TAXREP 19/14

(ICAEW REP 51/14)

ICAEW TAX REPRESENTATION

DISCUSSION PAPER – APPROACHES TO PREVENTING CHARITIES BEING SET UP TO AVOID TAX

Comments submitted on 11 April 2014 by ICAEW Tax Faculty in response to HM Revenue & Custom discussion paper *Approaches to preventing charities being set up to avoid tax* published on 14 March 2014

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion paper *Approaches to preventing charities being set up to avoid tax* published by HM Revenue & Customs (HMRC) on 14 March 2014.

2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

3. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 2, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

4. ICAEW is a world leading professional membership organisation that promotes, develops and supports over 142,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

5. As leaders in accountancy, finance and business our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. Together we contribute to the success of individuals, organisations, communities and economies around the world.

6. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

KEY POINT SUMMARY

7. We support the premise that charities should not be used to facilitate tax avoidance and agree that steps are required to prevent abuse without affecting the operation of bona fide charities or hindering tax relief claims on genuine charitable donations.

8. We do not accept that either version A or B is necessary and that a better approach is the use of existing legislation coupled with proper policing by HMRC and the Charity Commission (CC). There is a danger that charitable revenues will decrease if charities are seen as vehicles for tax avoidance. Lax governance and failure in the enforcement of existing law has allowed leakage and some abuse. Effective monitoring is required over the life of the charity and this is dependent on the regulators, CC and HMRC, being appropriately resourced for this purpose. The existing monitoring does work to some extent as there was no Gift Aid paid out by HMRC in the much publicised Cup Trust where a charity was to be used as a vehicle for abusive tax avoidance.

9. The discussion document mentions that use of the term "tax advantage" could be taken to include the advantages of ordinary tax reliefs. Version A says that the explanatory notes and guidance will make it clear when HMRC considers arrangements to be abusive. We have a general concern, not limited to charity taxation, that HMRC is seeking to widen the concept of tax avoidance by the increasing use of the term "tax advantage" (as defined in s1139 CTA 2010) as a proxy for "tax avoidance". The problem with the s1139 definition is that it makes no distinction between tax reliefs that Parliament intends to be used and those that it does not. To deal with this issue in guidance is unsatisfactory because guidance does not form part of the parliamentary record that a court or tribunal can take into account in determining the meaning of “tax advantage” in a particular case, it is not legislation and can be changed “on a whim” (as was the guidance on specialty debts). The continued use of the phrase “tax advantage” in these circumstances would give HMRC an unacceptably wide discretion to limit bona fide tax reliefs.

10. Both version A and B concentrate on the inception of the charity and it would probably be relatively easy to overcome the hurdles and be classed as a genuine charity and then to be used subsequently for tax avoidance. There should be more policing over the life of a charity not just by HMRC but also by the CC to prevent abuse.

11. In our view the existing targeted anti-avoidance rules (TAARs) and the General Anti-Abuse Rule (GAAR) could probably be used to prevent abuse of charities without the addition of new legislation. If the current TAARs do not catch a particular scheme, any “extreme abuse” would be caught and countermanded by the GAAR.

RESPONSES TO DISCUSSION PAPER QUESTIONS

Q1: Would either of the approaches mentioned above achieve the objectives? If not why not?

12. In our view Version A is too widely drafted and it is inappropriate to draft a “catch all” clause and then reduce its scope by guidance. This approach does not conform to our ten tenets, see Appendix 2, in particular it would not be statutory and subject to parliamentary scrutiny nor would it be certain as the guidance could be changed by HMRC as and when it chose.

13. The problems involved in retrospective revocation, e.g. the creation of additional tax liabilities arising out of transactions by the charity that are wholly unconnected with the avoidance in question. There would also be side effects for innocent third parties dealing with the organisation in good faith (e.g. bona fide donors and suppliers).

14. What HMRC is proposing involves a more extreme sanction (retrospective revocation of charitable status) than would be applied to a private sector tax avoider and is out of all proportion to the risk to the exchequer that involves the abuse of charitable reliefs. Moreover, the sanction would be permanent in the absence of any provision for the organisation to be able to reapply for entitlement to charity tax reliefs after the avoidance has ceased.

15. Version B is narrower but to such an extent that schemes could probably find a way round the legislation with little difficulty as noted in the discussion paper.

16. Both versions concentrate on the creation of the charity but in our view that is only part of the problem and more emphasis should be put on the on-going management of the charity.

Q2: 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.

17. We feel very strongly that there is existing effective legislation to stop the abuse of charities for tax-avoidance purposes, which HMRC should use in preference to imposing new sweeping anti-avoidance rules which may extend far beyond their intended target.

18. In particular the Tainted Charity Donations rules were developed through extensive consultation with the sector to replace the Substantial Donor rules, a previous attempt to stop taxpayers using charities for tax avoidance purposes. The substantial donor rules penalised charities for entering into transactions with substantial donors, in many cases where there was in fact no tax avoidance. They also tied up the resources of charities in working out whether the rules applied and monitoring their donor database, and stopped them entering into certain transactions that were charitable and had no tax avoidance motive. The Tainted Charity Donations rules prevent the donor getting tax relief where there is an arrangement to give a financial advantage to the donor and this is specifically the mischief that the new rules are supposed to prevent.

19. Similarly the Approved Charitable Investment rules prevent a charity getting tax relief on funds which it applies to making loans or investments for non-charitable purposes.

20. In our view HMRC should discourage tax avoidance by publicising and enforcing the existing rules, rather than inventing new ones that may penalise innocent charities and transactions.

21. Appendix 1 lists the approach taken by various countries around the world including the UK to preventing abuse of the tax reliefs offered for charitable gifts and charities.

22. A simple system requiring forward notification to HMRC where a gift triggers Gift Aid in excess of a defined sum with the tax relief approved in advance of the claim being made by the individual could help prevent abuse; a risk flag to suggest to HMRC they need to ask some questions before handing over large sums of Gift Aid.

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APPENDIX 1

ANTI-AVOIDANCE MEASURES IN SELECTED COUNTRIES

United Kingdom

Budget 2014 proposal

Adds an “establishment condition” to the existing conditions that must be met for a charity to qualify for UK charity tax reliefs:

“The securing of a tax advantage for any person
is not the main purpose [Version B]
is neither the main purpose nor one of the main purposes [Version A]
of any arrangements in the course or as a result of which that body of persons or trust was established”

Initial concerns are that:

- tax advantage is wider than tax avoidance and includes reliefs that Parliament intended charities to make use of (e.g. personal and corporate foundations, friends of and similar supporting organisations, agency charities (e.g. Charities Aid Foundation), dual qualified charities, exemption of profits donated by charity subsidiaries, etc.);
- denial of all charity tax reliefs is an extreme sanction that should be reserved for serious cases of abuse;
- HMRC guidance is insufficient protection;
- abusive schemes are already caught by the GAAR and/or the various TAARs that exist.

If the term “tax advantage” is retained charities need the safeguards that are built into the GAAR before HMRC can invoke this provision.

Registered pension schemes

A comparison can be made with the abuse of pension schemes for avoidance purposes.

The pre-2004 regime included a purpose test for approval of pension schemes in s590(2)(a) ICTA 1988: “the scheme is bona fide established for the sole purpose …of providing relevant benefits tin respect of service as an employee”.

There doesn’t appear to be any case law on the application of this provision. HMRC guidance suggests that it was invoked where there was a concern that the scheme would acquire tax-exempt investments that were of a kind or used in such a way as to produce a *non-relevant* benefit for the beneficiaries or the employer (para. 20.45 of IR 12).

Currently a registered pension scheme cannot be deregistered on this ground (see HMRC manual RPSM04105020). However, Schedule 5 of the Finance Bill 2014 includes provisions (see paras. 2 and 6) to allow HMRC to refuse registration of new pension schemes or to deregister existing pension schemes that have not been established, or are not being maintained, wholly or mainly for the purpose of making authorised payments of pensions and lump sums. Para. 2 will also give HMRC power to apply a fit and proper person test to scheme administrators. This wording is better targeted than the charity clause but potentially broader in scope in that it is an on-going test that would catch an abusive takeover of an existing bona fide pension scheme.

Targeted Anti-Avoidance Rules

There are a number of existing charity related TAARs that predate the introduction of the GAAR:

- the donor benefit rules (ss416-417 ITA 2007)
- the non-charitable expenditure rules (ss 539-548 ITA 2007)
- the share gift rules (ss 437-440 ITA 2007)
- the tainted charity donation rules (ss 809ZH-809ZR ITA 2007)
- the management condition including the fit and proper persons test (Sch 6, FA 2010).

There is also a new TAAR in clause 30 of FB 2014 (avoidance schemes involving the transfer of corporate profits) which is clearly worded sufficiently broadly to cover profit donations by charity subsidiaries to parent charities that are companies. Note for this purpose the wide definition of a group in s357GD CTA 2010 which can cover, inter alia, two companies whose financial results are consolidated. Although the guidance note issued by HMRC on 19 March states in paragraph 41 that such arrangements are not considered to be tax avoidance because the subsidiary and the charity are taking advantage of tax reliefs which are intended to be used this way, this appears to be a concession as the definition of a tax advantage in s1139 CTA 2010 does not take account of whether a tax relief is used in a way intended by Parliament and there is currently nothing in the parliamentary documents to support an argument that this provision is not intended to apply to charities.

The General Anti-Avoidance Rule

The July 2012 consultation on the introduction of a GAAR included the following charity example in Annex B which HMRC considered would be an appropriate target for the GAAR:

"Example 3: "Gifts" to charity
This scheme was another wholly artificial arrangement where a taxpayer, who sustains no Economic loss, claims relief for a gift to a charity which in reality receives almost no value.

An individual acquires gilts, which are 'gifted' to a charity once the charity has granted put options to two trusts. The beneficiary of the trusts is the individual making the 'gift'. The put options allow one of the two trusts to acquire the gilts at 1% of the market value subject to certain conditions. The gilts are then sold by the trusts, and the sale proceeds are returned to the individual by way of interest free loans.

The individual claims relief for the gift of the shares. By setting the market value of the gilts against his income for the year, the individual effectively receives relief at 40% of the market value of the gilts."

However, no charity examples were included in the GAAR guidance issued in April 2013 that was approved by the Advisory Panel.

The GAAR operates for the purpose of countering tax advantages arising from arrangements that are abusive (s206(1) FA 2013). The guidance makes it clear that the primary policy objective is to deter taxpayers from entering into abusive arrangements and to deter promoters from marketing such arrangements, and that tax arrangements that are not abusive are not within the scope of the GAAR (para. B3.1).

The taxes to which it applies are basically the same as those from which charities can claim relief under Schedule 6 FA 2010 with the following differences:

- the GAAR applies to PRT;
- the charity tax relief conditions apply to VAT, stamp duty and SDRT.

The fact that the GAAR does not apply to VAT reflects the development by the ECJ of a separate anti-abuse rule for VAT purposes known as the *Halifax* doctrine after the case of that name (C-255/02).

The definition of a “tax advantage” for the purposes of the GAAR (s208 FA 2013) essentially mirrors that used for corporation tax purposes (s1139 CTA 2010) – which HMRC proposes to adopt for the purposes of the establishment condition. The GAAR definition is slightly wider in that it includes deferral of a tax payment or advancement of a tax refund and avoidance of an obligation to deduct or account for tax.

The GAAR takes priority over any other legislation applying to the taxes covered by the GAAR (s212 FA 2013).

The scope of the GAAR is limited by a number of taxpayer safeguards that are built into the rules (para.B12 of the guidance):

- a requirement for HMRC to establish that the arrangements are abusive (reversing the normal burden of proof);
- a requirement for HMRC to show that the arrangements cannot reasonably be regarded as a reasonable course of action (the “double reasonableness” test);
- allowing the court or tribunal to take into account any relevant material as to the purpose of the legislation;
- a requirement for HMRC to obtain the opinion of an independent advisory panel as to whether an arrangement constituted a reasonable course of action before the GAAR can be applied.

Further taxpayer protection is provided by the limitation of any counteraction to what is required to achieve a just and reasonable result (s209 FA 2013).

South Africa

Charity specific rules

South African charities qualify for tax reliefs by applying to the South African Revenue Service for approval as a “public benefit organisation” (PBO). Before granting approval the Commissioner must be satisfied that the PBO “is or was not knowingly a party to, or does not knowingly permit, or has not knowingly permitted, itself to be used as part of any transaction, operation or scheme of which the sole or main purpose is or was the reduction, postponement or avoidance of liability for any tax, duty or levy which, but for such transaction, operation or scheme, would have been or would have become payable by any person under this act or any other Act administered by the Commissioner” (s30(3)(c) Income Tax Act 1962).

Where the Commissioner is –
(*a*) satisfied that any public benefit organisation approved under subsection (3) has during any year of assessment in any material respect; or
(*b*) during any year of assessment satisfied that any such public benefit organisation has on a continuous or repetitive basis,
failed to comply with the provisions of this section, or the constitution, will or other written instrument under which it is established to the extent that it relates to the provisions of this section, the Commissioner shall after due notice withdraw approval of the organisation with effect from the commencement of that year of assessment, where corrective steps are not taken by that organisation within a period stated by the Commissioner in that notice (s30(5) ITA 1962).

Where the Commissioner has so withdrawn his approval of such organisation, such organisation shall, within six months or such longer period as the Commissioner may allow after the date of such withdrawal, transfer, or take reasonable steps to transfer, its remaining assets to any other organisation which is -
(*a*) approved in terms of this section; and
(*b*) not a connected person in relation to such organisation (s30(6) ITA 1962).

If the organisation fails to transfer its remaining assets as specified above, an amount equal to the market value of the assets which have not been transferred, less an amount equal to the *bona fide* liabilities of the PBO, will be deemed to be taxable income which accrued to the organisation during the year of assessment in which the approval was withdrawn.

Once an exemption has been withdrawn, an organisation may re-apply for approval in the year of assessment following the year of the withdrawal. If the Commissioner is satisfied that the non-compliance giving rise to the withdrawal has been rectified, the Commissioner may grant the approval.

General Anti-Avoidance Rules

A general anti-avoidance rule (GAAR) contained in the ITA 1962 applies where:

(1) an impermissible avoidance agreement has been entered into with its sole or main purpose being to obtain a tax benefit; and

(2) in the context of business:
  - it was entered into or carried out in a manner that would not normally be employed for bona fide business purposes other than for the obtaining of a tax benefit; or
  - it lacks commercial substance;

(3) in the context other than business, it was entered into or carried out by means or in a manner not normally employed for a bona fide purpose, other than obtaining a tax benefit; or

(4) it has created rights or obligations which would not normally be created between persons dealing at arm's length or it would result directly or indirectly in the misuse or abuse of the provisions of the ITA 1962.

If the above requirements are met, the SARS may:

- disregard, combine or recharacterize the arrangement or any step thereof;
- disregard any accommodating or tax-indifferent party or treat this party and any other party as one and the same person;
- determine the parties who are connected persons in respect of each other as one and the same person;
- reallocate any income or expenditure between the parties;
- recharacterize any income of a capital nature as income of a revenue nature;
- treat the transaction as if it has not been carried out, or in any other manner that in the SARS's view is adequate for the prevention or diminution of the tax benefit.

The presence of certain criteria is considered as indicative of tax avoidance. These include:

- the legal substance of the arrangement as a whole is inconsistent with, or differs significantly from, the legal form of its individual steps;
- the presence of round trip financing (described as a funds transfer between the parties which significantly offsets, reduces or eliminates any business risk incurred by a party to the arrangement);
- the presence of an accommodating or tax-indifferent party (described as a party for whom the amounts received from the arrangement are not subject to normal tax, or the tax liability is significantly offset by an expenditure incurred by that party under the arrangement); and
- the presence of elements which have the effect of offsetting or cancelling each other.

Apart from the statutory GAAR, South African common law principles will unmask simulated transactions. These are transactions where the parties thereto have wilfully disguised the true legal nature of the transaction to, for example achieve a particular tax result.

Australia

Charity specific rules

Australia has a number of TAARs, including a charity related TAAR which provides that a donor cannot claim an allowable deduction for a gift to a charity that is greater than the value received by the charity, where the donation forms part of an arrangement for the charity to provide benefit or transfer property to the donor, or where the charity does not obtain full title and custody of the property (s78A Income Tax Assessment Act 1936).

The Commissioner also has power to revoke a charity's endorsement to access tax concessions (s426-55 Taxation Administration Act 1953). Revocation can be retrospective, for example if the charity was not originally entitled to be endorsed. However, it appears that revocation cannot be based on past events alone, but must be based on facts that are present at the date of the revocation decision (*Commissioner of Taxation v Cancer and Bowel Research Association Inc* [2013] FCAFC 140).

One of the conditions for endorsement for income tax exemption is that the fund is applied for the purpose for which it was established (s50-60 Income Tax Assessment Act 1997). Even a partial breach of this condition can lead to revocation, notwithstanding that there is substantial compliance with the terms of the trust (*Commissioner of Taxation v Bargwanna* [2012] HC 11).

The Commissioner will also consider revocation if the charity has its registration revoked by the federal charity regulator the Australian Charities and Not-for-profits Commission. However, the new Australian government has presented a bill to repeal the legislation establishing the ACNC so this ground for revocation will cease to exist if the bill is passed.

General Anti-Avoidance Rules

Australia has a GAAR that enables the Commissioner of Taxation to cancel all or part of the tax benefits obtained from a scheme unless the tax benefits would have occurred, or might reasonably be expected to have occurred, if the arrangement had not been entered into (s177F Income Tax Assessment Act 1936).

New Zealand

Charity specific rules

Income tax relief is generally granted only to a charity that is a "tax charity" (s CW41 Income Tax Act 2007). For New Zealand charities this requires the charity to be registered as a charitable entity under the Charities Act 2005. Although it appears that the Commissioner does not have a direct power to revoke tax charity status, this status will be lost if the Charities Services of the Department of Internal Affairs (formerly the Charities Commission) decides to remove the charity from its register.

Charities Services can deregister a charity that;

- no longer meets the requirements for registration;
- has acted in a way that is considered to be "serious wrongdoing"; or
- has significantly and persistently failed to comply with the Charities Act.

Deregistration only has prospective effect (s 31 Charities Act 2005). However, the Inland Revenue reserves the right to tax the entity from the date when it was established if it is found never to have had a charitable purpose.

Serious wrongdoing is defined in s 4(1) Charities Act 2005 as:
(a) unlawful or a corrupt use of the funds or resources of the entity;
(b) an act, omission, or course of conduct that constitutes a serious risk to the public interest in the orderly and appropriate conduct of the affairs of the entity;
(c) an act, omission, or course of conduct that constitutes an offence; or
(d) an act, omission, or course of conduct by a person that is oppressive, improperly discriminatory, or grossly negligent, or that constitutes gross mismanagement.

Charities Services considers that the types of activities that may be considered to be serious wrongdoing under section 4(1)(b) and (d) to include:
- persistent failure to keep proper financial records;
- filing financial reports that are largely inaccurate;
- inability to account for the way public donations are used;
- presenting largely inaccurate information to the public about the charity's purpose or activities;
- money laundering;
- allowing funds to be used to assist illegal activities or terrorism;
- making or allowing private financial profit;
- persistently working outside the rules of the charity; or
- knowingly allowing an officer who does not qualify in terms of the Charities Act to remain as an officer, unless a waiver has been granted.

Following deregistration the entity will in principle be fully subject to the income tax rules applicable to companies or trusts, as the case may be. However, the tax law does not currently prescribe clear rules for dealing with the transitional period. Following a July 2013 consultation on the tax implications of deregistration, the Government presented a tax law amendment bill which – inter alia - addresses this issue; the relevant provisions are intended to take effect from April 2014. These include the imposition of a tax charge on the net assets of a deregistered charity that continues to operate beyond the first anniversary of its deregistration. In effect the deregistered charity has a 12 month grace period to apply its assets to charitable purposes.

General Anti-Avoidance Rules

New Zealand has a GAAR which provides that an arrangement which has tax avoidance as one of its purposes or effects is void for income tax purposes as against the Commissioner of Inland Revenue (s BG1 Income Tax Act 2007). To determine whether tax avoidance exists it is necessary to consider whether the arrangement, viewed in a commercially and economically realistic way, makes use of the Income Tax Act in a manner that is consistent with what Parliament would have intended for the relevant provisions (*Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115).

Canada

Charity specific rules

To access the various federal tax benefits accorded to charities a charity must register with the Canada Revenue Agency. The CRA has discretionary powers to revoke the registration of a registered charity in the following circumstances set out in section 149 (4.1) Income Tax Act 1985:
(*a*) if it has entered into a transaction (including a gift to another registered charity) and it may reasonably be considered that a purpose of the transaction was to avoid or unduly delay the expenditure of amounts on charitable activities;
(*b*) if it may reasonably be considered that a purpose of entering into a transaction (including the acceptance of a gift) with another registered charity to which paragraph (*a*) applies was to assist the other registered charity in avoiding or unduly delaying the expenditure of amounts on charitable activities;
(*c*) if a false statement, within the meaning assigned by subsection 163.2(1), was made in circumstances amounting to culpable conduct, within the meaning assigned by that subsection, in the furnishing of information for the purpose of obtaining registration of the charity;

(*d*) if it has in a taxation year received a gift of property (other than a designated gift) from another registered charity with which it does not deal at arm's length and it has expended, before the end of the next taxation year, in addition to its disbursement quota for each of those taxation years, an amount that is less than the fair market value of the property, on charitable activities carried on by it or by way of gifts made to qualified donees with which it deals at arm's length; and
(*e*) of a registered charity, if an ineligible individual is a director, trustee, officer or like official of the charity, or controls or manages the charity, directly or indirectly, in any manner whatever.

For the purposes of circumstance (e) above, an ineligible individual is defined in s 149 (1.1) ITA 1985 as an individual who has been:
(*a*) convicted of a relevant criminal offence unless it is a conviction for which (i) a pardon has been granted and the pardon has not been revoked or ceased to have effect, or (ii) a record suspension has been ordered under the Criminal Records Act and the record suspension has not been revoked or ceased to have effect;
(*b*) convicted of a relevant offence in the five-year period preceding that time;
(*c*) a director, trustee, officer or like official of a registered charity or a registered Canadian amateur athletic association during a period in which the charity or association engaged in conduct that can reasonably be considered to have constituted a serious breach of the requirements for registration under this Act and for which the registration of the charity or association was revoked in the five-year period preceding that time;
(d) an individual who controlled or managed, directly or indirectly, in any manner whatever, a registered charity or a registered Canadian amateur athletic association during a period in which the charity or association engaged in conduct that can reasonably be considered to have constituted a serious breach of the requirements for registration under this Act and for which its registration was revoked in the five-year period preceding that time, or
(*e*) a promoter in respect of a tax shelter that involved a registered charity or a registered Canadian amateur athletic association, the registration of which was revoked in the five-year period preceding that time for reasons that included or were related to participation in the tax shelter.
For the purposes of (e) above, a tax shelter is defined as a "gifting arrangement" involving manipulation of the rules granting tax credits or tax deductions for charitable gifts so that the tax benefits exceed the costs of the arrangement (s237.1 ITA 1985). Tax shelter promoters are required to file information returns in respect of reportable transactions and to apply to the CRA for an identification number for the scheme being promoted.

Canada introduced a range of intermediate sanctions for non-compliance with the tax law requirements imposed on charities in 2004. These sanctions mainly involved the imposition of financial penalties or suspension of the ability to issue donors with receipts for their gifts. However, it remains CRA policy to seek revocation in cases of serious non-compliance. Serious cases of non-compliance include those where:

- the non-compliance reaches certain thresholds (either in absolute terms, such as the dollar value of expenditures on non-charitable activities, or relatively, such as the percentage of expenditures devoted to non-charitable activities);
- the non-compliance involves breaches of the *Criminal Code* (such as fraud or hate crime) or other quasi-criminal statutes;
- the non-compliance involves breaches of the core requirements of the *Income Tax Act* (such as the requirement that an organization be established for exclusively charitable purposes, as compared to a less central provision, such as that requiring charities designated as charitable organizations to concentrate on operating their own programs, rather than funding other charities); or
- the organization is not abiding by the terms of a compliance agreement.

In cases of **aggravated** non-compliance, the CRA will likely move directly to revoking the charity's registration. These include cases where one or more of the following factors are present:

- the organization has a previous record of serious non-compliance, and the current form of non-compliance is both serious and intentional;
- the non-compliance has resulted in a substantial adverse impact on others (beneficiaries, donors, or funders), particularly where the organization cannot or will not remedy the harm done; and
- the organization cannot or will not bring itself into compliance.

General Anti-Avoidance Rules

Canada also has a GAAR (s245 Income Tax Act 1985). This provides that where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

An avoidance transaction means any transaction or series of transactions that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction or series of transactions may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

USA

Charity specific rules

US charities obtain exemption from federal and state income tax on most forms of income and capital gain by applying to the Internal Revenue Service for classification as a 501(c)(3) organization (s 501(a) Internal Revenue Code). Maintenance of 501(c)(3) status requires the organisation to be both organised and operated exclusively for charitable purposes. Prohibited changes in the governing instruments or the activities of the organisation can therefore result in the IRS revoking its tax-exempt status. Revocation can be retrospective, although this would normally be reserved for the most serious non-compliance or cases where the organisation was never entitled to exemption. Revocation does not bar reapplication for 501(c)(3) status if the organization adjusts its powers and/or behaviour to conform to the requirements of this status.

An organisation's 501(c)(3) status is automatically revoked with prospective effect if it fails to file the federal income tax return form 990 for three successive years (s6033(j) IRC). The charity can reinstate its 501(c)(3) status with retrospective effect if it has a reasonable excuse for failure to file the returns.

Intermediate sanctions for public charities were introduced in 1996 to provide the IRS with appropriate sanctions that fall short of revocation. Their scope is limited to the imposition of an excise tax and penalties on the provision to insiders of excessive economic benefits, and the imposition of similar taxes and penalties on the charity managers who participate in such transactions knowingly and without reasonable cause (s 4958 IRC).

There is a separate regime for charities that are classified as private foundations. Private foundations are subject to a number of severe restrictions on their activities, breach of which typically involves the imposition of an excise tax and penalties on the foundation, and the imposition of similar taxes and penalties on the charity managers who participate in such transactions knowingly and without reasonable cause (ss 4940-4946 IRC).

In addition public charities and private foundations - and their managers - can be subject to an excise tax if they participate in a prohibited tax shelter transaction (s 4965 IRC). Prohibited transactions include transactions identified by the IRS as potentially abusive "listed" tax avoidance transactions and reportable transactions that are confidential or which include contractual protection for the promoter. Tax-exempt entities that participate in a prohibited tax shelter transaction must disclose the fact to the IRS.

General Anti-Avoidance Rules

There is currently no GAAR as such. However, there is an economic substance doctrine that disallows tax benefits that are beyond the intended scope of the applicable provisions of the IRC. The doctrine formerly applied under common law and has been codified for transactions entered into after 30 March 2010. The economic substance doctrine will be applied unless (i) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering the transaction.

Transactions are also subject to review under common law doctrines developed by the courts, including the business purpose doctrine, the substance-over-form doctrine, the step-transaction doctrine and disregard of sham transactions.

APPENDIX 2

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax/tax-faculty/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)