

## Representations on s54 Finance Act 2006 The 'Substantial Donor' Legislation

### Executive Summary

This paper sets out the considerable concerns that we have in relation to the operation of the substantial donor legislation contained in Section 54 Finance Act 2006. We believe that the charity sector is only just realising the extent of the impact of the amendments made by s54 as the HMRC Guidance issued in May 2007 becomes more widely read and understood.

The costs and uncertainties brought about by this legislation to law abiding charities and their donors is, in our view, wholly inappropriate.

Our purpose therefore in writing these representations is to dialogue with HM Revenue and Customs, the Treasury and Ministers of HM Government, in conjunction with other sector representatives in order to find legislative solutions that meet the Government's original policy objectives whilst releasing the sector from undue burdens.

By doing so, we hope to see the Voluntary Sector continue to be vibrant and to thrive in what it does best: bring benefit to the public and, in particular to local communities.

We have deliberately limited our observations to those that we have encountered in practice so that our particular contribution to this debate is restricted to real life examples rather than theoretical fears. By doing this, we seek to demonstrate that our concerns are both real and likely to be common in practice. We are aware of many other weaknesses in the legislation in catching innocent charity activity, such as in land transactions and beyond. However, we have resisted the temptation to provide a catch all analysis for the reasons set out above. Others in the sector will no doubt provide examples in areas relevant to their own activity.

### **Summary of key issues**

Key issues that we have identified as having the potential to cause damage to the charity sector:

1. The scope of bona fide charitable activity negatively impacted by s54 is considerable, and greater than initially anticipated.
2. Charity trustees will be forced to make operating decisions based on tax considerations and not based on sensible strategy or pursuit of charitable objectives.
3. There is no mechanism for distinguishing between the legitimate transactions that are clearly not motivated by tax avoidance and those which have clear tax avoidance motives.
4. The legislation does not limit the penalty of contravening the legislation to tax on the lower of the tax relieved gift or the non charitable expenditure. As a consequence a charity may suffer a tax liability that far outweighs the tax benefit of the original gift. The legislation is therefore disproportionate.
5. It is the charity that will suffer all of the costs and 'restitute' the tax rather than the substantial donor, who will retain the benefit of their 'abuse'. The deterrent effect of the legislation is thereby significantly diminished.

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6. Major donors who have no tax avoidance motive will be put off making significant charitable donations to a single charity because of the potentially intrusive nature of the due diligence that charities will need to undertake if they are to comply with the legislation.
  7. Charities will risk suffering significant tax costs due to innocently accepting donations that give rise to a s54 cost either at the time of donation or in subsequent periods.
  8. The administrative and compliance burden of s54 arising out of the practical complexity (rather than theoretical complexity) is very high for a wide number of charities.
  9. For some charities the cost could be so significant that it may mean seriously curtailing some operations.
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10. HMRC Guidance does little to remove uncertainties; It only briefly covers some of the issues and limits explanation of fundamental concepts such as connected persons to a few lines.
  11. The effect of the legislation appears to be so contrary to the stated intention of only capturing those knowingly abusing the charity tax benefits that there is a danger this will create adverse attitudes towards HMRC and to compliance.

The Paper is set out in 6 sections, as follows:

**Section 1:** Is introductory and sets out the background to our concerns;

**Section 2:** Covers real life examples of innocent transactions that are caught under the legislation as presently framed. This forms a major part of this Paper.

**Section 3:** Illustrates that the number of substantial donors in the church and Christian charity sector is not as small or rare as Government would suggest; yet these are the sort of people in society that maintain high moral standards and desire to do 'the right thing'.

**Section 4:** Sets out the extent of the compliance burden, which is significant, covering systems, practical considerations, staff training etc.

**Section 5:** Poses some high level suggested solutions. We will be happy to work with HMRC and The Treasury in developing these ideas.

**Section 6:** Raises a number of significant questions that we have resulting from our conversations with HMRC and experience to date on s54 issues. We would welcome your response to these to enable us to advise our constituents.

In conclusion, it is our view that far from helping to achieve the stated Government policy of encouraging the growth of charitable giving, particularly amongst the wealthy, these measures are set to discourage significant and sustained charitable giving.

For further information or to discuss any aspect of the Paper, please contact the joint authors:

Kevin Russell, Technical & Professional Services Director, Stewardship  
E: [kevin.russell@stewardship.org.uk](mailto:kevin.russell@stewardship.org.uk) Direct dial: 020 8502 8572

Stephen Mathews, Senior Charity Consultant, Stewardship  
E: [stephen.mathews@stewardship.org.uk](mailto:stephen.mathews@stewardship.org.uk) Direct dial 020 8502 8588

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Stewardship PO Box 99, Loughton, Essex, IG10 3QJ  
tel: 08452 26 26 27 [www.stewardship.org.uk](http://www.stewardship.org.uk)

## 1. INTRODUCTION

### About Stewardship

Stewardship is both a gift aid user and representative umbrella body for the Christian charitable sector. The charity currently processes over £40 million a year in gross gift aid donations. Stewardship also provides a range of professional services to Christian churches and charities with a mission purpose of sharing knowledge and encouraging good practice in law and finance. The staff team include qualified accountants, a chartered tax adviser and a lawyer as well as other professionals.

Part of our work includes the issue of e-mail bulletins covering new laws and regulations as well as points of good practice. We also publish Briefing Papers on similar themes and provide an annual seminar programme for the churches and charities that we serve.

### Background to the concerns expressed in this paper

Whilst we, in common with the overwhelming majority of the charity sector applaud the Government's policy intention of preventing charities being cynically used for tax avoidance, we have become very concerned that Section 54 Finance Act 2006 has and will have a much wider and deeper impact than may appear at first sight. This has particularly become apparent since the issue of HM Revenue & Customs' Guidance on s54 and as we seek to apply that Guidance on a practical level. In particular, we are concerned as to the cost of compliance, the impact on charities normal day to day business and the adverse impact that these measures will potentially have on generous charitable giving.

When the legislation was originally introduced in the Budget 2006 it was outlined as being to counter abuse in the charity sector. The Budget Press Release stated

"those likely to be affected" would be "Individuals and companies who *misuse* charitable reliefs *through the use of charities they control*" [emphasis added].

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The Explanatory Notes accompanying the Finance Bill 2006 stated in relation to Clause 54:

*"Charitable reliefs have increasingly been exploited by individuals seeking to avoid paying tax rather than to benefit good causes – by securing tax relief on large donations to charity and then extracting value from the charity in a variety of ways. This clause is designed to address such abuse **without discouraging genuine philanthropy or creating unnecessary administrative burdens on charities**" [emphasis added].*

Numerous comments made by the Paymaster General during the Standing Committee A debate of Clause 54 on 18 May 2006 also make it clear that the Government's intention was to target the mischief without adversely impacting the normal business of charities. The general theme of the Government's position was that the legislation would only bite in situations where the charity and other parties to the transactions 'knew they were doing wrong'.

However, this paper demonstrates, using real life examples, that the legislation is currently too widely drafted with the result that:

- (1) it does not sufficiently target the mischief intended;
- (2) It puts an intolerable compliance burden on charities.

This is because aspects of the legislation will catch many *normal and bona fide* charitable operations.

We are anxious to give accurate guidance to our constituent churches and charities so that they can comply with the law and also avoid inadvertently finding themselves in a position of tax liability as a result of innocent charitable activity. We have therefore been in dialogue with HMRC Charities since September 2006, on the application of the new law. Themes that have emerged from these discussions include:

- HMRC awareness that there were some unexpected and undesirable effects of this legislation.
- That guidance would be issued outlining how HMRC intended to apply the legislation.
- Detailed advice to our sector should await that guidance, if at all possible, as otherwise we may unhelpfully create 'scaremongering'.
- That we could expect to see some tidying up amendments in Finance Bill 2007

We were therefore disappointed to see that no amendment of the legislation was announced in the 2007 Budget package. Guidance on Section 54 was not finally issued in May 2007. This indicated that:

- The legislation would be taken as it stood.
- The impact on the genuine operations of the sector was seriously understated.
- The approach would be restrictive without allowance for motive or circumstance.

In subsequent discussions with HMRC Charities Technical and others in the sector, it would appear that the implications of these provisions are little understood both in Government and in

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the sector and that they will in fact impact much wider circumstances than anyone had previously anticipated.

This contrasts with the Government's belief and intention at the time that the Finance Bill was debated:

Mr. Goodman: "... [The Paymaster General] said that the rules are targeted at those who abuse the reliefs. But will the proposed changes also catch those who do not abuse the reliefs? If so, what justification is there for that?

Dawn Primarolo: "I was going to come to the point about those who do not abuse the reliefs. .... ***If the charities are behaving according to charity law and are acting in the best interests of their charitable objectives, they cannot innocently have been in a transaction of this type*** because they would have noticed that they were paying or transferring value to a substantial donor that would not have been in the best interests of the charity. That comes back to the point about record keeping. Charities know well enough what they are doing. The overwhelming majority will have no concerns about the clauses. Although it is unfortunate, it sometimes happens—thus the requirement on HMRC. ... I can understand why charities would be fearful if such concerns were well founded, but they are not. ... That is why I am taking as much care as I can in responding to give assurance that the fears underpinning the amendments—more record-keeping, taxation of innocent transactions, restriction of charities—are ill-founded." [*emphasis added*]

Col 284 Standing Committee A, 18 May 2006

"I am trying to be clear and reassure the Committee that the aim is to target mischief, not to prevent charities from working" Dawn Primarolo Col 286 Standing Committee A, 18 May 2006

Julia Goldsworthy: "I understand that the target of the regulations is charities that are consciously exploiting loopholes and seeking to benefit a major donor. ***Will the Paymaster General accept that there are charities with substantial major donors that are acting perfectly within the law but will now have to take on an additional burden of compliance?***

Dawn Primarolo: "No, I cannot accept that. We are discussing a very narrow set of circumstances. ***If a charity is complying with charity law and the requirements of its charitable status, all its transactions should comply with them.***" [*emphasis added*] Col 286 Standing Committee A, 18 May 2006

The statement made in the recent HMRC guidance:

*"These provisions are not intended to hamper legitimate activities of charities or donors, so there are exceptions to make sure the measures do not catch certain arm's length transactions. Most (but not all) transactions that a charity will enter into for charitable purposes and on arm's length terms are exempted from the new rules."*

is contradicted by the Guidance itself and by the interpretation given on issues we have raised with HMRC Charities Technical. In fact, **a wide range of legitimate transactions are caught** and the exceptions are very limited and of little benefit to the legitimate concerns expressed herein.

We believe it important to set out our concerns as we believe that insufficient regard is being paid to the impact on the sector.

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### 2. INNOCENT TRANSACTION CAUGHT BY THE LEGISLATION

#### Examples of innocent transactions caught by the legislation

All the following are **real** examples and not created ones in order to provide theoretical but unlikely difficulties to the legislation. They all involve charities where there are substantial donors but none of which have provided more than 10% of the finances of the charity over a 6 year period. In most instances the substantial donations from any individual have been under 3% and in some instances under 0.1% of the income. In all instances the legislation catches transactions where it is clear that there was no intent to abuse tax reliefs and where there is no influence, overt or hidden, on the decision making of the charity:

#### Small/Medium sized charities (Income under £250,000)

##### 1. Employment / grant support of 'next generation'

Many smaller / medium sized charities have supporters who are deeply committed to their work not just in terms of time, skills and energy but financially as well. Over time these charities have often been those that have made the greatest impact because of the resultant dynamic and knowledgeable leadership. Young adults who have 'grown up with the work', being children of committed supporters and current leaders, will frequently be those that are best placed to take the work of the charity forward. This is particularly so in the church and Christian charity sector but will also be evident in other charities where there is a strong community identity and passion with the charitable cause.

Employment of these individuals, where someone in their family has been a 'substantial donor' now carries a tax surcharge. This means charities will not employ or provide training to those that the trustees may consider to be the **most able** to fulfil the required roles but instead will have **their** decisions **dictated by tax legislation**.

One of the co-authors of this paper is personally aware of a number of charities within 10 miles of his home that will be materially impacted by the legislation in this way. Following are 4 real life examples:

- Employment as a youth worker by a church where a parent, employed as a senior professional in London, was a regular supporter until retirement 3 years before (4.9% of total income over the previous 6 years).
- Provision of grant funding for training for work with Aids and other health related matters in Africa and UK of a post graduate student who is the daughter of an executive who had received a redundancy payment from his employer and made one 'substantial donation' from that (2% of the charity's income over the 6 year period).

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- A church with a congregation of 120 people, a number of which are in senior management positions with institutions in London. We have identified 14 adults *in the congregation* who are 'connected to' substantial donors (5 in total) by reason of birth, marriage or business partnership. These families are those which are most likely to be involved in leadership and development of the work (no one individual being the source of 5% of income and combined amounting to less than 20% of total income).
- An anonymous gift of £25,000 given to a charity in 2005. A condition was that the identity of the donor remained anonymous except to the 'Gift Aid secretary'. The gift had no 'strings attached'. The result of the HMRC guidance is that for the next 6 years all grants and employment decisions need to be referred by the trustees to the Gift Aid secretary in case the funding or employment decision inadvertently breaches the legislation. The Gift Aid secretary must now be trained to enquire of the donor as to any relatives or connected charities of the donor even though the gift was made without 'strings'. When the Gift Aid secretary steps down from that post they must pass on to their successor (who will need to be trained) the relevant details so the compliance process can be continued.

The time spent over the next 6 (or 12, if a gift of £100,000+) years in managing the compliance of this issue, even though of no relevance in the original transaction, is significant.

The trustees may be placed in an unenviable situation in the future whereby they have to refuse to employ an applicant, without giving good reason (which may itself lead them into difficulties with employment law and, in extremis, a Tribunal Case) or alternatively employ and 'enjoy' a large and open ended tax liability far in excess of the original gross donation!

#### 2. Lump sum gifts from individuals who are employees

Numerous cases are recorded of charity employees who are committed to the work of the charity wishing to financially support its work especially where they wish to lead by example. Both of the joint authors of this paper give to the charity for whom they work. Most church pastors, vicars, employed leaders etc. will support their church out of their income. That support is nearly always generous and sacrificial and is built on the tenets of Christian generosity. It is also not unusual for people in this position to supplement this regular giving either from liquidated savings to support a particular need, vision or campaign or to use funds received from an inheritance or other windfall. This can turn a generous, sacrificial giver into a substantial donor.

On the subject of remuneration of substantial donors, the Paymaster General commented:

"... but **the rules are targeted at those who abuse the reliefs**. Providing for the payment of employees not to be caught would enable artificial employments to be created by those still seeking to abuse the charitable relief. Charitable workers are not always the most well-paid people. It is almost a vocation. The individuals concerned are making a huge contribution. *In looking across the work of charities and how much they pay and whom they employ I do not see that the problem **could** arise* and so it increases my anxiety that ghost employment might be created here in order

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to create a category of employees" [*emphasis added*] Dawn Primarolo (HC Hansard, Standing Committee A, 18 May 2006 Col 283).

We would respond to these comments as follows:

- There is almost an accusation in this quote that any charity employee who makes a substantial gift to their employing charity will have wrong motives and will be a ghost employee seeking to abuse the charity reliefs. This is simply not the case.
- The rules in this regard are not targeted at all.
- The rules here do not contemplate the possibility of a person connected to the donor being employed by the charity for perfectly legitimate reasons and for reasons unconnected with the substantial donation.
- Generalisations and judgments about the levels of pay and motives of employees in the charity sector should not be made. Some employees are relatively well paid. Some are nevertheless highly motivated to give financially as well as with time and effort. Comment has already been made above about substantial one off giving by employees. On pay levels, reference should be made to charity pay surveys such as the annual Croner Rewards Survey.
- As the legislation presently stands, the risk of the innocent employment being penalised appears to be out of all proportion with the scale of the mischief.
- Rather than treating **all** charity employees who are or are connected with a substantial donor as tax avoiders in a ghost employment, a statutory test of bona fides of employment together with alternative means of verifying whether or not the employment is genuine should be engaged.

HMRC guidance appears to be that these gifts should not be subject to Gift Aid or meet any other definition of 'relievable gift' if the employment was started after 22 March 2006.

However, the complexities introduced fail to recognise the nature and structure of many small / medium sized charities. The financial work is often carried out by volunteers who frequently change. This means that trustees and those administering Gift Aid may change. Whilst 'substantial donor registers' for this size of entity may appear simple this is not always the case. From our experience we forecast that employees making substantial donations in such innocent circumstances will result in charities being unjustly penalised for **far in excess** of the tax benefit of the original gift.

A secondary aspect of this type of situation is that, because the legislation includes retrospection in testing the circumstances that lead to a donor becoming a substantial donor an employee may already be a 'substantial donor'.

Whilst the legislation provides two exceptions, both of these are being interpreted in a much more limited way than it appears would be reasonable:

#### Exception for employments commencing prior to 22 March 2006

A previously unincorporated charity with which we are involved with incorporated on 1<sup>st</sup> April 2006. The employment contracts of the staff transferred to the new charity under the TUPE regulations. This has highlighted a further problem.

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Where the employment has or will go through some form of transfer, even if that transfer is under the TUPE regulations (e.g. incorporation of an unincorporated trust in order to limit the risk to trustees of their personal liability and to ease recruitment of new trustees), HMRC appear to intend to treat this as a 'new employment' such that the exception for contracts made before 22<sup>nd</sup> March 2006 **does not** apply. This is curious and seems to imply that the incorporation (or for that matter any other charity transfer, such as on a merger) is somehow part of a tax avoidance scheme involving ghost employment. This would mean the responsibility of the charity to the employee under employment legislation is incompatible with the tax legislation.

Consider a charity merger. If a current employee of charity A had made a substantial donation to Charity B a few years previously (whilst then employed in a well paid commercial employment) and, after 22 March 2006, Charity A is merged into Charity B, does the employee's 'new' employment under TUPE now become tainted and subject to a tax charge?

Theoretical as this second example may seem, we are trying to illustrate the many and varied ways in which Section 54 can and will bite in perfectly innocent circumstances, often arising from actions outside the control of those that made (or accepted) the original donation.

Exception for trustee payments authorised by the Charity Commission etc.

The exception for payment of charity trustees (s506A(5)) for being a trustee is no exception at all since charity trustees as a general principle cannot be paid at all, for reasons of conflict of interest. Even when payment is permitted, this is not for being a trustee but for other (non-trustee) services rendered by the trustee. Section 73A(7) Charities Act 1993 as inserted by s36 Charities Act 2006 preserves this position.

To our knowledge the Charity Commission have only provided authorisation for payment of a trustee to one charity. The exception to S506A(5) is therefore effectively irrelevant and is no exception at all.

### 3. Employment of administrative staff who become relatives

Another real life example comes from the same local charities. This highlights the unintended impact and difficulty in applying the legislation.

In this case, there was no connection between the donor and employee at the time of the gift or at commencement of the employment. An individual became a substantial donor whilst single. Subsequent to the gift he married the sister of an employee of the charity. HMRC advise us that the employment is caught by the legislation although at the times the charity (a) received the gift and (b) made the decision to employ, there was no connection.

Whilst this example may seem unusual there are many churches and other 'community type' charities where this will actually occur in practice.

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Generalising, this example highlights the wider problems with Section 54, problems which seem almost limitless – of changing circumstances outside of the charity's control which bring otherwise 'untainted transactions' into the tax penalty net.

In other words, the law of unintended consequences mean that the charity suffers arbitrary taxation. There can be no certainties meaning that charities cannot plan for the future, in case for reasons outside of the charity's control, a connected person relationship is created elsewhere. If we have understood the law correctly, legislation that allows this, even if HMRC choose subsequently not to apply it in this way, risks bringing the law into disrepute.

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### Larger grant making charities

The most common difficulty for the larger charity would appear to be where grant support is made to a person who *happens* to be connected to a substantial donor - even if the funding for that grant is unconnected with the substantial donor. It will still be caught as 'financial assistance' by a charity to a substantial donor ... or connected person (s506A(1)(f)).

Paragraph 11.4.2 of the HMRC Guidance defines financial assistance as including the provision of a loan, guarantee or indemnity, or a Shari'a compliant financial product within s46 FA 2005 but also includes **charitable grants to beneficiaries**. It is notable however that whilst s506C(7)(b) which provides the legislative definition of 'financial assistance', makes reference to the provision of a loan, guarantee or indemnity and financial products within s46 FA 2005, **it makes no mention of charitable grants to beneficiaries**.

### Volume of transactions

If financial assistance is taken to include **charitable** grants to beneficiaries, this alone will present significant difficulties in compliance to organisations such as Charities Aid Foundation, Stewardship and other charities receiving donations from a large number of donors and also making grants to a large number of bodies and individuals as part of their bona fide charitable work.

### Connected person links

If a substantial donor makes a gift to a large grant making charity for its general purpose with no strings attached, and that same charity happens to make charitable grants funded by donations from an entirely different set of donors unconnected (in terms of s839 et al) with both the donor and the recipient, the fact that the substantial donor is connected in some way with the beneficiary of the 'independent funding stream' will taint that entire funding for no better reason than the gift by the substantial donor. This is not a theoretical idea but a very real problem for the types of charity mentioned above.

Compliance issues are already costing us dearly in terms of systems changes, staff costs and potentially, professional advice. Whilst we are very willing to do all that we can to counter abuse of any kind, we are not at all happy that we should absorb significant charitable funds on an ongoing basis to actually limit rather than promote bona fide charitable work because of poorly targeted legislation.

These particular difficulties arise as a consequence of having to obtain information and monitor hundreds, if not thousands, of transactions where there may potentially be 'connections'. The legislation appears to create a tax charge on the grant to a person who is connected with **any** substantial donor even though this connection does not have to be 'causative'. As a consequence any substantial donor connection, even though unknown to the charity, possibly unknown to the donor and unconnected to the donation, can result in tax penalised expenditure.

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A technical analysis of the legislation and guidance indicates the persons connected to a substantial donor include:

- Close family members
- Close family members of spouse/civil partner
- Close family members of future spouse/civil partner\*
- Future close family by marriage/civil partnership\*
- Business partners and their spouses
  
- Companies run by a combination of any of the above.
- Overseas charities with a majority of trustees who are a combination of the above.
- UK charitable trusts 'settled' by any of the above.
- UK Charities with a majority of trustees who are a combination of the above. (The Guidance makes no reference to this but tax lawyers are suggesting that this is within the definition of Section 839 ICTA 1988). Discussions with HMRC Charities indicates that these were not thought to be relevant. HMRC may consider these to be connected to the donor, but cannot state in which circumstances). \*

\*In the case of entities such as companies or charities there is no guidance. The Guidance does not adequately address the key issue of who the 'connected persons' are.

#### Future establishment of connected person link

It appears from discussion with HMRC Charities that the connection between a substantial donor and a connected person can begin by virtue of events taking place after the donation and thus be brought within the scope of the legislation as a result of the (new) connection. Presumably this conclusion is arrived at by taking s506C(3) and (7)(a) together. The risk of a charity being caught by this would appear to be higher in relation to remuneration (s506A(5)) than a s506A(1) transaction since s506(1) demands a transaction to take place whereas s506A(5) appears to just require remuneration to be paid, whether under an existing contract or otherwise.

#### Example

Mr. A is employed by charity X on 31<sup>st</sup> March 2006 who make up their accounts to 31<sup>st</sup> March each year. On 30<sup>th</sup> March 2012, B a person otherwise unconnected to Mr. A makes a donation of £100,000 to charity X. On 31<sup>st</sup> January 2018, B marries C who happens to be the sister of Mr. A.

#### Analysis:

- B is a substantial donor for the period 1<sup>st</sup> April 2005 to 31<sup>st</sup> March 2023, a period of 18 years.
- S506A(5) does not appear to need a transaction or a contract per se to trigger its operation; merely the payment of remuneration by the charity.

But ...

- Mr. A is not connected with B until the marriage to C on 31<sup>st</sup> January 2018 (chargeable period 1 April 2017 to 31<sup>st</sup> March 2018)

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On this basis, it would appear that Mr. A's salary becomes not charitable expenditure either (slightly retrospectively) from 1 April 2017 onwards or from 31<sup>st</sup> January 2018 (the latter date probably being the more correct interpretation of s506A(5)). Either way, the charity is punished for the wedding of A and C following B's 'innocent' donation almost 6 years earlier.

This is not thought to be the legislative intent and of uncertain legal interpretation but it may be the approach adopted.

Other examples of subsequent connection can be envisaged. For example a charity receiving a grant (financial assistance) from another charity may not be connected to the donor when the donation is received, but could become so some years after the event by appointing the donor's husband's brother or their business partner to their trustee board. Neither donor nor the paying charity may be aware of the connection.

In this case, unlike payment of remuneration, there is a requirement for a transaction. This would seem to mean that s54 will not apply unless the charity receiving the grant is connected to the donor in the same chargeable period as the transaction is entered into (s506C(3)).

### Example

Mr. D makes a donation to Charity E of £100,000 on 31<sup>st</sup> March 2006 (the charity makes its accounts up to 31<sup>st</sup> March each year). On 30<sup>th</sup> April 2006, E makes a charitable payment to Charity F. D is a trustee of F but has no control over F. In 2010, the trustees of F appoint several further trustees to the board of F each of whom is 'connected with' D by more tenuous relational of business links. Nobody realises that F is now controlled by D and persons connected with him by virtue of these persons forming a majority of the trustee board.

### Analysis:

It is recognised that Mr. D is a substantial donor at all material times.

In the chargeable period (year to 31<sup>st</sup> March 2007) that the charitable payment is made by E to charity F, F is not connected to Mr. D.

S506A does not apply since s506C(3) applies s506A to "a transaction entered into *in a chargeable period* with a person who is a substantial donor [or person connected with him – s506C(7)(a)] *in respect of that period* ..."

In 2010, F becomes connected to Mr. D but there is no transaction entered into in 2010.

Clearly, the danger for charity E is that it must not make any further charitable grants to charity F from 2010 onwards as they *will* then be transactions to which s506A applies. **BUT** how will they know about the change in status of charity F? It is very unlikely that they will if they are a large grant making charity, even if they are advised of the changes in the names of the trustees (which is not usual practice). Again, this presents an intolerable compliance burden on normal charitable activity.

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The choices facing the larger grant funding charities are therefore:

- Accept no tax effective donations which result in any 'substantial donors' (therefore seriously affecting funding and the range and extent of charitable activity that can be undertaken). This would appear to be directly contrary to the stated Government intention of increasing support for charities and doing so with tax effective support.
- Build in procedures which capture all potential 'substantial donations' (which in themselves may be comprised of cumulative small donations) so that all **current connected persons** of the potential donor are:
  - Identified
  - Matched to those that have been in receipt of grant funding in the last 6 years
  - Consider whether there may be grant funding to them in the next 12 years
  - Accept or reject the donation.
  - Communicate with its potential donor base as to why it is undertaking enquiries which some will consider 'intrusive' and 'indicative of suspicion'.

*(It should be noted that for each individual donor the list of connected persons can frequently run to more than 20 individuals or entities – and in many cases to very many more – **one of the co-authors has over 40 connected persons**. It should also be noted that becoming a substantial donor can occur by even a small gift if there have been other gifts during the previous rolling 12 months)*

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- Build in monitoring processes which prevent *any* grants being made until *all current* connections with 'substantial donors' are investigated. This itself is likely to have a very negative impact on the donor's motivation to give.
  - Issue requests to all substantial donors that they supply information on any *changes* to their list of connected parties (which would appear to require them asking for information from their connected parties as they will almost certainly be unaware of the connections of, for example, their business partners / siblings or spouses close family)
  - Provide them with a timetable to respond within.
  - Match the potential grant beneficiaries to the existing and updated list.
  - Communicate with its potential donor base as to why it is undertaking enquiries which some will consider 'intrusive' and 'indicative of suspicion'.

It should be remembered that for the larger charity, especially ones that achieve their charitable objectives by involving their donors through the medium of 'charity vouchers', 'charity cheque books' etc., the list of substantial donors could easily be 500. If each donor has an average of 20 connected individuals and charities (which is likely to be an underestimate) **this means there is a list of 10,000 individuals and entities, which is changing through time, to continually monitor and compare their grant making against.**

None of these alternatives appear practical. At best they are extremely expensive and detrimental to 'donor relationships' and it is likely that there will be a significant reduction in donor interest as a result. **At worst the entire operation of the charity becomes unviable.**

The impact upon these charities appears out of proportion to the benefit of the legislation seemingly due to insufficient consideration of issues and debate in Parliament. Changes to the legislation to bring in reference to 'proportionality' of income as opposed to absolute financial thresholds would make an enormous impact in reducing the compliance costs without risking significant weakening of the legislation.

### 3. SUBSTANTIAL DONORS & COMPLIANCE PROBLEMS

#### Relevant evidence on 'substantial donors'

It is asserted by both the Government and HMRC that most charities will have few, if any, substantial donors and that, therefore, compliance with the legislation will be simple. That charities will easily recognise an offending transaction because their one or few substantial donors will be exerting undue influence on the charity.

Whilst it is acknowledged that for many charities Section 54 will have limited impact because they receive little or no funding that would fall within the substantial donor thresholds, there are nevertheless a wide number that are *significantly* impacted as a result of having a *large number* of donors who do meet the criteria.

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Examples of these are not limited to charities in the 'faith' communities although it is possible these will be most affected. Any charity that has genuine supporters who are 'affluent' or 'deeply committed' are likely to be impacted.

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Whilst we do not have sector wide statistical evidence to call upon, the authors of this paper have very many years' financial experience in the Charity Voluntary Sector working professionally for and within the Sector. Their personal knowledge and experience suggests that a significant number of charities in certain sectors will be very seriously impacted. Sectors most likely to be affected are:

- Larger grant making charities

The issue here is the volume of grants received and made. Since the thresholds (£25,000 and £100,000) are absolute rather than relative to overall income, charities with a substantial donor base will be a very large number of persons 'connected to' any one substantial donor to monitor and eliminate. Depending on the nature of the charitable objects, this alone can pose a compliance nightmare.

- Charities with a smaller but personally committed donor base

Charities within this category may be seriously impacted. Here, there are two issues: potential compliance costs and the risk of genuine operating decisions being affected solely by the requirement to avoid a s54 tax charge thereby distorting their charitable operations.

Within a *10 mile radius* of the residence of one of the co-authors, we are aware of at least *5 situations that fall into this category*, which will create a material impact on the charities' operations.

Even without statistics it is clear to us that Para 11.2.10 of the HMRC guidance which states that "Relatively few donors will fall within the definition of substantial donor; and many charities will have no substantial donors" shows a lack of understanding of the sector as a whole. This is deeply regrettable. Whilst the terms 'relatively few' and 'many charities' may technically be correct, there is still a sizeable enough proportion of the sector that are affected. **We therefore strongly urge the Government and HMRC to conduct a radical review of the legislation and guidance in the light of greater research and consultation with the sector. Otherwise the cost to the genuine charity sector will very possibly outweigh the benefits from the legislation.**

Whilst the thresholds of £25,000 in a 12 month period and £100,000 over 6 years may initially seem high, this is not the case for donors who are convinced of the benefit to society and committed to the work of charities. Their generous and self-sacrificial giving in support of that work is a natural outcome. In fact many of those that are time poor and cash rich typically as a result of success in business, generous support for charity is their way of 'putting something back' or giving thanks for their material success. There are frequent examples of this level of altruism in the national press.

Statistical evidence points to charitable giving of 10% of income or higher by individuals is frequent. Surveys among sections of the Christian sector suggests that 30% of donors give 10% or more of their income to their church and 52% of married couples give 10% or more of their income to Christian charities. Further, in the Christian sector, it is not unusual for individuals to

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give a proportion, often 10% of an inheritance to charity. This may be done under gift aid, possibly bringing 'ordinary' but generous donors within the substantial donor category.

On top of this there will be special appeals (e.g. the Tsunami or a specific local need) which motivate donors into additional giving over and above their regular giving. This certainly seems at odds with the apparent presumption that there will be few substantial donors in total and that those in that category need to be treated as 'potential tax avoiders'.

As a consequence the impact of this is far greater than an initial reading of the legislation would suggest. The guidance appears to imply that such levels of giving will very largely come from donors intent on tax avoidance. Our experience and that of others is that this is not the case and the funding of these donations often comes from:

- Individuals of good intent with high earnings.
- Individuals receiving a one off bonus
- Individuals being affected by needs (such as the McCann family) who will cash in savings.
- Individual's receiving legacies
- Companies with ethical management

With the emphasis and support of the Government to the charity sector there are many thousands of donors falling in this category.

#### 4. COMPLIANCE BURDEN

The legislation is currently framed so that a single £100,000 donation will give rise to 'substantial donor' status **for 18 years**: 6 chargeable periods before the date of donation, 6 periods after plus the chargeable period of gift and 5 further periods. **All in respect of the one gift!** Example 2 in Section 11.3 of the HMRC Guidance (ignoring the implementation date of the legislation for the purpose of making the point) illustrates this 18 year period.

In the Standing Committee Debate when asked about the extended period of impact (HC Hansard, 18 May 2006, Cols 288 & 289), the Paymaster General responded by postulating that maybe tax avoidance was taking place over longer periods and is more widespread than HMRC believes. With all due respect, this completely misses the point. The point is that **this places a compliance requirement on the charity concerned to monitor transactions and link them to the donor or connected persons for a 18 year period in exchange for one gift!** Suddenly, accepting that gift in the first place does not seem such a good idea: If we then work on the basis that there is absolutely no tax avoidance motive, the charity now has to:

- Identify all 'relievable gifts'. In the case of company gift aid payments (s339 TA 1988), the charity may not be aware that the gift is 'relievable' without further specific enquiry.

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- Ensure that their systems record the gift in a way that it is 'in their sights' for 18 years;
- Carry out due diligence to know all of the individuals, businesses and charities that the donor may or may become connected with. ***This to be carried out on an ongoing basis, since personal, business and other circumstances will change over and 18 year period;*** This presumes that charity staff (whether professional or otherwise) will be able to understand and apply the connected persons rules in s839, s506C(5), s416, s660G and so on!
- Have systems in place not only to monitor whether an offending transaction is taking place but to ensure that the right people (compliance staff for example) are made aware of the fact by operational staff;
- That the appropriate action is taken to either prevent the transaction taking place or to self assess the resultant tax.

Over an 18 year period, there will be many changes in a charities staffing. So systems would need to be watertight – a huge infrastructure cost in building very sophisticated software algorithms which will need to be maintained in a world of fast changing IT platforms.

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If one multiplies that up for monitoring of all gifts whether single, or cumulatively reaching the £100,000 threshold, working out the 'tainted' period for each (which will potentially differ in each case), then checking whether an offending (but innocent) transaction has occurred between the charity and the donor, the compliance and bureaucratic nightmare becomes apparent. In short it places an intolerable, unacceptable and unjustified compliance burden and tax liability risk on the charity for no gain whatsoever.

The examples in section 2 demonstrate the type of innocent transactions that we have in mind.

To reiterate, the tax cost of the offending transactions can potentially far outweigh the tax originally recovered. For example, where a connected person is a **bona fide employee** of the charity for a significant part or all of the 18 year 'tainted' period, rendering their entire salary (and presumably on costs such as employers' national insurance and pension contributions) as non-charitable expenditure.

The indication from fund raisers to the sort of questions and restrictions that may occur when donors are interested in funding £25,000 or more is that there will be a wide number who consider the intrusion and perceived implication of 'suspicion' excessive compared to the benefit of giving (which is in itself a cost to them). This will without doubt reduce the funds being available for the genuine charity sector.

### 5. SUGGESTED SOLUTIONS

If there are not to be significant costs to large sections of the charity sector, changes to legislation and practice will be needed. We feel that these changes would include:

- Consultation with the sector on the impact and interpretation of the legislation to be properly considered in the light of the improved understanding.
- Introduce a tax avoidance motive test
  - Recognise law currently penalises genuine charitable activity
  - Recognise that the rules trap the 'innocent' as well as the 'guilty'.
  - Recognise that current compliance costs are so high as to outweigh the benefit.
  - Recognise that complexity of law and connected persons provisions currently introduce present and future uncertainties as to the impact on donors and charities.
- Introduce a clearance mechanism (see below) to bring assurance to charities where there is uncertainty
- Only penalise remuneration from bogus or non-arms length employments
- Consider reducing the period over which a donor remains a 'substantial donor' where the gift is of £100,000 or above.

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- Introduce amendments to thresholds to define a 'substantial donor' relative to the charity's income (and perhaps other measures of donor influence) and not according to absolute value of gift.
- Limit the tax liability arising to the lower of (a) the tax reclaimed on the substantial donor's gift and (b) the non-charitable expenditure.

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### The question of a 'clearance mechanism'

Anti-avoidance tax legislation which would otherwise entangle legitimate commercial transactions often has a tax avoidance motive test and sometimes a 'clearance procedure' whereby, if the simple facts of the transaction would result in it being caught and adversely treated, the transactors can write giving full facts to HMRC and obtain clearance that the anti-avoidance legislation will not be applied. It is understood that the reason this was not introduced in this legislation was that this had a cost to HMRC.

The effect of having such a clearance system would be to significantly reduce the inappropriate costs to legitimate charities outlined above, especially if it can be 'weighed' after the event as well as before. This is thought important since the legislation is virtually guaranteed to catch entirely innocent transactions. Whilst there will still be some costs in identifying transactions and providing details to HMRC these would be very small in comparison with the enormous 'preventative' data capture and monitoring that will be required with matters as they stand.

The effect of not having a clearance mechanism is that the charity sector itself is having to pay a very significant cost of undertaking compliance checks. Added to this is the hidden opportunity cost of not undertaking what would otherwise be legitimate charitable transactions which will now be treated as 'taxable' under this legislation.

Before this legislation is applied in practice we would urge HMRC to reconsider its position on clearance, and introduce both a tax avoidance motive test and a clearance procedure, both of which should be given retrospective effect.

Costs could be contained by having a series of 'general clearances' which could be built upon over time as experience of the new legislation is gained as well as a mechanism for 'specific clearances'. The general clearances would follow the model of the former long since repealed legislation covering Treasury Consents for transfers of assets abroad.

## 6. KEY QUESTIONS FOR HMRC AND THE GOVERNMENT

There follows a list of some of the key questions that have arisen as we have sought to understand and apply this legislation. There may be other questions that arise in due course as the sector gains experience of these provisions:

- A substantial donor gives to Charity A. In what circumstances, if any, is Charity B 'connected to' that substantial donor where Charity A provides charitable grants to Charity B such that the grants from A are treated as 'non-charitable expenditure'?
  - Firstly where the recipient charity is a trust?
  - Secondly where the recipient charity is a charitable company?
  - Thirdly where the recipient charity is an 'association'?
- If there are such circumstances why is the guidance completely silent on the subject?

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- For 'voucher' charities in what circumstances, if any, are grants from that charity to a charity nominated by a substantial donor considered 'non-charitable' [It has been suggested (informally) by HMRC that firstly the donor and receiving charity and, secondly, the giving and receiving charity may be treated as 'connected' in these circumstances.]

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- If that is the case please advise on the following:
  - Which charity bears the responsibility for ensuring there is no expenditure which breaches the legislation?
  - Which charity bears the tax cost should this occur?
  - How is this to be handled when the originally nominating donor wishes to remain anonymous?
- Please confirm the impact of key dates for 'connections' relative to a substantial donor that change over time (e.g. new business partners, spouses, entities under common control) over the approximately 18 years that the charity must consider the connections of its substantial donors.
- How are charities expected to establish:
  - All the connected persons of a donor where this information may well not be known to the donor (e.g. business partners and wider family connections)?
  - Changes of connections that occur throughout the relevant period (see question above)?

Without launching enquiries that are likely to be detrimental to donor relationships and their willingness to give?

- Is the legislation intended to catch substantial anonymous gifts (which may or may not be 'relievable') and if so, how are the charities executives to handle this?
- What will be the HMRC approach to those charities that have inadvertently ended with 'connected person transactions' outside the exceptions where it is obvious to all that these were genuine charitable activities which were only caught by the complexity of the new legislation?
- Please confirm that s54(3) or in the alternative s54(2) Finance Act 2006 will apply to employment contracts entered into prior to 22 March 2006, such that s506(5) will not apply to any remuneration paid under that contract.
- Please also confirm that where an employment created prior to 22 March 2006 is transferred under the TUPE regulations that it will not be considered to be a new employment. If such a confirmation is not forthcoming please:
  - Advise how this conclusion can be within the spirit of the legislation?
  - How a charity reconciles this with their employment law responsibilities?
- Please clarify in what other circumstances changes in the terms and conditions of an employed worker's circumstances would be considered to be a 'new employment'?
- From a policy perspective, why is it that the charities will pay the tax penalty even though the benefit accrues (and will continue to accrue) to the errant substantial donor?
- We are concerned that all public statements relating to this legislation refer to such a small number of charities being affected but, if our understanding of the legislation is correct, it would appear to affect a very wide number of charities and some charities very considerably. Are there any plans to alter this so the public statements are not misleading?