MILLS & REEVE

briefing

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The Common Reporting Standard (CRS) and Charities

The CRS affects all charities, as even the trustees of charities that are not required to report directly to HMRC are likely to be asked by their banks and investment managers to confirm the position of their charities.

Its reporting requirements will only apply to certain charities which receive a significant proportion of their income from investments, and where those investments are wholly or partly managed by a financial institution.

HMRC can charge a penalty of £300 for breach of an obligation under the CRS, including late filing. It can also charge a penalty of up to £3,000 for the provision of inaccurate information.

The first reports to HMRC are required by 31 May 2017. So charity trustees need to think about the CRS now (if they haven't already).

The CRS forms part of an effort to develop a global standard for the automatic exchange of information (AEOI) about financial accounts, in a bid to increase transparency and reduce tax evasion. It draws considerably on FATCA, the US provisions to reduce tax evasion by US citizens and legal entities. FATCA, however, contains an exemption for charities from its reporting requirements. **The CRS does not give any exemption to charities**.

The International Tax Compliance Regulations 2015, which implement the CRS in the UK, require 'Financial Institutions' to collect, maintain and report certain information to HMRC. This information may then be exchanged with other jurisdictions.

Can a charity be a "Financial Institution"?

The short answer is: yes. Generally, a charity which receives the majority of its income from donations or grants is not likely to be a Financial Institution. However, if a charity:

- receives 50 per cent or more of its income from financial assets, assessed by examining its income over:
  - the three years to 31 December of the year preceding that in which its status is to be determined; or
  - the period in which the charity has been in existence, if shorter; and

- has its financial assets managed by another Financial Institution (for example, a fund manager employed by a Financial Institution) which has discretionary authority over the charity's assets either wholly or in part

the charity may be a "Managed Investment Entity", which is a type of Financial Institution as defined by the Regulations.

Discussions between HMRC and the Association of Charitable Foundations has clarified that unit trusts are not regarded as being investments under "discretionary management", as HMRC regards the charity as "essentially taking a share in the profits of the unit trust rather than investing into the market directly. This means that charities that have placed all their investments in unit trusts will not be caught by the CRS, as they will not have any financial assets under the discretionary management of a financial institution.

If a charity is not a Financial Institution, it will be deemed to be an 'Active Non-Financial Entity' with no reporting requirements. Even if a charity has no reporting requirements under the Regulations, however, the charity trustees are likely to be asked by the Financial Institutions with which the charity holds accounts (for example, banks) to confirm the position of the charity under the Regulations, and these requests for information cannot be ignored. Therefore, **all** charity trustees should take the time to consider their position and obtain advice if necessary.

What must a Financial Institution do?

A charity which is a Financial Institution must review its financial accounts to determine whether any such accounts are reportable accounts, carry out due diligence as required under the CRS, and then report the relevant information in respect of any reportable person or entity holding the reportable account to HMRC annually.

To break this down:

1 What is a financial account?

1.1 In the case of charities, "Equity and Debt Interests" is the relevant category of financial account created by the Regulations. As the definition refers to equity or debt interests, this means that the type of financial account, and identity of the person holding the account, varies depending on the structure of the charity.

1.1.1 For charitable trusts:

(i) An equity interest is any interest held by a person who is treated as a settlor or beneficiary of all or any part of the trust, or any other natural person exercising ultimate effective control over the trust (i.e. individual trustees rather than corporate trustees). Any person with a right to receive a distribution from the trust is a beneficiary. Any person who receives a discretionary distribution from the trust is also a beneficiary, but only in the year of the distribution.

(ii) Debt interests include all loans made to a charitable trust and other forms of indebtedness, including formal and informal arrangements, whether or not any interest is attached to the debt.

1.1.2 For charitable associations:

HMRC has said that the equity interests for charitable associations are similar to those for charitable trusts.

1.1.3 For charitable companies, including charities incorporated under Royal Charter, charitable incorporated organisations (CIOs) and Scottish charitable incorporated organisations:

(i) An equity interest is an interest held by a shareholder, or any other person with an interest in the profits or capital of the company, including shares held by way of a program-related or social investment. HMRC, however, has said that it does not consider a member of a company limited by guarantee, charitable company incorporated under Royal Charter or CIO to hold an equity interest in the company, as such a person has no interest in the profits or capital of the company.

(ii) Debt interests include all loans made to charitable companies and other forms of indebtedness, whether there are formal or informal arrangements in place, and whether or not any interest is attached to the debt.

1.2 One thing is immediately clear from looking at the definitions of equity and debt interests for the different structures: a far broader range of people are considered to hold financial accounts in relation to a charitable trust than an incorporated charity. The burden on charitable trusts to comply with the requirements of the CRS will be correspondingly more substantial.

Example:

A charitable trust works towards the relief of poverty and makes around 100 grants to those in need in the UK and India each year. All grants are made at the discretion of the Trustees, and those receiving grants vary from year to year.

Its trustees have looked at the CRS requirements, and have discovered it is a managed investment entity (and so a Financial Institution for the purposes of the CRS), as more than 50% of its income has come from investments managed under a discretionary investment management agreement by an investment manager during the last three years.

This means it now needs review its financial accounts, and carry out due diligence to determine which accounts are reportable. So, who are the holders of its financial accounts? As a charitable trust, all of the following are considered holders of interests in its equity:

- Its settlor
- Its trustees and
- Any individual who has received a grant as a result of the exercise of the discretion by the trustees during the year, either in the UK or in India.

This means that the charitable trust has around 100 financial accounts to review and on which to carry out due diligence.

By contrast, if all the facts set out in this example above remain the same except the charity is a charitable company limited by guarantee rather than a charitable trust , the only financial accounts subject to review would be those held by shareholders in the company. In the absence of any social investment or programme related investment in relation to the charitable company, if the charity was a company limited by guarantee, there may well be no financial accounts to review at all.

2 What is a reportable account?

2.1 A reportable account is a financial account (so, an equity or debt interest as set out above) which is held by a reportable account holder. A reportable account holder is a person who is tax resident in a reportable jurisdiction other than the UK. A full list of reportable jurisdictions can be found here.

2.2 At present there are 55 countries signed up to exchange information from 2017. More will follow from 2018, so charities falling within the remit of the CRS will need to check the list again next year to see which additional jurisdictions are confirmed as reportable.

3 What information must be reported to HMRC?

3.1 In respect of each reportable person holding a reportable account, the following information must be reported to HMRC:

- Name
- Address
- Jurisdiction(s) of tax residence
- Entity status, where the account holder is an organisation that is a Financial Institution or a Non-financial Entity under the provisions of the CRS (e.g. another charity)
- Tax Identification Number(s) in respect of all reportable jurisdictions
- Date of birth (where account holder is an individual) and
- Account value

3.2 The account value, again, will depend on the type of equity or debt interest:

3.2.1 For a charitable trust:

(i) the value of grant paid during the calendar year in the case of grant recipients;

(ii) the value of the settlor's interest in the charitable trust (in the vast majority of cases, a nil value); and

(iii) the principal sum of the debt together with the amount of any repayments made during the course of the year, in the case of a debt interest.

3.2.2 For a charitable company:

(i) the value which is potentially repayable by the charity to the holder of the relevant equity interest, in the case where equity value has been issued; and

(ii) the principal sum of the debt together with the amount of any repayments made during the course of the year, in the case of a debt interest.

4 What due diligence must be carried out to obtain the information to be reported?

4.1 Charities which are Financial Institutions can ask reportable account holders to self-certify the information which needs to be supplied to HMRC. Unless a charity knows or has reason to know that a self-certification is unreliable or incorrect, it is entitled to rely on the self-certification.

4.2 A charity must be able to confirm that the self-certification it has obtained is reasonable, however, taking into account the rest of the information it has received previously in relation to the account holder. HMRC acknowledges that different grant making charities will have obtained different information from which to confirm reasonableness as part of their processes, depending on the size of grant, the recipients of the grants, and other factors.

4.3 Where a charity cannot confirm that the self-certification is reasonable, it will have to obtain either:

4.3.1 A further valid self-certification which the charity **can** confirm is reasonable or

4.3.2 A reasonable explanation of the original self-certification, together with documents supporting the validity of the original self-certification

and, in the second case, make sure it retains a copy of the explanation and supporting documents (or a note of these).

Example:

The charitable trust asks potential recipients of its grants in the UK to complete an application form. As part of that form, each applicant is asked to tick a box to confirm he or she is tax resident in the UK. The applicant is also asked to provide confirmation of name and address, and his or her bank account details.

This year, one applicant has ticked the box to indicate that he is tax resident in the UK and has confirmed his home address as being in London. The bank account details, however, are for a Indian bank account and the charitable trust has a previous correspondence from the potential grant recipient giving an address in India.

The provision of the Indian bank account details and the previously used address in India suggest that the applicant may actually be resident in India for tax purposes. The self-certification fails the reasonableness test, and the charity should seek proof of identity and address from the applicant, or an explanation and documents in support of the original self-certification.

4.4 There is no set form of self-certification. HMRC envisages that charities will obtain the self-certification required as part of the administrative process prior to the new account holder obtaining an interest in a financial account. So, in the case of a grant making charitable trust, the self-certification can be made part of the grant administration process, and the self-certification can be made face to face, online, by telephone or by correspondence.

4.5 Although the self-certification can be made face to face or by telephone, however, it would be prudent for charities to maintain a written record of the self-certification.

Exception to requirement to obtain self-certification for some entities

4.6 When the account holder is not an individual, but, for example, another charity, there is an exception to the requirement to obtain self-certification which will be useful for some charities. Where a reporting charity can reasonably determine, based on information in its possession or information that is publicly available, that the account holder is tax resident in the UK, a self-certification is not required.

4.7 HMRC has confirmed that the information held in the public registers of the Charities Commission of England and Wales, the Charities Commission of Northern Ireland, and the Office of the Scottish Charity Regulator may be used to determine that the charity is resident for tax purposes in the UK. Any charity registered with one of these regulators is considered to be resident in the UK, and any grant paid to such a charity will not be reportable.

4.8 Clearly, this exception to the self-certification rule should relieve the administrative burden on some grant-making charities subject to the Regulations quite substantially.

5 What must the Financial Institution do with the information collected?

5.1 Financial Institutions must report the information obtained during the previous calendar year to HMRC by 31 May of the following year. They can do this (once registered for the service) by:

5.1.1 uploading the data they have collected in relation to reportable accounts through the online Portal http://www.gateway.gov.uk/ through the Reportable Accounts submission schema or

5.1.2 if they have few reportable accounts, using a form-based system manually to enter their reportable accounts.

5.2 In addition, charities must retain the information reported, or a record of the steps taken to obtain the information (in the case of self-certifications by face to face methods, for example) for a period of **six years** from the end of the year in which the charity carried out the process of review, due diligence and self-certification on the financial account in question.

6 What will HMRC do with the information received?

6.1 HMRC will transmit the information in relation to each reportable account holder to the relevant jurisdiction annually.

6.2 HMRC, and the other tax administrations in the jurisdictions which have signed up to the CRS, must protect the confidentiality of the reportable account holders and safeguard their data. The CRS requires that the use of the data should be limited to the purpose of ensuring tax compliance. Before sending any data, HMRC will have to check that the receiving jurisdictions have the required standards in place to ensure the confidentiality of the account holders.

6.3 Despite these requirements, there is clear cause for concern for some charities operating in other countries in relation to the human rights of grant recipients. HMRC recognises that situations in which the sharing of information with another jurisdiction about the grant recipient may potentially put the recipient at risk. Guidance is expected from HMRC on how these kinds of situations will be dealt with in due course.

What if a charity fails to comply with the reporting requirements?

Firstly, it is encouraging to note HMRC's statement in its guidance to charities on the application of the CRS:

> "For the early years of AEOI reporting HMRC's approach to compliance by charities that are Financial Institutions will be a soft landing; we will not seek to apply penalties where charities have made efforts to carry out due diligence requirements and report accurately."

HMRC acknowledges the challenges facing charities in complying with the CRS, in particular for grant making charities which have to carry out due diligence on grant recipients. It also recognises that late awareness of the impact of the CRS legislation on charities means that charities have had less time to put the appropriate processes in place to comply with the requirements of the CRS.

HMRC also realises that some grant making charities subject to the requirements of the CRS will have made grants during 2016 without having carried out the appropriate due diligence on grant recipients. It will apply the "reasonableness" test to such situations, but, where possible, it expects charities to carry out the due diligence required on those financial accounts retrospectively.

Where a charity has made "reasonable efforts" to comply with the CRS, but HMRC considers that the charity has still not met the requirements, HMRC says it will work with the charity to try to improve the charity's processes so it can achieve compliance. When considering each charity's due diligence process and reasonableness checks on the self-certifications obtained, HMRC will take into account the size and complexity of the charity, its other regulatory and governance processes and the nature of the grants it is making,

However, HMRC does say that it "will not rule out the imposition of penalties" where charities have failed to engage with the requirements. The CRS cannot be ignored! HMRC can charge a penalty of £300 for breach of an obligation under the CRS, including late filing. It can also charge a penalty of up to £3,000 for the provision of inaccurate information.

What should charity trustees do next?

- Check whether their charity is a Financial Institution or a Non-financial Entity:
  - How much income does the charity receive from investments?
  - Are any of the investments managed externally, and, if so, how?
- If the charity is a Financial Institution:
  - Review "financial accounts" of the charity in existence during 2016 to identify which accounts are held by reportable persons
  - Consider the data protection law implications of obtaining and holding the information required, and ensure the charity is compliant with the law in this area
  - Carry out due diligence on account holders, including obtaining the necessary self-certifications
  - Register as a Financial Institution with HMRC if there are accounts to be reported
  - Report the information obtained for any reportable accounts to HMRC by 31 May 2017
  - Retain the information obtained in respect of the charity's financial accounts for the period of six years from the end of 2016.
- In case of doubt, seek advice!

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