

WHEN A CHARITY GIVES NO TAX ADVANTAGES

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It is hard to find professionals today who are aware that the regulation and supervising of charities in most countries has absolutely nothing to do with equity or preventing abuse. It is about taxation. The moment that charities were given special tax exemptions was the day that tax planners began to use them for tax avoidance. The evolution of the law of regulation of charities is entirely a product of the continuous war between tax collector and tax payer.

For hundreds of years, charities lay largely unregulated and unsupervised. Prior to the Reformation, the whole area of charitable giving was ecclesiastical. The Church courts looked after it. Almost every charitable activity was related to the Church, which ran the schools, the hospitals, the poor houses, and the welfare system. At the Reformation, this was all nationalised. In consequence, the church courts could no longer enforce charitable funds (indeed, it was the desire to break up and confiscate the charitable holdings of the church that led to the Reformation in both England and in Scotland. The difference was that in England it was the monarchy doing the confiscation whereas in Scotland it was the aristocracy).

It then fell to the state to take the place of the church in enforcing charitable arrangements. The question then arose as to what activities would be enforced by the state, and thus what were charitable. The essence of the problem was how to ensure that funds that had been *publicly* raised or donated, or which the public had an interest in otherwise, did not finish up in *private* pockets as had largely happened to church property at the Reformation in Scotland and Ireland. If the funds were private in the first place, the state was uninterested. Thus, charitable

purposes were defined as having an essentially public character. The law officer

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responsible for issues of public policy was the Attorney General. Thus, the Attorney General became the ultimate enforcer of a charity.

In England, the first attempt at this was in the Statute of Charitable Uses of 1601, which stated, in its preamble, a non-exclusive list of charitable activities. Interestingly, the list simply includes everything that the pre-Reformation monasteries used to do, and therefore came under the Church courts. The theory was that if the “charity” was for a purpose other than those listed, it was not a traditional area for “charity”, and the courts would not interfere in what was regarded as a private matter.

All this changed when income tax was introduced, and charities became exempt from the new tax. Suddenly, my private charity becomes a powerful tax planning tool. The state, in response, now has to define what a charity is, define the circumstances in which it will get a tax break, and define the relationship between the donor and the assets.

The more sophisticated the country, and the higher the personal tax rates become, the more important is the anti-tax avoidance requirement. As these taxes rose, there was a growing need to define what a charity was for tax purposes. That is the origin of the *Pemsel* case, *Special Commissioners of Income Tax v. Pemsel* [1891] 3 TC 53. In this case, Lord Macnaghten set out definitive guidelines (the Macnaghten rules) that have been effective ever since. He determined that the word charity embraced four areas:

- (a) the relief of poverty
- (b) the advancement of education
- (c) the advancement of religion
- (d) other purposes beneficial to the community not falling under the preceding heads.

This judgment provided the basis for the definition in the law of all those countries that followed English legal principles. Curiously, even though the regulation of charities emerged as a response to tax planning, the English principles were slavishly followed even in countries that had no direct tax at all!

Notwithstanding that, however, it was, and remains perfectly possible for a philanthropic organisation to function outside these definitions. It will, of course, get no tax breaks. But in addition, it will not be regulated by the state. This has

been perceived as a major issue, as any organisation with, for example, political objectives cannot be a charity as defined. Thus Greenpeace and Amnesty International are not charities because they have quasi-political activities.

Other countries have approached the matter differently. Most countries in Europe have no definitions. Professionals in the Netherlands and Switzerland for example simply do not understand why the state takes any interest in private charities other than in the context of tax law. At the opposite end of the spectrum is the USA.

In the USA, where charity law *per se* is a matter for individual states, the federal tax rules in the Internal Revenue Code are overwhelmingly important, and follow very similar lines to those laid down in the *Pemsel* case. The list of exempt organisations and the charitable purposes which are acceptable are set out in the Code:

“Corporations, and any community chest, fund, or foundation, organised and operated exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involves the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on of propaganda or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in or intervene in (including the publishing or distribution of statements) any political campaign on behalf of (or in opposition to) any candidate for public office.”²

These rules are similar to the Macnaghten rules, although, as might be expected, rather more prolix and wider in certain aspects. There are also provisions in the Code that relate to the conduct of a private charitable foundation. These rules are very demanding, effectively preventing the donor from being involved directly in the management of the charity or its assets. It is for this reason that many Americans gaze longingly on the more relaxed attitudes of authorities outside the USA. The only reason why most do not follow their gaze is that a donation to a non-US charity does not qualify for a tax deduction, and the tendency of US tax to follow the assets makes establishing offshore charities both difficult and complex. Few tax lawyers in the USA either know of or are interested in such charitable arrangements outside the USA.

² Section 501 (c)(3) Internal Revenue Code.

In civil law countries, the definition of a charity for tax purposes is purely a tax matter, and the state has no other interest in it. In recent years, with the advent of money laundering laws, this is no longer seen as even remotely interesting. A trustee of a charitable (however defined) foundation who stole the foundation funds would be guilty of common theft and of money laundering. Of course, the question is how would he be discovered, but that is seen as an issue to be addressed by the lawyer drafting the foundation documents, and again, no business of the state. In France the problem is solved by simply not giving any tax breaks for gifts to private foundations, but instead applying confiscatory tax rates. There are almost no private foundations in France.³

At the opposite end of the spectrum from France is, no surprise, the USA, where charities play an enormously important part in the social fabric of the country. Despite the very restrictive rules in the Internal Revenue Code, the tax breaks are generous and attractive. In addition, the USA has developed forms of charitable entities that are very powerful indeed in encouraging charitable activity. The most remarkable of these is the Charitable Remainder Trust (and its sibling the Charitable Lead Trust). These forms of charitable trust are unique to the USA, although there have been great efforts made in recent years to encourage the United Kingdom to adopt them, so far without success.⁴

There has been recent legislation in both Scotland⁵ and in England & Wales⁶. In this the Macnaghten rules have been replaced entirely by new definitions. There is a new list of charitable purposes, in which there has been placed an emphasis on public interest. But, once again, we are looking at tax driven rules.

The private educational sector in Britain is almost entirely made up of independent schools owned and run by public charitable trusts, run on a “not-for-profit” basis. That is why they are called “public schools” to distinguish them from private schools run to make a profit for their private individual owners. The public schools, as charities, have tax exemptions. But for many years the political left in Britain has hated them because they are superb schools, and as such attract the

brightest and the best. Thus the intention in the new legislation was, for blatantly

³ The Jacobin tradition in France favoured a state monopoly over the public interest and until 1987 there were no specific laws regulating foundations. The Act of 1st August 2003 on sponsorship, foundations and associations introduced a series of reforms and was intended, inter alia, to promote the establishment of foundations.

⁴ See *Charitable Remainder Trusts: A Proposal*, James Kessler QC, CL&PR 8/2 [2005] 1-24 and *Lifetime Legacies*, Tilley Forster, CL&PR 8/2 [2005] 25-42.

⁵ Charities and Trustee Investment (Scotland) Act 2005.

⁶ Charities Act 2006. The Act was passed on 8th November 2006, but is being brought into force in stages that are not expected to be completed until 2009.

political reasons, to discriminate against educational establishments structured as public charitable organisations. In order to accommodate this view, the Charities Act has bent over backwards to force a “public” interest into the law.

In the new English Act, in brief the definition of charitable purpose is as follows⁷:

- (1) *For the purposes of the law of England and Wales, a charitable purpose is a purpose which:*
 - (a) *falls within subsection (2), and*
 - (b) *is for the public benefit*
- (2) *A purpose falls within this subsection if it falls within any of the following descriptions of purposes-*
 - (a) *the prevention or relief of poverty;*
 - (b) *the advancement of education;*
 - (c) *the advancement of religion;*
 - (d) *the advancement of health or the saving of lives;*
 - (e) *the advancement of citizenship or community development;*
 - (f) *the advancement of the arts, culture, heritage or science;*
 - (g) *the advancement of amateur sport;*
 - (h) *the advancement of human rights, conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity;*
 - (i) *the advancement of environmental protection or improvement;*
 - (j) *the relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage;*
 - (k) *the advancement of animal welfare;*

⁷ Section 2, Charities Act 2006.

- (l) *the promotion of the efficiency of the armed forces of the Crown, or of the efficiency of the police, fire and rescue services or ambulance services;*
- (m) *any other purposes within subsection (4).*

But what of those jurisdictions which have always traditionally simply followed English law? Many simply do not have the same tax concerns. Many do not have the politics of envy to drive legislation.

In the Isle of Man, for example, the desire to “control” charities has reduced current charity law to a shambles.⁸ But even so, there are some very attractive features. For example, in the United Kingdom, a charity is exempted from direct taxation on its passive income. But if it owns a trading entity, for example a retail outlet manned by volunteers, such a trading entity is *not* exempt. In the Isle of Man, because the company is not taxed *per se*, a trading company which transfers all taxable profits to a charitable parent is not taxed on such profits, and the parent is not taxed either, being a charity. Thus it is possible to run a major commercial operation on a completely tax free basis.

Another cause for thought is that charities are nowadays highly over regulated. Not merely are there the anti-tax avoidance rules, but the introduction of anti-money laundering legislation, and the regulation of financial and professional institutions have introduced new elements that have increased the regulatory burden substantially. Typically, the charity is regulated by the Registrar of Charities. The corporate vehicle of the charity is regulated by the Companies Acts. The administrator or trustee is regulated by the Financial Regulatory Authority.

So where are we heading? In an offshore non-tax jurisdiction context, the desire to legislate to prevent tax evasion becomes absurd. We must therefore go back to first principles. What is a charity? Why is a charity regulated at all? What is regulation trying to achieve? What is the cost, and is there, in fact, any benefit?

There are two reasons for the regulation of charities (as opposed to their mere registration). The first is the public interest argument. Where an organisation (irrespective of the nature of that organisation) wishes to solicit funds from the general public, there is a public interest in ensuring both that the public are not misled, and also that the funds so raised are applied as intended. If we define a charity that raises funds by soliciting from the general public, as a ‘public charity’, it is clearly important that such a public charity is regulated and supervised.

⁸ Under the Charities Registration Act 1989 the Chief Registrar has the power to refuse registration if the charity does not have a substantial and genuine connection with the Isle of Man. This requirement is currently given a stricter interpretation than hitherto.

Secondly there is a reputational argument. There is a need to ensure that any organisation intended for philanthropic purposes (as opposed to profit making purposes) is properly and honestly administered by its managing body. The simplest way to meet this need is to regulate the persons on the managing body, rather than the charity itself. Of course, in almost all “offshore” locations, such service providers are already tightly regulated. One has to go the USA or the UK to find completely unregulated and maverick corporate and trust service providers.

If a “Public Charity” needs to be regulated and supervised, can the same be said of a Private Charity? By definition, a private charity does not solicit funds from the public; its funds come from a single source, in much the same way as a private company or an experienced investor fund, both of which have a substantially relaxed regulatory regime. The structure of the private charity will have been determined by the original founder/donor. The funds are his. He has determined how they will be administered and disposed of. There seem to be no grounds whatsoever for the state to intervene, other than through the normal mechanisms provided by equity for the observance of normal trust or company law.

In a private charitable arrangement, there can be a variety of mechanisms governing the arrangement. We have seen that in the USA, there are mechanisms for charitable organisation that are very different to anything found in Europe, and which are very attractive. In a jurisdiction that focussed on regulating the administration, rather than preventing tax avoidance, there could be developed many forms of charitable and philanthropic structures, driven by the charitable purposes and the needs of those for whom the benefits are intended. If the founder/donor wishes to make a donation to the private charity conditional (on being paid a pension for life, for example), then it is difficult to see why he should not.

Until now, the powerful force motivating against these developments has been that tax is seen as a matter for individual countries. Therefore, in the European Union, charities are treated differently from country to country. But all that is beginning to change. The European Commission has already instructed several member states to cease such discrimination.⁹ Soon, it will be obligatory to give a UK donor to a Netherlands charity the same tax treatment as he would have got had he made the donation to a UK charity.

The opportunities for non- or low-tax jurisdictions in this area are immense.

⁹ To date the European Commission has requested the following countries to end discrimination against foreign charities: United Kingdom (Press release IP/06/964, 10th July 2006), Ireland & Poland (Press release IP/06/1408, 17th October 2006) and Belgium (Press releases IP/05/936, 14 July 2005 and IP/06/1879, 21 December 2006).