

Discussion paper – approaches to preventing charities being set up to avoid tax

Policy objective

1. The Government wants to ensure that the part the tax system plays in supporting charities is protected from abuse that would harm both the sector and the Exchequer.
2. This discussion paper seeks views on the advantages and disadvantages of alternative versions of draft legislation to help deter those who would seek to establish charities for tax avoidance purposes. We recognise that both versions are limited in their effect and would therefore be interested in views on whether there are other, better ways of achieving the same objectives.

Background

3. The Government recognises that Britain's charity sector makes an invaluable contribution to society, whether at the community, national or international level. The Government is committed to supporting charities and to helping the sector achieve even more. Government support includes a generous set of tax reliefs for charities and their donors.
4. The Government recognises that the tax system plays an essential role in supporting the charity sector, including legitimate tax planning by donors, and is committed to protecting this form of support. However, the generous nature of charitable reliefs means that they will be targeted for exploitation. The Government will always look to protect the good name of the charity sector and safeguard taxpayers' money by closing down opportunities that a tiny minority of people exploit to misuse the reliefs.
5. The Government remains committed to working closely with the sector in understanding the nature of the challenges the sector faces and in developing workable safeguards. Accordingly, the Government would like to find a legislative solution that would prove effective against extreme cases of abuse without risking damage to genuine charities. This paper seeks views on what form further action should take to protect the sector from persons who seek to abuse it to avoid tax..

Charities and tax

6. Charitable tax reliefs for charities and donors can be broken down into:
 - tax reliefs for charities – including income tax and corporation tax reliefs on income and certain VAT reliefs
 - tax relief on donations to charities – including Gift Aid, Payroll Giving, and tax relief on gifts of qualifying investments such as shares and land

7. Total tax reliefs to charities, including business rates relief, are now worth over £4 billion a year. Gift Aid alone is a significant tax relief for charities, with repayments of donors' tax to charities reaching over £1 billion in 2012-13.
8. Recent cases in the public eye have focussed attention on attempts to abuse charity tax law using Gift Aid. One such scheme involved highly artificial and circular trading of Government gilts between a charity and its 'donors'. In that case, a charity received 'donations' only a small fraction of which were used for charitable activities.

What is a charity for tax purposes?

9. A new definition of 'charity' for taxes administered by HM Revenue & Customs (HMRC) was introduced by Part 1 of Schedule 6 to the Finance Act 2010. Charities and their donors are entitled to claim UK charitable tax reliefs administered by HMRC if the charity is a charity under the law of England and Wales (or would be were it established in England or Wales), established for wholly charitable purposes, and meets certain other conditions:
 - the location condition: the organisation must be established in a European Union Member state or a relevant territory (currently Iceland and Norway)
 - the registration condition: the organisation must be registered by the Charity Commission for England & Wales, or an equivalent charity regulator in its home country, if required by law
 - the management condition: the managers of the charity must be 'fit and proper persons'

Tax avoidance using charities

10. As mentioned above, in order to be a charity under the law of England and Wales an organisation must be set up for wholly charitable purposes.
11. At the point a charity is established there is generally no evidence for regulators or HMRC to be aware of, to indicate that a charity is being set up for anything other than wholly charitable purposes. The governing documents of the charity will ostensibly be charitable and it is only with hindsight that it becomes clear that the charity was established as part of a contrived tax avoidance arrangement.

12. Forexample:

- A charity that is set up ostensibly to make general charitable grants may not be very active until it is used for a multi-million pound avoidance scheme a year or two later. In the meantime, the charity may have received small donations from its founders and claimed Gift Aid repayments on those donations, without carrying out any charitable activities
- A promoter of tax avoidance schemes develops a complicated scheme using charity donor tax reliefs to try to avoid tax. The scheme depends upon a charity being actively involved in the scheme. The promoter establishes a charity to carry out the necessary transactions with the 'donors' recruited by the promoter

13. While HMRC can, and does, challenge such avoidance schemes, one approach to deterring this kind of abuse of charitable tax reliefs would be to withdraw all entitlements to charity tax reliefs to an entity which was later found to have been established under arrangements seeking to abuse the tax system.

14. Autumn Statement 2013 announced that legislation would be brought forward to prevent charities being set up to avoid tax. HMRC already challenges such schemes under existing legislation but new legislation could deter some potential avoiders. This would save HMRC resource through reducing the need to challenge schemes through litigation, often involving hundreds of participants in an avoidance scheme.

Progress to date

15. HMRC has considered how to deter charities from being set up for avoidance purposes. The approach to date has been to build on the definition of a charity to explicitly exclude charities where the main, or one of the main, purposes of establishing the charity is to facilitate tax avoidance arrangements.
16. Following some informal consultation on our possible approach, charity sector representatives highlighted the importance of striking the right balance between protecting the reputation of charitable reliefs and not putting off innocent potential donors. However, redrafting the legislation to address these concerns could lead to the measure being watered down to such an extent that it could result in a measure with little practical effect.
17. Two possible versions of draft legislation [A] and [B] are set out in the annexes at the end of this paper.
18. Both versions rely on establishing a motive of securing a tax advantage in the context of the arrangements under which the charity was established.

19. One issue is that the term ‘tax advantage’ could be taken to include the advantages of ordinary tax reliefs. Representative bodies expressed concern that this test could catch a charity established to seek money from donors and to claim repayments under Gift Aid to help fund its activities.
20. Another issue is that a charity that was established for genuinely wholly charitable purposes and then taken over with a motive to abuse the tax system would not be caught. Although HMRC could use the management condition mentioned in paragraph 9 above to tackle this kind of abuse, distinguishing between genuine charities taken over, and charities set up, as part of arrangements to avoid tax would be very tricky in practice. Not only would this be a problem for HMRC, it could also increase uncertainty for donors.

Version A

21. In contrast to Version B, this approach relies on preventing a charity being recognised by HMRC if, in essence, one of the main purposes or results of its establishment is to secure a ‘tax advantage’.
22. The test in this approach is geared towards ‘tax advantage’ as given by section 1139 of the Corporation Tax Act 2010, rather than ‘tax avoidance’.
23. The sector representatives we have consulted informally with were concerned that the scope of the ‘purpose’ in this approach could create doubt about recognition by HMRC of private charitable foundations and corporate charitable foundations. They felt this because in these cases it is arguable that one of the main purposes of establishing a foundation is the obtaining of a tax advantage, specifically Gift Aid and other reliefs on donations.
24. If we were to take this approach, HMRC would make it clear when arrangements would be considered abusive by HMRC through the Explanatory Notes published with the clause and in guidance.,.

Version B

25. The approach here is to narrow the purpose test from one of a number of purposes to a single main purpose.
26. This reduces the likelihood that legitimate charities would be affected because it would be clear that the main purpose of a legitimate charity is philanthropy rather than getting a tax advantage.

27. However, this narrower purpose test could make it easier for determined avoiders, the intended target of the measure, to subvert the legislation. They could do this by ensuring that another ostensible, significant purpose exists, whether or not it is to be realised. Accordingly, it would seem to add little, if anything, to the existing anti-avoidance defences for charity reliefs.

Summary

28. We would like to find a legislative solution that would prove effective against extreme cases of abuse without risking concern to genuine charities.
29. To help us resolve these issues, we are seeking views on the following questions:
- Would either of the approaches mentioned above achieve the objectives? If not, why?
 - Do you think there would be other ways the Government could deliver these objectives – either through new legislation or other means? If you do, tell us what you think these are and why they would be better.

Timetable for next actions by Government

30. What you tell us will be taken into account when we decide how to proceed. We appreciate that the charity sector and donors would like to know how the Government intends to proceed and so a statement clarifying this will be made as soon as possible after the end of the consultation.

Contact and deadline for comment

31. If you have any questions about this paper, please contact David McDowell on Telephone: 03000 585284 (email: david.mcdowell@hmrc.gov.uk).
32. Feedback to the paper should be submitted to charitypolicy.taxteam@hmrc.gov.uk by 11 April 2014.

Annex A – draft legislation for approach A

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Consultation Draft

1 Charity not to be established for tax avoidance

- (1) In Schedule 6 to FA 2010 (definitions of charities etc) -
(a) in paragraph 1(1), after paragraph (b) insert -
 “(ba) meets the purpose of establishment condition,”,
(b) after paragraph 2 insert -

“2A (1) A body of persons or trust meets the purpose of establishment condition if the securing of a tax advantage for any person is neither the main purpose, nor one of the main purposes, of any arrangements in the course, or as a result, of which that body of persons or trust was established.

- (2) In sub-paragraph (1) -
 “arrangements” includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable);
 “tax advantage” has the same meaning as in section 1139 of CTA 2010.”

Annex B – draft legislation for approach B

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Consultation Draft

1 Charity not to be established for tax avoidance

- (1) In Schedule 6 to FA 2010 (definitions of charities etc) -
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