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26 May 2017

Mr Anthony CHU
Clerk to Public Accounts Committee
Legislative Council
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Mr CHU,

Public Accounts Committee
Consideration of Chapter 1 of the Director of Audit's Report No. 68
Government's support and monitoring of charity

As requested in your letter of 22 May 2017, I append below the information required –

- (a) It is noted from the minutes of the Sub-committee on Charities of the Law Reform Commission (LRC) that staff from the Inland Revenue Department (IRD) took every opportunity to explain and clarify the role of the IRD in administering section 88 of the Inland Revenue Ordinance (IRO) in respect of the recognition of tax exemption status to charitable organisations. The legal advice of 2003 was not provided to the LRC. In paragraph 7.15 of its Report on Charities published in December 2013, the LRC stated that *“The IRD is responsible only for the tax exemption aspects of charitable organisations. It is not responsible for registering charities or for monitoring their conduct.”*

In view of the concerns of the Ombudsman and the Public Accounts Committee (PAC) regarding the control of charitable fund-raising activities, the Government explored means to strengthen the control. For this reason, the IRD sought the advice of the Department of Justice (DoJ)

in September 2003. The legal advice was sought in a general policy context without the reference to any specific case.

In our reply to PAC on 4 May 2017, we provided the gist of the legal advice on this matter after consulting DoJ. The Government does not consider that it is appropriate to disclose the legal advice it has obtained which is subject to legal professional privilege. For sake of easy reference, the gist of the legal advice is reproduced below –

Issue	DoJ's Advice
Whether it is legally proper for IRD to deny or withdraw a charity's tax exemption status when the charity or its trustees or directors have been convicted of any offence involving deception, fraudulent acts or misappropriation of donations received or any offences punishable under the Theft Ordinance.	It would depend on the merits of each particular case. IRD may deny or withdraw the exemption status of an institution if it is in fact not a charity but, e.g., is a vehicle used in the commission of fraud. However, an isolated incident may not be necessarily conclusive as to the true nature of the business of an institution. Further, an offence committed by an official of an institution may not necessarily be attributable to the institution.
Whether it is legally proper for IRD to overturn a charity's tax exemption status solely because the charity has not complied with any obligations or guidelines, whether statutory or not, which are not provided in the Inland Revenue Ordinance	No.

- (b) Section 88 of the IRO provides general tax exemption to charities. When considering an application under section 88 of the IRO, the IRD's role is to determine whether the organisation is a charity at law having regard to all the relevant facts and circumstances and if so, recognise the tax exemption status. For this purpose, the IRD will examine, among other things, the governing instrument of the organisation. In particular, the IRD will scrutinise the object clauses, income clause and dissolution clause to ensure that all the objects of the organisation are charitable in nature and that there are adequate safeguards to prevent the channelling of funds for non-charitable purposes. This is an important threshold test for the IRD to deliver its role in accordance with section 88 of the IRO.

The IRD conducts periodic reviews on tax-exempt charities to ensure that their objects remain charitable and that their activities are compatible with their objects. In the course of the periodic review, if a charity is found to have breached a clause of its governing instrument, the IRD needs to ascertain whether such breach would fundamentally affect its charitable status. The IRD will seek clarifications from the charity about the breach and ask the charity to propose remedial actions. In determining whether the breach fundamentally changes the organisation's charitable status, the IRD will take into account all the relevant facts and circumstances, including the nature, reasons, materiality and proportionality of the breach. If a charity blatantly breaches the provisions of its governing instrument and the IRD, after taking a holistic view, considers that such breach fundamentally changes its charitable status, it would withdraw the tax exemption status.

Insofar as the breach of a key clause in the governing instrument by a charity, e.g. on prohibition of payment of remuneration to members of governing body, it is for the charities concerned to propose remedial actions for the IRD's consideration. Such remedial actions can take different forms, such as cessation of payment, refund of remuneration received by such members, resignation as members of governing body, etc. The key consideration of the IRD is whether a charity's non-compliance with the clause of its governing instrument would fundamentally change its charitable status. As noted by the LRC in paragraph 7.15 of the Report on Charities in 2013, the IRD is responsible for the tax exemption aspects of charitable organisations but not registering charities or monitoring their conduct.

- (b)(i) In 2016, when the IRD was aware that 9 Executive Committee members of Charity D were paid remuneration for the years ended 31 March 2012 to 2014, the IRD asked Charity D to confirm if the practice was still in force; and provide details of the payments and remedial actions to address the breach of the relevant requirements in its governing instrument. In its reply, Charity D advised that the 9 Executive Committee members were also employees of the charity at the relevant times but they had resigned as Executive Committee members in late 2013 or early 2014. Hence, no remuneration had been paid to members of the Executive Committee since then.

The IRD considered that the cessation of the remuneration arrangement is an acceptable remedial action in relation to the breach and was satisfied that Charity D was not established for the private benefit of specific

individuals. In addition, the IRD, having regard to capacity in which the 9 Executive Members were employed, the remuneration of other employees in similar capacity and the scale of operation of Charity D, was of the view that the remunerations paid by Charity D to the 9 Executive Committee members for the years ended 31 March 2012 to 2014 (ranging from \$4.3 million to \$4.7 million) might be a technical breach of its governing instrument. As such, the IRD considered that the charitable status of Charity D was not affected.

- (b)(ii) In the periodic review conducted on Charity E in 1999, it came to the notice of the IRD that Charity E had made payments totalling \$20,700 (described as “顧念款”) out of total income of \$4 million to one trustee and two Executive Committee members. After clarifying with Charity E, the IRD noted that the payments were meant to meet the travelling expenses and basic living requirements of its members, including the trustee and the two Executive Committee members, who took an active interest in spreading the Gospel and rendering services to Charity E. Since Charity E had shown that the payments to the trustee and the two Executive Committee members had been fully repaid to it and had confirmed that it would strictly observe the relevant provisions in its governing instrument that no remuneration or benefit in money or money’s worth would be paid to its trustees or Executive Committee members, the IRD considered that the breach did not fundamentally change Charity E’s charitable status. As such, the IRD continued recognising Charity E’s tax exemption status.

In the 2007 review, the case officer noticed that Charity E had again breached its governing instrument by making payments totalling \$43,500 out of total income of \$8.3 million for 2006 and 2007 to one Executive Committee member. The IRD drew Charity E’s attention to the potential contravention of the clause relating to the remuneration of the trustees and Executive Committee members, sought explanation on the payments and asked it to take remedial actions. In reply, Charity E stated that it made payments to its members who were old, sick or in need of care, including the Executive Committee member. Taking into account that Charity E had provided evidence to show the said sum of \$43,500 had been fully repaid to it and that it undertook not to make such payments in future; and that the payment was duly explained, the IRD considered that the breach did not fundamentally change Charity E’s charitable status. As such, the IRD continued recognising Charity E’s tax exemption status.

In both occasions, the IRD adopted a consistent approach in dealing with Charity E's breach of paying remuneration to the trustees and Executive Committee members.

As regards the remedial action proposed by Charity E, the IRD considered that Charity E's undertaking of not making such payments in future was acceptable in the circumstances of the case and there is no evidence to indicate that the breach rendered Charity E not satisfying the public benefit requirement of charities.

In concluding the 2007 review, the then case officer was of the view that given the lapse of time, the management of Charity E might have undergone changes since 1999 so that they might not be fully aware of the clause in its governing instrument for prohibiting payment of remuneration to trustees and Executive Committee members. As such, the IRD issued a warning letter to Charity E reminding it to comply with the relevant provisions in its governing instrument in future. Since the IRD has no authority to withdraw a charity's tax exemption recognition on the basis of just a breach of the governing instrument of the charity if the breach does not fundamentally change the charity's charitable status, the IRD had ceased to issue similar warning letters but instead have issued letters to charities reminding them of the need to comply with the key provisions in their governing instrument.

- (b)(iii) As indicated in paragraph 6.6.3 of the Staff Handbook of the Charitable Donations Section, in processing a reinstatement application from a charity, the IRD has, all along, been adopting an approach similar to handling new applications and will be examining all the necessary submissions from the charity afresh.

In the case of Charity F, the member of the Board of Elders who received the love gifts (in the range from \$3,773 to \$53,582 out of total income ranged from \$355,885 to \$546,127 for the years ended 30 June 2003 to 2013) was a pastor. When Charity F was notified of the breach, it decided to stop making payment to the pastor and recouped the payments for the last two years, i.e. \$3,773 (for 2012) and \$9,400 (for 2013) from the pastor. According to Charity F's financial statements, no love gifts were paid in 2014. Having regard to all the relevant facts and circumstances, including that the objects of Charity F were still charitable and that it was not established for the private benefit of specific individuals; the nature and the amount of the love gifts; and the remedial actions taken, the IRD considered that the breach did not fundamentally change the charitable

nature of Charity F and reinstated the recognition of its tax exemption status in 2015.

In the case of Charity G, a director received \$30,000 in 2008, \$130,000 in 2009, \$80,000 in 2010, \$70,000 in 2011 and \$65,000 in 2012 (out of the total income of Charity G ranged from \$287,571 to \$759,783 for the years 2008 to 2012) from Charity G. Upon advice by the IRD of the potential breach of the clause relating to payment of remuneration to directors in its governing instrument, Charity G explained the circumstances leading to the payments to the director and stated that its members were not aware that its directors were not permitted to receive remuneration. Having understood such prohibition, the above-mentioned director resigned from the Board of Directors in April 2013 and agreed to repay half of his remuneration for the years 2008 to 2012 to Charity G. Having regard to all the relevant facts and circumstances, including that the objects of Charity G were still exclusively charitable and that it was not established for the private benefit of specific individuals; the reasons of making the payments to the directors; the remedial actions taken, the IRD considered that the breach did not fundamentally change the charitable nature of Charity G and reinstated the recognition of Charity G's tax exemption status in 2015.

- (b)(iv) For Charity F, its tax exemption recognition was withdrawn by the IRD in 2003 as it had failed to respond to the IRD's enquiries. In 2011, Charity F applied for reinstatement of the recognition, and explained that it had not informed the IRD of its new address, resulting in the non-receipt of the IRD's past enquiries.

For Charity G, its tax exemption recognition was withdrawn by the IRD in 2006 due to its failure to respond to the IRD's review questionnaire. In 2012, Charity G requested the IRD to reinstate the recognition of its tax exemption status, and explained that it had not informed the IRD of its new address, resulting in the non-receipt of the IRD's past queries.

Like handling new applications for tax exemption recognition, the IRD sought for the necessary information in order to determine whether Charity F and Charity G were charities at law. The information includes the governing instrument, past activities and accounts, as well as the outstanding information. After examining the relevant facts including their effort to rectify the breach in the past and their commitment to adhere to the provisions in the governing instruments in future, the IRD considered that both Charity F and Charity G's objects remained charitable. The payment of love gifts by Charity F and remuneration by

Charity G to members of their governing body was not material enough to fundamentally change their charitable status. As such, the IRD reinstated the tax exemption recognition of Charity F and Charity G in 2015.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Kelvin Lo', with a small flourish at the end.

(Kelvin Lo)

for Secretary for Financial Services and the Treasury

c.c. Commissioner of Inland Revenue (Attn: Ms Judy Yip)