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Global tax transparency and the nonprofit sector

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Global tax transparency is a pretty easy idea to get behind; in societies with a functioning tax authority, it should be unlawful for a taxpayer to squirrel assets away from proper scrutiny. And yet, over the last decade, as global transparency initiatives have proliferated, so too have the criticisms: The burden of the increased regulation (confusing compliance requirements, slower account opening, and higher fees) is borne by all account holders, and risk-averse financial institutions are overly restrictive in their implementation and quick to "de-risk" by withdrawing banking services.

Within this, the frustrations of non-profit organizations (NPOs) deserve particular attention. NPOs have been swept up in the scope of these regimes without sufficient justification—they are no longer considered by the Financial Action Task Force (FATF) to pose any particular risk of abuse. See FATF Recommendation 8 revisions of June 2016.

Particularly with the Common Reporting Standard (CRS), too little attention has been paid, and too late, to the legal, regulatory and operational realities of NPOs. Moreover, arbitrary differences in effect based not on charitable purposes or activities, but an NPO's legal form, tend to undermine the anti-evasion justifications given by legislators.

Background to the Modern Transparency Landscape

The Organisation for Economic Co-operation and Development (OECD) began actively targeting tax leakage in the early 1990s—with the Exchange of Information on Request (EOIR) regime. However, the EOIR was limited in its effect—the limited take-up of multi-lateral treaties, and the absence of treaties with certain key jurisdictions, particularly.

By April 2009, as part of a response to the failures of the global financial crisis, the G20 leaders declared that the era of bank secrecy was "over". See London Summit—Leaders' Statement 2 April 2009. The focus was on banks and structures used to obscure the assets and income of wealthy individuals and businesses. NPOs, which devote assets to public benefit purposes, were not ostensibly part of this focus.

In parallel, FATF released the first version of its Recommendations aimed at combatting the misuse of financial systems in 1990. The 9/11 attacks led to an increased focus on the financing of terrorism. The FATF Recommendations were revised and included for the first time an express focus in the nonprofit sector in its Recommendation 8 (R8). Rather unhelpfully, R8 included the phrase "particularly vulnerable" to describe the risk of abuse of NPOs for terrorist financing purposes. However, helpfully, R8 proceeds on a "functional definition" basis—FATF defines NPOs based on their "activities and characteristics", and from there considers risk and proportionality. See International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation: The FATF Recommendations, updated June 2019.

Foreign Account Tax Compliance Act (FATCA)

2009 is a watershed moment for tax transparency efforts, both at the G20/OECD level, and with the introduction of FATCA (in fact brought in as part of the Hiring Incentives to Restore Employment Act of 2010; Regulations were issued in 2012).

FATCA is broad and complex; a U.S. regime with international effect that is aimed at identifying the assets U.S. taxpayers may not be properly reporting to the Internal Revenue Service (IRS). Its full effect is outside the scope of this article, but briefly, FATCA requires financial institutions (FIs) to report to the IRS information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers have a significant interest. FATCA must be seen alongside its Intergovernmental Agreement (IGA) regime, since as an alternative to registering directly with the IRS, FIs can instead comply with the relevant IGA in their jurisdiction of residence.

NPOs are not fully excluded from FATCA—like any other person or entity engaging with a bank, NPOs are required to self-certify their FATCA/IGA status. However, crucially, the FATCA Regulations and the IGAs recognize NPOs as such using a "functional definition" based on their purposes, activities and registered status, and limit the effect of the regime on them using a 'deemed compliant' category. See U.S. Department of Treasury Resource Center, Foreign Account Tax Compliance Act (FATCA).

As a result, the impact of FATCA on most NPOs is limited to the periodic completion of a (perhaps confusing) self-certification form.

Common Reporting Standard (CRS)

The FATCA/IGA approach proved attractive to tax authorities, and the G20 endorsed a proposal for a global automatic exchange of information model, culminating in the OECD's CRS. See OECD, Automatic Exchange Portal.

CRS is based substantially on FATCA, but is global in scope. Like FATCA it requires financial institutions to collect information about account holders and report this to their local tax authority for onward exchange. The information is gathered, as under FATCA, primarily by account holder declaration.

Whereas FATCA and its IGA regime involve information being delivered up to the IRS (either directly or via the FI's tax authority), the onward exchange of information under CRS is between the tax authority of the reporting FI and that of the account holder's jurisdiction of tax residence. This therefore allows multi-lateral information exchange on a truly global basis. CRS applies in participating jurisdictions, though account holders resident in other jurisdictions may be affected. The OECD maintains a list of participating jurisdictions (see OECD, Automatic Exchange Portal, CRS by jurisdiction) where readers will note the conspicuous absence of the United States.

While similar to FATCA, the most significant difference for NPOs, is the absence of any functional definition to recognize NPOs as "deemed compliant", or low risk. This results in NPOs pursuing the same purposes and activities, but through different legal forms, being treated differently, which has been one of the main criticisms of CRS from NPOs. It has never been officially confirmed by the OECD why it decided to depart from this helpful aspect of FATCA/IGAs.

NPOs as Reporting FIs

An NPO is most likely to be a reporting FI as a Managed Investment Entity. This will be the case if: (a) its gross incoming resource over the preceding 3 calendar years is predominantly attributable to trading or investing in Financial Assets; and (b) all or part of the assets are managed externally under discretionary authority.

An NPO that satisfies this test is obliged to report the details of Account Holders. Most regulated NPOs globally will hold assets for nonprofit purposes, and not on account of individuals or entities. Nevertheless, CRS will in some cases, but not others, treat grants to charitable beneficiaries as reportable Financial Accounts.

The example of an English charitable trust is instructive as the UK was an early CRS adopter and has both a sophisticated regulator of charities as well as channels for engagement between the tax authority (HMRC) and the charity sector:

An English charitable trust that satisfies the Managed Investment Entity test will have to identify the tax residence of every one of its charitable grantees and report this information to HMRC for onward exchange to the jurisdiction in which grantees self-certified as resident. If the grantee is itself resident in a jurisdiction that is not participating (including the US), then in certain circumstances, the charitable trust may have to obtain the relevant information from the 'controlling persons' of the grantee, i.e. to look through the grantee entity to natural persons. The process of analysis, obtaining declarations and subsequently reporting applies with no de minimis threshold. A small charity, and any charity giving small grants, will have to comply regardless of the disproportionate impact on their activities.

A charitable company formed in England & Wales and undertaking the same grant making activity would have no obligation to report on its grantees even where it satisfies the Managed Investment Entity test and is classified as an FI. There is a narrow technical explanation for the different treatment of these functionally similar NPOs that relates to the way "account holder" is defined. However, the broader point is that the absence of a functional definition that excludes legitimate NPOs from the FI reporting obligation (regardless of legal form) leads to arbitrary outcomes, and could even have an effect on NPO structuring and grant-making.

Human Rights Concerns

There has been some concern among non-profit organizations that reporting may be risky for grantees. For instance, a NPO may be loath to report the home address and personal details of a grantee working within a repressive jurisdiction on a socially progressive purpose such as equality and human rights, LGBT rights or certain aspects of women's health. While integrity of the data management systems is intended to be a pre-requisite for information exchange between participating jurisdictions, the nervousness of NPOs to provide the information that may endanger grantees and their families is understandable.

Trust Register

As part of the European Union's anti-money laundering regime, a mandatory register of trusts was introduced under The Fourth Money Laundering Directive ((EU) 2015/849). In comparison to CRS and even FATCA, the impact of the Directive's Trust Register on NPOs is minimal, even as it has been expanded under The Fifth Money Laundering ((EU) 2018/843) to include all charitable trusts. The primary objection is that the increased administrative burden for NPOs does not appear to be justified with any identifiable benefit, and is additional to NPO's compliance burden generally.

Conclusion

The same global financial crisis that spurred the above transparency regimes also created a perfect storm for many NPOs: public sector austerity left NPOs to address increasing social need with less resource, all while shouldering more compliance cost and burden than ever before. In this context, exacerbated more recently by political and environmental uncertainty, legislators and implementing authorities should be called more fully to account when they seek to impose additional compliance obligations on NPOs. It has still not been adequately explained how grantee reporting by some charitable trusts, but not by any charitable companies, may help to reduce tax evasion, much to the frustration of the NPOs and grantees affected. This is not good enough in an era when NPOs are consistently expected to do more with less.

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