

# Tax exemptions and charities

## 1 General

**17.1** There is no overall tax exemption for charities. The lack of a general exemption means that awareness of the tax issues and careful organisation are sometimes necessary if charities are to keep their tax liabilities to the minimum and preserve their funds for charitable works.

Important exemptions exist for income tax, corporation tax and capital gains tax, as do significant reliefs for stamp duty, stamp duty land tax and value added tax.

**17.2** Many of these exemptions have been added or amended over the years, and a major criticism of the way charity tax exemptions operated was that there were a number of glaring inconsistencies in the way exemption for direct and indirect taxes often worked. A government review of charity taxation gave rise to a number of changes in the Finance Act 2000 (FA 2000) to attempt to address this issue, and further changes in following Finance Acts have extended charity tax reliefs but also introduced further regulatory and anti-avoidance legislation for charities. VAT regulations, exemptions and reliefs are dealt with in Chapter 20 and partly in Chapter 18.

## 2 Income tax and corporation tax

**17.3** Charities which are constituted as trusts (charitable trusts) are subject to income tax and all other charities (and CASCs) are subject to corporation tax. Although a charity may have 'trust' within its name and make no reference to a limited company it may still be subject to corporation tax. For instance, charities whose inception arose by an Act of Parliament or by Royal Charter are subject to corporation tax.

**17.4** Reliefs from income tax are now contained within the Income Tax Act 2007 (ITA 2007) ss 520 to 537, and exemption for corporation tax is still currently contained within s 505 of TA 1988 and apply for income tax purposes for tax years up to 2006/07. The new income tax exemptions applicable from 2007/08 broadly mirror those contained within the Income and Corporation Taxes Act 1988 (TA 1988) which previously applied to both income and corporation tax. We shall discuss some of the minor differences introduced with ITA 2007 later in this book. Needless to say, the current legislation is not a

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general exemption from taxation, but provides a range of specific exemptions for which claims must be submitted. For income tax, claims must be made within five years of 31 January next following the end of the year of assessment. A charity constituted as a company must claim within six years from the end of the accounting period concerned. These time limits are to reduce by two years from April 2010. See Chapter 19 for time limit changes and Gift Aid.

**17.5** Claims for repayment of income tax suffered on investment income and both income and transitional relief are made on Form R68, obtainable from the HM Revenue & Customs (HMRC) on request. Transitional relief claims have a two-year time limit.

**17.6** Under the UK taxation system of self-assessment, any charity, whether constituted as a trust or company, must self-assess its income and gains if required by notice to file a tax return. The HMRC's detailed guidance notes for charities, found on the HMRC website ([www.hmrc.gov.uk](http://www.hmrc.gov.uk)), state that the majority of charities will not be required to make tax returns every year but that returns will be issued to charities based on a risk assessment or on a random basis. Nevertheless, the reality is that once a charity has been issued with a return it can expect to have to complete returns on a regular basis.

**17.7** However, a charity must complete a self-assessment tax return if the charity has income (note not necessarily profit) or gains which either does not fall within one of the taxation exemptions or is income or gains used for non-charitable purposes (*non-charitable expenditure*, see part 4 of this chapter)

**17.8** There are special supplementary pages to the standard tax returns which charities must complete if called upon to do so (copy of forms in Appendices). These pages form part of the tax return of the charity and require the disclosure of figures, exempt income and gains, related expenses and details of a charity's general administration expenses and assets. It is important to note that these pages legally constitute the charity's claim to tax exemption. The charity must also declare:

- that all its income and gains are exempt; and
- that all income and gains have been applied for charitable purposes only; or
- that some income or gains may not be exempt or may not have been applied for charitable purposes.

**17.9** Whilst most of the information required to file these forms will be readily available from the charity's accounting records, some of the questions demand such a degree of detail that further sub-analysis of the records is usually required. For example, one question asks for the total amount of grants made by the charity, splitting these between those made within the UK and those outside. In addition, the way the SORP requires charities to disclose their income does not always make it easy for the questions on the tax return to be answered from the accounts.

**17.10** More importantly, however, the person responsible for the form should carefully consider the implications of the answers to the question. Some of these are carefully chosen to reveal the extent to which the charity may not be applying its income and gains for charitable purposes only, for example, making grants outside the UK without taking the necessary reasonable care to ensure that they are applied for charitable purposes or making loans to a subsidiary company at less than a commercial rate of interest (see **18.17**).

### The exemptions

**17.11** TA 1988 s 505 exempts from corporation tax:

- (a) profits or gains taxable under Schedule A or D, arising in respect of rents or other receipts from an estate, interest in or right over any land, whether situated in the United Kingdom or elsewhere, to the extent that the profits or gains:
  - (i) arise in respect of rents or receipts from an estate, interest or right vested in any person for charitable purposes; and
  - (ii) are applied to charitable purposes only;

The exemption has been extended to include distributions from Real Estate Investment Trust introduced with the Finance Act 2006.

The provisions in (a) (i) and (ii) above are reflected for income tax purposes in ITA 2007 s 531(2). The exemption for income tax is extended to the unusual circumstances where rent is treated as trading income (s 531(1)) but this will not apply to income from a property business.

- (b)
  - (i) income chargeable under Schedule D Case III, for example, interest, annuities and other annual payments, including covenants, and some royalties;
  - (ii) income that would be taxable under Schedule D Case III if UK-sourced, but which is not so sourced, and is therefore taxable under Schedule D Case IV or V;
  - (iii) dividends and other distributions taxable under Schedule F;
  - (iv) dividends and other distributions taxable under Schedule D Case V because they have an overseas source, but which would be taxable under Schedule F if they had a UK source; and
  - (v) non-trading gains on intangible fixed assets charged under Schedule D Case VI;
 and applied to charitable purposes only;
- (c) public revenue dividends on securities in the name of trustees, taxable under Schedule D, to the extent that the dividends are applicable and applied only for the repair of any cathedral, college, church or chapel, or other building used only for the purposes of divine worship (also exempt for *income tax* under ITA 2007 s 533);

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- (d) profits of trade carried on by a charity, whether in the UK or elsewhere, if the profits are applied solely to the purposes of the charity and either:
  - (i) the primary purpose of the charity; or
  - (ii) work in connection with the trade is mainly carried on by beneficiaries of the charity; and
- (e) profits accruing in respect of a lottery if:
  - (i) exempt in accordance with Schedule 11 part 1 or 4 of the Gambling Act 2005; or
  - (ii) promoted in accordance with a lottery operating licence within Part 5 of the above Act, (or promoted and conducted under Northern Ireland equivalent) AND

the proceeds are applied solely to the charity's purpose.

The exemption for public revenue dividends applied for the repair of cathedral, college, church or chapel, or other building used only for divine worship, was introduced by the Finance Act 1996, and means that local appeals such as 'Friends of the Church Steeple' are now exempted.

## Small trades

**17.12** A major change introduced by FA 2000 s 46 was the addition of a general exemption for small trades carried on by charities (now charitable companies). The profits of any trade will be exempt from corporation tax either where gross trading or other income chargeable under Schedule D Case I or Case VI does not exceed certain limits, or the charity could reasonably have expected at the beginning of any year that the limits would not be exceeded.

**17.13** The turnover limit is the greater of two sums:

- (a) £5,000; and
- (b) the lesser of £50,000 and 25% of a charity's total incoming resources.

An equivalent income tax exemption applies for charitable trusts within ITA 2007 s 526 (referred to as *small-scale trades*) and s 527 for miscellaneous types of income within ITA 2007 s 1016, (essentially income previously taxed under Schedule D Case VI but now falling within Part 5 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005)). The exemptions now applicable to charitable trusts under ss 526 and 527 have removed the requirement for trades to be carried on wholly or partly in the UK, applicable under FA 2000 s 46.

**17.14** Exemption applies on the condition that the income or profits received by the charity are applied solely for charitable purposes. Where not all income or gains are so applied, restrictions of a charity's tax exemptions may occur (see **17.39**). There is a subtle difference between the wording of the condition attaching to exemption for most types of income, which must be applied for

charitable purposes only, and that for trading income (both in TA 1988 s 505 and FA 2000 s 46, where the income has to be applied solely to the purposes of the charity, ie ploughed back into the charitable activity).

**17.15** A number of types of income or profits are not exempted by TA 1988 s 505 or Part 10 of ITA for charitable trusts. Schedule E income is not exempt, but this is not relevant since individuals cannot themselves be charities.

**17.16** The exemption in respect of Schedule F income ceased to have effect from 6 April 1999, when Advance Corporation Tax (ACT) was abolished, since, as a consequence, the tax credit on UK dividends became notional and not repayable. This change alone was calculated by some observers to cost the charity sector as a whole about £400 million. To soften the blow, a transitional relief was introduced on a sliding scale which ceased in 2003/04.

### **Trading activities**

**17.17** Trading profits are not exempted unless as described above, namely carried out by the beneficiaries of the charity or in the course of the carrying out of a primary purpose of the charity, or within the small scale limits, mentioned above.

**17.18** The tax issues relating to trading activities carried on by charities, and the ways in which the profits of trading activities carried on for the benefit of charities can flow through in a form which is exempt under TA 1988 s 505 and ITA 2007 s 524 are discussed in detail in Chapter 18.

### **Interest and annual payments**

**17.19** Exemption from income and corporation tax applies to all forms of interest, whether annual or short and with a UK or overseas source. It also includes interest payable gross by building societies.

**17.20** Annual payments are exempt from tax. The question as to what constitutes an 'annual payment' for tax purposes is dealt with in more detail at **19.3** below in connection with deeds of covenant. Suffice to say that it must be pure profit in the charity's hands, so that a charity receiving an annual payment does not have to do anything to earn it, nor be obliged to offer anything in return.

**17.21** Copyright or other royalties may constitute annual payments, especially if given or bequeathed to the charity, but care needs to be taken where a charity takes action to exploit such rights, as such activities can often constitute trading. Royalty payments or other income from intellectual property, certain telecommunication rights and foreign distributions are now specifically exempt for income tax purposes under ITA 2007 s 536, again, providing they do not constitute a receipt from trading (per Chapter 2 of Part 2 ITTOIA 2005) and are applied to charitable purposes only.

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### **Land transactions**

**17.22** Other one-off receipts may not be exempted from tax unless derived from land (see TA 1988 s 505(1)(a) or ITA 2007 s 531), or for non-trading intangible assets (s 505(1)(c)(iic)).

**17.23** Thus, for example, certain types of one-off income, such as share underwriting commission, enjoyed by a charity may be taxable.

**17.24** Charities are exempt from capital gains tax (or corporation tax on capital gains) where land or buildings are sold which were either used for charitable purposes or held as investments, (see **17.36** on capital gains tax). However, TA 1988 s 776 imposes on a charitable company a charge to tax under Schedule D Case VI where land is obtained, held or developed with the sole intention of realising a gain on its disposal. HMRC do not accept that TA 1988 s 505(1)(a) exempts a charge under s 776. For charitable trusts, an equivalent charge to income tax arises under ITA 2007 s 755 and there is no exemption within s 531 for gains from land. Charity trustees are under a duty to obtain the best possible result for the charity and when seeking to do this by selling land with development potential may often achieve a sale which includes a share of the developer's profit if certain profit levels are achieved, often referred to as an 'overage' within the sale contract. If such a sale is in prospect, professional advice should be sought as early as possible in the negotiations before proceeding (see *Page v Lowther* [1983] STC 199, where the trustees did exactly that and were caught by s 776). Alternatively, HMRC could seek to remove exemption from such a disposal by assessing the transaction as an adventure in the nature of trade. Either way, professional advice should be obtained before entering into any significant land transaction.

### **Fundraising events**

**17.25** Fundraising events that might technically be defined as trading are exempted from income and corporation tax provided they fulfil the requirements for VAT exemption laid out in Chapter 20. This exemption is contained in extra-statutory concession ESC C4 and enacted for trusts within ITA 2007 s 529. Whereas the old pre-2000 concession generally only applied to one-off events, the current concession and legislation can apply to a series of events.

**17.26** Following the new alignment of the direct and indirect tax exemptions concerning the raising of money through holding events, the criteria for exemption are laid out in full in Chapter 20. By keeping within those criteria, a charity will be exempt from both income or corporation tax and VAT.

### **Miscellaneous exemptions**

**17.27** A number of other minor exemptions from tax can be found elsewhere in the legislation. Charities are exempted from special charges in connection with certificates of deposit by TA 1988 s 56(3)(c) and ITA 2007 s 534. They are also exempted from the accrued income scheme (TA 1988 s 715(1)(d))

and ITA 2007 s 645) and from the 40% tax charge on the repayment of pension fund surpluses as the employer (TA 1988 s 601(4)).

### Contemplative orders

**17.28** ESC B10 grants specific relief to contemplative religious communities and their members, as some communities are not entitled to the exemptions from tax contained in s 505. This is because purely contemplative orders are not seen as carrying on the charitable purpose of the advancement of religion because their activity is inward looking rather than evangelistic. The question as to whom the income of such a community actually belongs is another difficult point to determine.

**17.29** ESC B10 assists with these difficulties. It allows an amount being equal to an individual's personal allowance to be regarded as the income of a member of the community, and the aggregate of the members' personal allowances to be offset against the income of the community. Where this aggregate exceeds actual income, the excess can be used against capital gains in that tax year. Carry forward of the excess used to be allowed, but this is no longer possible, with the exception of allowances unused as at 5 April 1995, which can be carried forward until exhausted.

### Anti-avoidance

**17.30** In addition to the anti-avoidance legislation contained in TA 1988 s 776 relating to capital gains on land (see **17.24**), HMRC has significant other powers to counteract the abuse of charitable status. Although there is no general exemption from tax for charities, favourable exemptions make charitable status an attractive prospect for the avoidance of tax. Although artificial schemes are less common, there are traps in place to catch opportunists but these are also wide enough to catch many innocent transactions.

**17.31** One of the most controversial pieces of anti-avoidance legislation is the substantial donors anti-avoidance rules introduced in the Finance Act 2006. These rules were designed to prevent transactions where a donation is effectively returned to a donor. This applies to transactions entered into on or after 22 March 2006.

**17.32** Under these rules it is the donor who benefits from tax relief on the donation and from the value extracted by the donor, but it is the charity that is denied relief by treating the value of the transaction as *non-charitable expenditure* (see part 4 of this chapter) restricting the charity tax exemptions mentioned above. The current rules may trap transactions which would appear to be innocent transactions carried out on an arm's length basis, for example remuneration to employees who are also substantial donors may be caught under the current rules. Charities must also monitor transactions with substantial donors for periods which could span over a decade. The government has acknowledged the concerns of the sector and the substantial donors' legislation is currently under consultation.

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**17.33** There are general anti-avoidance provisions under TA 1988 s 703 which deals with the cancellation of tax advantages accruing from certain transactions in securities. Exempt bodies are not outside this legislation, which was made clear in *Commissioners of the Inland Revenue v Universities Superannuation Scheme Ltd* [1997] STC 1. In this case, a company purchased its own shares from the appellant, a pension scheme otherwise exempt from tax, giving rise to a distribution. The monies received by the appellant consisted of repayment of capital and a dividend. They then claimed a tax credit of over £850,000. The Revenue challenged this as the credit had arisen from a dividend which was of an ‘abnormal amount’ and they succeeded in raising an assessment under Case VI for the amount of the tax credit. Advance clearance should be sought from HMRC’s Technical Division if this section could apply to a transaction.

#### **Claiming relief**

**17.34** Charities should remember that claims for relief from tax under TA 1988 s 505 and ITA 2007 s 524 onwards can be made as soon and as often as they wish, providing they hold the necessary tax vouchers. It is not necessary to wait until the end of the tax year or to accumulate vouchers to a specific threshold.

**17.35** In addition, it is possible to receive interest gross on certain holdings. The Bank of England will pay interest on government securities gross on receipt of an application accompanied by the charity registration slip issued by the Charity Commissioners. Banks and building societies will also pay interest gross as long as they are provided with proof of charitable status. It is important to provide this proof when the relevant account or deposit is opened to avoid tax being deducted automatically.

## **3 Capital gains tax**

**17.36** Charities are exempt from CGT provided that the gains are applied for charitable purposes, except in one circumstance. To prevent temporary charities being used to avoid liability to CGT, TCGA 1992 s 256(2) revokes the exemption where assets held on charitable trusts cease to be subject to such trusts. If this occurs, the trustees are treated as if they had disposed of and immediately reacquired the assets at open market value. The gain on the deemed disposal is chargeable to CGT. Assessments must be raised by the HMRC within three years of the end-of-the-year of assessment in which the asset ceases to be held on charitable trusts.

**17.37** Unfortunately, as with several anti-avoidance provisions, this withholding of exemption can affect genuine transactions by charities, as well as transactions with the aim of avoiding tax. One example would be where property has been given to a charity for a fixed term, after which it passes to a member of the donor’s family. The Charity’s trustees would then be liable for CGT on the unrealised gains attaching to the property when passed on. This

treatment can carry back to any earlier disposals that were reinvested in other assets which continued to be held at the end of the fixed term. This carry back is not restricted by the six-year limit. The carry back to previous disposals may also be made on those who were trustees at the time of those disposals, rendering them potentially personally liable to CGT. Therefore, trustees in such a situation must ensure that they retain sufficient assets to meet this liability before they transfer the property to the ultimate beneficiary, and obtain an indemnity from them.

**17.38** Another situation in which this can be an issue is where a charity has run its course and no longer has charitable objects to which income and gains can be applied. Trustees in this position should apply to the Charity Commissioners for a scheme under Charities Act 1993 s 16 to widen the charitable objects of the charity in order that property can continue to be held with the income and gains being applied for charitable purposes.

#### 4 Application for charitable purposes

**17.39** For CGT purposes, a gain is not a chargeable gain if it accrues to a charity and is applied for charitable purposes (TCGA 1992 s 256). However for charitable companies under corporation tax, TA 1988 s 505 requires income or profits to be applied to charitable purposes only. Similarly, for trusts ITA 2007 s 524 requires income or profits to be applied to the purposes of the charitable trust only. Although a charity's administrators may think that this is a simple condition to meet, being a charity and application for charitable purposes is not one and the same thing. Tax relief is restricted where particular expenditure is not incurred for charitable purposes or incurred partly for charitable purposes (for income tax and corporation tax) or specified by legislation as non-charitable expenditure. The rules on non-charitable expenditure were revised from 22 March 2006 and changes how the restriction applies.

**17.40** Prior to these and earlier changes, charitable purposes were not defined in statute and reliance was placed on Lord McNaghten's judgment in *Income Tax Special Purposes Comrs v Pemsel* [1891], which summarised charitable purposes as the relief of poverty, the advancement of education, the advancement of religion and other purposes beneficial to the community. As explained in Chapter 1, a new modern definition of charitable purposes is contained in the Charities Act. Provided the charity applied its income and gains within the bounds permitted by its articles or trust deed and within these charitable purposes, there should be no problem. However, there may still be grey areas or differences of emphasis as to what does or does not come within charitable purposes. HMRC current guidance states that they will not necessarily treat expenditure as non-charitable expenditure where it is not specifically authorised within the articles or trust deed if it is clearly of a charitable nature. They will often seek guidance from the Charity Commission in such cases, but they will consider expenditure which is prohibited or restricted in the charity's articles or deed as non-charitable expenditure.

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### **Non-charitable expenditure**

**17.41** The meaning of non-charitable expenditure is now contained in ITA 2007 s 543 and can be summarised as:

- any expenditure which is not incurred for charitable purposes only;
- losses made in a trade which is not a charitable trade or would not fall within one of the other tax exemptions if a profit had been made;
- payment or restriction as a result of a transaction with a substantial donor;
- investments or loans which are not qualifying investments or loans (ITA 2007 ss 558 and 561 and TA 1988 Sch 20);
- certain payments to an overseas body (ITA 2007 s 547).

For corporation tax the definition is treated as broadly the same, although TA 1988 refers to charitable expenditure instead.

### **Payments to an overseas body**

**17.42** Where payments are made to overseas bodies including overseas registered charities TA 1988 s 506(3) (and ITA 2007 s 547) requires the trustees of the donor charity to take reasonable steps to ensure that the money is used by the foreign body for charitable purposes. Any failure to do this, or carelessness by a UK charity in these circumstances, would leave the donor charity in the UK within the rules on non-charitable expenditure and faced with a consequent restriction of its tax exemptions. Please note that HMRC will only accept what is considered 'charitable purposes' under UK law. This legislation is primarily designed to counter artificial tax avoidance schemes. The legislation does not define 'reasonable steps'. HMRC have issued guidance on their interpretation of reasonable steps and where payments are small and one-off they will expect no more than an exchange of correspondence between the two bodies confirming the details of the payment, intended purpose and confirmation that the sum has been applied accordingly. For large payments or ongoing commitments HMRC will expect further evidence such as independent verification that sums have been used for charitable purposes.

### **Qualifying investments and loans**

**17.43** Charity law requires that charities making investments avoid speculation or undue risk with a proper spread of investments. A charity must also avoid making investments which contradict its charitable purpose.

**17.44** For charitable trusts, the legislation now refers to approved charitable investments and loans but this is used synonymously with qualifying investments and loans still used for corporation tax in TA 1988 Sch 20. Although the list of qualifying investments for trusts is wider, these are generally the same and can be summarised as follows:

- Investments in common investment funds, common deposit funds and similar funds established for the exclusive benefit of charities.
- Any interest in land other than an interest held as security or debt.
- Investments authorised under the Trustee Investment Act 1961 which includes National Savings Certificates/UK Government Treasury Bills including Northern Ireland Treasury Bills, certificates of tax deposit,
- Bank deposits where interest is payable at a commercial rate and is not part of an arrangement where a loan is made to some other person.
- Deposits with a building society, National Savings or other credit institution authorised with mutual principles.
- Shares or securities listed on a recognised stock exchange or (per Schedule 20 and corporation tax) are dealt in on an Unlisted Securities Market (see 17.45 below).
- Investments in unit trust schemes or an open-ended investment company.
- A loan or other investment as to which HMRC are satisfied is made for the ‘benefit of the charity’ and not for the avoidance of tax by the charity or any other person.

**17.45** An interesting point is that the Unlisted Securities Market is no longer in existence, rendering this section of Sch 20 without impact. The effective ‘replacements’ for the USM, the Alternative Investment Market and PLUS (or previous OFEX market), are not included within the specifically qualifying investments listed in Sch 20. However, HMRC regard stocks quoted on AIM as being listed on a recognised stock exchange for the purposes of the relief for gifts of quoted shares to charity in FA 2000 s 43 – see 19.47 below. It appears that AIM stocks would be regarded as qualifying but PLUS investments should be considered on a case-by-case basis as to whether they are qualifying investments.

**17.46** HMRC will accept that a loan or investment is ‘for the benefit of the charity’ where made on sound commercial terms based on the facts of each case. They will accept a loan which carries a commercial rate of interest, is adequately secured and is made under a formal written agreement with reasonable repayment terms. Although HMRC may give an opinion as to whether a loan or investment is qualifying there are no formal pre-clearance procedures.

**17.47** As the shares in a trading subsidiary company, discussed in the next chapter, are not listed shares, this investment falls into the last category listed above and will need to satisfy HMRC that it is for the benefit of the charity. Often the activities of a trading subsidiary will further the charitable purpose of a charity and for commercial or other reasons the charity has chosen to carry out this trade or activity in a separate entity. This would clearly be for the benefit of the charity by furthering its charitable purpose. Where the intention is for the subsidiary to carry on other income generating activities, HMRC will want the charity to have evidence that the charity has made an informed decision demonstrated by say a business plan with cashflow forecasts and illustrating

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an expected reasonable rate of return. Investments in subsidiaries are discussed further in the next chapter.

### **Transactions with substantial donors**

**17.48** As discussed in **17.32** these anti-avoidance rules are currently under government consultation and therefore this is only a brief summary of the main principles contained in TA 1988 ss 506A–506C and ITA 2007 ss 549–557.

**17.49** These provisions restrict charity tax exemptions by deeming a charity to incur non-charitable expenditure where certain transactions are entered into with substantial donors from 22 March 2006. A substantial donor is a person, which includes a company, if that person has made ‘relievable gifts’ to a charity of at least:

- £25,000 in a 12-month period; or
- £100,000 (an increase announced in Budget 2009 from 23 April 2009) in a six-year period

falling within the charity’s Chargeable Accounting Period (tax years to 5 April for a trust). The above test applies to donations from connected persons, which has a wide definition within ITA 2007 s 993 and TA 1988 s 839, and will also apply to transactions with connected persons. Connected charities are treated as one charity for this purpose although there is no strict definition of what constitutes a connected charity and is assumed to be those with similar trustees. A person who has become a substantial donor carries this status for the next five chargeable accounting periods.

**17.50** A substantial donor will not include another charity, housing association or Registered Social Landlord. A wholly-owned subsidiary of a charity (or more than charity) is excluded in so far as it is donating to one of the charities which own the company.

**17.51** ‘Relievable gifts’ is a gift qualifying for tax relief (other than just IHT relief) and includes Gift Aid donations, gifts of shares/securities and real property, payroll giving, gifts of assets with CGT relief, gifts of trading stock, plant and machinery and gifts from settler-interested trusts.

**17.52** Types of transaction that fall within these rules are:

- the sale or letting of property;
- the provision of services;
- the provision of financial assistance, whether provided to a charity from a substantial donor or vice versa;
- exchange of property between a charity and a substantial donor apart from certain disposals to charities at an undervalue;
- investment by a charity in the business of a substantial donor unless shares are listed on a recognised stock exchange;

- remuneration by a charity to a substantial donor unless remuneration to a trustee approved by the regulatory body or court.

Exceptions apply to the sale or letting of property, provision of services or financial assistance where from a substantial donor to a charity in the ordinary course of their business on arm's length terms and which is not part of an arrangement to avoid tax.

### Accumulating income

**17.53** Often there can also be significant delays between the receipt of income or gains and their application, specifically where funds are being built up for a specific but long-term project or charitable purpose. If there appears to be no application of funds, HMRC may seek to withdraw or deny the tax exemptions available to a charity. The question of application was the subject of the Court of Appeal case *IRC v Helen Slater Charitable Trust Ltd* [1981] STC 471. This case was concerned with the payment of income by the trustees of the appellant to the trustees of the Slater Foundation Ltd, another charitable company, with the same trustees as the first. The Inland Revenue claimed that as the money paid over had been accumulated to no specific purpose and had not been spent and, they believed, there had not been any change in the beneficial ownership of the funds, the payment did not constitute application for charitable purposes.

**17.54** The court held that, despite the trustees of both charities being the same people, they were separate trusts, with neither trust having power in law to direct the affairs of the other. The appellant trustees had, therefore, applied the funds for charitable purposes by passing them to another charity. The recipient charity had received a capital sum and was, therefore, only liable to account for the application of any income arising therefrom.

**17.55** Although the case was not decided on the precise point, the remarks of Lord Justice Oliver in the *Helen Slater* case are of prime importance. In commenting on two conflicting dicta of the judges in the earlier case of *General Nursing Council for Scotland v IRC* [1929] 14 TC 645, he said:

'Charitable trustees who simply leave surplus income uninvested cannot, I think, be said to have applied it all, and, indeed, would be in breach of trust. But if the income is reinvested by them and held, as invested, as part of the funds of the charity, I would be disposed to say that it is no less being applied for charitable purposes than if it is paid out in wages to the secretary'.

**17.56** As the Revenue in the *Helen Slater* case had conceded that, subject to the trustees not acting ultra vires, accumulation for a specific purpose does represent application for charitable purposes, the only problem appears to lie with accumulation for general purposes. The remarks of Lord Justice Oliver seem to indicate that even general accumulations can constitute application for charitable purposes. This is as long as the very minimum that has been done by the charity in question is consciously to reinvest any surplus income so that

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it can be said to have been applied. However, the point is still not totally free from doubt, and it may be legislated in the future or tested again by HMRC through the courts in an extreme case. However, the Inland Revenue did mount an attack in the case of *Nightingale Ltd v Price* [1996] STC (SCD) 116 before the Special Commissioners. They had sought to deny charitable exemption under the precursor of TA 1988 s 505 on the grounds that the income received by way of covenant from the property development and trading subsidiaries of the charitable company *Nightingale Ltd* was not applied for charitable purposes. The income was re-lent at interest to a property holding company controlled by the director of the charity and the charity's subsidiary companies. The Inland Revenue was not successful before the Special Commissioners, who found that the income was applied for charitable purposes only, since the charity's policy was to increase its own resources by lending money to subsidiaries and associated companies at high rates of interest. The Inland Revenue did not pursue this case through the courts, and it remains to be seen whether HMRC will attempt to pursue a similar case in the future.

**17.57** HMRC guidance states that accumulations of income will not normally be challenged unless they are kept in cash or a current account or are being accumulated for a project where there appears to be a conflict of interest between the interests of the charity and the interests of the trustee(s) or provider of the funds.

**17.58** To counter avoidance by using the *Helen Slater* principle, an amendment to TA 1988 s 505(2) was made in FA 1996. This provides that any payments by one charity to another, being not for full consideration, not otherwise chargeable to tax or otherwise eligible for relief under s 505(1), are taxable under Schedule D Case III as an annual payment. This follows the *Slater* case in that the charity making the payment has applied those funds for charitable purposes, but requires the recipient also to show that they have applied the funds for charitable purposes. The recipient can still claim exemption for tax on these grounds, and the donor does not have to deduct tax before making the payment.

**17.59** Where, however, the recipient charity is not resident in the UK, the onus of proving that the money has been applied for charitable purposes falls on the UK-resident donor charity. See **17.42** above.

**17.60** Positive misuse of a charity's income in applying it for non-charitable purposes is rare, but inadvertently using income for such purposes can endanger the tax exemptions of any charity, however well-intentioned. There are two ways in which the application of income can slip into dangerous territory: administration costs and non-charitable activity. While HMRC allows that reasonable administrative costs are necessary for the achievement of a charity's objects, and are therefore indirectly applied for charitable purposes, they or the Charity Commission can investigate excessive administration costs. Although this is a subjective question, expenditure by the officers of a charity that is seen as 'extravagant', such as unnecessary foreign trips, is an example of what could be investigated (see Chapter 8 for the accounting requirements concerning administrative expenses).

**17.61** A strict legal definition of charitable purposes would exclude activities that are political. An occasional foray into this field, subject to the rules governing non-qualifying expenditure, will generally be tolerated by HMRC, but sustained and significant political or other non-charitable activity will not be. Activity at such a level should be contained within a separate body with separate sources of income if at all possible. The worst case scenario if this is not done is that a charity's tax exemptions may be totally withdrawn, and their very charitable status may be in danger.

## 5 Non-charitable expenditure – the restriction of tax exemptions

### For chargeable accounting periods from 22 March 2006

**17.62** The current rules for calculating the amount of any restriction for non-charitable expenditure are contained in ITA 2007 ss 539–542 and the amended TA 1988 s 505 (subsections (3)–(7)). If a charity incurs non-charitable expenditure or is deemed to incur such expenditure within a chargeable accounting period, the equivalent amount of tax relief on income or gains are forfeited, referred to as attributing income, to the non-exempt amount, per ITA 2007 s 540. The legislation is more concise than the complex rules applicable to periods commencing before 22 March 2006. The new rules are to a certain extent less generous as charitable expenditure can no longer be matched with income in a chargeable period before non-charitable expenditure. However, ITA 2007 s 542 does allow the charity to choose which sources of income are to lose exemption. This may affect the level of tax payable if any but the trustees of the charity must specify to HMRC its allocation within 30 days of HMRC notifying the charity of the requirement to restrict relief. HMRC will accept details disclosed in a tax return as notification. A charity must complete a self assessment tax return and account for any tax due for the period it has incurred non-charitable expenditure.

**17.63** 'Relievable income and gains' is income and gains which would otherwise be eligible for relief or exemption mentioned at **17.11–17.29** and **17.36**. Non-charitable expenditure is allocated firstly to the charity's relievable income and gains of the current chargeable accounting period. Any 'unrelieved' non-charitable expenditure is then allocated to the remainder of total income and gains in the chargeable accounting period. Total income and gains will include the relievable income and gains, income and gains not subject to relief or exemption, and receipts from all other sources such as legacies, other gifts and non-taxable grants. If there is further excess non-charitable expenditure this is carried back to the previous chargeable accounting period and treated as non-charitable expenditure of the previous period. If there still remains a surplus it is then carried back to previous years ending up to six years before the end of the current chargeable period.

**17.64** It appears strange that relievable income or attributable income as referred to in legislation for trusts in ITA 2007 s 540(3) includes all income which have exemptions under that part (Part 10). Exemptions under s 521(4)

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include donations under Gift Aid. It could be argued that there is not a source of income as they are purely gifts.

### Example 1

**17.65** In Example 1, Charitable company A has the following:

<b>Year ended 31 December 2008</b>	£
Legacies	200,000
UK dividend income	70,000
Bank interest	30,000
Non-charitable expenditure	80,000

Both UK dividend income and bank interest is relievable income. The charity selects to allocate non-charitable expenditure to the £70,000 dividend income first and the remaining £10,000 to bank interest. As a company, the charity will pay no further tax on the dividend income so £10,000 will be payable at the prevailing corporate tax rate.

### Example 2

**17.66** As in Example 1, with results for the following year:

<b>Year ended 31 December 2009</b>	£
Legacies	40,000
UK dividend income	10,000
Bank interest	5,000
Non-charitable expenditure	100,000

The £100,000 non-charitable expenditure is first offset against relievable income of £15,000, the interest and dividends, with £5,000 chargeable to tax. £40,000 is allocated to the remainder of total income and gains, legacies which are not subject to tax. The remaining surplus of £45,000 is carried back and allocated to the previous year, first to the relievable income of £20,000 bank interest (giving rise to a tax charge) and then £25,000 to the legacies.

**17.67** The six year carry back period may include periods under the old rules, commencing prior to 22 March 2006. Carry back is permitted to the extent that a restriction for non-charitable expenditure would have arisen under the previous regime.

### For chargeable accounting periods starting before 22 March 2006

**17.68** The basic rules for calculating the amount of any restriction of tax exemption for non-qualifying expenditure were contained in the previous version of TA 1988 s 505(3) for periods commencing before 22 March 2006. This laid down that if in any chargeable period a charity had:

- (a) relevant income and gains not less than £10,000; and
- (b) relevant income and gains exceeding qualifying expenditure; and
- (c) the charity incurs or is deemed to have incurred non-qualifying expenditure;

then tax relief will be restricted.

**17.69** The amount of income and gains to which the restriction applied is found by comparing the excess of relevant income and gains over qualifying expenditure with the amount of non-qualifying expenditure. Tax exemption is withdrawn for so much of the excess of relevant income and gains over qualifying expenditure as does not exceed the amount of non-qualifying expenditure.

**17.70** Similarly to the new rules, for the purposes of this test, relevant income and gains do not necessarily include all the income and gains a charity receives. Relevant income and gains are only those income and gains which would be taxable if they were not exempted by TA 1988 s 505(1) or TCGA 1992 s 256(1).

**17.71** Qualifying expenditure includes all expenditure in the period laid out solely for charitable purposes and any commitments made for such expenditure to be entered into in the period. It will obviously include any investments, loans or expenditure connected with them and permitted by Sch 20. It also includes reasonable fundraising and administration expenditure. Where, however, the charity makes payments to bodies outside the UK, it will only be regarded as making qualifying expenditure provided the charity concerned has taken reasonable steps to ensure that their payment will be applied for charitable purposes. Non-qualifying expenditure, in addition to investments or loans outside Sch 20, will include all non-chargeable expenses, for example, trading expenses, political activities, excessive administration costs, etc.

**17.72** Thus, the purpose of the legislation is to penalise any charity which misapplies its income and gains by denying tax relief on the appropriate proportion of its income and gains up to the limit of the expenditure misapplied. The de minimis limit should not be forgotten in that, for the rules on non-qualifying expenditure to apply, the charity must have relevant income and gains of £10,000 or more in any one year. In addition, relevant income and gains do not include any income or gains which are exempt under separate provisions from TA 1988 s 505(1) or TCGA 1992 s 256. Contrast the following examples.

### Example 3

**17.73** In Example 3, Charity X has the following income:

## 17.74 Tax exemptions and charities

	£
Grants from other UK charities	250,000
UK dividend income	50,000
Gift Aided donations	40,000
Its expenditure comprises:	
Grants to UK charities	30,000
Administration costs (of which 60% is deemed excessive by the Inland Revenue)	100,000
Grants to overseas bodies (£80,000 of which was handed over without prior research on the part of Charity X to a little known tax haven charity which promptly misappropriated it)	180,000

Charity X will have its tax exemptions and reliefs restricted as follows:

	Income £	Relevant Income £
Grants from other UK charities	250,000	250,000
UK dividend income	50,000	50,000
Gift Aided donations	40,000	40,000
	340,000	340,000

	Total expenditure £	Qualifying expenditure £
Grants to UK charities	30,000	30,000
Administrative expenses	100,000	40,000
Grants to overseas bodies	180,000	100,000
	310,000	170,000

**17.74** Thus, non-qualifying expenditure is £140,000. The excess of relevant income and gains over qualifying expenditure is £170,000. Charity X will therefore have its tax reliefs and exemptions restricted by the lesser of these two amounts, and will therefore pay tax on £140,000 of relevant income and gains.

### Example 4

**17.75** In Example 4 (in the same year), Charity Y, with exactly the same qualifying and non-qualifying expenditure as Charity X in example 3, has the following income:

	£
Grants from UK charities	150,000
UK dividend income	50,000
Donations from the public (including £40,000 donations under Gift Aid)	140,000

**17.76** The computation for Charity Y is:

	Income	Relevant Income
	£	£
Grants from UK charities	150,000	150,000
UK dividend income	50,000	50,000
Donations	140,000	40,000
	340,000	240,000

**17.77** Whereas non-qualifying expenditure, as for Charity X, is £140,000, the excess relevant income and gains over qualifying expenditure is only £70,000 (£240,000 less £170,000). Charity Y will therefore suffer restriction of its tax reliefs and exemptions only on £70,000 of relevant income – the lesser of the two amounts. In other words, part of the non-qualifying expenditure is effectively deemed to have been met from income which is not relevant income.

## 6 Value Added Tax

**17.78** There is no general relief from VAT available to charities. Once the registration threshold of taxable supplies has been exceeded, a charity must register and account for VAT as any other trader. This is a complex area discussed in Chapter 20.

## 7 Inheritance tax

**17.79** The aspects of inheritance tax relating to giving to charity are considered in Chapter 19. Charities themselves benefit from the relief in the Inheritance Tax Act 1984 s 58(1)(a), which applies to charities constituted in the form of a trust. Charities constituted as trusts are almost invariably drawn up as discretionary trusts.

**17.80** The relief applies to the charges made under the system by which a periodic ten-year charge is imposed on discretionary trusts. This system involves tax being due, albeit at a reduced rate, on the value of the assets held by a discretionary trust on every tenth anniversary of its foundation. Property held for charitable purposes only by permanent charitable trusts is exempted from this periodic charge.

**17.81** If the property ceases to be held for charitable purposes, however, the charge can be triggered unless it is given to another charity or applied for such purposes. It will also arise if the trustees make a disposition reducing the value of the settled property otherwise than for charitable purposes.

## 17.82 *Tax exemptions and charities*

# 8 Business rates and council tax

## Business rates

**17.82** Local taxation is divided into business rates (which apply to businesses) and council tax (which applies to individuals).

Charities receive a mandatory reduction of 80% on uniform business rates. Further relief, up to the total amount otherwise due, can be given to charities at the discretion of local authorities. Following the case *Oxfam v City of Birmingham District Council* [1976] AC 126, the Rating (Charity Shops) Act 1976 was introduced, which entitles charity shops to qualify for the relief, provided that they wholly or mainly sell donated goods and the profits are applied for charitable purposes.

## Council tax

**17.83** Council tax is chargeable on private dwellings, and is determined by the value of the property, graded in eight valuation bands (A to H). Certain properties can be exempt from the tax and occupants may qualify for reductions or discounts. Charities also receive both specific and partial exemptions. Subject to these properties, where charities will be liable to council tax, are:

- residential care homes, hostels, nursing or mental homes;
- staff flats or accommodation in residential property;
- houses in multiple accommodation; and
- convents, monasteries and church houses.

**17.84** Properties exempt from council tax include those occupied only by students or as armed forces' barracks and married quarters. Also included are properties that are vacant for certain reasons, including those waiting to be occupied by a minister of religion, or vacated by someone who has gone into care or gone to care for another person. Residential properties owned by charities that are vacant for up to six months are partly exempt.

**17.85** Claims must be made for other reductions. The disabled reduction scheme applies where at least one resident is substantially and permanently disabled, and the property contains either space for a wheelchair to be used inside, or a room other than a kitchen, bathroom or toilet, mainly used by that person and essential to their needs. Under the scheme, valuation can be on the band below the one that would otherwise apply, apart from Band A.

**17.86** Where all adult residents of a property fall into the following categories, council tax is reduced by 50%. If one resident is outside the categories, the reduction is 25%, but if two or more are outside, there is no reduction. The categories are:

- patients in homes receiving treatment or care in a residential care home, nursing home, mental home or hostel;

- some care workers, where the person being cared for receives specified benefits and the carer is resident and works at least 35 hours per week (the spouse or child of the recipient is excluded); and
- care workers employed by the Crown, a charity or a local authority, or introduced by such to a third party, where they reside in premises provided by their employer, work at least 24 hours per week, and do not earn more than a certain limit.

**17.87** If a claim for relief under the above schemes is rejected, an appeal can be made to a Valuation Tribunal.

## **9 Benefits-in-kind, stamp duty, betting duty**

**17.88** Where charities act as employers, they are subject to the normal PAYE (pay as you earn) and NIC (National Insurance Contributions) regimes. Where a director of a charity has total emoluments of less than £8,500, expenses reimbursed to that director are not subject to the benefits in kind legislation. Volunteer drivers who are paid a mileage allowance may be seen as receiving a taxable profit element if the allowance paid exceeds amounts necessary to merely reimburse the cost of fuel and running costs. HMRC can tax this profit element, and so it would be more sensible to limit mileage allowances to agreed rates published by HMRC.

**17.89** The introduction of the national minimum wage may affect charities that make nominal payments to volunteers. Where such payments are being considered, a charity should carefully structure the method by which they are made.

**17.90** Charities are not liable for stamp duty on conveyances, transfers or sales or leases (FA 1982 s 129), but where stamp duty does apply, it will apply to the full amount of the consideration for sale, including VAT, where that tax is applicable. VAT does not apply to the amount paid to HMRC as stamp duty as this does not form part of the consideration for the supply for VAT purposes (SP 11/91).

**17.91** Small lotteries or raffles incidental to exempt entertainments, or private lotteries or societies lotteries defined by Sch 11 to the Gambling Act 2005, may be organised by a charity and exempt from pool betting duty. Additional regulations govern lotteries run by charities and information about them can be obtained from the Gaming Board.

## **10 Landfill tax**

**17.92** Landfill tax is a tax per tonne of waste disposed of at licensed landfill sites. It is accounted for by landfill site operators. Bodies registered for landfill tax that make 'qualifying contributions' to approved bodies can get credit for landfill tax paid or payable in respect of 90% of the amount of each qualifying

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contribution in any accounting period. This credit can only be claimed, however, up to 20% of the annual landfill tax liability of the contributing body.

**17.93** An approved body for the purposes of landfill tax is one that is concerned with the environment, including the fields of waste management, reclamation, pollution control, and that is precluded from distributing any profit it may make. Any charities active in areas as described above may wish to seek advice in order to attract as many qualifying contributions as possible by maximising the extent of the credit available for contributors.

## **11 Community amateur sports clubs**

**17.94** The Finance Act 2002 s 58 and Sch 18 apply some of the charity exemptions described above to Community Amateur Sports Clubs (CASCs) which are not charities. From 1 April 2004, such bodies became exempt from corporation tax on trading income where turnover is less than £30,000 per annum and property income is less than £20,000 per annum. Between 1 April 2002 and 31 March 2004, these limits were £15,000 and £10,000 respectively.

**17.95** Individuals are entitled to Gift Aid relief and CASCs can claim basic rate tax (and transitional relief from 6 April 2008 to 5 April 2011) from donations but not subscriptions. Gifts to CASCs are exempt from Capital Gains Tax and Inheritance Tax and, from 1 April 2004, the 80% mandatory relief from business rates also applies to CASCs in England and Wales.

**17.96** To become a CASC, a club's constitution must comply with certain conditions and register with HMRC. The club must be open to all members of the community without discrimination for the purpose of facilitating and encouraging participation in a wide range of sports which are listed together with the registration form on the HMRC website, [www.hmrc.gov.uk/charities/casc/register.htm#1](http://www.hmrc.gov.uk/charities/casc/register.htm#1). The constitution of the club must prevent the distribution of surpluses to members and for any proceeds on dissolution to be applied for charitable purposes or given to charity. Once registered as a CASC, there is no provision allowing deregistration.