

Charities – Direct Taxes Update

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The purpose of this note is to highlight certain areas involving direct taxes which charities may wish to consider following the Budget and publication of the Finance Bill 2006. This note deals with the following areas:

1. Changes to corporation tax rates.
2. New legislation regarding mixed trading activities.
3. Anti-avoidance.
4. Miscellaneous issues.

Corporation tax rates

The exemption from corporation tax for profits up to £10,000 has been removed from 1 April 2006. The nil rate band has been replaced by a single band of profits up to £300,000 being taxed at a rate of corporation tax of 19%. Companies with profits over £1.5m are taxed at the full corporation tax rate of 30%. Profits between £300,000 and £1.5m are taxed at an effective rate of corporation tax of 32.75%. In reality the corporation tax return for companies with profits in the mid range band is much more complicated.

The nil rate band has proved very useful for charities with trading subsidiaries as it has enabled them to build up a small amount of working capital in the subsidiary without suffering corporation tax on the retained profits. It should be remembered that where charities have a corporate group the £300,000 band is divided between all companies within the group that are not dormant. Therefore if there are three companies within the group each company has a 19% tax band of £100,000. It is not possible to pass any unutilised tax band to other group companies.

Action Points

1. Charities will need to decide if they are going to pay tax on any non-revenue deductible expenses (such as depreciation in excess of capital allowances and entertaining expenses) or cover the amount of tax in a Gift Aid payment which may lead to negative reserves in the trading company.

2. Trading subsidiaries will have to get used to making Gift Aid payments of all profits to the parent charity.
3. For accounting periods which end before 1 April 2006, for example accounting periods to 31 December 2005, the charity can consider making use of the nil rate band in its trading subsidiary to build up reserves in the trading subsidiary. It is also possible to make use of the proportion of the nil rate band for any accounting period which straddles 31 March 2006.

Capital allowances

First year capital allowances for small companies has been extended from 40% to 50% for one year from 1 April 2006. A small company is a group or company which satisfies two out of the following three conditions:

1. No more than 50 employees.
2. Turnover not more than £5.6m.
3. Balance sheet assets of not more than £2.8m.

The claiming of capital allowances can reduce the amount of corporation tax payable on profits in the trading subsidiary and should not be ignored if the trading subsidiary has spent reasonable sums of money on buying plant and machinery for the purposes of its trade.

Mixed trading activities

New rules are being introduced in the Finance Act 2006 to apply for a chargeable period commencing on or after 22 March 2006. This is because HMRC are no longer able to treat a charity as carrying a number of separate trades but would have had to treat the charity as carrying on one trade. Therefore accounting periods ending on 31 December 2006 will still be within the old rules. The legislation will result in a separation of trade for tax purposes with the trade being split into:

1. A trade which is exercised in the course of carrying out a primary purpose of the charity i.e. primary purpose trading; and

2. A non-primary purpose trade which is not carried on by beneficiaries of the charity.

Tax relief for charities will be available for the primary purpose trade and any non-primary purpose trade which is carried on by the beneficiaries. This could lead to a possible loss of tax relief on profits of some charities. However this is better than the non-primary purpose trade tainting the whole of the charity's trade resulting in the loss of tax relief on the whole of the trade.

Charities may still be able to claim tax relief under section 46 Finance Act 2000 (Exemption for Small Trades). The requirements for the exemption of the small trades are that the income or profits are applied solely for the purposes of the charity and either:

1. The charity's gross income for the period does not exceed the greater of:
 - (a) £5,000; and
 - (b) the lesser of £50,000 and 25% of all the charity's incoming resources (i.e. profits) for the chargeable period. (These amounts are reduced pro-rata for chargeable periods of less than 12 months); or
2. The charity had, at the beginning of the chargeable period, a reasonable expectation that its gross income for the period would not exceed the requisite limits.

Anti-avoidance

Anti-avoidance provisions in the Finance Bill 2006 deal with the following issues:

1. Transactions with substantial donors.
2. Non-charitable expenditure.
3. Receipt of gifts or donations from companies.

Transactions with substantial donors

The mischief targeted by this particular legislation was individuals making substantial donations to charities on which they would then claim income tax relief and the individuals then receiving substantial benefits back from the charity. The new rules will prevent the charity claiming tax relief on the payment made to the substantial donor.

A substantial donor is an individual who gifts £25,000 or more in a 12 month period or £100,000 or more in a 6 year period. If the individual is a substantial donor for one chargeable period he is treated as a substantial donor to the charity in respect of the following 5 years. The legislation particularly targeted the following transactions:

- (a) The sale or letting of property by a charity to a substantial donor.
- (b) The sale or letting of property to a charity by a substantial donor.
- (c) The provision of services by a charity to a substantial donor.
- (d) The provision of services to a charity by a substantial donor.
- (e) An exchange of property between a charity and a substantial donor.
- (f) The provision of financial assistance by a charity to a substantial donor.
- (g) The provision of financial assistance to a charity by a substantial donor.
- (h) Investment by a charity in the business of a substantial donor.

There are certain exceptions to the new rules including transactions that take place in the course of the business carried on by the substantial donor or the charity which are on arm' length terms, and not for the avoidance of tax. Therefore a charity would have to show that any transactions with a substantial donor were on terms which would apply to any other person with whom the charity would deal in the ordinary course of carrying out the primary purpose of the charity.

Non-charitable expenditure

Section 505 of ICTA 1988 contains a mechanism that reverses tax relief granted to a charity where it incurs non-qualifying expenditure. The restriction of relief applies where a charity has relevant income and gains of more than £10,000, the charity incurs non-qualifying or non-charitable expenditure and the charity's qualifying charitable expenditure does not equal or exceed its relevant income or gains. Tax relief is disallowed if the qualifying expenditure is less than the relevant income with the amount being disallowed being equal to the non-qualifying expenditure. Until 22 March 2006 a de minimis amount of £10,000 had applied. This de minimis amount is being removed and it will result in a pound for pound claw back of tax relief on non-charitable expenditure. Any excess of non-charitable expenditure over total income in the current year will result in the excess non-charitable expenditure being carried back to earlier accounting periods.

Gifts from companies

Charities are subject to restrictions on the value they can pass to close companies making gifts or donations to the charity. A close company is a company that is controlled by five or fewer participators (generally the shareholders). These rules will now be extended to gifts or donations by all companies and therefore there will be a limit on benefits that may be received by the donor company from the charity. The limits are contained within section 339 ICTA 1988 in which no tax relief is available for companies where company receives benefits in consequence of making the gift that exceed the following limits:

1. For donations not exceeding £100, 25% of the gift.
2. For donations exceeding £100 but not exceeding £1,000, £25.
3. For donations exceeding £1,000, 2.5% of the gift up to a maximum of £250.

Therefore charities will need to keep records of the value of benefits received by all companies as a result of donations. In particular charities should consider reviewing sponsorship agreements which do not constitute trading.

Miscellaneous issues

The Budget and Finance Bill 2006 contained a number of miscellaneous issues which could have an impact on charities.

1. The home computer initiative was removed for new schemes adopted on or after 6 April 2006. Tax relief is still available if the computer equipment was provided to the employee on or before 5 April 2006.
2. An individual may only receive one mobile telephone from their employer free of tax under the benefits in kind legislation. Therefore it would not be possible to make available more than one telephone to an employee, for example, supplying telephones to spouses and children.
3. The national minimum wage will increase from October 2006 to the following levels:
 - Over 22 - £5.35 per hour
 - Age 18 to 21 - £4.45 per hour
 - Age 16 to 17 - £3.30 per hour

Action Points – Summary

- Utilise corporation tax nil rate band for accounting periods ending on or before 31 March 2006 to get retained profits for working capital in a trading subsidiary free of corporation tax.
- Do not forget to use any apportionment of the nil-rate band for accounting periods straddling 31 March 2006.
- Do not forget that the corporation tax bands are divided between group companies.
- Remember to claim capital allowances on plant and machinery particularly at the enhanced rate of capital allowances in the first year available for one year from 1 April 2006 for small companies.
- Ensure records are kept of income from non-primary purpose trading not carried on by beneficiaries of the charity.
- Ensure that no prohibited transactions are carried on with substantial donors.

- Limit as much as possible non-charitable expenditure to avoid claw back of tax relief on profits.
- Review the sponsorship agreements regarding benefits paid to all companies not just close companies.

If there are any questions about the details contained within this note please contact Andrew Evans at Geldards LLP, telephone 029 2039 1761 or email: andrew.evans@geldards.co.uk.

This briefing note is intended solely as an overview of the law. It was last updated on 28 April 2006. No responsibility can be accepted for the completeness or accuracy of this briefing note and professional advice should be taken in relation to any specific problems.

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