Shekels that Shackle – tax incentives and philanthropy

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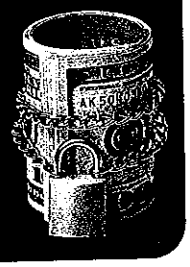

The time has come for philanthropists to consider whether the shekels provided by governments by way of tax incentives for charitable giving serve to shackle philanthropy. Tax incentives are considered a prerequisite for philanthropy to flourish. The fiscal benefits are real. The issue is whether the financial leverage is worth the consequent fettering of creativity and innovation allowed to charities by the tax authorities.

Governments grant charities significant fiscal benefits when they provide gift aid from the Treasury, as in the United Kingdom, or allow donors to claim tax deductions, as in the United States. These benefits cost the state substantial amounts of tax revenue and it is appropriate that states have strict regulations to prevent their generosity from being abused. In any event, the shackles on benevolent innovation do not generally arise from statutory protections against abuse, but from the historical framework and ideology of the common law of charity.

The law of charity limits creativity in many subtle ways that are not readily apparent to a philanthropist not schooled in the Byzantine legal labyrinth which gave rise to the modern law of charity. One of the more significant constraints on a philanthropist wanting to achieve transformative change is the common law prohibition on advocacy aimed at permanently altering political policy. The law is also slow to embrace non-traditional means of achieving public good as charitable.

An area of much greater interest to entrepreneurs and investors is the tension between sustainability and charitable dependence. Entrepreneurs are persons who built their wealth by taking risks and recognising that no business can succeed unless it develops an ongoing revenue stream that is substantially greater than its expenses. Charity law takes a very narrow view of what level of business activity is allowed to charities, allowing only business activities that are "incidental and ancillary" to an organisation's charitable activities. Historically, charities were confined to activities which could only be supported by donations, and donations were often more forthcoming when a charity was in complete dire straits. Consequently, there are many examples of donors inadvertently rewarding charities for mismanagement by making compensating donations. The consequence is that well managed charities which met their budget or even achieved a small surplus were effectively penalised by having donations withheld.

The donor-funded model achieved sustainability by encouraging donors to set aside large endowments and have the investments fund an annual income stream into the charity. Because the charity took legal title to the endowment, the rules governing the investment policy were generally very conservative. There is a certain irony in the fact that entrepreneurs who created their fortunes by taking risks and building sustainable businesses turn those fortunes over to charities to be invested on a risk averse basis so as to remove the income risk of that charity.

Tax planning was as important a consideration in many of these endowments as policy planning. Until very recently, the estate tax in the United States represented over 50% of the capital of the estate but could be entirely avoided by a charitable bequest. At that tax rate, the tax shekels going to charity were considerable and any consequential shackles seemed incidental. As a result, the professional advice received by persons planning their estate generally focuses entirely on the immediate tax benefits rather than the long-term implications arising from restrictions on the management and use of the funds. The number of charitable foundations in the United States needs to be understood in part as a consequence of the magnitude of estate, gift and generation skipping taxes on inter-generational transfers of wealth.

Another tax on transfers of capital is tax on capital gains. Capital gains taxes are generally significantly lower than estate taxes. However, in countries like the United States and Canada there are significant tax incentives to donate to charity to offset capital gains taxes. This is particularly true if the wealth is in the form of publicly traded securities because donors can avoid including any capital gains in their income while still claiming a full charitable deduction. The shekels are generally worth the shackles if sophisticated planning enables the donor to immediately use the full charitable deduction.

In most parts of the world, however, the trend is toward reducing tax rates paid by individuals, especially on investment income. At the same time there is a huge increase in the restrictions being placed on the activities and investment policies of charitable foundations with a corresponding increase in aggressive audits of charities by the tax regulators. Tax regulators are inclined to perceive large transfers of wealth, particularly those accomplished by sophisticated planning, as tax avoidance rather than as an altruistic contribution to the public good.

One's first reaction is to be offended that the tax authorities do not appreciate how much more of the cost of the charitable gift is borne by the

donor than the state. Even in a country like Canada, with a relatively high marginal tax of 44%, the donor is contributing significantly more than the state to every dollar received by a charity. However, I have moved beyond being angered by the tax authority's economic calculations to learning from it. We increasingly recommend to philanthropists that they consciously calculate whether the shekels received by way of tax incentives are worth the shackles on innovation and regulatory restrictions that attach to charity status. Only if the tax incentives are large enough do we recommend that a philanthropist donate their money to a charity they control.

Where the tax benefits of donating to a "charity" are insignificant, tax-paid funds should be transferred to an alternative benevolent structure such as a Canadian non-profit organisation, a non-charitable purpose trust or a foundation in a tax haven. Usually, there is economic justification for a portion of a philanthropist's wealth to be directed into a charity subject to the tax regulator. However, when a philanthropist understands that the shackles governing charities apply equally to funds that are contributed without the offsetting benefit of tax shekels, he or she will frequently put any excess funds into a benevolent vehicle which is tax exempt but does not provide direct tax benefits to the donor.

Funds donated to an alternative benevolent structure can be invested by professional money managers, or the donor to simply attain the highest economic or social return consistent with both the investment and philanthropic philosophies of the donor. By contrast, most regulatory regimes for charities require that a fixed percentage of income be paid out to other charities every year. In the United States this figure is 5% of the fair market value of the private foundation's investment capital. Such payout rules both shackle the investment strategies available to the charity and make it much more difficult to build up the capital of the endowment. These payout rules do not apply to non-charity benevolent structures. There are now some ten-figure benevolent funds which have grown to that size only because the philanthropists chose to forego the shekels of the American charity world and went offshore with tax paid money where they were able to avoid mandatory payouts in early or lean years and multiply the value of the capital base of their endowment funds.

Excess business holdings rules, which preclude a foundation and related persons from holding more than 20% of any corporation, represent an even more significant regulatory shackle on private foundations. The 20% rule, which is operative in both Canada and the United States, effectively prevents a foundation from investing in controlled corporations whose strategic purpose is to run specific businesses related to the purposes or programmes of a charity so as to enable the charity to attain ongoing sustainability while achieving its charitable objectives. One example would be a culinary school that increased the learning experience of its students and revenues to the school by running a successful catering business in the community. Another example would be a charity that, prior to building a clinic or hospital in Africa, bought up much of the land surrounding the facility in order to capitalise on the increased value of the land once the hospital was operational. Such a land acquisition might not match the scale of the Disney Corporation's purchases of land in Florida prior to building Disney World, but the strategic thinking would be the same.

The regulations around excess business holdings and carrying on business activities significantly shackle the entrepreneur from providing sustainability to the operating charity he wants to create or fund. Unfortunately, both the law and charities fail to recognise that the entrepreneur may have done far more "charity" or "public benefit" through the sustainable employment created by his for-profit corporate activities than he will ever achieve funding handouts from a food bank to the unemployed.

The ideology of charity law is that arm's length donors give unrestricted donations to charities and that charities continue to be dependent upon the capricious generosity of donors with grovelling gratitude for any largesse motivated by a sense of *noblesse oblige*. This is an ideology of dependence that is not approving of entrepreneurship which results in self-sufficient sustainability.

The most successful innovation in the charity world internationally in the last decade has been the provision of microcredit loans to impoverished persons so they can finance micro-businesses. The law of charity allows this "commercial" activity to its beneficiaries as long as the recipients are very poor and the businesses are very small. However, a non-charity benevolent vehicle could make these loans available on a much larger scale to businesses which are much more sustainable and which generate employment for others. Part of the reason that microcredit programmes are successful is that they do not tolerate the language and ethos of charity in funding and developing a micro-business which will enable borrowed funds to be repaid.

The charity world needs to recognise that there are many wealthy and well-intentioned philanthropists for whom the very concept of "charity" is ideologically abhorrent because they believe it fosters a culture of dependence. They strongly believe that the only good charity is to provide a job to an impoverished person so that person no longer requires charity. I am not suggesting that all philanthropists should subscribe to this view or that it is a superior philosophy. However, when these people wish to invest large amounts of capital in ways which accomplish public good through employment or cause related businesses, they should not be excluded or judged less worthy because they want a *modus operandi* which is more innovative than the traditional charity law framework.

The solutions which we as professional advisors put before modern philanthropists must balance the costs and benefits of shekels versus shackles. The solutions for philanthropists in jurisdictions with high tax rates and attractive tax benefits for charitable donations will almost always involve both a charitable foundation and a tax efficient benevolent structure. We must show them how to use the charitable funds to build the hospital and the benevolent funds to acquire, develop and manage the surrounding lands so as to make the hospital sustainable.

The shekels may often be worth the shackles. However, philanthropists must be made aware of the shackles and use alternative and complementary benevolent structures when there are no compelling tax reasons to donate the funds to a charity. Even when the tax incentives are significant, benevolent structures which are not explicitly charitable may better enable an individual philanthropist to fulfil his or her aspiration to be innovative in pioneering philanthropic programmes or to use a different ideological paradigm to accomplish public benefit. This is particularly true for offshore philanthropists who do not pay significant tax on their investments and want to fund public good in foreign jurisdictions without attracting unnecessary and unwanted attention from the tax authorities.

"A momentum for cross-border philanthropy in Europe?" *July 2005, Issue 158*
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