Background Briefing

Regulating the Foreign Activities of Charities: A Comparative Perspective

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The Pemsel Case
FOUNDATION

"The law of charity is a moving subject"
– Lord Wilberforce

About Us

Named after the 1891 House of Lords decision, *Commissioners for Special Purposes of the Income Tax v. Pemsel*, [1891] A.C. 531, which established the four principal common law heads of charity used in Canada and elsewhere, The Pemsel Case Foundation is mandated to undertake research, education and litigation interventions to help clarify and develop the law related to Canadian charities. The Pemsel Case Foundation is incorporated under the Alberta *Societies Act* and is a registered charity.

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Introduction

The common law has long recognised that charities may advance their purposes beyond the borders of their home jurisdiction. From the iconic charity case, *Commissioners for Special Purposes of Income Tax v Pemsel*[1] in 1891, which involved a charitable trust established in the United Kingdom to support and advance 'missionary activities among heathen nations', it has been broadly permissible for philanthropic trusts to carry out their charitable purposes in foreign lands. Constraints on doing so largely stem from additional statutory or regulatory measures adopted by a charity's home jurisdiction.

As charities must act lawfully and cannot conduct themselves in ways that contravene public policy, what qualifies as charitable in different jurisdictions may vary in accordance with local law and regulation. For charities operating in foreign jurisdictions, there are two principal concerns for government that lead to restrictions: mitigating the risk of charities being misused for terrorist purposes and preventing the diversion of resources for non-charitable purposes. The importance of the latter takes on an added dimension when a significant tax expenditure is available in the home jurisdiction to support the charity's work.

In the century plus since *Pemsel*, the difficulties of redressing the misuse of charitable resources occurring in another jurisdiction (and any associated leakage from the tax base), has prompted many countries to implement interventionist, and often complicated, measures applied in the home jurisdiction to discourage or curtail opportunities for abuse once funds are transferred abroad. The approaches have been varied and are quite country-specific.

In response to the threat of terrorism, countries have introduced extensive additional and coordinated measures to regulate cross-border charity. At the same time, the Financial Action Task Force (FATF), an independent intergovernmental body that sets international standards and promotes implementation of measures for combating terrorist financing, introduced Recommendation 8 to address specific terrorist financing vulnerabilities and threats faced by the charitable sector. Recommendation 8 and its Interpretive Note (INR8) serve as an international policy standard that influences the domestic regulation of the foreign activities of charities.

More recently, FATF has acknowledged that the charitable sector's vulnerability to terrorist financing may have been overstated and that 'not all NPOs are inherently high risk (and some may represent little or no risk at all)'.[2] FATF subsequently revised Recommendation 8 and INR8 to remove language stating that not-for-profit organisations (NFPs) were 'particularly vulnerable' to terrorist abuse, recommending that countries should instead use 'focused and proportionate measures', commensurate to the risks identified by the country through a risk-based approach.[3] As a result, governments will need to re-assess their domestic regulation of charities operating overseas to ensure consistency with FATF's new approach. This presents an opportunity for a more mature regulatory approach that strikes an appropriate balance between curbing the potential terrorist threat, while minimising the regulatory burden on these charities and enabling legitimate cross-border charitable flows.

Regulation of the charitable sector, like regulation of the for-profit sector, can be broadly conceptualised as both preventing the occurrence of certain undesirable activities that may take place in the sector (a 'red light' concept) and enabling the sector to thrive (a 'green light'

[1] [1891] AC 531 (*Pemsel*).

[2] FATF, *International Standards on Combatting Money Laundering and the Financing of Terrorism and Proliferation: The FATF Recommendations*, February 2012 (OECD/FATF 2016) 56.

[3] The Global NPO Coalition on FATF, 'NPOs applaud important changes in Financial Action Task Force (FATF) policy – NPOs no longer considered "particularly" vulnerable' (Press Release, 29 June 2016).

concept).[4] At the same time, regulation of the charitable sector can be distinguished from other sectors in that its primary objective is to preserve the public trust in charities and to protect the public purse from unintended consequences of the charitable tax concessions. For government, the task becomes balancing prescriptive 'red light' regulation, primarily through legislative rules and other regulatory requirements to prevent the abuse of charities and misuse of charitable funds, while enabling 'green light' regulation through soft law regulatory instruments and self-regulation to enable the sector to flourish. By combining elements of both, government can realise the operational advantages of the latter, while retaining the enforcement benefits of the former.

Applying these concepts to the regulation of the sub-sector of charities operating internationally requires the adoption of 'red light' measures to address the specific objectives of mitigating the risk of charities operating overseas being misused for terrorist financing and other criminal purposes. At the same time, regulatory objectives for this sub-sector necessarily include 'green light' measures to promote the efficient use of charitable resources and to facilitate legitimate cross-border charity.

To understand the current domestic regimes for the regulation of foreign charities, a comparative analysis was undertaken to examine how governments in four OECD countries – Canada, the United States (US), the United Kingdom (UK) and Australia – have responded to the challenges and opportunities presented by a changed global landscape.

Evaluation of Approaches

The comparative analysis revealed a range of approaches to the problem of how to regulate the foreign activities of charities in a changed global environment. In all of the jurisdictions examined there is a role for each of the three branches of government. Prescriptive statutory initiatives that govern the sector are undertaken by the legislature, which are subject to interpretation by the courts as cases arise. In practice, regulation of this sector – and, more specifically, of the subsector of charities operating internationally – is carried out by the executive agencies that are charged with implementation and enforcement.

Australia's approach is based on a statutory version of the common law definition of charity, with regulation occurring mainly through its fledgling national regulatory agency, the Australian Charities and Not-for-profits Commission (ACNC), in conjunction with the Australian Tax Office (ATO). The UK similarly has codified the common law concept of charity, regulated by its longstanding charity regulator, the Charity Commission of England and Wales (Charity Commission) with an increasing regulatory role undertaken by the UK tax authority, HM Revenue and Customs (HMRC). The US and Canada, while maintaining the common law concept of charity, do not have a national regulatory agency and instead regulate charities primarily through their federal tax authorities, the Internal Revenue Service (IRS) and the Canada Revenue Agency (CRA).

To evaluate the approaches undertaken to regulate the foreign activities of charities, this section examines the different regulatory tools or instruments used in each jurisdiction. These tools represent a broad spectrum of red and green light measures that seek to address the specific objectives of mitigating the risk of charities operating overseas being misused for terrorist financing and limiting the tax concessions to their charitable purpose, while encouraging the efficient use of charitable resources and facilitating legitimate cross-border flows of charity.

[4] Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation: Theory, Strategy, and Practice* (Oxford, 2012) 4.

Legislative Measures

The legislative measures adopted across all four jurisdictions examined provide a means of prescriptive 'red light' regulation to prevent the abuse of charities and misuse of charitable funds. In addition to legislation strengthening terrorist financing measures since the 2001 terrorist attacks, each jurisdiction has provisions in its tax legislation containing geographic limitations on the ability of charities to engage in charitable endeavours overseas. The interpretation of these provisions by the tax authorities and the courts, have impacted the ability of charities and their donors to engage in international charitable work.

Australia's *Income Tax Assessment Act 1997* (Cth) (*ITAA 1997*) contains the 'in Australia' residency and operational requirements for income tax exemption and gift deductible status. The 'in Australia' requirement for income tax exemption states that an organisation has 'a physical presence in Australia and, to that extent, incurs its expenditure and pursues its objectives principally in Australia'.[5] The 'in Australia' requirement for DGR status states that 'the fund, authority or institution must be in Australia'.[6] As interpreted by the ATO, these 'in Australia' residency and operational requirements restrict the ability of Australian charities and their donors to engage in overseas charitable work. At the same time, the Australian courts have taken a more permissive approach to the foreign activities of Australian charities and this appears to have caused a shift in approach by the ATO that has yet to be officially adopted.

UK legislation does not contain provisions that explicitly limit the foreign activities of charities. However the *Finance Act 2010* (UK) contains requirements as to: jurisdiction (the charity must be subject to the control of a relevant UK or EU court or the equivalent in another country); registration (the charity must be registered as a charity in the UK or with any equivalent requirement in another country); and management (its managers must be 'fit and proper persons'). These requirements serve to limit access to UK charitable status and tax relief.[7] In addition, a UK charity must submit to a reasonableness determination by HMRC prior to sending charitable funds overseas, evidencing that it has exercised control over the funds.[8] These restrictions have undermined the more permissive approach undertaken by the European Court of Justice (ECJ) towards cross-border charity.

In the US, while there are no geographic limitations on income tax exemption in the *Internal Revenue Code* (*IRC*),[9] the 'in US' requirement for deductibility of charitable contributions does not permit a tax deduction for charitable contributions made directly to foreign charities. This requirement provides that in order to be eligible to receive tax deductible contributions, the charity must be 'created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States'.[10] The IRS allows a deduction if a donation to a US charity is used for charitable work abroad in furtherance of its mission or if the donation is made through a US charitable

[5] *ITAA 1997* s 50-50(1)(a). Emphasis added. There are limited exceptions to this 'in Australia' provision for institutions specifically prescribed by the Income Tax Assessment Regulations to be tax exempt.
[6] *ITAA 1997* s 30-15. Emphasis added.
[7] See *Finance Act 2010* (UK) c 13 s 30 sch 6.
[8] See *Income Tax Act 2007* (UK) s 547; *Corporation Tax Act 2010* (UK) s 500.
[9] *Internal Revenue Code of 1986* (US), as amended.
[10] *IRC* s 170(c)(2)(A).

intermediary, provided it exercises 'control and discretion'. The US Tax Court has generally adopted a more permissive approach than the IRS to the foreign activities of charities.

In Canada, foreign-based entities cannot be registered as charities because there is an 'in Canada' residency requirement contained in the definition of registered charity in the *Income Tax Act* (*ITA*), [11] which states that a charity must be 'resident in Canada and was either created or established in Canada'.[12] In some limited circumstances, foreign entities may be eligible to be 'qualified donees' and afforded similar treatment to Canadian registered charities, however these instances are rare.

In Canada, all registered charities are subject to the 'in Canada' residency requirement contained in the definition of registered charity in the *ITA*, which states that a charity must be 'resident in Canada and was either created or established in Canada'.[13]

The CRA has interpreted this requirement, together with a provision defining a charitable organisation as a body 'all the resources of which are devoted to charitable activities carried on by the organization itself'[14] to mean that registered charities can only use their resources overseas through gifts to qualified donees (although this status is generally not available to foreign charities), or to carry on their 'own activities', which requires meeting significant 'direction and control' requirements over the use of funds. This restrictive approach has been upheld by the Canadian Federal Court of Appeal.

The geographic limitations in the tax legislation and their interpretation by the tax authorities and the courts are summarised in table 1 below.

Table 1 Geographic restrictions in tax legislation and their interpretation

Country	Legislative provisions with geographic limitations	Interpretation of legislative provisions by tax authorities*	Interpretation of legislative provisions by the courts*
Australia	'In Australia' residency and operational requirements for income tax exemption and gift deductible status (*Income Tax Assessment Act 1997*)	Restrictive (but under review)	Permissive
UK	Indirectly through jurisdiction, registration and management structural requirements and reasonableness determination for charitable tax relief (*Finance Act 2010*)	Restrictive	Permissive (ECJ)
US	'In United States' residency requirement for deductibility of charitable contributions (*Internal Revenue Code*)	Generally restrictive	Generally permissive
Canada	'In Canada' residency requirement for charitable status and tax relief (*Income Tax Act*)	Restrictive	Restrictive

- This is assessed based on the extent to which the statutory interpretation would permit or restrict charities and their donors to engage in cross-border charitable endeavours.

[11] *Income Tax Act*, RSC 1985, c 1.
[12] *ITA* s 248(1).
[13] *ITA* s 248(1).
[14] *ITA* s 149-1(1).

Regulatory Measures for Charities Generally

Governments in the four jurisdictions examined have introduced a range of tools to regulate charities, whether by the charity regulator, tax authorities, or both. These include requirements upon registration as a charity, followed by ongoing compliance and reporting measures once charitable status has been obtained. These tools are summarised in table 2 below.

Table 2 Tools to Regulate Charities Generally

Mechanisms **Country**	**Registration requirements**	**Governance standards**	**Reporting requirements**	**Record-keeping requirements**	**Inquiries/ compliance reviews/audits***
Australia	- ACNC: registration (including governance standards) - ATO endorsement for tax concessions	ACNC: governance standards	ACNC: annual information statement	ACNC: 7 years	ACNC: minimal compliance reviews ATO: minimal inquiries/audits
UK	Charity Commission & HMRC registration	None	Charity Commission: Annual return	Charity Commission: 6 years	Charity Commission: extensive inquiries (under new legislation) HMRC: minimal inquiries/audits
US	IRS registration	None	IRS: Form 990	IRS: 3 years	IRS: minimal inquiries/audits
Canada	CRA registration	None	CRA: annual information return	CRA: 6 years	CRA: extensive inquiries/audits

- The scale on which these are assessed ranges from minimal to extensive, based on the number undertaken.

Regulatory Measures Specifically for Charities Operating Overseas

Governments in the jurisdictions examined have introduced a combination of 'red light' and 'green light' tools to specifically regulate the foreign activities of charities. Many of these compliance measures have been introduced as part of the process for registration as a charity. Other measures are triggered once charitable status has been obtained through additional reporting requirements or the imposition of strict 'red light' control requirements. All of the jurisdictions provide strong 'green light' regulation through guidance on issues involving charities carrying out international activities. International aid and development charities are subject to further government regulation through various screening processes required to be eligible for government funding and through contractual requirements in their grant agreements with these government agencies. The additional tools used to regulate the foreign activities of charities are summarised in table 3 below.

Table 3 Specific tools to regulate charities operating overseas

Tools Country	Additional application or registration requirements	Additional reporting requirements	Control requirements	Guidance for charities operating internationally	Additional inquiries & audits	Contractual requirements /screening processes for gov't grants
Australia	- ACNC: additional questions upon registration - Overseas Aid Gift Deduction Scheme - External conduct standards (not yet implemented) - Register of Environmental Organisations (REO)	- ACNC: minimal information in annual information statement - REO: annual return	None (may be included in external conduct standards if implemented)	ACNC: minimal	No	Department of Foreign Affairs and Trade/ accreditation
UK	HMRC: jurisdiction requirement for foreign (European) charities	Charity Commission: minimal information in annual return	HMRC: extensive control requirements when sending funds overseas to enable HMRC to make a reasonableness determination	Charity Commission: extensive	Charity Commission & HMRC: charities selected on risk basis including terrorist financing	Department for International Development/ none
US	- IRS: additional questions upon registration - US Treasury: Anti-Terrorist Financing Guidelines & Specially Designated Nationals List	IRS: extensive information in Form 990	IRS: minimal control requirements for public charities sending funds overseas; more extensive for private foundations (expenditure responsibility & equivalency determination)	IRS: minimal	No	United States Agency for International Development/ registration requirements
Canada	- CRA: compliance with anti-terrorism legislation	CRA: quite extensive information in annual information return	CRA: extensive control requirements when working with intermediaries overseas	CRA: extensive	No	Global Affairs/ institutional profile

Self-regulatory Mechanisms Led by the Charitable Sector

International aid and development charities are subject to 'green light' self-regulation through the peak bodies for NFPs involved in international aid and development. All of these organisations have some overriding document of principles for their members, with most undertaking a greater regulatory role by requiring periodic self-assessments or accreditation processes and reporting requirements, with consequences for non-compliance. Table 4 below outlines the different self-regulatory mechanisms used in the four jurisdictions.

Table 4 Sector-driven self-regulatory mechanisms for international development charities

Mechanisms Country	Code of Conduct/Standards/ Charter	Self-assessment/ accreditation	Reporting requirements	Consequences for non-compliance
Australia	Australian Council for International Development (ACFID) Code of Conduct	ACFID: self-assessment	ACFID: annual reports	ACFID: suspending or revoking Code signatory status
UK	Bond Charter	None	None	None
US	InterAction Standards	InterAction: self-assessment	InterAction: completion of compliance form every 2 years	InterAction: suspension of membership or denial of membership application
Canada	- Canadian Council for International Cooperation (CCIC) Code of Ethics and Operational Standards - Imagine Canada: Standards Program	- CCIC: self-assessment - Imagine Canada: accreditation	- CCIC: renewal of compliance every 3 years - Imagine Canada: annual compliance report	- CCIC: suspension of membership or denial of membership application - Imagine Canada: Loss of accreditation

Key trends

The findings from the comparative analysis revealed a number of key trends:

- Tax authorities across the four jurisdictions have generally taken a restrictive 'red light' interpretation of the geographic limitations contained in their tax legislation, which has served to constrain the foreign activities of charities and their donors.
- Other than Canada, the courts have generally adopted a permissive 'green light' approach to the foreign activities of charities. The Canadian Court of Appeal has resisted this trend and instead sanctioned the CRA's restrictive approach.
- Across all jurisdictions there has been a proactive use of tools by government to regulate the foreign activities of charities. In Canada, the UK, and the US, there is an emphasis on ongoing regulation through strict 'red light' control measures. Canada appears to be both the most prescriptive in terms of the CRA's interpretation of 'direction and control', as well as enforcement through audits.

- International aid and development charities in Australia, the US and Canada are subject to particularly stringent screening processes in order to obtain government grants, and government agencies across all four jurisdictions regulate the activities of these charities through their grant agreements, which contains provisions for ongoing monitoring and compliance.
- Outside government regulation, there is robust self-regulation through peak bodies for the international development sector. In Canada, the US and Australia, these self-regulatory mechanisms have rigorous ongoing compliance measures, as well as consequences for non-compliance.

The findings from the comparative analysis also revealed that relative to the regulatory constraints on the foreign activities of charities in the other common law jurisdictions examined, the restrictions placed on Canadian registered charities are particularly onerous. The Canadian restrictions stem from both the provisions of the *Income Tax Act* that limit how registered charities can operate, the interpretation of these provisions by the courts, and the prescriptive regulatory approach adopted by the CRA. This regulatory regime, focused primarily on 'red light' measures to prevent undesirable consequences from international charitable endeavours has impeded the ability of Canadian charities and their donors to effectively engage in charitable work outside Canada. The result is over-regulation of charities operating outside Canada, placing a disproportionate burden on charities that are not at risk and stifling legitimate cross-border charitable work.

Summary

When considering reform of the current regime governing the work of Canadian charities overseas, the approaches and experience of the four jurisdictions examined in the comparative analysis suggest that there is an opportunity for the government to move towards:

- Applying a more risk-based approach to regulation;
- Adopting a less restrictive approach to the 'in Canada' residency requirement;
- Removing excessive control requirements and replacing them with other regulatory measures; and/or
- Reducing overlap between regulatory bodies overseeing international charitable work.

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