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THE DONOR CONTROL/ PUBLIC BENEFIT BALANCE UNDERLYING PHILANTHROPIC TAX CONCESSIONS

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1 Introduction

While various specific rationales remain contested, in broad terms, many people would accept that charitable donation concessions are provided to support the charity sector. Support is provided to increase the sector's production of particular goods and services and to generate process benefits from the way that charities operate, such as pluralism and altruism. In other words, support is provided to achieve public benefit. However, I argue that in many common law jurisdictions, especially the United States and Canada where revenue authorities are the primary charity regulators, regulation of charities and donors by revenue authorities promotes donor autonomy and control to the detriment of public benefit.

At first glance, this seems strange, especially given tax authorities' goal of protecting the tax base. However, tax regimes and tax authorities often weigh donor autonomy against the public interest, viewed as tax base protection. They thus focus on the leakage of private benefits to donors that have some monetary value. Yet donor control extends well beyond donor extraction of charity resources to include the selection of charitable projects or charity grant recipients, the concomitant allocation of foregone public tax dollars to those projects and the manner in which such projects or charities are to be conducted. In contrast, sector-specific regulators, such as charity commissions in Australia or England and Wales, tend to balance donor autonomy against the public interest viewed through the lens of the proper administration and effective use of charity property. This perspective potentially permits greater attention to the more intangible values and interests that donors may wish to project into the future through charities (Chan 2016: Ch 5; Picton 2018: 192, 196–201).

To investigate the issue, this chapter will look at five areas. First, regulation of the benefits that a donor receives in return for making a gift – an area that tax regulation should be well placed to police. Second, general operational tax rules. Third, the tax law distinction drawn in some jurisdictions between public and private charities, which starts to address questions of donor control but remains focused on private benefits. Fourth, tax restrictions on political activity, which form an exception to the suggestion that tax law is primarily focused on restricting

private benefits. Fifth, the tools available to tax regulators to deal with ineffective use of charity assets as compared with those available to sector-specific regulators.

Before doing so, the chapter discusses the rationale for charitable donation concessions and the tension between protecting donor autonomy and promoting public benefit. It also outlines concerns about material donor control over donated funds, most particularly the risk that this poses for democratic institutions. The chapter concludes with some exploratory thoughts on reforms.

2 The tension between protecting donor autonomy (hence control) and promoting public benefit

Our legal institutions, such as property law and tax law, both shape and are shaped by societal norms and behaviour. Principles such as donor autonomy to freely dispose of property apply and are expressed within these institutions and are thus moulded by those institutions (Reich 2018: ch 1; Saunders-Hastings 2018: 157–158). Donor autonomy is therefore not absolute but regulated in certain ways by tax and related laws. For example, donors have freedom to choose their preferred project amongst the universe of charitable purposes – whether by selection of an existing charity or by creation of a new charity. The legal form of the selected charity can make it easier or harder for future generations to alter that purpose. Rather than a charity that directly carries out its purposes, the recipient charity might be an intermediary foundation, providing further flexibility as to the time at which the donation is ultimately used and as to the selection of recipients. Further, donors have some ability to control the manner in which the charitable project is conducted by imposing gift restrictions under contract, trust or property law; by writing those restrictions in a charity’s constitution or trust deed; or by holding a seat on the charity’s board or governing body.

To understand how tax law expresses donor autonomy and addresses donor control, we might think it relevant to understand the rationale underlying charitable donation concessions. As noted by Brody (and recently by the OECD), there is ‘no single, unified and coherent tax policy with respect to non-profit organizations – and no single rationale’ (Brody 2018: 484; OECD 2020: 22). Nevertheless, when introducing income taxes, legislators have typically suggested that donors would reduce their gifts unless a concession was provided (Colinvaux 2018: 445; Brody 2010: 603). Commentators have linked this reason to ‘subsidy theories’ that focus on the role of tax concessions in supporting the achievement of ‘public benefit’ by charities (Colinvaux 2018: 445; Duff 2014: 208–214; OECD 2020: 22). I intend to refer broadly to such subsidy theories – being support for the positive externalities of charities, not merely subsidies to finance goods that government would otherwise be expected to provide. For the purposes of this chapter, the positive externalities encompass the public benefits not just from inducing charities to produce goods and services such as health care, education and welfare but also process benefits from the manner in which charities operate, such as charities’ role as sites of collective and political action, as well as in the promotion of pluralism or altruism (O’Connell 2018: 395; Atkinson 1997: 403; James & Rose-Ackerman, 1986: 86–87; Hemel 2020: 147–148; Chia et al 2011: 17–20). This link seems especially apt in the many jurisdictions that make donation concessions broadly available to most charities (e.g., United States, United Kingdom, Canada), such that there is substantial overlap between the tax-exempt charities and the donation concession charities (Colinvaux 2018: 447).

Some writers supporting the subsidy theory link with donation concessions also suggest that encouraging donations where taxpayers are able to direct support to the charities of their

choice can itself promote pluralism and civic participation (Krever 1991: 11–13; Duff 2014: 213–214). However, donation concessions structured to provide the most benefit to the wealthy (especially so in the United States) undermine equality of opportunity (Fleischer 2018), reducing the degree of added pluralism (Reich 2018: 132–133; Duff 2014: 216–217). Conceiving of public benefit as including process benefits highlights the independence of the charity sector from government, in that the process benefits arise from voluntary selection and/or association rather than government administration. Further, the very form of donation concessions typically involves indirect, not direct, government support and oversight, again emphasising sector independence and autonomy (Gergen 1998: 1399–1403).

Finally, it has also been suggested that the income tax deduction can be justified on the basis that the donated income never formed part of the tax base, but many commentators dispute this by regarding donations as voluntary personal consumption of the donor's income (Duff 2014: 204; Krever 1991: 5–8).

In summary, donation concessions are intended to achieve public benefit but to operate in a manner that leaves substantial autonomy with donors and charities, not least to avoid disincentivising donations. This reflects the general charity law interplay between respecting donor intent and overriding donor intent to achieve a greater or fairer public benefit (Dal Pont 2017: [6.6]; Chan 2016: 53–54; Mulheron 2006: 87–89). Accordingly, I do not propose that tax regulators should have unfettered ability to impose their views on charities about how those charities could more effectively use their resources to achieve public benefit.

Nevertheless, there is some basis for worrying that the balance under income tax rules has shifted too far in favour of donor control and away from public benefit. Reich, Lechterman and Vallely, amongst others, have identified growing inequality, in combination with generous charitable donation tax concessions, as resulting in increased control of the charity sector and its activities by a wealthy elite (Reich 2018; Vallely 2020; Lechterman & Reich 2020: 184). In particular, they warn about the potentially anti-democratic nature of intermediary foundations.¹ See also OECD 2020: 23. Saunders-Hastings adds to this criticism by suggesting that tax legislation, amongst other laws, privileges elite donor views about public benefit over the views of others (2018: 150, 157; see also Pevnick 2013).

Horvath and Powell provide material examples of extensive control exercised over philanthropic undertakings by some of the wealthiest philanthropists such as Gates, Zuckerberg and Bloomberg (Horvath & Powell 2020: 117). They suggest that there has been a return to extensive donor involvement in philanthropic endeavours and infusion of the business practices that proved so successful for the donors in the corporate world – reflecting a return to practices from the time of Carnegie and Rockefeller (Horvath & Powell 2020: 117). This was a time when the U.S. Congress became concerned about and legislated to regulate the activities of private foundations. From an empirical perspective, Teresa Odendahl highlighted several decades ago that elite philanthropy ‘support[s] institutions that sustain their culture, their education, their policy formulation, their status – in short, their interests’ and that this involves ongoing control over donated funds (1990: 232). More recently, and in keeping with these findings, Susan Ostrander has identified material donor control over donated funds from analysis of the United States professional adviser literature (2007).

If a small group of donors is permitted material control over their donated assets, in addition to the potential harm to democratic institutions, there are further potential detriments to public benefit. Lester Salamon's ‘philanthropic paternalism’ describes one drawback, in that donors impose their preferences on the public, in contrast to the community discussion about public benefits that should be pursued (1987: 41). This has also been characterised as a failure to build mutual relationships between givers and receivers and the community bonds that

some justifications for the charity sector emphasise (Vallely 2020: 466–467, 672–673; Ostrander 2007). There is also an intergenerational dimension, with Fleischer worrying that control over donated assets can enable the intergenerational transfer of political and economic power (2018: 440. See also Odendahl 1990: 4–5, 232). Further, permitting donors in the current generation too much autonomy may breach principles of intergenerational justice about the balance of autonomy between generations (Murray 2021).

Charitable donation concessions are also very large (e.g., US\$48.3 billion in the United States in 2019 [Treasury (US) 2020], \$AU1.8 bn in Australia in 2019 [Treasury (Au) 2020]), such that material public benefit should be expected for the material amounts of tax foregone. As well, charitable donation concessions typically benefit wealthier donors to a greater extent.² This may be because they constitute a deduction in the context of a progressive income tax system, thus providing a larger tax benefit to higher-rate taxpayers (e.g., Australia, United States), although larger tax benefits are still effectively provided to higher income earners under the UK's hybrid Gift Aid concessions and (assuming that they donate more) under Canada's two-tiered credit system. In the United States, in particular, the high standard deduction under the Tax Cuts and Jobs Act of 2017 has been estimated to mean that only 9% of taxpayers will now itemise – and thus gain a benefit from – their charitable donations (Colinvaux 2019: 1007–1008). Furthermore, the United States provides stunningly concessional treatment for donations of appreciated assets – assets such as company shares whose value reflects unrealised capital gains. A gift of such assets potentially enables a deduction based on the fair market value of the asset but with the donor not required to bring into assessable income the difference between the asset's tax cost and its fair market value (Brody 2018: 500). Canada and the United Kingdom adopt a similar approach for a more limited class of assets (such as listed company shares – and, in the United Kingdom, land) (Duff 2014: 199; Henderson & Fowles 2015: [20–038], [20–046]; Special Senate Committee on the Charitable Sector 2019: 108), and the Canadian Special Senate Committee recently recommended a trial extension to all company shares and to land. Australia generally imposes capital gains tax on inter vivos gifts of property³ but would potentially provide a corresponding deduction for the market value of the donated property (Income Tax Assessment Act 1997 (Cth) div 30).

3 Tax regulation of donor control

Chan has argued, in relation to the Canada Revenue Agency, that tax regulation and tax regulators seek to balance donor autonomy against the public interest in guarding the breadth and integrity of the tax base (2016: Ch 5). Similar assertions have been made of charity tax regulators in the United States and, before the introduction of Australia's charity commission, of the Australian Taxation Office (ATO) [Colinvaux 2018: 454; Treasury (Au) 2011: 29]. On the other hand, regimes for sector-specific regulators, such as charity commissions in Australia or England and Wales, tend to balance donor autonomy against the public interest viewed through the lens of the proper administration and effective use of charity property, which potentially permits some greater attention to the more intangible values and interests that donors may wish to project into the future through charities (Chan 2016: Ch 5; Picton 2018: 192, 196–201). Given the controversial nature of some of the wider questions of public interest in the effective use of charity property, as opposed to tax base protection (Colinvaux 2018: 454), it is also understandable that tax authorities may shy away from these broader notions of public benefit. Some of these structural barriers are investigated further in the following. First, though, it is important to consider the notion of a 'gift', the private/public distinction and political activities.

3.1 Gifts

Tax laws frequently provide significant attention to charitable donations to ensure that the donor does not receive a material benefit in return, or at least no benefit with respect to amounts that are being claimed as deductions or credits (O’Connell 2018: 413–414; Chan 2016: 113–117). Potentially this means that tax regulators are well placed to monitor control rights obtained by donors. By way of example, in Australia, the income tax law requires either a ‘gift’ (interpreted by the case law to mean that the donor receives no material benefit or advantage by way of return) (ATO 2005: [37]–[44], [142])⁴ or certain contributions for a right to participate in a fundraising event or by way of bid at a charity auction, in which case the deduction is only the difference between the contribution and the market value of the right to participate or the charity auction goods [Income Tax Assessment Act 1997 (Cth) s 30–15(1)]. On their face, these provisions are very broad. However, much of the ATO guidance indicates that breach would occur where something of economic value is received in return and that benefits such as networking opportunities, public recognition and reporting on the use of donated funds, are not captured (ATO 2005: [170], [186], [196], [202]).⁵ Nevertheless, the ATO does move beyond marketable benefits to also consider that membership rights and other things that have value to the donor would be caught.⁶ Additionally, an anti-avoidance provision denies a deduction where the donor or an associate obtains a right, privilege or benefit other than the benefit of a tax saving [Income Tax Assessment Act 1936 (Cth) ss 78A(2)(c), 78A(3)]. The provision is also deemed to apply where the charity recipient does not immediately receive or have the unconditional right to retain custody and control of the property or does not obtain an immediate, indefeasible and unencumbered legal and equitable title to the property. While the ATO expressly notes that these provisions extend beyond ‘pecuniary’ and ‘proprietary’ benefits, the ATO considers that the goal of the provisions is to ensure that ‘the benefit to the fund will equal the deduction allowed to the taxpayer’ and that they are not intended to apply to ‘genuine gifts made in ordinary circumstances’ (ATO 2005: [206]–[207]). While reflecting donor control, it is difficult to characterise donor conditions on use of funds for certain purposes within the recipient’s overarching purposes or that require expenditure at a particular time as involving the return of a material benefit to the donor (see, e.g., Silver 2021), though unless care is taken, the form of the conditions may raise risks as to receipt of an unencumbered title (see, e.g., O’Connell 2020: 382–383).⁷

In the United States, deductions under Internal Revenue Code §170 are available for gifts (a transfer of property without consideration) or contributions to most §501(c)(3) charities⁸ but with the amount of the deduction limited by the market value of benefits received in return (26 CFR §1.170A-1; Fishman, Schwarz, & Mayer 2015: 775–782). Treasury Regulation CFR §1.170A-1(h)(2) focuses especially on the fair market value of benefits received in return, and CFR §1.170A-13 excludes benefits with an ‘insubstantial value’, such as minor annual membership rights or tokens bearing the charity’s logo [26 CFR §1.170A-13(f)(8); IRS 1990]. This indicates that hard-to-value rights to require a charity to use funds for purposes within its overarching charitable purposes or to be expended at a particular time do not sit easily as benefits received in return (Eason 2007: 701–702; Colinvax 2016: 26–30; Hopkins 2014: 503). However, retained rights to provide ongoing directions to a charity as to the specific application of donated property (e.g., choice of recipients of charity services) are likely to breach the tax requirements on the basis that they reduce or eliminate any contribution in the first place or that they are benefits that materially reduce its value (Eason 2007: 702–703; Hopkins 2014: 505–508).

It is perhaps not surprising, then, that gift agreements do generally permit material conditions or restrictions on the use of funds, many running to tens of pages (Eason 2007: 698–707; Innes & Boyle 2006: 72–74). Further, donors could avoid many of these requirements by first setting up a charity before making a donation. If the constitution or trust deed of the charity sets out the preferred purposes, including rules as to when those purposes should be pursued, it is then simply a matter of making a gift (albeit, as discussed further subsequently, gifts to privately controlled charities are often afforded less generous tax concessions and are subjected to more restrictions) to an existing charity that happens to accord with the donor's views and permits control by way of intergenerational protection of the charitable purposes set out in the constituent documents. Further (and again subject to the public/private charity distinction), donors may retain actual control of the charity to which they donate.

3.2 General organisational and operational rules and control

Other than gift transactions, tax regulators typically pay close attention to charities at the point of registration. As the technical meaning of 'charity' requires that a charity have certain charitable purposes and be for the public benefit, this requires some attention at the initial stages to matters of public benefit and hence means that donors do not have completely unfettered autonomy to determine their projects – they must be charitable. We might now question how rigorous this screening process is in the United States for organisations filing a form 1023-EZ.

Further, most jurisdictions do include some sort of general operational test in their tax rules. In Australia, to be eligible for income tax exemption, a charity must be registered as such by the federal charities commission, the Australian Charities and Not-for-profits Commission [Income Tax Assessment Act 1997 (Cth) s50–55], and meet several special tax conditions, including that the charity must 'comply with all the substantive requirements in its governing rules' and 'apply its income and assets solely for the purpose for which [it] is established' [Income Tax Assessment Act 1997 (Cth) ss50–51, 50–50(2)].

Similarly, United States charities are subject to an 'operational' test due to the wording of Internal Revenue Code §501(c)(3).⁹ The Internal Revenue Service (IRS) has interpreted this requirement for organisations that raise and pass on funds to other charities (and potentially organisations that both raise funds and directly pursue their charitable purposes, such as universities) as requiring the organisation to distribute or expend assets 'commensurate in scope with its financial resources' (IRS 1964, 1989: 13–16). In Canada, to be a tax-exempt 'charitable foundation' requires 'a corporation or trust that is constituted and operated exclusively for charitable purposes', while a tax-exempt 'charitable organization' is 'an organization, whether or not incorporated . . . all of the resources of which are devoted to charitable activities carried on by the organization itself' [Income Tax Act, RSC 1985, c 1, s149.1(1)]. This is a very general and vague test (Man 2011: 25–26) and seems chiefly concerned with whether ongoing activities are consistent with the organisation's charitable purpose (Ontario Law Reform Commission 1996: 288; Innes & Boyle 2006: 16–17).

The UK tax legislation contains no blanket income tax exemption for charities. Instead, specific categories of income and gains are rendered exempt, with the exemptions applying to most types of income and gains (HMRC 2020: Annex i, Kessler, Wong & Birkbeck 2019: 285–286). Other than minor exceptions (see Kessler, Wong & Birkbeck 2019: 136–137, 142, 162), and some minor changes in wording, each of the exemptions only applies to income or gains so far as the income or gain is 'applied to charitable purposes only' or 'applied for charitable purposes' [Corporation Tax Act 2010 (UK) c 4, pt 11 chs 2–3; Income Tax Act

2007 (UK) c 3, pt 10; Taxation of Chargeable Gains Act 1992 (UK) c 12, s 256(1)]. This is virtually identical to the Australian ‘application-for-purposes’ requirement. In addition, the UK rules contain a set of ‘charitable expenditure rules’, which, in broad terms, reduce the income tax exemptions to the extent that a charity has a ‘non-exempt amount’ for a tax year [Corporation Tax Act 2010 (UK) c 4, s 492; Income Tax Act 2007 (UK) c 3, s 539; Taxation of Chargeable Gains Act 1992 (UK) c 12, ss 256(3), (3A)]. The aim is to address the fact that, unlike the Australian provisions, the UK primary exemption provisions focus only on a charity’s income or gains, not misapplication of its other assets (HMRC 2020: Annex ii). To have a ‘non-exempt amount’, a charity must have, among other things, ‘non-charitable expenditure’ for the relevant tax year [Corporation Tax Act 2010 (UK) c 4, s 493; Income Tax Act 2007 (UK) c 3, s 540; Taxation of Chargeable Gains Act 1992 (UK) c 12, ss 256(3), (3A)]. The definition of this phrase includes a range of listed items, including ‘expenditure’ that is ‘not incurred for charitable purposes only’ [Corporation Tax Act 2010 (UK) c 4, s 496; Income Tax Act 2007 (UK) c 3, s 543].

These tests focus on whether charity assets are being properly administered. While there is some overlap, they are not concerned with the broader question of whether a charity is effectively using its assets to achieve public benefit. For example, in the context of accumulation of charity assets, the tests seem ill equipped to stop donors from directing charities to save for the future and so project their views well into the future. As set out by Murray (2015), for reasons of policy and doctrinal analysis, the Australian ‘application-for-purposes’ test is better characterised as being focused on maladministration that affects whether funds are used to promote a charity’s purpose. Excessive accumulation or other ineffective uses of charity assets might amount to maladministration where they involve an exercise of power by charity controllers in a way that breaches their duties. However, the starting point is to identify a breach of duty, and a decision to use assets in a less effective way than is possible will not necessarily amount to a breach. Likewise, in the United Kingdom, the application for purposes test has been accepted by commentators and the HMRC as being focused on a class of failures to comply with the charity’s rules (Kessler, Wong & Birkbeck 2019: 142–146).

Similarly, in Canada, ‘operating’ an entity for charitable purposes and ‘devoting’ funds to ‘charitable activities’¹⁰ are sufficiently broad as to encompass an application of funds by way of accumulation (such that they do not impose a temporal requirement to directly spend or distribute funds: Innes & Boyle 2006: 16–17), or to encompass a range of uses that promote the charitable purpose but that are not the optimal use of funds. The United States operational test is differently worded to, and has less clearly defined boundaries than, the Australian focus on maladministration. However, it is arguable that a test focused on whether an entity ‘engages primarily in activities which accomplish one or more of [its] exempt purposes’ ought to be construed in the same way as the Australian ‘application-for-purposes’ test, since both examine whether acts are in furtherance of the charitable purposes. This would appear to leave scope for a range of acts that further a charitable purpose but do so in ways that less effectively generate public benefit. In any event, even if the IRS’s ‘commensurate in scope’ interpretation is accepted, commentators suggest that the test would only apply to accumulation in very narrow circumstances, for instance, where distribution/expenditure rates are extraordinarily low or controllers have breached their duties by diverting material funds to their own private benefit (Siegel 2009: 11–12, 16; Simon, Dale & Chisolm 2006: 283).¹¹

The United States also applies penalty taxes, and potentially revocation, where ‘disqualified persons’ receive ‘excess benefits’ from public charities (Internal Revenue Code §4958). An excess benefit arises where the value of the economic benefit provided by the charity exceeds the value of any consideration provided by the disqualified person (e.g., a low/no-interest

loan) [Internal Revenue Code §4958(c)(1)(A)]. Disqualified persons include people in a position to exercise substantial influence over the charity's affairs (and their associates), such as a board member or trustee, a CEO and most likely a founder or substantial contributor [26 CFR §§53.4958–3(c), 53.4958–3(e)(2)(i) and (ii)]. Disqualified persons should thus include donors who exercise control in relation to the charities that they found or to which they donate. However, the rules are focused on economic benefits received by donors (Mayer 2012: 88), not on difficult-to-value rights to project the donor's views (see 26 CFR §§53.4958–4). A similar comment could be made about the Canadian undue benefit penalty taxes [Income Tax Act, RSC 1985, c 1, s 188.1(4)]. 'Undue benefit' is defined broadly to include the 'amount' of property or rights conferred by the charity and would apply to a proprietor, trustee, member, settlor or major contributor to a charity [Income Tax Act, RSC 1985, c 1, s 188.1(5)]. While the Canadian provisions are broader, the need to identify an 'amount' and to calculate a penalty based on this amount also suggests that the Canada Revenue Agency is unlikely to apply the provisions to hard-to-value rights. Again, to similar effect, the Australian public and private ancillary fund rules impose penalties where benefits are provided to those with some ability to control the fund, such as directors of the trustee company, founders and donors [Taxation Administration (Private Ancillary Fund) Guidelines 2019 (Cth) r22; Public Ancillary Fund Guidelines 2011 (Cth) r42]. The penalty must be calculated based on the 'amount' or 'value' of the benefit provided. Moreover, the provisions would not seem to apply where control rights are not received from the charity but are instead built into the charity's formational documents – such as the voting rights of a member or the articulation of a particular charitable purpose and means of pursuing that purpose.

3.3 Public/private charity distinction

An important distinction that is made in several jurisdictions in policing issues of control is to have separate regimes for public charities and more restrictive rules for more tightly controlled private charities/foundations. The United States, for instance, distinguishes 'private foundations' from public charities. Private foundations are, in a broad sense, charities that raise their funds from a limited pool of persons rather than the general public and are controlled by a restricted range of persons (Simon, Dale & Chisolm 2006: 269).¹² In keeping with the 1965 Treasury Report on private foundations, extra requirements apply to private foundations that seek to eliminate private benefits for donors (Fremont-Smith 2004: 76–80; Mayer 2012: 87). A range of penalty taxes may be imposed on the private foundation and/or its controllers motivated largely by concerns around private benefits: provisions concerning self-dealing, excess (i.e., non-portfolio) business holdings and investing in a manner that jeopardises carrying out the charitable purpose (Internal Revenue Code §§4941, 4943, 4944). These rules go some way to replicating controller duties of loyalty and care (Fremont-Smith 2004: 264–300). However, the rules are also intended to extend beyond private benefits to constrain control in various ways (Fremont-Smith 2004: 76–80). Several measures discourage attempts to direct excessive accumulation, as foundations must typically make annual distributions of 5% of 'the fair market value' of their net investment assets (Internal Revenue Code §4942). Private foundations are also subject to a 2% excise tax on net investment income [Internal Revenue Code §4940(a)], although the rate drops to 1% for foundations that sufficiently increase their distributions [Internal Revenue Code §4940(e); and see also Fremont-Smith 2004: 264–265]. Engaging in certain 'taxable expenditures', such as payments for political campaigns and lobbying, can potentially also result in excise taxes (Internal Revenue Code §4945). Further, donation concessions for donations to private foundations are less generous (Madoff 2016: 166–167; Hemel 2020: 159),

and disclosure and international grant-making requirements for private foundations are more onerous than for public charities (Hemel 2020: 159; OECD 2020: 124–125).

Australia also distinguishes between public and private ‘ancillary funds’ and between ancillary funds (which are subject to a disbursement quota) and other (public) deductible gift recipient charities (which are not subject to a disbursement quota). Australian charities do not automatically qualify for donation concessions. However, charitable trusts in the form of public or private ancillary funds can qualify as deductible gift recipients [Income Tax Assessment Act 1997 (Cth) s 30–15(1) item 2]. The public/private distinction relates to the range of persons who may donate to and administer the trust [Taxation Administration (Private Ancillary Fund) Guidelines 2019 (Cth) rr8(c), 12, 24; Public Ancillary Fund Guidelines 2011 (Cth) rr14, 44–45]. Ancillary funds are thus philanthropic intermediaries that receive donations and then (eventually) distribute them to other deductible gift recipients.¹³ Public ancillary funds are subject to a less demanding disbursement requirement: 4% (5% for private ancillary funds) of the market value of the fund’s net assets as at the end of the preceding financial year [Taxation Administration (Private Ancillary Fund) Guidelines 2019 (Cth) r15; Public Ancillary Fund Guidelines 2011 (Cth) r19]. The public and private ancillary fund guidelines are otherwise very similar, containing rules as to the trustees’ degree of care; the need for a member of (private), or a majority of (public), the decision-making committee of the fund to be persons with a degree of responsibility to the community; exclusion from control of a fund for persons convicted of indictable taxation offences; limits on trustee indemnification; disclosure of related party transactions, along with restrictions on such transactions; and various investment limits [Taxation Administration (Private Ancillary Fund) Guidelines 2019 (Cth) rr12, 14, 18(3), 21, 22; Public Ancillary Fund Guidelines 2011 (Cth) rr 13–14, 16, 18, 26.2, 33–40, 41–42].

Canada also differentiates private from public foundations and public charities, with private foundations restricted in their ability to carry on business activities or to incur debts not linked to their charitable operations, restricted in their ability to make non-arms-length investments and subject to excess corporate holdings restrictions and donation concessions being slightly less generous for donations to private foundations (Gillen, Smith & Waters 2012: [14.III]; Income Tax Act, RSC 1985, c 1, ss 38, 149.1(4), 188.1, 189.1). It appears that the main concern with private foundations has been the potential for donors to claim donation concessions but to then maintain some personal benefit from donated property rather than genuinely applying assets to foundation grant expenditure (Gillen, Smith & Waters 2012: [14.III]). All Canadian charities registered for income tax and donation concession purposes are subject to a disbursement quota of 3.5% [Income Tax Act, RSC 1985, c 1, ss 149.1(2)(b), (3)(b), (4)(b)], with that rate applying to the average value of property not used directly in charitable activities or administration over the preceding 24 months (i.e., investment assets).¹⁴ The United Kingdom does not employ a public/private charity tax distinction but does have tainted donation rules that apply where the donor enters into an arrangement with a recipient charity that results in a *financial advantage* to the donor or an associate [Corporation Tax Act 2010 (UK) c 4, pt 21C; Income Tax Act 2007 (UK) c 3, pt 13, ch 8; Kessler, Wong & Birkbeck 2019: Ch 7].

One issue with private foundation restrictions is that they are only partially effective in limiting donor control. In particular, the payout rules are set so low as to enable perpetual existence of private foundations – enabling donors to project their views far into the future. And, as discussed by Murray (2021: Ch 7), if the timing of benefit provision is the issue, payout rules do not necessarily fit with intergenerational justice as a principled basis for approaching the timing issue. Further, lobbying expenditure could simply be provided by way of a (non-earmarked) grant to a third-party organisation to circumvent the United States taxable expenditure rules (Fremont-Smith 2004: 280–281).

More fundamentally, ‘donor advised funds’ (DAFs), which are seeing increasing use in the United States, United Kingdom, Canada and Australia (Charities Aid Foundation 2020; Murray 2020), represent a breaking down of this distinction. A DAF is a named management account within a charitable foundation (usually a public charitable trust or corporation).¹⁵ A donor makes a gift of property to the charitable foundation and typically obtains a tax deduction or credit. While the donor retains no ownership interest in the property transferred and has no legal power to direct the charitable foundation’s dealings with the property, the charitable foundation provides administrative and investment assistance to the donor and gives the donor advisory privileges about how it should deal with the donated property. The charitable foundation thus often acts in accordance with the donor’s wishes about when and to whom to distribute. The commercial imperative for charitable foundations to act in accordance with donors’ wishes is emphasised where financial services firms provide DAF services as part of their wealth management operations, which is the case for some of the largest DAF sponsors such as Fidelity Charitable and Goldman Sachs Philanthropy Fund. In essence, a DAF is a public charity but with some of the features of donor control that might otherwise be accessed via use of a private foundation. The existence of DAFs also permits United States and Canadian private foundations to effectively avoid their payout rules, as they are permitted to distribute to DAFs (Murray 2020: 271–272, 293–296).

It should be emphasised, as demonstrated by the *Fairbairn v Fidelity Investments Charitable Gift Fund* lawsuit,¹⁶ that donors have less control over a DAF than over a private foundation of which they are the trustee or a director of the trustee company. Thus, despite their recent stratospheric growth, reliance on DAFs may diminish, so leaving a material public/private foundation distinction in place. Further, Australia and Canada apply disbursement requirements to both public and private foundations (indeed, all tax registered charities in Canada). The United States has also taken some steps to maintain the public/private charity distinction as a result of Pension Protection Act 2006 reforms that apply additional self-dealing rules to DAF providers, moving them closer to the treatment of private foundations (Lehmann 2007: 35–37). However, the additional excise taxes on excess benefits transactions, taxable distributions, prohibited benefits and excess business holdings appear largely aimed at benefits derived by donors, their advisors and their affiliates (Mayer 2012: 87). They are not aimed at broader issues of control and timing of benefit provision to ultimate charity beneficiaries (Madoff 2016: Ch 6).

3.4 Political activities

Whether charities ought to be able to engage in campaigning or political lobbying activities is a controversial topic in many jurisdictions (O’Connell 2018: 408–409). It extends well beyond questions of donor control. However, political activities are considered in this chapter, as they provide a relatively unusual instance of tax rules that seek to restrict the projection of donor views. Examining the political activity rules provides insight into whether this type of tax rules is likely to be a successful way of policing intangible control rights held by donors.

Where donations are made to charities in order to carry out political activities, they can be seen – amongst other things – as a projection of donor views and as an attempt to control the use of donated funds to influence public debate and the choice of public benefits pursued. As asserted by Emma Saunders-Hastings, commentators frequently underestimate the similarities between electoral campaign spending by elites and ‘elite philanthropy’ in the sense that philanthropic donations can act as alternative means of achieving political influence (2018: 150–151). One response, in the United States and, until recently, Canada, has been to limit charity lobbying and to prohibit charity campaigning (that is, electioneering) through tax rules. For instance,

in the United States, §501(c)(3) Internal Revenue Code provides that for charity registration, ‘no substantial part of the activities of [the charity] is carrying on propaganda, or otherwise attempting to influence legislation’, with some ability to elect out of this vague test into a more certain cap or percentage of expenditure test under §501(h), though the caps are relatively low, going up to only the lesser of 20% or \$1m of expenditure. In relation to campaigning, §501(c)(3) states that the charity must ‘not participate in or intervene in . . . any political campaign on behalf of (or in opposition to) any candidate for public office’. In Canada, the case of *Canada Without Poverty v A-G (Canada)* (2018) ONSC 4147 has led to legislative amendments that retain a prohibition on campaigning [Income Tax Act, RSC 1985, c 1, ss149.1(6.1) and (6.2) provide that a registered charity must not ‘devot[e] any part of its resources to the direct or indirect support of, or opposition to, any political party or candidate for public office’] but that expressly permit non-partisan ‘public policy dialogue and development activities’ – that is, political advocacy [Income Tax Act, RSC 1985, c 1, ss149.1(1), (10.1)].

Constraining tax support in this way is not an attempt to protect tax base integrity but rather a weighing of the benefits and detriments to the public from supporting political activities that advance a charitable purpose and protecting the independence of the charity sector and government (Colinvaux 2018: 448–449). Given the odd role that this imposes on tax regulators, note that the United States and Canadian experience provides some evidence of the difficulties in employing tax regulation of campaigning activities (see also O’Connell 2018: 413–414). For instance, although interpreted broadly in the Treasury regulations, the United States campaign restriction is not always robustly enforced, with the United States IRS still reeling from the fallout over its targeting of politically aligned charities (Fishman, Schwarz & Mayer 2015: 463–497; Treasury Inspector General for Tax Administration 2017). President Trump also issued a vaguely worded executive order to the IRS requesting that it *not* take compliance action against campaigning by religious organisations (Exec Order No 13798, 3 CFR 346 2018). Furthermore, the United States institutional response has included the creation and expansion of tax concession categories for political lobbying and campaigning entities (Internal Revenue Code §527 political organisations) that can remain connected in various ways with registered charities – for example, via Internal Revenue Code §501(c)(4) social welfare organisations and §527 political action committees (Fishman, Schwarz & Mayer 2015: 494–502; Hopkins 2019: 399–400). Moreover, this is in the broader United States context of the existence of some general electoral law regulation of campaign financing but with that regulation materially limited by the *Citizens United* decision (*Citizens United* 558 US 310 (2010)), which effectively removed caps on not-for-profit and for-profit corporation electoral expenditure (Fishman, Schwarz & Mayer 2015: 502–506). In Canada, the *Canada Without Poverty* case resulted from the imposition of increased political activity reporting and audits by the Canada Revenue Agency, which has led to a partial governmental about-face and much public criticism of (and support for) the Agency (Parachin 2016: 1048, 1050–1054).

In keeping with Saunders-Hastings’s reflection on the similarities between ‘elite philanthropy’ and campaign finance, rather than relying on tax rules and tax regulators, it may make more sense to police charity political activities and associated issues of donor control through campaign financing/electoral legislation and regulators like the Federal Election Commission in the United States. In Australia, for example, while the approach is not perfect (see, e.g., Beard 2019: 40–42), Australian electoral legislation requirements apply across the board to charities and other non-party political actors [Commonwealth Electoral Act 1918 (Cth) pt XX]. If electoral expenditure (being certain expenditures on matter communicated or intended to be communicated for the dominant purpose of influencing the way electors vote in a federal election) thresholds are exceeded, then the relevant entity must register and report donations used for that

expenditure to the Australian Electoral Commission. Entities that meet ‘third party campaigner’ or ‘political campaigner’ thresholds are also required to disclose their ‘electoral expenditure’, which is to be placed on a public ‘transparency register’ [Commonwealth Electoral Act 1918 (Cth) pt XX div 1A and div 5A].¹⁷

The difficulties that regulation of political activities poses for tax regulators are reflected in the next section, which examines more generally the structural barriers that inhibit tax regulators from policing donor control for the public benefit.

3.5 The tools of tax regulators versus charity commissions and other structural barriers to encouraging public benefit

Commentators such as Chan and O’Connell have suggested that some tax regulators are not well established to monitor the ‘public-welfare compliance’ of charity projects (Chan 2016: 113–117; O’Connell 2018: 416).¹⁸ However, this is only partly due to lack of provisions focusing on the operation of charities. As we have explored previously, there are a number of operational tests that apply under tax legislation, but the general operational tests largely focus on whether a charity is properly administering its assets, not the further question of whether it is effective in its use of assets – and the issue of whether donor control is impeding effectiveness. Rules precluding benefits in return for gifts hold some promise for regulating control rights on gifts to existing charities. However, they typically require tax regulators to form a view of the value of such difficult-to-value rights and, in practice, do not appear to be impeding substantial gift agreements under which donors specify the use of their donated funds. Minimum distribution requirements for private foundations (and public foundations in Australia and all charities in Canada) impose some limits on donor ability to project their views into the future, though the distribution rates are set sufficiently low that no charity is likely to be forced to terminate. The political activity rules also constrain activities, but in a very porous way.

Given that they typically have tools available to deal with some aspects of the ‘public welfare compliance’ of charity projects, a portion of the criticisms levelled at tax regulators must relate to their practical administration of the tax rules. Part of the problem is that tax regulators, unlike charity commissions, do not have an institutional focus on charities (Owens 2017: 82; Boris & Lott 2017: 97; Gillen 2016: 136, 156–157). The IRS is also underfunded to regulate charities and is still suffering from its regulation of political activities, as discussed previously (Ascher 2014: 1597; Owens 2017: 91). The Canada Revenue Agency has also been affected by its own political activity audits and by perceptions of bias in its role as charity regulator arising from its role as a tax collector (Wyatt 2017: 148–153; Special Senate Committee on the Charitable Sector 2019: 109). Inaction for these reasons will be difficult to resolve, though making it easier to act through more express and better calibrated tools would potentially help.

Second, what is also missing are tools to reform the use of charitable assets to reduce donor control so that they can be applied more effectively. This is not a call for an unbounded tax regulator power to direct the use of charity assets but for a more structured ability to intervene. Administrative/deviation schemes (which alter the administrative machinery of a charity) or *cypès* schemes (which vary the charitable purpose) are key ‘mechanism[s] by which to prescribe the means to pursue charitable objects and, crucially, to ensure that those objects remain capable of fulfilment over time’ (Dal Pont 2017: [14.6]). They help ensure the effective use of charity assets and can be accessed by state and provincial attorneys-general and, in some cases – as for the Charity Commission for England and Wales generally and for the Australian Charities and Not-for-profits Commission in more limited circumstances – by charity commissions. However, many commentators have noted the patchiness of regulation at the level of the United

States and Canadian states and provinces (de March 2017: 127–128; Fremont-Smith 2004: 53; Brody 2004: 946–950). Additionally, the availability of *cy-près* schemes is more limited in many United States jurisdictions¹⁹ than in Australia or England and Wales and is far more limited in Canada, where *cy-près* variation is largely limited to the common law circumstances of ‘impossibility’ or ‘impracticability’ of purpose (Gillen, Smith & Waters 2012: [14.VI.B]). In Australia and in England and Wales, *cy-près* can be obtained where the charitable purposes have ‘ceased to provide a suitable and effective method of using the trust property’ having regard to the ‘spirit of the trust’ or ‘appropriate considerations’,²⁰ or where it is ‘impossible, impracticable or inexpedient’ to carry out the purpose.²¹

Commentators have noted that even the current expanded administrative scheme and *cy-près* provisions could go further in limiting donor control and that this could be achieved in ways that retain a degree of respect for donor autonomy (Murray 2021; Picton 2018). For example, this could be achieved by allowing a set time period for greater donor control during which the existing administrative scheme and *cy-près* scheme rules apply, followed by a broadening of the circumstances in which the effective use of assets to achieve public benefit trumps donor intent.

4 Reform and conclusion

In considering reforms, it is important to remember that the donor autonomy/public benefit balance includes a potential reduction in public benefit if donors give less property because their autonomy is diminished.²² Further, if the public benefit achieved by charities is viewed as potentially including a range of process benefits linked to the private pursuit of public purposes, then we should favour reforms that are more consistent with the independence of charities from government.

One relatively minor reform would be to strengthen the public/private charity distinction that is made for various tax purposes in the United States, Canada and Australia so that it better accounts for donor advised funds. The public/private charity distinction is not currently made in the United Kingdom and could be considered as an additional tool to regulate private control of charities.

More fundamentally, in jurisdictions such as the United States and Canada, where the tax authority is the primary charity regulator, a further step could be to provide the tax authority with access to tools to modify a charity that mirror the administrative scheme and *cy-près* provisions. This may not always require new provisions. For instance, it may be that legislative extensions of *cy-près* or administrative schemes already provide open standing or broad standing for interested persons in some jurisdictions (American Law Institute 2020: §94 cmt g; Murray & Wesson 2020: 1338–1342). It may also be arguable at common law that interested persons extend beyond charity trustees/directors and attorneys-general to tax regulators (American Law Institute 2020: §94 cmt g; Murray & Wesson 2020: 1338–1342). Thus, it may be possible to provide tax regulators with standing – or confirm the existence of standing – to apply to court to use existing *cy-près* and administrative scheme mechanisms. This could even assist in jurisdictions such as Australia that have a charity commission but where *cy-près* and administrative scheme reform has chiefly been the domain of state attorneys-general (McClure et al 2018: 34).

This approach would be more consistent with the independence of the charity sector and the autonomy of donors than a confiscatory tax or the imposition of caps on the quantum of donations to individual charities.²³ That is because it would still leave decision-making with the charity board once the administrative or *cy-près* variation has been applied. As administrative scheme and *cy-près* provisions already contain elements that seek to protect donor intent to

some degree (whilst balancing it against the public benefit achieved by the variation), concerns about loss of donor autonomy and reduced donations should be ameliorated.

However, unlocking new powers for tax regulators does not necessarily mean that they will want them or will use them. In particular, the proposed reform would do little by itself to address tax regulators' lack of institutional focus on charities, lack of funding to regulate charities or perceived revenue bias. Nevertheless, clearly identifying new powers may overcome some lack of institutional focus. Further, if the IRS or Canada Revenue Agency better supported state and provincial regulators through coordinated action and education, this would be appealing on the basis of federalism and would fit with more recent academic work on charity regulation within a federation (Mayer 2016: 944–945; Simon, Dale & Chisolm 2006: 270). This is not likely to prove easy; indeed, even after the Pension Protection Act 2006 expanded the IRS's ability to disclose information to state regulators, information-sharing arrangements between the IRS and state regulators appear virtually non-existent (Owens 2017: 83; Boris & Lott 2017: 106). However, a coordinated approach has the potential to reduce the cost of action for a tax regulator, since it can also rely on the contribution of some resources by state regulators. The involvement of non-revenue authorities could diminish a perceived revenue bias of regulatory action. Further, establishing regular interactions and information sharing with state and provincial regulators – for example, under inter-agency memoranda of understanding – also has the potential to generate a base level of institutional focus on charities.

Finally, tax regulators could also better support or encourage charity trustees and directors to themselves access administrative or *cy-près* schemes so as to remove donor controls. This would be even more consistent with the autonomy of the charity sector from government. However, it is not proposed as the primary approach, as it is subject to the risk of jurisdiction-shopping by donors keen to find a jurisdiction in which there is little scope for action by trustees or directors.

Notes

- 1 Reich also outlines functions that charitable foundations could potentially form that would be consistent with democratic institutions: the social innovation and problem solving that foundations and some other charities can engage in due to the long-term and risky approaches that are open to them as a result of limited accountability mechanisms and lack of a profit motive or political cycle: Reich 2018: 152–153, 159–166.
- 2 For recent overviews of charity donation concessions across these jurisdictions, see Martin 2018; O'Connell 2018; Colinvaux 2019.
- 3 Capital gains arising from testamentary gifts are disregarded, but generally no corresponding deduction is provided either: Income Tax Assessment Act 1997 (Cth) ss 30–15(2), 118–160.
- 4 Similarly, in the United Kingdom for Gift Aid, there must be a 'gift', and the Gift Aid provisions also require that there be no 'benefit' for the donor associated with the gift: Kessler et al 2019: ch 15. Sections 110.1(1) and 118.1 of the Income Tax Act, RSC 1985, c 1 (Canada) also require a 'gift' in order for a charitable deduction or credit to be available, though the provisions are premised on a gift existing to the extent of an 'eligible amount' which exceeds an advantage received by the donor: s248(31); Canada Revenue Agency 2020.
- 5 In the United Kingdom, see also Kessler et al 2019: ch 15; HMRC 2020: ch 3, [3.19].
- 6 See the HMRC's more forgiving approach to membership rights (HMRC 2020: ch 3, [3.37]).
- 7 While the imposition of a trust or a charge on the property would breach the provision, the creation of a contractual personal obligation on the charity in the form of a condition subsequent would appear to be permissible.
- 8 §501(c)(3) public safety organisations are excluded.
- 9 The provisions and the regulations [26 CFR §§1.501(c)(3)–1(c)(1)] refer to organisations 'organized and operated exclusively for . . . charitable . . . purposes' and provide that 'An organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An

- organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose’.
- 10 The Canadian Supreme Court has interpreted ‘charitable activities’ by reading in a charitable purpose requirement, noting that it is ‘the purpose in furtherance of which an activity is carried out, and not the character of the activity itself, that determines whether or not it is of a charitable nature’: *Vancouver Society of Immigrant and Visible Minority Women v MNR* [1999] 1 SCR 10, [152] (Iacobucci J).
 - 11 The IRS’s main concern appears to be that charitable assets will be diverted to private purpose (e.g., as remuneration payments to controllers): IRS 1989: 14–15.
 - 12 ‘Private Foundations’ are actually defined in *Internal Revenue Code* §509(a) as a remainder category. That is, all §501(c)(3) organisations that do not fall within four categories of public charities: ‘traditional public charities’ under §509(a)(1), charities that largely support themselves from sources other than investment income under §509(a)(2), ‘supporting organisations’ under §509(a)(3) that are closely linked to another public charity and ‘testing for public safety’ organisations under §509(a)(4).
 - 13 Although they are not permitted to distribute to other ancillary funds.
 - 14 Minimum property value thresholds apply, such that the rate is 0% below the threshold.
 - 15 As to the characteristics of DAFs, see Special Senate Committee on the Charitable Sector 2019: 109–113; Internal Revenue Service 2019; Hussey 2010: 60–61, 64–65; Internal Revenue Code §4966(d)(2).
 - 16 2018 WL 6199684 (ND Cal 2018). The dispute relates to the speed with which Fidelity Charitable disposed of donated shares.
 - 17 Additional restrictions apply to foreign donations.
 - 18 O’Connell notes tax regulators’ ability to determine initial eligibility but greater difficulty in monitoring ongoing fulfilment of mission, especially where the entity is not paying any tax.
 - 19 Statutory extensions are less widespread and more varied in the United States, but many states have adopted grounds such as a purpose becoming ‘wasteful’, ‘inexpedient’ or ‘prejudicial to the public interest’: Ascher et al 2006: §39.5.
 - 20 Charitable Trusts Act 1993 (NSW) s9(1); Charities Act (UK) s 62(1)(e)(iii); Trusts Act 1973 (Qld) s105(1)(e)(iii); Trustee Act 1936 (SA) s69B(1)(e)(iii); Variation of Trusts Act 1994 (Tas) s5(3)(e)(iii); Charities Act 1978 (Vic) s2(1)(e)(iii).
 - 21 Charitable Trusts Act 1962 (WA) s7(1)(a); Variation of Trusts Act 1994 (Tas) s5(2); Charitable Trusts Act 1957 (NZ) s32(1).
 - 22 The existence and extent of this reduction is contested. Studies on donation concessions suggest that they generally have a small impact on amounts donated: Heist 2019; Reich 2018: 121–122. On the other hand, reduced giving by plutocrats might actually be of public benefit by permitting a greater plurality of voices: Saunders-Hastings 2018: 159.
 - 23 Such a cap could be an effective restraint on donor control (Odendahl 1990: 239).

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