.

[21] Nyssens and Huybrechts (2020), p. 45.

[22] Borzaga (2020), p. 36.

[23] De Boer et al. (2019), p. 37.

[24] CPB Netherlands Bureau for Economic Policy Analysis et al. (2014), Bijlsma and Overvest (2018), and Hemels (2020).

5 Taxation and Funding of Social Enterprises

Just like any other enterprise, social enterprises need capital to work with. Because of their different earning model, social enterprises may not always be able to use the same arrangements to obtain their funding. The type of funding will often be related to the phase the social enterprise is in. The more mature and the less risky a social enterprise becomes, the more regular funding will be available. Some social enterprises will never (want to) reach that stage and will always rely on alternative funding. This section discusses the tax aspects of three different types of funding: donations, loans and investments.

5.1 Donations

In an initial phase, social enterprises might not have access to either capital markets or loan markets. The business model may be too risky for regular investors and banks. In those cases, companies, individuals and charities may donate a starting capital to the social enterprise. Such donations may also be used as seed money or growth finance, helping to reduce the initial risk and making it possible to attract other funding in the form of investments and loans. Gani (2021, p. 537) gives the example of social enterprises that want to develop devices for the world's poorest countries or that are seeking medicine for diseases that are only found in such countries. He observes that these companies generally operate with start-up capital that comes from a donation or public or private subsidies and that with this seed money, development is conducted and, in the best case, a product is developed and then sold at a price that is just enough to cover research and production costs and to enable the company to start researching a new product or drug.

A donation means that there will not be a direct financial return flowing from the social enterprise to the donor. Of course, there might be, just as with any donation, [25] an indirect benefit, such as a warm glow feeling, an increase in reputation or meeting the demands that society or the market make for a corporate socially responsible behaviour.

If the social enterprise does not have charitable status, gifts made by individuals will in most cases not be eligible for tax breaks for charitable giving. For example, as CICs cannot obtain charitable status in the UK, no Gift Aid can be claimed on donations to such CICs.

However, if there is a business rationale for the donation, such as corporate social responsibility (CSR) policy (which includes but is certainly not limited to sponsoring), companies in certain jurisdictions might be able to deduct the donation as

[25] Bekkers and Wiepking (2011).

business costs. [26] Whether this is possible depends on the national corporate income tax law.

5.1.1 Charities Not Always Allowed to Donate to Social Enterprises

Not all jurisdictions allow charities to keep their charitable status if they make donations to social enterprises. Bitterová and Surmatz observe, based on a DAFNE/EFC survey, that some European countries [27] explicitly allow charities to give grants to for-profit organizations such as small green start-ups but that other countries [28] do not allow this kind of activity. [29] From the overview in the survey, it follows that in several countries, [30] it is allowed in theory but may be difficult in practice.

The Netherlands belongs to the last group. The Dutch tax administration can be reluctant to regard donations to for-profit entities as charitable. As the Dutch charitable status requires that at least 90% of the spending is for the public benefit, this point of view can be problematic. This might effectively make it impossible to fund social enterprises and help them up on their feet, not just in monetary terms but also in reputational terms. If a well-renowned charity has donated money to a new social enterprise, it might be easier for that social enterprise to attract funds from other market parties as well. As there is a clear rationale for such donations in specific cases, the Dutch philanthropic sector has asked the Dutch Ministry of Finance to regard donations to for-profit entities as charitable if the donation pursues one or more of the philanthropic objects of the charity. It is not clear whether the Ministry of Finance is willing to meet this wish of the sector.

5.2 Tax Assignation Systems

Instead of or in addition to tax incentives for charitable giving, some countries allow taxpayers to assign a certain proportion of their tax due to an organization of their choice. Originally, such tax assignation systems were introduced for churches, but nowadays, they also include other organizations. According to the European Commission (2020, p. 74), this may include social enterprises, although it might be that these are mainly social enterprises that fulfill charity requirements.

[26] For a more elaborate discussion I refer to Hemels (2021).

[27] Albania, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Hungary, Luxembourg, Liechtenstein, Montenegro, North Macedonia, Norway, Poland, Portugal, Romania, Slovakia, Spain, Ukraine, United Kingdom.

[28] Czech Republic, Denmark, Finland, France, Italy, Latvia, Malta, Sweden, Kosovo, and Turkey.

[29] Bitterová and Surmatz (2021), p. 31 and the full overview on p. 97.

[30] Estonia, Russia, Serbia, Switzerland.

Tax assignation systems make the decision-making on how to spend that portion of tax revenue more democratic. Usually, only one organization can be chosen. Italy has applied this system since 1985: first, only for designation of 0.8% of income tax to a church (*otto per mille*) but, as of 2006, also for designation of 0.5% of tax due to non-profit organizations (*cinque per mille*). [31] Several countries, especially in Eastern Europe, apply this tax assignment system. Examples are Hungary, Lithuania, Poland, Romania and the Slovak Republic. [32] In 1997, Hungary was the first eastern European country to introduce this system. If the designation option is not used, the tax goes to the state. According to Nährlich (2013), 25% of Romanian taxpayers (2011), 40% of Polish taxpayers (2008), 46% of Hungarian taxpayers (2007) and 54% of Slovak taxpayers used the assignation system. In Portugal, an allocation scheme has existed since 2001. Taxpayers can allocate 0.5% of their personal income tax to a church, religious community or charity. [33]

According to the European Commission (2020, p. 74), this type of government grant for social enterprises is less important than other forms of public support, but it regards it as interesting for its potential impact on scaling.

5.3 Investments and Loans

Social enterprises that have some profit-making capacity may be able to attract investments or loans. For some social enterprises (depending on the phase they are in or the activity they perform), it will not be possible to provide an adequate compensation for the high risk linked to such investments or loans. This is, for example, reflected in lower interests than market rates for micro-finance.

As will be discussed in the remainder of this section, some countries apply special tax schemes to encourage investments in social enterprises.

5.3.1 UK Social Investment Tax Relief

A rather unique [34] scheme seems to be the Social Investment Tax Relief (SITR), which the United Kingdom (UK) introduced in 2014. The government wanted to enable individuals to invest in social enterprises that struggle to raise finance and that are unable to issue shares because of their legal structure. [35] SITR is one of four venture capital schemes to help small or medium-sized companies and social

[31] Mastellone (2013).

[32] Nährlich (2013) and OECD (2020), p. 89.

[33] OECD (2020), p. 89.

[34] In the 2019 consultation of the scheme, none of the respondents mentioned being aware of directly comparable international examples of similar tax reliefs: HM Treasury (2021b), para 3.17.

[35] For an elaborate discussion of the requirements see HM Revenue & Customs (2019).

enterprises grow by attracting investments. Under this scheme, investors can deduct 30% of the cost of their investment in new shares or debt from their income tax liability. In addition, individuals may defer capital gains tax (CGT) by investing a chargeable gain in a qualifying social investment. The tax incentive is thus obtained not by the social enterprise itself but by its investors.

The idea behind the incentive is that it will allow investors to agree on a lower return than would suit the risk related to the investment. New shares may not be preference shares, and a debt investment may not be secured on any assets and must not have an interest rate higher than a reasonable commercial interest rate. Neither a loan nor the shares may be paid back within 3 years after the investment.

CICs, community benefit societies with an asset lock and charities can make use of SITR. The entity or a qualifying subsidiary must use the money raised for a qualifying trade or for the preparation thereof. Many activities (both inside and outside the UK) qualify, but several do not. The reason for these exclusions is that because of the nature of the activity, the social enterprise has access to regular finance, or the activity is at risk of being misused by tax planners. A further requirement is that the entity tries to make a profit. In addition, the entity may not:

- Have more than £15 million in gross assets immediately before the investment is made
- Have 250 or more full-time equivalent employees at the time of investment
- Be controlled by another company
- Have more than £16 million in gross assets immediately after the investment is made

The maximum amount of investment over the lifetime of the social enterprise is £1.5 million. This includes money received by subsidiaries, former subsidiaries or acquired businesses.

SITR was notified state aid. [36] When the UK was still part of the EU, the aid qualified either as GBER state aid or de minimis state aid (for which further limitations of the maximum amount applied).

Limited Use of SITR

Only a limited number of social enterprises made use of the STIR. Between 2014 and the end of the tax year 2016–2017, around 50 social enterprises raised £5.1 million of investment through SITR. [37] The cost of the scheme in those 3 years was less than £2 million in total. However, the use of the scheme increased. In 2018–2019, 75 social enterprises received investment through the SITR scheme, and £3.6 million

[36] See Sect. 3 for a general discussion on state aid for a discussion in relation to SITR HM Treasury (2021a).

[37] HM Treasury (2019).

worth of funds were raised. [38] In 2020, it was calculated that since SITR was launched, 110 social enterprises has raised funds amounting to £11.2 million through the scheme. [39] That was lower than anticipated when STIR was introduced. [40]

Floyd (2019) identified several challenges that might explain the limited use. These include a lack of awareness among charities and social enterprises, the slow pace of legislative change and SITR not being sufficiently tailored to the needs of charities and social enterprises. In 2019, HM Treasury launched a consultation on SITR. [41] The outcome of this consultation was published in March 2021. [42] Many respondents viewed investments through SITR as an important funding option, though many reported relying on intermediaries to assist them (para 2.8). Most respondents felt that tax is an important lever for supporting social enterprise funding, though opinions varied on whether it is the most appropriate lever (para 2.28). For investors that are less motivated by the social aspects of enterprises, the tax relief could provide an added financial incentive. Other respondents were unsure about how far tax incentives would influence investor behaviour, with many emphasizing that investors were more interested in other issues (para 2.31). Some respondents felt that as a large number of their investors did not claim SITR's income tax relief, the government should allow them to 'gift' the equivalent relief to the social enterprise as a corporation tax relief (para 2.34). A few respondents felt that many investors using SITR are attracted by the social purpose first and that the tax relief is more 'nice to have' than the primary motivator (para 3.6). Poor awareness of SITR among investors and social enterprises was seen as a major driver of the scheme's low take-up. One respondent's survey found that of 168 enterprises responding, 70% did not understand what SITR is, 97% had never tried to use SITR and 70% did not intend to use it in the next 12 months (para 3.14). Other respondents felt the low take-up was driven by the scheme's restricted eligibility criteria (para 3.16).

Considering the responses in the consultation and in recognition that, due to the ongoing effects of Covid-19, it was a difficult time for social enterprises, in April 2021, the UK government decided to extend SITR for 2 more years (until April 2023) in order to continue supporting investment to social enterprises that are most in need of growth capital. [43] The government announced that it would continue to monitor the social investment market and assess the most appropriate form of support for the policy objectives that SITR was introduced to achieve.

All and all, the SITR experience in the UK does not seem to make a convincing point for introducing such a scheme to investors in other countries. As a matter of fact, the Netherlands had such a scheme between 1998 and 2007 for private investors

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[38] HM Revenue & Customs (2020), p. 12.

[39] HM Revenue & Customs (2020), p. 12.

[40] HM Treasury (2021b), p. 4.

[41] HM Treasury (2019).

[42] HM Treasury (2021b).

[43] HM Treasury (2021b).

in films. This tax incentive was rather costly and did not prove to be very effective and efficient and was replaced by a direct subsidy. [44]

5.3.2 Charities Not Always Allowed to Invest in Social Enterprises

Also with respect to loans and investments, it is relevant for charities to know whether providing such funding to social enterprises may jeopardize their charitable status.

Bitterová and Surmatz (2021, p. 67) observed that in Europe, the legal and tax rules are not very clear-cut but that the requirement to preserve the value of the capital makes riskier investments more difficult. They mention an ongoing debate regarding the need for a more favourable environment for such investments. In the overview in the 2021 DAFNE/EFC Comparative Highlights of Foundation Laws, [45] it is stated that 26 European countries [46] allow (if certain requirements are met) foundations to allocate grant funds towards furthering their public-benefit purpose, which (can) also generate income such as recoverable grants, low-interest loans and equities. Seven European countries [47] do not allow this according to this overview. The overview might not tell the whole story for all countries as, for example, according to this overview, this would be allowed in the Netherlands, which may be correct from a pure civil law point of view, but for the charitable status (which is a tax status and not a civil law status), this is currently not clear-cut. For Sweden and Liechtenstein, this is made explicit in the overview, which says that it is not certain that such investments will enable the foundation to keep its tax privileges.

In the United States, mission-related investments (MRIs, also referred to as impact investments) that are designed to generate both social and financial returns are not deemed charitable activity, nor do they qualify as charitable distributions. [48]

5.3.3 Programme-Related Investments

In the United States, the so-called programme-related investments (PRIs) are regarded as philanthropic spending in tax legislation. PRIs are defined as investments in which:

1. The primary purpose is to accomplish one or more of the foundation's exempt purposes

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[44] For a more elaborate discussion I refer to Hemels (2017b).

[45] Bitterová and Surmatz (2021), p. 31.

[46] Albania, Belgium, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, Greece, Hungary, Ireland, Kosovo, Latvia, Lithuania, Luxembourg, Malta, North Macedonia, Norway, Poland, Portugal, Romania, Serbia, Slovakia, Switzerland, Ukraine, and the UK.

[47] Austria, Cyprus, Italy, Slovenia, Spain, Russia, and Turkey.

[48] Levitt (2011).

2. Production of income or appreciation of property is not a significant purpose, and
3. Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose [49]

Such PRIs count toward the 5% of assets that US foundations are required, under US tax law, [50] to pay out every year. The recipients of PRIs need not be within a charitable class if they are the instruments for furthering an exempt purpose of the charity. For example, the legal structure of LLLCs was intended to provide foundations with a business entity to which they could safely make PRIs without jeopardizing their charitable status. [51] The IRS guidance [52] mentions various examples of PRIs, including low-interest or interest-free loans to needy students, high-risk investments in non-profit low-income housing projects and investments in businesses in low-income areas.

In the United Kingdom, PRIs are also recognised for charitable purposes. [53] PRIs that further the object of the charity are considered for the UK expenditure requirement. [54]

In the Netherlands, the Dutch tax administration regarded PRI in the same way as other investments. As a result, charities that engaged in PRI on a large scale could be confronted with the Dutch anti-hoarding requirement for charities and lose their charitable status. In 2020, the government announced that, in collaboration with the philanthropic sector, guidance would be published on PRI that does not breach the anti-hoarding requirement. [55] This promise has not yet been met; word is that this is due to staffing shortage at the Ministry of Finance. This indicates that such change is not deemed to have high priority for the Dutch government.

6 Value-Added Tax Concerns of Social Enterprises

Other than is the case for corporate income tax, the starting point for VAT is not the legal form of the entity but the transaction. For the VAT to apply, there must be a supply of goods or services for a consideration. [56] A social enterprise that only provides services free of charge, for example free advice or counselling, does not fall within the scope of VAT. [57]

[49] Internal Revenue Service (2021).

[50] Section 4942 Internal Revenue Code.

[51] Vitello (2011).

[52] Internal Revenue Service (2021).

[53] Charities (Protection and Social Investment) Act 2016.

[54] Charity Commission for England and Wales (2017).

[55] Kamerstukken II, 2019–2020, 35 437, no. 7, p. 5.

[56] Article 2 VAT Directive.

[57] ECJ 1 April 1982, Case C-89/81, Hong Kong Trade Development Council, ECLI:EU:C:1982:121.

In addition, if only voluntary donations are received, there is no supply for consideration.[58] This is the case, first of all, because there is no legal agreement with the donor and, second, because there is no necessary link between the service and the payments. Such activities are, therefore, also out of the scope of VAT.

The VAT Directive defines 'a taxable person' as any person (which includes legal entities) that, independently, carries out in any place any economic activity, regardless of the purpose or results of that activity. [59] In this respect, 'economic activity' has a wide scope and is an objective term in the sense that the activity is considered per se and without regard to its purpose or results. [60] It is not relevant that activities are not for profit or pursue a social purpose. Social enterprises that supply goods or services for a consideration will, therefore, in general be considered taxable persons for the purpose of VAT.

6.1 VAT Exemptions

Being a taxable person does not necessarily mean that VAT must be charged on (all) transactions. The VAT Directive includes exemptions for certain activities in the public interest. [61] These include hospital and medical care; the supply of human organs, blood and milk; the supply of services and goods closely linked to welfare and social security work and the protection of children and young persons; education; supplies by non-profit-making organizations with aims of a political, trade-union, religious, patriotic, philosophical, philanthropic or civic nature to their members in their common interest in return for a subscription, provided that this exemption is not likely to cause distortion of competition; the supply of certain services closely linked to sport or physical education by non-profit-making organizations to persons taking part in sport or physical education; the supply of certain cultural services; and the supply of goods closely linked thereto.

For several exemptions, conditions may apply, such as a prohibition on systematically aiming to make a profit and to distribute any profit that nevertheless arises; management by volunteers; approved prices or prices that are lower than commercial prices; and the exemptions not being likely to cause distortion of competition to the disadvantage of commercial enterprises subject to VAT. [62]

In addition, many countries apply an exemption for persons with an annual taxable (e.g. non-exempt or outside of VAT) turnover not exceeding a given

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[58] ECJ 3 March 1994, Case C-16/93, R.J. Tolsma v. Inspecteur der Omzetbelasting Leeuwarden, ECLI:EU:C:1994:80.

[59] Article 9(1) VAT Directive.

[60] ECJ, 6 Oct. 2009, C-267/08, SPÖ Landesorganization Kärnten, ECLI:EU:C:2009:619, para. 16–17.

[61] Chapter 2 of Title IX of the VAT Directive (articles 132–134).

[62] Article 133 VAT Directive.

threshold, so-called small enterprises. [63] This threshold varies between countries. As of 1 January 2025, the threshold may not be higher than €85,000. EU Member States may exempt such small enterprises from certain administrative obligations. Social enterprises that have a turnover below the threshold can, therefore, benefit from this exemption.

6.2 The Problem of Irrecoverable Input VAT

Insofar as a taxable person uses goods and services for taxed transactions, he is entitled to deduct VAT in respect of supplies provided to him by another taxable person. [64] Social enterprises that are within the scope of the VAT may thus be able to recover the VAT they paid on their inputs insofar as no exemption applies on their supplies.

For social enterprises that are not taxable persons and thus out of scope, VAT is a cost that cannot be recovered. The same applies to social enterprises with exempt activities or that apply the exemption for small enterprises. This disadvantage will probably not outweigh the advantage of not having to comply with administrative VAT requirements for social enterprises with relatively little input VAT charged to them.

For social enterprises that incur large costs for supplies and services (including investments in real estate and equipment), being able to deduct input VAT may be of great relevance. In such cases, providing exempt services or supplies or making use of the exemption for small enterprises is detrimental.

The European Charities' Committee on Value-Added Tax (ECCVAT) estimated that EU charities lose about €6 billion a year in irrecoverable VAT. [65] For the UK, it was calculated that irrecoverable VAT costs charities £1.8 billion a year. [66] It was guessed that significant amounts of the output VAT are absorbed by charities rather than being charged to their 'customers' and therefore burden the charity sector. [67] The same problem arises for the broader group of social enterprises to which an exemption applies or that are out of scope.

The problem of irrecoverable input VAT might induce social enterprises to ask for a fee even if they would prefer to provide these for free. VAT thus affects the economic decisions of social enterprises negatively. In 2020, the OECD concluded that distortions from VAT concessions for philanthropic entities typically arise from VAT exemptions applicable to the output of these entities and that these may result

[63] Articles 281–294 VAT Directive.

[64] Article 168 VAT Directive.

[65] https://www.eccvat.org/resources/.

[66] London Economics (2020).

[67] London Economics (2020), pp. ii–iii.

in a competitive advantage or in a disadvantage. [68] All in all, the exemptions in certain cases have the effect of distorting economic decisions and competition, thereby creating economic inefficiencies and a deadweight loss. [69]

6.3 Reduced VAT Rates

A reduced VAT rate does not have the drawback of an exemption as it does not restrict the deduction of input VAT. Such a reduced rate may benefit social enterprises. In Sweden, for example, a reduced VAT rate is applied on certain repairs to stimulate the reuse of goods. This was part of the Swedish government's strategy for sustainable consumption. [70] Such a reduced rate does not apply specifically to social enterprises as every taxable person that delivers such services benefit from it. An exception is Italy, where a 5% VAT rate is applied for certain social cooperatives. [71]

6.4 Alternatives

Exemptions and reduced VAT rates are not the most efficient way to stimulate certain economic activities. The OECD observed in 2020 that VAT exemptions, reduced rates and zero rates can create unfair competition, especially if the incentive only applies to philanthropic organizations and the VAT-exempt goods or services supplied by a philanthropic entity are also provided by businesses that charge VAT on their sales. [72] Such businesses might include social enterprises that do not meet the non-profit requirement. According to the OECD, unfair competition is the reason why some countries, including Canada and Ireland, do not exempt from VAT certain goods and services provided by philanthropic entities. Belgium, Chile, Colombia, Estonia, Indonesia, Italy and the Slovak Republic do not have preferential VAT treatment for philanthropic entities and apply the standard VAT rules.

The problem of not being able to deduct input VAT is difficult to solve within the framework of VAT. [73] More effective solutions can be found outside the VAT system, by granting direct subsidies. Obviously, direct subsidies also have budgetary and competition implications, but these are less than solutions within the VAT system. Governments can better target direct subsidies than VAT incentives, leading

[68] OECD (2020), p. 32.

[69] Cnossen (2003) and De la Feria (2009).

[70] Regeringskansliet/Finansdepartementet (2016), article 7(1)(2)(6) Mervärdesskattelagen.

[71] European Commission (2020), p. 94.

[72] OECD (2020), pp. 32, 65.

[73] See more in-depth: Hemels (forthcoming).

to less spillover effects. Strict, qualitative criteria can be established to decide whether an entity qualifies for a direct subsidy or not.

In 2011, the European Commission specifically mentioned that Member States can introduce targeted compensation mechanisms, outside of the VAT system, to alleviate the cost of VAT on the acquisitions of non-profit-making organizations. The Commission called on Member States to make use of the existing options to alleviate the burden of VAT on non-profit-making organizations. [74]

Several countries already apply this solution. For example, when public museums and galleries in the UK could no longer charge an entrance fee for their permanent collections, they could no longer (fully) recover VAT. To compensate museums for this disadvantage, the UK introduced a special VAT refund scheme [75] for museums and galleries that meet strict criteria and are listed in the VAT (Refund of Tax to Museums and Galleries) Order 2001 (SI 2001/2879). [76] Eligible museums can reclaim VAT incurred in relation to free rights of admission. The scheme does not form part of the general VAT system, but certain rules in UK VAT legislation apply to it.

7 Conclusion

As social enterprises vary widely in activities and scope, it is understandable that governments are hesitant in granting all social enterprises a corporate income tax exemption. Some social enterprises may benefit from such an exemption, for example, if they meet the requirements for being a charity. In jurisdictions that have a specific legal form for social enterprises, that legal form is often precluded from having charitable status. The reasoning behind this is probably keeping a level playing field between social enterprises and regular for-profit entities with similar activities and ensuring fair competition.

Especially in relation to the funding of social enterprises, tax legislation might have an inhibitory effect. Rules for donations and charitable expenses often do not fit in the context of social enterprises. Some governments recognize this, whereas others are still struggling with these hybrid and modern forms of philanthropy. I agree with Durand et al. (2021, p. 564) that the idea that the preponderance of profitable economic activities within an organization should inevitably imply its

[74] Communication from the Commission to the European Parliament, the Council and the European economic and social committee, On the future of VAT Towards a simpler, more robust and efficient VAT system tailored to the single market, 6 December 2011, COM(2011), p. 10. Available at https://ec.europa.eu/taxation_customs/sites/default/files/resources/documents/taxation/vat/key_documents/communications/com_2011_851_en.pdf.

[75] Article 33A VAT Act 1994 and VAT Notice 998, VAT refund scheme for museums and galleries, https://www.gov.uk/guidance/vat-refund-scheme-for-museums-and-galleries-notice-998.

[76] Available at https://www.gov.uk/guidance/vat-refund-scheme-for-museums-and-galleries-notice-998#annex.

for-profit motives, and therefore its incompatibility with public interest is largely erroneous.

For VAT problems of social enterprises, solutions may only be found outside the VAT framework in the form of direct subsidies.

All in all, for the moment, the relation between social enterprises and taxation can still be characterized as living apart together, in some jurisdictions more apart and in others more together. The latter is more beneficial for the social enterprise sector.

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