

# Response to the HMRC Public Consultation Substantial donors to charity

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# 1 EXECUTIVE SUMMARY

Stewardship has a particular interest in the operation of the substantial donor legislation originally contained in Section 54 Finance Act 2006 as both a charity that has been heavily impacted by it and as an umbrella body for the Christian charitable sector which encompasses tens of thousands of charities.

We have engaged with HM Revenue and Customs (HMRC) and other Government Departments on the shortcoming of Section 54 for the last two years, submitting our own Representations Paper to HMRC and to HM Treasury in July 2007.

We wholly agree with and support the stated objectives of the current Public Consultation. However, this response demonstrates that the proposed legislative amendments fail to meet these objectives.

## Circumstances not addressed

Our response identifies some of the circumstances where the proposed amendments simply **do not** address our concerns. We have not addressed any of the additional concerns that arise for example, in relation to property transactions as others are better placed than us to do so.

## Risks of the legislative approach

Because of the approach taken by this legislation (that a charity is 'guilty' until proven innocent by a relevant exemption) and the piecemeal approach to amending this very complex legislation, we fear that **further** circumstances of innocent transactions that are inadvertently caught will emerge over time.

## Dual regulation

The substantial donor legislation itself creates a dual layer of regulation since much of the abuse that is targeted is already covered by existing trust and charity law. This makes for poor regulation. In this respect, both the existing and amended Substantial Donor rules contravene the Hampton principles<sup>1</sup>.

## Hampton Principles

Although not specifically commented on further in the text of our Response, we are of the view that the existing and amended Substantial Donor Legislation contravenes the Hampton principles of Economic Progress, Compliance and Enforcement (including the Principles set out in the Macrory Review), and Accountability.

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<sup>1</sup> Reducing Administrative Burdens: Effective Inspection and Enforcement, Philip Hampton, March 2005.

## Repeal

We therefore favour a total repeal of the Substantial Donor legislation and that in it's place focus is given to the effective prosecution of existing law including inter-Departmental co-operation (such as is provided by Section 10, Charities Act 1993), and that high profile publicity is given to cases where donors or charities have abused tax reliefs for improper purposes.

## Alternative approach

We would be content with additional power being given to HMRC to withdraw tax reliefs where existing trust and charity law is breached and there is a clear tax avoidance motive present.

By taking this approach, 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.

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## 2 INTRODUCTION

### About Stewardship

Stewardship is both a gift aid user and representative umbrella body for the Christian charitable sector. The charity currently processes over £50 million a year in gross gift aid donations. Stewardship also provides a range of professional services to Christian churches and charities including training and support on new and existing law and regulation. Our mission purpose is to share knowledge and encourage good practice in law and finance. The staff team include qualified accountants, a chartered tax adviser and a lawyer as well as other professionals.

### Stewardship's engagement with the Substantial Donor legislation

In July 2007 we set out in representations to HMRC and HM Treasury considerable concerns that we had in relation to the operation of the substantial donor legislation contained in Section 54 Finance Act 2006. We considered that the costs and uncertainties brought about by this legislation to law abiding charities and their donors was wholly inappropriate. Since then our concerns have widened as the impact of the legislation in practice has become even more apparent.

We therefore welcomed the publication, in July 2008, of the Public Consultation by HM Revenue and Customs of a review of this anti-avoidance legislation. We are grateful for HMRC's willingness to engage with the charity sector over the last 18 months on this issue and in seeking to understand the unintended but significant adverse impact of the Substantial Donor legislation on law abiding charities and their donors.

In responding to this very welcome Consultation, we hope and call upon HMRC, the Government and other relevant Government Departments to consider wider ranging measures than those set out in the Consultation Document alone, to address the sector's concerns as comprehensively as is practicable. We are grateful for the opportunity to contribute to this process, and to help create a suitable environment where charities are able to flourish whilst deterring those that would abuse charity tax reliefs for non-charitable purposes.

Throughout this Paper, for simplicity. Legislative references are to the Corporation Tax provisions of ICTA 1988 but our comments apply equally to the corresponding provisions of ITA 2007.

### Stated objectives of the Public Consultation

The charity sector acknowledges and supports the need for a legal framework that addresses the risks posed by those who "... influence or set up charitable structures with a view to avoiding tax rather than with any charitable intent."<sup>2</sup> The Consultation Paper acknowledges that there is a "... balancing act for Government to counter this type of abuse **without discouraging charitable giving or creating unnecessary administrative burdens.**"<sup>1</sup> (In this quote and those that follow, emphasis has been added by Stewardship).

In commenting that the legislation provides exemptions from the anti-avoidance legislation for innocent transactions, the Consultation (Paragraph 1.4) rightly observes that "*It is ... vital that*

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<sup>2</sup>Substantial donors to charity: A review of anti-avoidance legislation around large donors to charity. HMRC Consultation Document 15 July 2008

*the legislation exempts the correct transactions thus providing tax relief for innocent transactions. It is also important that innocent charities do not suffer a significant administration burden”<sup>1</sup>*

Paragraph 1.6 states: *“The aim of the consultation is to ensure that the substantial donor regime best reflects the needs of both Government and the charitable sector. That is one that deters avoidance but that exempts all transactions that a charity has cause to carry out in the course of its charitable activities and which minimises the administration burden for charities.”<sup>1</sup>*

Paragraph 2.1 reads *“The Government believes that if all transactions which charities can be reasonably expected to carry out with their substantial donors are exempt, charities will not incur a charge under the substantial donor rules. Nor should there be a significant administration burden, as there will be no ‘caught’ transactions for a charity to monitor and report.”<sup>1</sup>*

We wholly support these stated objectives. However, as our Response demonstrates, these objectives will not be met by the proposed amending legislation. **We believe that the originating legislation should not be amended but repealed in its entirety because:**

- (a) It is fundamentally flawed and built on the wrong foundations.
- (b) It creates dual regulation contrary to the principles of the Statutory Code of Practice for Regulators.<sup>3</sup> Better Regulation principles apply equally to Third Sector organisations as others.<sup>4</sup>
- (c) Amending a complex piece of legislation piecemeal risks the stated objectives of the Consultation not being achieved.

### Summary of key responses by Stewardship to the consultation

The Public Consultation document retains the underlying approach that all transactions with substantial donors or persons “connected” to them will result in “non charitable expenditure” by the charity unless specifically exempted. If a transaction is not covered by one of the specific exemptions, the charity has to pay “**penalty taxation**”.

The specific exemptions proposed in the Consultation document are intended to carve out innocent transactions.

However there are 2 fundamental flaws to this approach:

- The proposals fail to exempt some transactions which can clearly be entered into by charities going about their normal activity. The rules **therefore fail to exempt whole categories of innocent transactions** (see section 2).
- Considerable uncertainty arises over how HMRC will apply and interpret the arms length tests in practice. This gives rise to unacceptable risk on the charity in that it is expected to self assess from a potential position of uncertainty. The provisional guidance on this suggests a lack of understanding of charities’ valid operating principles (see section 3).

The proposed amendments set out in the Public Consultation go some way towards alleviating the difficulties but fail to deal with the issues comprehensively. As a result, there will still be a heavy administrative burden on charities and unnecessary restriction on genuine charitable activity.

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<sup>3</sup> Statutory Code of Practice for Regulators: BERR, 17 December 2007, coming into force 6 April 2008 (Legislative and Regulatory Reform Code of Practice (Appointed Day) Order 2007)

<sup>4</sup> For example, *ibid*, Page 7, Paragraph 1.2

Even with the proposed amendments in place, the law will:

- fail to exempt **whole categories of innocent and normal charitable activity**
- still leave **uncertainty**
- still be effectively **unworkable**.

Having considered the operation of the rules in the context of persons intent on abusing the tax reliefs available, we do not believe that the existing or proposed substantial donor legislation adds a significant further deterrent to pre-existing law, nor is it effective in recovering tax from those intent on abuse.

Far from helping to achieve the stated Government policy of encouraging the growth of charitable giving, particularly amongst the wealthy, the amended law will still have the potential to discourage significant and sustained charitable giving.

Because of dual regulation, these measure, even after amendment, appear to be at odds with the Government's commitments for Better Regulation because the law is insufficiently targeted, it is disproportionate and it inconsistent.

A wide range of concerns that we expressed in relation to the original legislation **remain unaddressed**:

- The risk of charities suffering significant tax costs due to innocently accepting donations that give rise to a cost either at the time of donation or in subsequent periods.
- The disproportionate impact of the legislation whereby a charity may suffer a tax liability that far outweighs the tax benefit of the original gift.
- That charity trustees are forced to make operating decisions based on tax considerations and not based on sensible strategy or pursuit of charitable objectives.
- That the legislation fails at a basic level to distinguish between legitimate transactions that are clearly not motivated by tax avoidance and those which have clear tax avoidance motives.

In order to balance the needs of Government with those of the charity sector, we believe that the Substantial Donor rules should be repealed. We would welcome the opportunity to work with Government in framing a more workable deterrent and protection to the Exchequer around existing charity and trust law legislation.

If after comprehensive debate full repeal is not considered viable, we regard it as essential that, in addition to the reforms proposed in the Consultation Document, a tax avoidance motive test is added to the rules alongside the repeal of Section 506A(3). Even then, we would remain concerned that a charity may find itself unwittingly entering into a seemingly innocent transaction that has been motivated by the tax avoidance of a substantial donor. We therefore submit that it is also essential that the tax burden of the Substantial Donor rules be shifted from the charity to the donor who benefits from the mischief.

### 3 INNOCENT TRANSACTIONS CAUGHT BY THE LEGISLATION

Even if the proposed changes as set out in the Consultation Document were implemented, there are a number of categories of innocent transactions that would continue to be tainted by the legislation.

In this section, we set out the difficulties that we see for Stewardship and the churches and charities that we work with. We have not sought to cover other categories of transaction that are still vulnerable under the amended legislation. Other respondents will no doubt cover these.

As will be evident from our Response, we together with our constituents and donors alike have experienced considerable problems complying with this legislation. However, we wish to point out that many charities are either *unaware* or simply *do not understand* these rules and therefore do not perceive there to be any problems. Due to the complexity created by the rules, we would not expect a large volume of responses to this Consultation. However, that should not be interpreted as a measure of the spread and depth of the problems created by Section 54 FA 2006.

#### Financial assistance other than grants

The original legislation treated as 'non-charitable expenditure' the provision of '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 alternative finance arrangements within s46 FA 2005 but also including charitable grants to beneficiaries.

The proposed Consultation amendments provide "a new exception from the application of the legislation ... where that financial assistance takes the form of a charitable grant provided by the charity in the course of the actual carrying out of a primary purpose of the charity".

However, it makes **no proposals** to include an exception for the provision of a loan, guarantee or indemnity, or alternative finance arrangements within s46 FA 2005 where provided in the course of the actual carrying out of a primary purpose of the charity.

#### Financial support by charities other than grants

Any loan, guarantee or indemnity, or alternative finance arrangements made to the substantial donor or to a person connected to them is therefore **automatically penalised** regardless of whether it is entered into completely innocently and wholly for the purpose of the charity.

A charity who, for example, makes loans or provides guarantees to individuals or charities as part of its charitable activity can very easily find that it is (or is about to be) in breach of the legislation. It is easy to envisage common circumstances where this will be a problem in practice:

- Providing emergency loans as part of a financial aid package.
- Providing long term loans as 'programme related investments' (also known as 'social investments').
- Providing long term mortgage loans for property purchase or development.
- Providing guarantees to those in need (e.g. unemployed/homeless people for renting who would otherwise require deposits).

- [Potentially] Providing property or equipment that would otherwise have to be rented.

Indeed, had this legislation been in force prior to 22 March 2006, one of our mortgage loans to a church will have been caught by this legislation for no good reason other than one of the trustees being a substantial donor. The prospect that a mortgage advance, made for perfectly bona fide charitable reasons, may lead to non-charitable expenditure of many **hundreds of thousands of pounds** - as a result of receiving maybe a £50,000 gift from a donor connected with the recipient church is incredible.

The only way for a charity to prevent the provision of tainted financial assistance is to:

1. install procedures, systems and training which is prohibitively expensive (see section 4), or
2. cease to provide assistance in that way.

The most common difficulty for this type of charity would appear to be where non-grant support is made to a person who *happens* to be connected to a substantial donor - even if the funding for that loan etc. is unconnected with the substantial donor. Whilst application of s506A(1)(f) may, on the face of it, appear straightforward the connected persons provisions make compliance difficult if not impossible, and is made all the more difficult by the proposed rewritten provisions of s506F (2) and (3).

Turning down mortgage applications for church building projects for reasons that you cannot disclose to the church (i.e. a connected person who is a substantial donor to us) is totally counter productive to both our charitable endeavour and the expansion plans of a charity applying to us for assistance. It would also lead to damaged relationship between the charity and its potential beneficiaries.

This has major impacts on both large financial support charities, such as Stewardship, who commonly provide loans as well as grants and also on smaller charities who only occasionally provide loans or guarantees, such as churches.

The current 'credit crunch' only serves to exacerbate the problems for churches etc. posed by this legislation. As banks and other financial institutions are understandably limiting or ceasing their exposure to loans to faith sector charities as they are perceived to be at the higher risk end of a lending portfolio churches etc. are increasingly turning to specialist lenders such as Stewardship who not only understand their financial and governance structures but also have an increased degree of mutual trust.

For Stewardship to apply the legislation fully would involve:

- Turning down mortgage applications and emergency loan support to charities who, especially in the current financial climate, may have limited or no other alternative simply because of a 'connection' to any one of our 'substantial donors'. The cost to the charity sector of this cannot be quantified.
- Turning down donations where we know or expect there to be a future loan required – for no other reason than Stewardship cannot afford to have a 'substantial donor' who is connected to a future borrower. **We have already had to turn away donations of over £2 million for reasons such as this.**
- Incurring high levels of administrative cost to monitor, enquire and assess the very many connections between donors and other donors and between donors and borrowing charities.

Churches, and other smaller charities, frequently make loans to other charities from their funds which are surplus in the short term, or financial assistance to members of the community in financial need. The proposed legislation would prevent this happening unless:

- The church had a policy of making no loans, or
- The church monitored its donors to see that none of them, when added to their 'connected persons' became 'substantial donors' and
- Understood the legislation covering when a charity or individual is connected with a donor

The church of one of the authors made a £35,000 loan to another local church to help with their rebuilding program. Under the current legislation making this loan could have cost the church £10,000 in tax penalty if it wasn't confident that there was no legal connection between the borrowing church and any of the individuals in the lending church who were substantial donors (of which there were 5 under the present legislation). See below for the problems in making these assessments.

### Financial assistance: the problem of 'connected persons'

We comment further in Appendix A on the issue of persons connected with the substantial donor. However, it is important to consider the difficulties expressed in this section in the context of the connected persons provisions. In Finance Act 2006, it was generally thought that one had to consider if an offending transaction(s506A) (such as financial assistance) has been entered into with the substantial donor ... or a person connected with them. However, the re-written provisions of ICTA and ITA 2007 proposed in the Consultation Document widen this previous understanding such that the *definition* of 'substantial donor' includes both gifts from the substantial donor and all persons connected with him or her.

This means that a substantial donor (and for that matter, the charity benefitting from his donation) may not know that he is a substantial donor! This theme is further explored in Example 1 below.

This now means that a charity has the additional burden of checking (a) if there is a person connected with a donor that turns that 'ordinary' donor into a substantial donor, and (b) if there is an offending transaction with that connected person. We would respectfully suggest that (a) alone is impossible to comply with.

#### Example 1

A gives a single gift of £49,000 to a charity as a result of receiving an unexpected legacy. The charity concerned is very close to the heart of A's family because of the work that it does. A's business partner's spouse (Mrs Z) (who A has never met and does not know) gives £1,000 to the same charity within 12 months of A's gift as she has had a good year in her business and has become aware of the good work of **the charity through her husband, A's business partner**. 'A' now becomes (unwittingly), a substantial donor. Almost 6 years later (and within the 'window' period provided by new s554C(1)), Mrs Z and her husband have hit upon hard times and knowing the good work of their cherished charity approach them and receive a significant interest free loan to help them get back on their feet.

The loan and the deemed interest are now non-charitable expenditure of the charity who have no idea that A was a substantial donor let alone the tax law connection between A and Mrs. Z.

#### Example 2

Mr. D makes a donation to Charity E of £125,000 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 loan to

Charitable company F. D is not a director trustee of F and has no control over F. In 2010, the directors of F appoint several further trustees to the board of F just one of whom is 'connected with' D (e.g. a brother in law or a more tenuous relation of business links). Nobody realises that F is now "controlled by D or persons connected with him" by virtue of a legally 'connected person' being one of the trustee board.

### Analysis:

It is recognised that Mr. D is a substantial donor at all material times. In the accounting period (year to 31<sup>st</sup> March 2007) that the charitable loan is made by E to charity F, F is not connected to Mr. D.

S506A does not apply since (new) s506A(8) applies s506A to "a transaction entered into *in an accounting period* with a person who is a substantial donor *in respect of that period* ("SD"), or to a person connected with SD"

In 2010, F becomes connected to Mr. D but there is no new transaction entered into in 2010. Our reading of (new) s506A(8) is that even though the connection is established in a period that Mr. D is a substantial donor, because that connection was not in existence *at the time that the transaction was entered* into, section 506A does not apply to the transaction. It would be helpful if HMRC are able to confirm their agreement to this interpretation.

However, there is clearly a danger for charity E is that it must certainly not make any additional loans to charity F from 2010 onwards as they *will* then have transactions to which s506A applies. If there is a significant change to the original loan terms, would this be regarded as a new transaction to which s506A *would* apply if A remains a 'deemed' substantial donor at the time?

How will they know about the change in *status* of charity F? It is very unlikely that they will if they are a large financial support charity, even if they are advised of the changes in the names of the trustees (which is not usual practice). This presents an intolerable compliance burden on normal charitable activity.

### Financial assistance: the problems of the compliance obligations

Charities who may potentially make loans, guarantees or other non-exempt 'financial assistance' would therefore have to choose between the following unworkable alternatives:

- Decline to accept any tax effective donations which result in a donor becoming a 'substantial donor' (including monitoring donations from persons connected with them, as above) thereby seriously prejudicing their funding and therefore the range and extent of charitable activity that can be undertaken. Clearly this is both impractical and unacceptable. It is also directly in contrast to the stated Government intention of increasing support for charities and encouraging tax effective giving.
- Build in procedures which capture all potential 'substantial donations' (which in themselves may be comprised of cumulative small donations **both** from the donor **and** their connected persons – where the connection may not even be known to any of the people involved) so that all *current connected persons* of the potential donor are:
  - Identified
  - Matched to those that have been in receipt of loan funding in the past 3-4 years

- Consider whether there may be loan funding to them in the next 8-9 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 is very important to note 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 of this response has identified 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 3 years.

- Build in monitoring processes which prevent *any* loans 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 loan beneficiaries to the existing and updated list.
  - Communicate with the potential donors as to why the charity is undertaking enquiries which some will consider 'intrusive' and 'indicative of suspicion'.
- Build in monitoring processes which prevent any loans being in place or altered, that may conflict with any future connections that charitable companies may make with 'substantial donors'. This requires, at the very least, some very difficult monitoring arrangements to be in place.

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' etc., the list of substantial donors could easily number 500 or more and is known in one charity to exceed 2,500. 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 50,000 individuals and entities**, which is changing through time, to continually monitor their actual or proposed loan portfolio.

**The legislation is therefore unworkable** – since 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 entire sections of the operation of the charity become untenable.

## 4 CONCERNS OVER INTERPRETATION

The proposed legislation outlined in the Public Consultation **exempts** the two key transaction types from s506A:

1. Remuneration paid to an employee under terms which are no less beneficial to the charity than may be expected in arrangements at arms-length.
2. Charitable grants provided by the charity in the course of the actual carrying out of a primary purpose of the charity on terms which are no more beneficial to the substantial donor or connected person than those on which grants are provided to others.

These two areas cover a large proportion of innocent transactions that would be caught by the original legislation.

What is or is not 'arms-length' is to be determined by the charity (on a 'self-assessment' basis) subject to any later challenge by HMRC.

### Remuneration

It is unclear to us why it is necessary to impose the arm's length test as HMRC already have the power to challenge excessive remuneration under the non charitable expenditure rules in section 505-6 TA 1988 . Flagrantly excessive remuneration paid by a charity would also amount to breach of trust on the part of the trustees.

Whilst remuneration for many charity appointments can be benchmarked there are many that cannot. For example, unique posts or where the particular employee brings unique knowledge, skills or attributes to the charity. How can the arms length test be evaluated in these circumstances, especially where that knowledge, skill or attribute comes at a premium price?

### Charitable grants

#### HMRC Guidance on the assessment of charitable grants

The draft Guidance which accompanies the Consultation Document appears to fail to address the diversity in the way in which charities make grants. Paragraph 3.2 of the draft guidance refers to the evidence that HMRC will look for in assessing whether or not the charity has provided financial assistance to a substantial donor. It states "The officer will look for evidence of whether:

- The charity's usual grant application procedure was followed and documented;
- The recipient was in *genuine and demonstrable financial need*;
- The trustees had properly documented their reasons for making the grant and that those reasons were consistent with the charity's objects and usual practices;
- The substantial donor (or any person connected with them) took part in the decision making process;
- The grant was *demonstrably* no more (and made on no different terms) than the charity would typically provide to an 'unconnected' third party." (*emphasis added*)

Whilst it is accepted that the Guidance refers to this as an example of the evidence that an office of HMRC would look for, charities need to know that HMRC will adopt a flexible and

reasonable approach. For example, the Guidance focuses on the relief of financial need. This is of course just one narrow head of charitable purpose amongst the whole range of purposes for which charities may make grants to substantial donors or persons connected with them.

Further concerns arise from this:

- 1 It is not always possible nor even desirable to make a grant which is demonstrably no more beneficial than the charity would make to an unconnected third party. For example, a grant under consideration may be quite unique in its character, or the trustees may decide (independently of any connection) that they want to focus on a particular area of their work such that they deliberately fund that area more generously than other parts of their grants programme.
  - 2 A substantial donor may well (legitimately) take part in the decision making process for a grant:
    - They may well have made their donation on the basis that it would enable a particular charitable purpose to be fulfilled (typically 'restricted fund' giving). Of course the gift aid benefit rules would need to be taken into account where a connected person is involved.
    - Many charities involve their donors as 'partners' in discussing the use of funding.
- Trustees of charities must of course carry the final discretion on the use of their funds but the Guidance should be clearer in describing how and when involvement of the substantial donor could be problematic.
- 3 Charity to charity grants are likely to be subject to entirely different assessment criteria especially where the recipient charity is UK based.

In applying the above test, there is a real danger that unless Trustees are confident that they can rebut HMRC enquiries on each of the criteria set out in the Guidance, they may feel obliged to undertake unnecessary administrative effort and go to great lengths in relation to potential grants in order to 'tick the boxes' so that they are more than watertight.

Even worse, charity trustees may feel the need to seek external professional advice in respect of more significant grants because of nervousness brought about by the proposed amendments to the legislation.

In general and in our experience, charity trustees tend to be risk averse, compliant and very cautious. This is particularly so in the light of the potential personal liability that trustees have in law. Combined with the way the legislation operates to penalise **the charity** (rather than the donor) where there is a substantial donor issue, it is likely to create an '*hyper-cautious*' approach.

This would bring enormous administrative effort and financial cost for no real benefit.

### Further comment on the draft Guidance accompanying the Consultation Document

- In Example 1, and at the end of Example 2 on Page 25, the phrase "It *may* therefore *choose* to complete its self assessment on that basis" is, we feel, wholly unhelpful.
- Given that the Guidance will be read by lay people in the charity sector, the reason for the connection between Mr Young and Y Limited in Example 2 needs explanation as it's derivation from law and common sense is somewhat obscure!

## 5 OTHER MAJOR CONCERNS

### General

Underlying our concerns is the attempt, which is believed to be fundamentally misguided, to create tax penalties which are applied to a charity for all transactions that it undertakes within the scope [of s506A] with other parties unless the transaction falls within certain narrowly defined exceptions.

This is misguided because:

- It starts by making everything 'guilty' unless it can fit within the narrow exceptions to make it 'innocent'.
- It is not practical to comprehensively define in legislation all the types of transaction that are 'innocent'. What makes transactions offensive is not the *type* of transaction (purchase, grant, loan, support, business supply, salary, financial arrangement, non-financial arrangement etc) but the ultimate outcome; namely it is avoiding tax by the use of charities for non charitable activity. Therefore, if this legislation is not to be repealed it would appear far better dealt with by having a 'tax avoidance motive' test. It may not be possible to define it, but generally, it is recognisable when seen! (An analogy is trying to define a smell – impossible to define in words but we know when something smells bad)
- The penalty is based on transactions that may be many times greater than the original donation. A loan is made of £1,000,000 by a charity to a second charity which is connected to a substantial donor of the first charity who may have given only £50,000. The tax relief on the original donation is very likely to be under £20,000. The penalty for the charity is in the region of £300,000!
- The penalty falls on the charity and not the donor. The charity may well not have received the tax relief in the first place and may be bankrupted by the penalty.
- Those intent on abusing charity tax reliefs will ignore these provisions and a complicit donor-controlled charity will simply not 'self-assess' their mischief. The guilty unless proven innocent approach of the legislation is therefore completely misplaced.

### Application of the legislation

HMRC has commented that these provisions will only be applied in cases of blatant abuse. However, this is an unacceptable approach for the following reasons:

- It creates uncertainty for charities.
- In 'self-assessing', charity trustees are potentially personally liable (for what could be a disproportionate penalty) and therefore will not want to rely on such an assurance unless there is a published statement to that effect.
- If the rules theoretically bite on a transaction but the charity does not 'self-assess', then the charity's auditor or independent examiner is duty bound under Part VII Proceeds of Crime Act 2002 to make a report to the Serious Organised Crime Agency and to the Charity Commission under the Whistle Blowing provisions of Charities Act 2006 (or the

equivalent provisions in Scotland and Northern Ireland). This could cause unwarranted difficulties for the Charity.

- Our understanding is that, legally, HMRC are not permitted to prosecute tax law on a selective basis. Therefore, it is quite possible that individual Revenue Officers will still take issue with otherwise innocent transactions.

## Duality of Regulation

Although the perceived mischief addressed by this legislation would appear to be adequately covered by existing trust and charity law in conjunction with the provisions of s505-6 and Schedule 20 ICTA 1988, we understand that HMRC were concerned, in 2006, that these protections did not extend to the whole of the UK. With the passing of Charities (Northern Ireland) Act 2008 last month, this concern is now time limited by the coming into force by that Act. Following that, duality of regulation would appear to apply to the whole of the UK.

## 6 RESPONSE TO THE SPECIFIC CONSULTATION QUESTIONS

Each of our responses to the specific consultation questions below should be read in the context of this entire document which adds detail to and explains our brief responses that follow.

### Exempt transactions

#### **Question 1: Would the proposed arms length exemptions (for arm's length remuneration and arm's length grant funding) be welcomed by charities?**

These are both important exemptions were the legislation not repealed. However:

- On remuneration, it would appear that the arm's length requirement does not add anything that is not already in existing charity law in that artificially inflated remuneration is already non-charitable expenditure under present legislation. Added to this, there is particular difficulties for some charities in establishing what an arm's length rate is.
- On grant funding, the benefit (which is welcome) is tempered by our concerns over HMRC interpretation, in practice, of the arm's length standard.

#### **Question 2: How many additional transactions do you envisage would be exempt under each of the proposed arms length tests that are not currently exempt?**

The question, as framed, does not adequately assess the issues. It fails to take into account:

- The number of transactions that are carried out, but only after breaking any 'connections' (for example, a connected person stepping down from the recipient charity), which then harms the recipient charity.
- The number of transactions that are currently being undertaken by charities in ignorance of the letter of the law as it currently stands.

However, for Stewardship we estimate that there would be approximately 150 transactions each year that would now be exempt. For an average active church, we would estimate several per annum.

#### **Question 3: What is the value of the tax savings that you would experience for each of the arms length transactions? Do charities anticipate that there would be any other benefits and quantifiable savings?**

We have not evaluated this as we do not consider an exemption from having to go to unjustified lengths to avoid an unjustified tax charge to equate to a tax saving! However, Stewardship could potentially make administrative savings of well over £100,000 per annum if exemptions eventually enacted were to cover all of our areas of concern including other forms of financial assistance such as loans, or if the legislation is repealed.

We are aware of one charity that incurred legal fees of between £15,000 and £20,000 restructuring in order to proceed with a *single* bona fide charitable transaction which would otherwise have been 'blocked' as financial assistance.

**Question 4: Are there any issues or concerns as to how this will work in practice and the extent to which charities are able to demonstrate that remuneration and grant funding are paid at arms length? What if any do you estimate the costs of providing this information to be?**

We have considerable concerns as outlined in our substantive response. The draft guidance appears to indicate a lack of understanding of the issues around charity recruitment, employment and remuneration on the one hand, and on the other, the basis of charitable grant making, and especially the degree to which it is fundamentally tied to financial need.

Presuming these were clarified satisfactorily Stewardship would not have concerns or significant costs itself as procedures are in place already. However, many smaller charities do not have such procedures in place and many trustees are not used to having to operate in regulatory framework of uncertainty. Charities may well feel the need to spend considerable time and legal costs gaining a level of comfort before proceeding. Therefore, these uncertainties are expected to significantly limit the level of benefit from this exemption.

**Question 5: Are there any other likely costs?**

In each area of potential breach of the substantial donor legislation, besides any tax cost, there is a significant administrative cost (recording, monitoring, evaluation risk) as well as legal and professional costs including, for example lawyer's and auditor's costs.

**Question 6: Are there any additional transactions which are not exempt but should be made so?**

Very definitely yes! In Section 2 above, we comment in detail on the omission of loans and other forms of financial assistance. Other commentators will likely draw attention to innocent property transactions.

#### **De-minimis limit for relievable gifts**

**Question 1: What proportion of charity donors make donations of less than £1,000 per charity per year?**

For Stewardship	– 68%
Churches	– on average 60-70%.
Other charities	– on average 80-90%

However, the relevance here is question 2. If you have to monitor transactions that may exceed £1,000 to add towards £125,000 over 3 years it makes very little difference to monitor them all. Other than for the smallest charities, it could in fact involve more work identifying and excluding donors whose gifts are less than £1,000.

**Question 2: Would this limit help in reducing administration costs?**

No. We do *not* think it would help significantly.

**Question 3: Is the limit of £1,000 too low?**

Yes, very definitely it is far too low. A figure of at least £5,000 would be needed to make any appreciable difference to the monitoring costs.

## Disregarding small payments or benefits

### Question 1: Would the proposed de-minimis limit (of £500 per annum) be welcomed by charities?

Yes, but see our response to Question 4.

### Question 2: How many donors will this affect?

For Stewardship: virtually none.

For churches and other charities: a reasonably significant number.

### Question 3: What would be the likely quantified savings? Are there likely to be any other benefits of costs?

Stewardship: none

Churches and other charities: This will be quite varied, depending on individual circumstances, but see our response to Question 4.

### Question 4: Is the proposed limit of £500 set appropriately?

Very definitely, no. The objective of the legislation is to counter abuse of the charity tax reliefs by *major* donors. For this disregard to be meaningful *and proportionate* to the cost and trouble of the legislation, the limit would have to be very significantly increased - more proportionate to the £50,000 donation threshold. The legislation **MUST** therefore be targeted at major abuse.

A figure of £5,000 or more per annum is the minimum we would see any value in having.

## Revised thresholds for defining substantial donors

### Question 1: Would the revised thresholds be welcomed by charities?

Yes, but this still fundamentally misses the vast cost for a large number of charities in monitoring thresholds and maintaining the systems, procedures and training even for the smaller number of substantial donors.

### Question 2: What are the current administration costs of monitoring donations?

The cost of monitoring donations themselves is only a tiny part of the cost of administration. The significant cost is that of monitoring activity once a "substantial donor" is identified. This is true for large and small charities.

Stewardship incurs costs in the areas of:

- Monitoring donations (relatively, a minor cost)
- Obtaining and maintaining records of "connected persons" before acceptance to establish whether this would lead to historic transactions being in breach (difficult and interruptive but not costly in financial terms)
- Monitoring all grants / loans against this list (very expensive)
- Discussing with donors situations that arise. For example, if a proposed donation is accepted, the substantial donor consequences. Some donations have been declined as a result (This is both administratively expensive and damaging to goodwill)

The activities involve:

- IT system changes
- Policies and procedures changes
- Staff training
- Staff administration and supervision
- Senior management involvement when difficult issues arise.
- Legal advice

The overall administration cost to Stewardship has not been calculated but is estimated to be in excess of £100,000 per annum.

This excludes the costs of the loss of grant income when the requirements of the legislation are incompatible with the circumstances of the donor/connected party recipient. 99% of potential 'conflict' cases involve a recipient charity which is only "connected" by reason of a connected person on the board of trustees/directors.

For smaller charities and churches:

The cost is largely in terms of additional volunteer time that is required for this rather than fruitful activity. In some instances it can be 'the straw that breaks the camel's back' as busy volunteer trustees/administrators try and cope with, what is to them, illogical and intrusive bureaucratic nonsense.

[A quote from one volunteer on a related issue: "I have no desire to let down the many elderly people we assist, but as a pensioner myself, I cannot contemplate running a small operation under such bureaucratic disciplines and fear that no one will be rushing to take my place... Those in Government fail to recognise that it is increasingly difficult to recruit volunteers "].

**Question 3: Would the proposed revisions to the thresholds for defining a "substantial donor" reduce administration costs to charities?**

Very definitely yes. However, not sufficiently for the remaining costs to be warranted and proportionate.

**Question 4: (a) Where charities do have significant costs are these predominantly from monitoring individuals? (b) Do charities consider there are any significant costs from monitoring corporate donors?**

(a) Individuals make up the majority of most charities 'substantial donors'.

(b) Yes. These have many complexities both technical and practical in dealing with corporate substantial donors given that a corporate donor may have a wide number of "connected persons" and enquiry is needed to ascertain the wider network of 'connected persons' that arise from these.

**Question 5: are their alternative limits that charities would prefer to see in place for defining substantial donors?**

The most appropriate answer is to repeal the legislation given it is wrongly founded.

However, for many charities the limits being purely 'absolute' rather than being 'relative' to their gross income means that even high thresholds are intolerably low for many larger charities.

Neither an absolute or relative threshold is likely to help philanthropy trusts which are funded very largely by one business or individual.

## APPENDIX A: SUBSTANTIAL DONORS & COMPLIANCE PROBLEMS

### Relevant evidence on 'substantial donors'

It was originally 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. Also 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.

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.

Whilst we do not have sector wide statistical evidence to call upon, Stewardship has very many years' financial experience in the Charity Voluntary Sector working professionally for and within the Sector. Our experience suggests that a significant number of charities in certain sectors will need to seriously consider the impact on them. Sectors most likely to be affected are:

### Charities with a smaller but personally committed donor base

Whilst the original 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. The proposed thresholds of £50,000 in any 12 month period and £125,000 over 3 years are a considerable relief.

However, there are a large number of well-resourced supporters whose generous and self-sacrificial giving in support of a charity's work is a natural outcome of their desire to see it succeed. 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 levels of altruism in the national press that will still exceed these thresholds. The most common will be:

- Wealthy philanthropists using family charitable trusts (e.g. the Sainsbury family, .....
- Well resourced supporters of charities with significant emotional appeal (e.g. the McCann family, many churches, etc).

### Larger grant making charities

The issue here is the volume of grants received and made. Since even the proposed higher thresholds (£50,000 in any one year and £125,000 over three years) 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.

As a consequence the impact of this is far greater than an initial reading of the legislation would suggest. The basis of the legislation 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 or inheritance
- Individuals being affected by needs (such as the McCann family) who will cash in savings.
- 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.

### Impact of "connected persons"

If a substantial donor makes a gift to a charity for its general purpose with no strings attached, and that same charity happens to provide charitable support 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 that the gift by the substantial donor. **This is not a theoretical idea but a very real problem for all types of charity.**

The 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 loan 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.**

We cannot see any practical way of monitoring donors to establish who is connected with whom. But this is essential under the legislation as it is the combined donations from all individuals or companies that are 'connected' with each other, and not just the donations from a single individual, that must be compared with the thresholds for the definition of a substantial donor. Even if a charity has an intimate knowledge of its donors, it would still be impossible to know that one donor is connected or not connected with another unless the charity asks detailed and very searching questions of each donor. Even with a small donor base, this is totally impractical and would be **very** counterproductive to the building of donor relationships.

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.

## PLUS, very critically:

- UK charitable companies where any **one** of the above is a director/trustee (this may be only one of a Board of Directors of 15 or 20 but still results in a legal 'connection' for tax purposes). In practice this is a **very common** situation.
- Overseas charities with a majority of trustees who are a combination of the above.
- Potentially UK charitable trusts 'settled' by any of the above and UK Charities with a majority of trustees who are a combination of the above. (The original Guidance makes no reference to this but tax lawyers are suggesting that this is within the definition of Section 839 ICTA 1988).

In the case of entities such as companies or charities there is to date no clear guidance. Nor does the proposed guidance appear to 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.

Many examples of subsequent connection can be envisaged. For example a charity receiving a loan (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.

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 and is known in one charity to exceed 2,500. 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 50,000 individuals and entities**, which is changing through time, **to continually monitor and compare their transactions against.**

## Length of period under consideration

The legislation is currently framed so that a single £125,000 donation will give rise to 'substantial donor' status *for 12 years*: 3 chargeable periods before the date of donation, 3 periods after plus the chargeable period of gift and 5 further periods. *All in respect of the one gift!*

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 12 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.
- Ensure that their systems record the gift in a way that it is 'on the radar' for 12 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 a 12 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 a 12 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.

If one multiplies that up for monitoring of all gifts whether single, or cumulatively reaching the £125,000 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.**

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

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.**

**The legislation is therefore unworkable** – since 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 entire sections of operation of the charity becomes unviable.