Managing Assets in Trading Charities: US, UK and Australian regulatory responses

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Introduction

Charities need funds to carry out their work. There are a limited number of sources of funds: donations, government grants, investments or trading being four dominant options. This paper focuses on the last of these options: 'trading' and in particular the regulation of charitable trading.

Trading by charities enlivens a number of unique challenges. Whilst the *principles applied* to address these challenges in the United States, the United Kingdom and Australia are very similar, the *practices* - the practical expression of those principles - are quite different.[1] This is because our common history shapes our shared foundations but our cultures have evolved differently over the centuries - and consequently so have our laws. My hope in this address, is that by succinctly stating the shared principles that we draw from, and by highlighting the differences that have evolved over time, I will help carry forward the discussion about China's draft charity laws. In many ways China is in a position to be envied for you start without the shackles of our past.

The shared principles underpinning the laws in the US, UK and Australia

Charity law in the US, UK and Australia is traceable to a statute passed in 1601 in England commonly known as the *Statute of Elizabeth.*[2] That legislation has become the foundation for the definition of charity and with it both the regulatory approach and the tax concession framework. I will deal first with the regulatory approach and then with the taxation issues but it will become apparent quickly that they are linked in the context of trading charities. I will close with some brief comments on the duties of trustees.

Before turning to the details, it will be helpful to set out three broad general principles that underpin the law in each of these countries. I know some of you will be familiar with some of the laws of the UK, USA and Australia and how technical and complicated they can be. By setting out the general principles first, I hope I provide a framework for making sense of the complexities.

1. For a purpose to be charitable it must be for public benefit.[3] What is for public benefit? This term is open to development by reasoning by analogy from the established charitable

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[1] In the UK tax law applies consistently but charity law is different between England and Wales, Scotland and Northern Ireland so I will use the law in England and Wales only in this paper for the sake of simplicity on charity as distinct from tax matters.

[2] Hubert Picarda QC, *The Law and Practice Relating to Charities* (Bloomsbury Professional, 4th ed, 2014) pg 11-14.

[3] There are exceptions to this general principle in each jurisdiction. *Charities Act 2011* (Eng. & Wales) s. 11, *Charities Act 2013* (Australia) s.5(b), Internal Revenue Service (Rev Feb 2015) *Tax Exempt Status for your Organization* Publication 557 available at http://www.irs.gov/pub/irs-pdf/p557.pdf accessed 13 September 2015. Jonathan Garton, *Public Benefit in Charity Law* (Oxford University Press,1st ed, 2013) ch 2; GE Dal Pont,

purposes. However, some purposes are presumed to be charitable in some jurisdictions so they do not have to prove this unless challenged; even for trading charities.

2. For an organisation to be a charity it must apply its assets *only* to charitable purposes. (Pursuing purposes that are incidental or ancillary to the charitable purpose does not vitiate this rule.)[4] So trading for charitable purposes is charitable but if trading is the purpose of the business it is a business and cannot be a charity – even if it is only one of the purposes.

3. Trustees of charities, that is those people in control of charities, are given wide (but not unlimited discretion) in deciding how the charity best carries out its charitable purpose. They must, though, act as a prudent person concerned *only* with carrying out the charitable purpose through the charity. They must not act in their own interests. So they may decide that carrying on a business is the best way to pursue the charitable purpose. I will come to an Australian court case that illustrates this later.

Whilst there are many other relevant laws, stating these three well-accepted principles from the outset will help to make sense of all of the details and differences to be discussed. I turn now to the differences, which are mainly specific ways of addressing these challenges. A natural division is between regulation and tax. I begin with regulation.

Differences in regulatory practice between US, UK, and Australia

The approach to regulation – who is the regulator?

It is often forgotten that the *Statute of Elizabeth* was passed for the regulation of the charity sector. In the United States, the UK and Australia the chief law officer of each jurisdiction, known as the Attorney General, has an overall responsibility to supervise all charities. [5] In practice, in all three of these countries, the supervision by the Attorney General has been quite lax most of the time.[6] Consequently, these countries have either chosen to set up a separate regulator for the charity sector or have required the taxing authority to carry out this regulatory function. There is also an inherent tension between the definition of charitable organisations for regulatory purposes and the definition to be used for taxation purposes. They are quite different functions. A nation may wish to regulate a class of organisations without giving it tax concessions and a nation might wish to give tax concessions to organisation that it does not consider it necessary to regulate. So in one of the most recent Australian cases, an organisation that breached tax laws was said to possibly still be able to be a charity for general law purposes but was not entitled to income tax exemption.[7]

From 1601, when the *Statute of Elizabeth* was introduced, to the present, England has typically had some sort of charity regulation outside of the tax system. The current version of the Charity

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Law of Charity (LexisNexis Butterworths, 1st ed, 2010) [1.7] and ch 3; Hubert Picarda QC, *The Law and Practice Relating to Charities* (Bloomsbury Professional, 4th ed, 2014) pg 29 and ch 2.

[4] Commissioner of Taxation *v Word Investments [2008] HCA; The Independent Schools Council v The Charity Commission [2011] UKUT 421 (UK Upper Tribunal, Tax and Chancery Chamber, 13 October 2011); GE Dal Pont,* Law of Charity *(LexisNexis Butterworths, 1st ed, 2010) [1.9] and [13.2]-[13.5].*

[5] Internal Revenue Service 1988 EO CPE Text *K Investments that Jeopardize Charitable Purposes* at http://www.irs.gov/pub/irs-tege/eotopick88.pdf [2].

[6] Marion R Freemont-Smith, *Governing Nonprofit Organisations – Federal and State Law and Regulation* (2004).

[7] *FCT v Bargwanna* [2012] HCA 11, High Court, French CJ, Gummow, Hayne, Heydon and Crennan J.

Commission for England and Wales dates back to 1853.[8] The United States, by contrast, has never had an English style charity commission. That role is, and has always been played, in effect, by the Internal Revenue Service (IRS) in that country. Australia had followed the US in leaving the regulatory roll of charities predominantly to its revenue authority the Australian Taxation Office - until 2012. In that year the Charities and Not for Profits Commission was established following the English model.[9]

The approach to regulation - what is to be regulated?

Looking at the issue of regulation conceptually, in the USA it is the taxpayer that is regulated and the taxpayer happens to be a trading charity for the purposes of this discussion. In the UK it is charities as charities that are regulated so the charity is regulated and the way it goes about its activities, namely trading, are scrutinised as to whether or not they are in pursuit of a charitable purpose. These are quite different approaches to regulating trading charities. One focuses primarily on tax, the other primarily on the charitable purpose.

Noteworthy is that the Australian Charities and Not for Profits Commission (ACNC) presently only supervises charities, including trading charities, but it is intended, in due course, to supervise the whole not-for-profit sector. This is an international first. To date no other country has endeavoured to regulate the whole of the not-for-profit sector. It is my view that this is an appropriate development as misappropriation of funds is arguably more likely to occur in trading not-for-profit organisations that gain tax concessions but are not charities rather than in trading charities. It makes sense, therefore, if there is to be an independent regulator that regulates the whole of the not-for-profit sector. In my view this will become increasingly important with the increase of not-for-profit social enterprises that blur the boundaries between charities and businesses.

The points I wish to make then, in closing this section on regulation is that an important threshold question is whether the regulation is to be tax or charity focussed, and second whether the regulation is to be for the whole NFP sector or merely charities. The view taken significantly shapes the way regulation of trading charities are approached. As we shall see the US has much more complex trading charity rules centred on tax than either the UK or Australia. So I turn to tax next.

Differences in tax practices

The importance of culture and values in understanding the differences

Before looking in detail at the different tax practices in the US, UK and Australia regarding trading charities, it is helpful to ground this in the different cultures and values of each of the countries. The point that I will make here is that, in my opinion, each country's tax reflects their cultural priorities and what they value. Appreciating this helps to understand the quite different practical application of general principles in the specific laws applying tax to trading charities.

The US rules in context

The United States was the first nation to introduce a tax on trading by charities. It did so in 1950 in response to claims that charities were competing unfairly with business.[10] That tax has been relatively

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[8] *Charitable Trusts Act 1853* with the current iteration established under the *Charities Act 2006* which was replaced by the *Charities Act 2011* (England & Wales).

[9] *Australian Charities and Not-for-Profits Commission Act 2012* (Australia)

[10] Brody, Evelyn, Breen, Oonagh B., McGregor-Lowndes, Myles, & Turnour, Matthew (2015) An unrelated income tax for Australia? In Hoque, Zahirul & Parker, Lee (Eds.) *Performance Management in Nonprofit Organizations.* Routledge Taylor & Francis Group, New York, pp. 87-108.

ineffective as a tax. In 1969 the US introduced an excise tax on some charitable investments.[11] That tax, too, has been relatively ineffective as a tax. The point I make, is, that that nation values business and does not want business to be, or be seen to be, at a disadvantage as against the not-for-profit sector. The fact the tax is ineffective has not led to its repeal. The continued existence of the tax sends a message that the US will not unfairly disadvantage business. Similarly regarding the ineffectiveness of the excise taxes – they are not there to function primarily as taxes. As the IRS explains:

> The Internal Revenue Statistics of Excise Taxes show that very little revenue is obtained from the penalty excise tax on jeopardizing investments. Yet, the tax is important as a deterrent to abuses in the management or investment of charitable funds. Internal Revenue officials believe that the small amount of tax indicates that the measure is really working. When an agent finds indications of abuse in a particular case, vigorous investigation and compliance action are necessary to uphold the integrity of charitable funds among private foundations and to preserve public confidence in our system of charitable giving.[12]

In the US there is no requirement that trading be separated into a separate legal entity, such as in the UK to which I will soon come. I suspect that the reason for this is that in a culture where business is highly regarded risk is more readily accepted. There are very stringent rules, though, about the investment of funds by charitable foundations.

At this point it is helpful to note that in both charity and tax law in all of these jurisdictions there is a conceptual distinction drawn between charities that deliver the charitable services and foundations that act only or principally as warehouses for money. This distinction is very important for understanding tax legislation in the US.

It is beyond the scope of this paper to explore all of those distinct rules in the US but it is important to note that the US *Inland Revenue Code* (IRC) has provisions that impose an excise tax on most US domestic investment income of private foundations. The Code also sets out five situations where a two-tiered excise tax can apply not only to foundations but also to the managers of the foundations and to certain persons who engage in disqualified acts called 'disqualified persons'. These taxes or requirements are expressions of the general principles set out at the beginning. The five are:

- Taxes on self-dealing between private foundations and their substantial contributors or other disqualified persons;[13]
- Requirements that the foundation annually distribute income for charitable purposes,[14]
- Taxes on certain business holdings;[15]
- Penalty excise taxes designed to discourage behavior detracting from a foundation's ability to further charitable purposes;[16] and,

[11] U.S. Code: Title 26 - *Internal Revenue Code* 4941- 4945.

[12] Internal Revenue Service, 1988 EO CPE Text K. INVESTMENTS THAT JEOPARDIZE CHARITABLE PURPOSES at http://www.irs.gov/pub/irs-tege/eotopick88.pdf accessed 9 September 2015

[13] *Internal Revenue Code* 4941 - Taxes on self-dealing.

[14] *Internal Revenue Code* 4942 – Taxes on Failure to distribute income.

[15] *Internal Revenue Code* 4943 – Taxes on excess business holdings.

[16] *Internal Revenue Code* 4944 – Taxes on investments which jeopardize charitable purpose.

- Penalty taxes on certain foundation expenditures.[17]

When each of the relevant sections of the IRC are examined it is clear the primary concern is to prevent the application of charitable resources to non-charitable or private benefit rather than the risk generally to loss of charitable assets.

Where there is private benefit in the U.S. there is a much greater willingness to punish those making the decisions, not just the charity with increased tax. In my view this is a very appropriate response. It can be argued that there is no such thing as bad charities – just bad charity managers. Addressing the problem at its root requires addressing the motivation for private benefit by punitive taxation of the persons enjoying the benefit rather than punishing the charity.

Where there is harm, or at least purposes being pursued which are contrary to US public policy, tax concessions for those charities can be removed. The racist practices of Bob Jones University were enough to extinguish the presumption of public benefit for that University. What this meant in practice was that that university was not entitled to income tax exemption.[18]

The UK Rules in context

England has had charity regulation separate from tax for over 400 years. In England, history is very important and some charities have existed for over 1,000 years. I suggest that it is the protection and preservation of charities that dominates the regulation and taxation landscape in that country. English law, both the regulation side and the tax side, work together to require charities to separate fundraising trading activities into a separate company so that the charity is protected from the risk of losing their assets. There are exceptions to this requirement. Charities that engage in trading to carry out their charitable purposes as distinct from fundraising are not required to separate their trading from their charity and there are three broad classes of trading permitted by a charity in England and Wales:

- 'primary purpose trading' which is trading that is directly referrable to the charitable purpose - such as a theatre charity selling theatre tickets;
- 'ancillary trading' which is trading that whilst not directly referrable is nevertheless part of doing what the charity does - such as a theatre charity selling food and drink; and,
- 'non-primary purpose trading' that does not put the charity's assets at significant risk - such as a theatre charity renting costumes it already has to the general public.

By way of brief summary then a charity must set up a separate trading subsidiary where the trading is non-charitable and involves considerable risk. This requirement that if charities are to trade they do so through another entity creates significant additional management and administrative work, arguably for no real gain (beyond risk management). As far back as 2002 a government commissioned report recommended repeal of this requirement.[19] The requirement continues to this date. The Law Commission is presently investigating simplifying the law in some areas that place burdens on

[17] *Internal Revenue Code* 4945 – Taxes on taxable expenditures.

[18] *Bob Jones University v United States*, 461 US 574, 591 (1983) discussed in Rob Atkinson, 'Nonprofit Symposium: Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses' (1997) 27 *Stetson Law Review* 395, 426.

[19] UK Government, 'Private Action, Public Benefit' (Strategy Unit, Cabinet Office, UK Government, 2002) para 2.12.

charitable activity and it will be interesting to see its requirements and which ones are adopted by the parliament.[20]

Trading charities may have to pay tax in the UK but if tax has to be paid there are processes for those funds, in effect, being credited back to the charity. Charities are allowed to enter into the equivalent of joint ventures with non-charities in the United Kingdom but there are rules regarding this. This paper focuses on trading by charities but, as might be expected, there are significant rules regarding investments by charities generally. Importantly if a charity in the UK trades so as to put its assets at risk the trustees may be liable for breach of trust.[21]

On the topic of disbenefit or harm, there was some debate when trade embargoes were being considered or applied against South Africa about whether charities could or should limit investments in businesses that traded in South Africa during apartheid. The general principle is that pursuing disbenefiting or harmful purposes cannot be charitable but what that means in business practice is unclear. Perhaps surprisingly, in more recent times, there has been a robust discussion over whether elite schools can be charities. The court held they were. The argument as to why they were not charities was packaged in a number of ways but one of them was that essentially private schools in England were more like clubs for the private benefit of rich children than genuine public benefiting institutions and this was harmful overall. Ultimately the Court held that all education is for public benefit and the mere fact that the schools are elite, in and of itself, did not deprive them of charity status. The debate continues as to whether a school can be for public benefit if there are no scholarships or other ways by which poor persons and the wider community can benefit. The broad general principle in the U.K. is that charities need to be ever mindful that their purposes, including their trading activities are for public benefiting purposes not for harmful or private benefiting purposes.

In the UK, and in Australia (to which I come next) the concern to ensure that charitable assets are applied to charitable purposes is not expressed primarily through the tax system. Perhaps also because there is not primary reliance on the tax system in England (and also in Australia) the focus tends to be on the charity rather than on those who operate the charity when it comes to tax matters. When it comes to addressing individuals there is power in the respective commissions of both England and Australia to remove or ban persons from acting as trustees of charities.

Whether that detailed approach works, is, in my opinion, doubtful. It will be interesting to see if the Law Commission in England recommends that it continue.

There is then, a quite different regime regulating trading charities in the United Kingdom but it draws upon concepts similar to those applied in the United States.

The Australian rules in context

I now turn to Australia. Australia is a relatively young country drawing from the experiences of both the US and the UK. We do not require charities to trade through a separate trading entity. We debated introducing an unrelated business tax like the US between 2009 and 2013 but elected not to adopt this. We take the view, I suggest, that taxes are for raising revenue and if we wish to regulate charitable behaviour that is best done directly rather than through taxation measures. At that time

[20] UK Government*, Charity Law: Technical Issues in Charity Law* (20 March 2015, CP 220).
[21] UK Government, Charity Commission, *Trustees trading and tax: how charities may lawfully trade* (2007) 16.

we also debated requiring charities to move trading assets into a separate entity as is required in England but decided not to require this. The burden on charities, apparently, was not worth the gain.

What then is the Australian position? In many ways, we have the simplest arrangements. Until the end of 2012 we relied principally upon our revenue authority to police charities. In December 2012 we established a separate regulator. We require all charities that wish to access tax concessions to now register with the Australian Charities Not for Profits Commission. Once registered we start from a presumption of public benefit for the traditional categories of charity. That is how we deal with the first general principle that the charitable purpose must be for public benefit. So we presume a trading charity is operating for public benefit until there is reason to doubt this provided it falls within the class of traditionally recognised charities. The second general principle was that a charity must apply its assets *only* to charitable purposes. We tackled this issue in two ways: first, through the Australian Charities and Not for Profits Commission, and then, when necessary, through the Australian Taxation Office. Both organisations have power to ensure that charitable funds are applied to charitable purposes. Regarding the third principle, we respect the authority of the people in charge of charities to decide how best to carry out the charitable purposes. However, we also have a number of ways (similar to the US and UK but sometimes more efficient) of enabling ordinary Australians to bring court actions against people in control of charities if they are not applying the charitable assets to charitable purposes. In addition to this many if not most charities in Australia are membership organisations and we generally rely upon the members to make sure that the people they have put in charge of the charity do what they are supposed to do. New regulations require charities to report to their members.[22]

How then are trading charities treated in Australia? The answer is that as long as the three concerns addressed at the outset are met there is no constraint in Australia on charities trading. They also do not have to separate charitable trading into a separate organisation although it does happen sometimes. This is best illustrated by the leading Australian case on charitable trading from our highest court: *Commissioner of Taxation v Word Investments Ltd.*[23] The facts were that a charity that specialised in Bible Translation set up another charity (not a trading subsidiary) to run a funeral business for it to raise funds. Each year, in effect, all of the profit of the funeral business charity were given to the Bible translation charity. The Australian Taxation Office took the view that the company running the funeral business was not a charity and should pay tax. The High Court of Australia held that the Commissioner of Taxation was wrong. The Court decided that the purpose of setting up the trading business was charitable and the fact that the funds came across each year to the non-trading charity illustrated this. Looked at in reverse, the Court explained that the charity running the funeral business could have done the charitable work itself but instead it chose to pay to have the work done by another charity specialising in the work. This is a choice charity trustees can make. So in Australia there is a very clear emphasis on purpose rather than activities. If the purpose is charitable then the activities can be entirely businesses and the organisation can still be charitable.

Australia is also very strict to remove tax concessions where there is private benefit. In another case before the High Court in 2012[24] a charity lost its tax exempt status because it lent funds to the people who managed it. Our High Court decided that it might be possible for the entity to continue as a charity for regulatory and other purposes but it was not entitled to income tax exemption. To maintain income tax exemption extremely high standards of conduct had to be maintained. Any falling short

[22] Australian Charities and Not-for-profits Commission Regulations (2013) s.45-10
[23] *Commissioner of Taxation v Word Investments* [2008] HCA 55
[24] *FCT v Bargwanna* [2012] HCA 11, French CJ, Gummow, Hayne, Heydon and Crennan J,

of that standard other than very minor infringements would lead to loss of income tax exemption in Australia.

The *Word Investment Ltd* case was handed down in 2008 and in the five years that followed Australia debated whether we should move more to a US tax arrangement or to a more UK approach. The only change adopted was the establishment of a separate Charities and Not-for-profits Commission. Consequently, it is possible for Australian charities to trade extensively but the test will always be whether or not their assets are being applied solely to charitable purposes. Because Australia does not have complex rules like the US governing investments we come back again and again to ask the question for what purpose does the charity exist and are its activities, including its trading, to be understood as ways of carrying out the charitable purpose. Charities need funds to carry out their work and in Australia trading is well accepted as a means of funding.

The Duties of Trustees

The US, the UK and Australia have taken different paths in the details of regulation and taxation but all three are remarkably similar in the way their laws have consistently required the people in charge of charities to always act in the best interests of others and not themselves. The case law in this area is remarkably consistent and where it has been necessary to spell this out in legislation the legislation as to the same or similar effect. So there are duties:

- To act in good faith and in the best interests of the charity and for a proper purpose (even if that means personal detriment);
- Not to use a position held or information against a charity, be it as a director, officer or otherwise to improperly gain an advantage or harm the charity;
- To apply the care and diligence that a reasonable person would in carrying out their duties; and
- Always be loyal to the charity which includes a duty to identify and manage conflicts of interest. As a subsidiary of this duty of loyalty expressed in the conflict of interest rule are rules preventing 'self dealing'. A person is clearly in a conflict where they make a decision on behalf of a charity to buy from or sell to themselves and the transaction can and will be set aside by a court.[25] This rule applies even if there is no actual benefit because the general principle is that we must avoid conflict of interest.

Concluding Comments

China stands in a unique position in the development of its charity laws because unlike the U.S, the U.K. and the Australia, it is not similarly fettered by its legal history. The first and arguably most significant issue we, in the common law tradition, have to deal with is whether the definition of charity for regulatory purposes should be the same as that for tax concession. This issue is arguably at its most significant in the context of trading charities. As a general proposition each jurisdiction uses the same definition for both regulating and for taxation. I query whether this is best.

Second, whilst there are quite significant differences in the detailed laws, all of these laws are intended to address the three general principles raised at the outset but the application of those principles in the context of trading charities is quite different. Each nation gives a jurisdictionally nuanced response.

[25] Tito v Waddell No. 2 [1997] 3 AllER 129, 241 Megarry V.C.]

Third, common law nations have been consistently demanding that trustees of charities always act in the charities best interests not their own and these requirements whilst strict, have served well.

My final observation is, then, that any nation like China developing its laws can possibly learn from our foundational principles in developing your laws, but when it comes to the details of how those principles are applied you may be better served by working these principles out in your unique cultural context, having regard to your values; rather than placing too much emphasis on the details of how any common law country has applied the principles in their particular context. Certainly we, in Australia have not followed the US or UK too closely and in the details neither the U.S. nor the U.K. have closely followed the other. The exception being the general duty to serve others not themselves.