A NEW MEANING TO CHARITY

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The context to and implications of the changes introduced by the Finance Act 2010

Embedded within the schedules to the Finance Act 2010 are a range of provisions which will significantly affect the taxation of charities. A far greater number of people will be affected by these changes than by the politically-charged 'bank payroll tax' introduced by the act and, moreover, they will be affected in a more fundamental way by these changes. It is therefore important that these changes are not allowed to be eclipsed in the wake of the febrile attention which has been concentrated on the headline provisions.

The most important changes are to do with international aspects. One important change with international implications (found in FA 2010, Schedule 8, Paragraph 2(1)) is the amendment to the condition in section 543(1)(f) ITA as to the application of funds, which a charity is to meet when transferring funds to a body outside the UK. Whilst it is beyond the scope of this article to consider this amendment in more detail, charity tax advisors ought to be aware of it. More pervasively, the definition of 'charity' has been amended to include charities established in other member states. The change provides further evidence of the reluctant syncretism of the domestic legislator, whose hand has been forced, when drafting charity reliefs, to reconcile his explicable sovereign desire for supervision of the recipient charity with the continental demands for freedom of establishment and capital. The author discusses the judicial background which has enforced this change and considers whether the introduced changes will suffice to appease Luxembourg.

The incompatibility of our traditional definition of 'charity' with EU law, which was inherently by reference to domesticity, was brought to the forefront by two recent decisions of the European Court of Justice. One had to do with the withholding by Germany of tax relief *to a charity* established in another member state with respect to income which arose in Germany: *Stauffer*. The other had to do the withholding by Germany of tax relief *to an individual* who donated gifts to a charity established

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in another member state: *Persche*. Before turning to the new FA 2010 provisions, it is worth refreshing our memories as to the issues which were germane to these cases.

The case of *Centro di Musicologia Walter Stauffer v Finanzamt Munchen fur Korperschaften* C-386/04 involved a charitable foundation, which was established in Italy and which received rental income from property it owned in Germany. The question arose as to whether Germany was required to extend the benefit of its charity tax reliefs to this charity. It was agreed by the parties that the charity, had it been established in Germany, would have qualified for relief under German law. The case was argued on the bases of the freedom of establishment (Article 52 EC Treaty, now Article 43 EC) and of movement of capital (Articles 73(b) and (g) of the EC Treaty, previously 67 to 73 EEC Treaty and now found in Articles 56 to 60 EC). The European Court of Justice held at paragraph 19 that the former basis did not apply because the property in Germany was not actively managed by the Italian charity. The matter then hinged upon whether there had been an infringement on the free movement of capital. Among other things, this involved a consideration of whether Germany was entitled to rely on a derogation of Article 56 EC (now Article 63 TFEU) under Article 58(1)(a) EC (now Article 65 TFEU). This latter article provided that Article 56 would be without prejudice to the right of Member States:

> (a) To apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested...

It was held that this derogation was to be interpreted restrictively:

> 32 Unequal treatment permitted under Article 73d(1)(a) of the EC Treaty must therefore be distinguished from arbitrary discrimination or disguised restrictions prohibited under Article 73d(3) of the EC Treaty. According to the case-law, for national tax legislation such as that at issue in the main proceedings, which distinguishes between foundations with unlimited tax liability and those with limited liability, to be regarded as compatible with the Treaty provisions on the free movement of capital, *the difference in treatment must concern situations which are not objectively comparable or be justified by overriding reasons in the general interest, such as the need to safeguard the coherence of the tax system or effective fiscal supervision...*

The German and UK governments had, in anticipation of such a view being taken, argued that a German charity and a foreign charity were not in fact 'objectively comparable' as a charity established in Germany would play an active role in German society and thus ease the burden of the state. However, the court rejected

this argument. This on the basis that the German rules did not actually require a German-established charity to carry on its activities solely within national confines and, accordingly, it did not follow that such a charity would have an alleviatory affect with respect to the burden of the state. The court then held the German rules to be in violation of the freedom of capital. What is interesting is the acceptance by the court in paragraphs 37 and 57 that if Germany had chosen to restrict the class of 'charity' by reference to the particular activities it carried on, then that in itself would not have been contrary to Article 56 EC. It is not unambiguously clear from these paragraphs of the judgment as to whether it would have been acceptable for Germany to define 'charity' by reference to a charity which carried on activities within Germany. This atavistic question arises in *Persche* and is discussed further below.

Another longstanding debate, with respect to charity tax reliefs, had to do with transnational donations. Under the rules of several member states, a gift by an individual to a charity established in another member state did not qualify for gift aid or whatever the corresponding relief was in that state. The UK was one such state and the European Commission issued a Press Release to it in July 2006, which asked that this discrimination be put right. However, no propitiatory legislation was forthcoming and it took the case of *Persche* to force the issue.

Persche v Finanzamt [2009] STC 586 involved an individual, Mr. Persche, who donated various items to a charitable retirement and children's home in Portugal. He was denied deductions in Germany and the matter reached the ECJ. Among the various questions put before the court, the relevant one, for the present purposes, was whether it was acceptable in light of Article 56 EC for German rules to deny relief with respect to gifts made to charities established in other member states. Reliance was placed by the various national governments on Article 58 EC and, once again, on the basis that a domestic and foreign charity were not objectively comparable. They expounded three arguments in favour of this proposition (paragraphs 32 and 42 of the judgment). First, that the definition of 'charity' may differ from member state to member state. This argument was rejected by the court on the basis that there was no requirement, as far as EU law was concerned, that there be a unanimous understanding of what comprised charity. All that mattered is that once a member state had set out its own definition, it was not to deny relief to charities established in other member states which fell within it. Secondly, that otherwise the member states would suffer a loss in revenues. This argument, reminiscent of the German government's stance in *Stauffer*, was rejected. The court pointed out, quoting *Manninen* [2004] ECRI-7477 as it did so, that the need to prevent the reduction of tax revenues was not an overriding reason in the public interest capable of justifying a restriction on a freedom instituted by the Treaty. The third broad argument was based on the need to safeguard 'the effectiveness of fiscal supervision'. This had to do with the practical difficulties for member states in verifying whether foreign charities actually satisfied the objectives of its national legislation or of monitoring the actual running of those bodies. Whilst the court had

sympathy with this practical consideration, the argument was rejected on the basis that it did not justify a blanket denial of relief. A member state was entitled to require the party (the individual or, as the case may be, the charity) claiming relief to provide the necessary information relating to the charity's annual accounts and activities (paragraph 55). Furthermore, reliance could be placed on by member states on Directive 77/799. If the claimant ultimately failed to provide the relevant information, then relief could, of course, be denied on those grounds. The overarching point, however, was that the denial of relief, if any, was to be *a posteriori* and not *a priori*.

It is interesting to note that, as in the case of *Stauffer*, in *Persche* the court did go to great pains to stress that a member state was entitled to define a 'charity' as it wished. The judgment states at paragraph 47:

> ...it is permissible for a Member State, as part of its legislation relating to the deduction for tax purposes of gifts, to apply a difference in treatment between national bodies recognised as charitable and those established in other Member States if the latter bodies pursue objectives other than those advocated by its own legislation.
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> As the Court held in paragraph 39 of the judgment in *Centro di Musicologia Walter Stauffer* , it is not a requirement under Community law for Member States automatically to confer on foreign bodies recognised as having charitable status in their Member State of origin the same status in their own territory. Member States have a discretion in this regard that they must exercise in accordance with Community law. In those circumstances, *they are free to define the interests of the general public that they wish to promote by granting benefits to associations and bodies which pursue objects linked to such interests in a disinterested manner and comply with the requirements relating to the implementation of those objects.*

To some member states, these words could have been viewed as leaving open the tantalising possibility that it was acceptable for a member state to restrict the class of charities which qualify for tax reliefs to those which carry on activities solely within that member state. If this were correct, then a discrimination which was expressly forbidden on the basis of locality of *establishment* could nonetheless be achieved on the basis of locality of *activity*. Some support from this construction could be taken from the fact that the courts, when addressing the 'loss of revenue' argument made in both these cases by the member states, made the point that German law did not, as a matter of fact, require a locally-established charity to act solely within national confines. In other words, it did not reject the argument on a point of principle (that is, that German law was not entitled to discriminate on such grounds) but rather refuted it on a point of fact (that German law did not, in actuality, discriminate on such grounds). However, what is more plausible is that the ECJ was simply covering all bases in the course of its judgment. The ECJ has in the past

demonstrated a proclivity to cover as many bases as possible in the interests of caution, though this defensiveness can sometimes result in more confusion. In any case, it appears that this is what happened here. Because, in addition to making the fact-based refutation, the court does also make the point that whilst a member state has a measure of discretion in defining a 'charity', this discretion must be exercised in accordance with community law and in a 'disinterested manner' (see quotation above and, in the context of *Stauffer*, see paragraph 39). It should follow from this that it would be as unacceptable for a charity to be defined by reference to the locality of its activities as it is for it to be defined by reference to the locality of its establishment.

If the UK government had previously felt entitled to ignore the Commission's earlier Press Release on the basis there was no certainty as to what the position was in law, once the *Persche* decision was given, it took speedy steps to rectify the position. These changes have now been introduced by Schedule 6 of the Finance Act 2010. Prior to these changes, a 'charity' was defined as a body of persons or trust established for charitable purposes only (for instance, see the income tax definition at section 989 ITA). Whilst this statutory definition was not in itself offensive, it had been interpreted restrictively by the courts. It had been held in *Camille and Henry Dreyfus Foundation v IRC* 36 TC 126 that bodies 'established outside the UK' did not qualify for UK tax relief, even if they were established for purposes which were accepted as charitable under English law. By 'establishment within the UK', what was required was that the trust must take effect and be enforceable under the law of the UK (see page 152 of that decision). The rationale underlying this condition was that it was important for courts to be able to supervise charities and direct their schemes. Though there was some uncertainty in this area, it was generally held to be sufficient to bring the place of establishment of a charity within the UK if, in the case of a trust, the governing law was English or the trustees were UK-resident (as was the case in *IRC v Gull* 21 TC 374) and, if, in the case of a company, it was incorporated under UK companies legislation.

Pararaph 1 of Schedule 6 of FA 2010 now provides:

> **Definition of "charity" etc**
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> 1 (1) For the purposes of the enactments to which this Part applies "charity" means a body of persons or trust that—
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> (a) is established for charitable purposes only,
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> (b) meets the jurisdiction condition (see paragraph 2),
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> (c) meets the registration condition (see paragraph 3), and
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> (d) meets the management condition (see paragraph 4).

This definition will apply for the purposes of income tax, capital gains tax, corporation tax, inheritance tax, value added tax, stamp duty land tax, stamp duty reserve tax and stamp duty (paragraph 7 of the schedule). This definition applies for the purposes of Chapter 2 of Part 8 ITA (gift aid) from the 6th April 2010. It applies for all other purposes of tax from such time as will be specified by an order made by the treasury In addition to the condition relating to purposes, it is now important to meet new conditions relating jurisdiction, registration and management. At first glance, this might seem odd as it constitutes a further tightening of the rules rather than a relaxation of them. However, what the domestic legislator no doubt expects will appease Luxembourg is the fact that these new conditions apply to charities established in the UK as they do to domestic charities. For instance, the condition relating to 'jurisdiction' is met if the charity falls to be subject to the control of either a UK court (of a specified level) or `any other court in the exercise of a corresponding jurisdiction under the law of a relevant territory'. For these purposes, a 'relevant territory' includes a member state and, in addition, any other state which is to be specified by the Commissioners for HMRC by regulations. Likewise, the 'registration condition' is met if, in the case of a charity within the meaning of the Charities Act 1993, the trust or body of persons has been registered in the register of charities or if, in any other case, it is registered in a register under the corresponding laws of a foreign territory. The 'management' condition is met if its managers are fit and proper persons to be managers of the body or trust.

It might be considered by the more sceptical among us, that the particular manner in which the changes have been affected has indeed been calculated to reduce, rather than increase, cross-border giving. It could be argued by such sceptics that the mere imposition of new conditions will result in discrimination, notwithstanding the fact the these conditions apply across the table, because, as a matter of evidence, it will be harder for a foreign charity to satisfy these conditions than it would for a local charity. The problem of indirect discrimination, by reason of administrative and evidential burdens, was considered in the case of *Persche*. It was recognised that the extension of relief to charities established in other member states was not the end of the matter in itself – there remained the question of additional administration burdens when making claims from abroad. Who would meet these – the member state or the party seeking the relief? It was stated in paragraph 59:

> As regards the administrative burden which the preparation of such documents may entail for the bodies concerned, it is sufficient to point out that *it is for those bodies to decide whether they consider it opportune to invest resources in the establishment, distribution and possible translation of documents addressed to donors established in other Member States* desirous of benefiting from tax advantages there.

The view of the court seems to be that the additional burden would have to be met by the charity and not by the member state. It also acknowledges that, in light of the administrative burdens, some parties may well reconcile themselves to the forfeiture

of tax relief. In other words, the court is itself reconciled to a certain degree of indirect discrimination. However, the overriding tenor of the decision is optimistic and the thinking appears to be that whatever information a member state could reasonably require as a predicate to the grant of tax relief, this should be obtained by the claimant easily enough. Paragraph 57 states:

> Whilst it is true that, in contrast to such a recipient body, the donor does not himself have all the information necessary for the tax authorities to verify whether that body satisfies the conditions required by the national legislation for the grant of tax advantages, particularly those relating to the manner in which the funds paid are managed, *it is usually possible, for a donor, to obtain from that body documents confirming the amount and nature of the gift made, identifying the objectives pursued by the body and certifying the propriety of the management of the gifts which were made to it during previous years...*

It is the authors' view that the information, which would be required to satisfy the conditions in Schedule 6 of UK FA 2010, is of the kind which is anticipated in the paragraph above. Even if it does not fall within the same categories, the information required by the 'jurisdiction' and 'registration' conditions should be just as easily obtainable by a donor. The question of whether a charity falls within the jurisdiction of another member state does unfortunately involve questions of law – however, the matter should be straightforward in most cases. As for the condition relating to the eligibility of managers, which is the most fact-sensitive of the conditions, it s worth noting paragraph 5 of schedule 6, which allows for dispensation in certain cases where this condition is not met. On this basis, it does not appear that the new conditions will prejudice foreign claims. It is also worth reiterating that there was always some uncertainty as to what the domestic test for 'established within the UK' was. Accordingly, if the legislator was to provide foreign equivalents to various limbs of the test, he had to first define the limbs themselves. This had never been done before and certainly not by statute. It was only once the limbs had been selected (*registration*, *jurisdiction* and *eligibility of managers*) that they could be moulded to be applied in a foreign context. To this extent, the new conditions do not so much signify the creation of new conditions as they do the crystallisation of old ones.