



Tax & VAT Update

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Charities – Direct & Indirect Taxes Update

The purpose of this note is to highlight certain areas involving direct and indirect taxes which charities may wish to consider following the Budget in 2007. This note deals with the following areas:

1. Changes to corporation tax rates.
2. Capital allowances.
3. Mixed trading activities.
4. Transactions with substantial donors
5. Non-charitable expenditure
6. Gifts from companies
7. Charitable Lotteries

Corporation tax rates

Companies with profits up to £300,000 will be taxed at a rate of corporation tax of 20% from 1 April 2007, increasing to 21% in 2008 and 22% in 2009. Companies with profits over £1.5m are currently taxed at the full corporation tax rate of 30% which will reduce to 28% from 1 April 2008. Profits between £300,000 and £1.5m will be taxed from 1 April 2007 at an effective rate of corporation tax of 32.5%. In reality the corporation tax calculation for companies with profits in the mid range band is much more complicated.

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 20% 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.

Capital allowances

First year capital allowances for small companies has been extended from 40% to 50% for a further year from 1 April 2007. 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 were introduced in the Finance Act 2006 to apply for a chargeable period commencing on or after 22 March 2006. This was because HMRC were 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 and there could have been a loss of exemption from tax on the whole of the trading profit. The changes to the rules result in a notional 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 exempt from tax); and

2. A non-primary purpose trade which is not carried on by beneficiaries of the charity (subject to tax)

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. The charity will need to apportion both income and expenditure between primary purpose and secondary purpose on a just and reasonable basis in order to calculate with reasonable certainty the turnover and profit from the secondary purpose trade which could be taxable.

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.

Charities that trade through their main charitable account will have to consider the motivation behind certain trading decisions, such as the inclusion of items for sale in a charity shop. Can a charity that cares for abandoned cats sell items that feature other animals? (Probably!). The rules may result in charities establishing a trading subsidiary to avoid the question.

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 and thereby deliberately using charities to facilitate tax avoidance. The new rules introduced in 2006 prevent the charity claiming tax relief on the payment made to the substantial donor. The intention of the legislation is to treat the transaction as non-charitable expenditure and deny the charity tax relief on income that would otherwise be exempt.

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. Therefore, a gift of £60,000 made on 5 March 1997 and a further gift of £45,000 on 15 February 2003 would trigger the provisions as would five annual gifts of £20,000. 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's 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.

Other exceptions include wholly owned subsidiaries of the charity; so the trading subsidiary can still gift aid its profits to the charity. Registered Social Landlords and Housing Associations will not be treated as substantial donors in relation to charities with which they are connected.

If an individual is a substantial donor and then enters into a prescribed transaction, any payment made by the charity will be treated as non-charitable expenditure. A de minimis limit applies where the amount of the benefit received is within permitted limits (see heading "Gift Aid").

Non-charitable expenditure

Section 505 of ICTA 1988 contains a mechanism that reverses tax relief granted to a charity where it incurs what is now called non-charitable expenditure previously called non-qualifying expenditure, i.e. when the expenditure does not directly relate to charitable activity. The restriction of relief applies where a charity has relevant income and gains, the charity incurs 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 has been 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 (including donations and legacies) will result in the excess non-charitable expenditure being carried back to earlier accounting periods and set against income, gains and donations of that period. The carry back can occur for up to six years.

Charitable expenditure is expenditure which is incurred exclusively for the purposes of the charitable objects. Non-charitable expenditure is not defined but presumably will include everything else. A charity that owns a building used for charitable purposes, such as a museum, which is also let for business functions on a commercial basis, may have to treat some of the money spent on up-keep of the building as non-charitable expenditure.

Gift Aid and 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 were extended in 2006 to gifts or donations by all companies and therefore there are limits on benefits that may be received by the donor company from the charity. For example, a company makes a donation to a museum and is entitled to hold a drinks reception at the museum. 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 limits.

Similar restrictions apply to the value of benefits individuals can receive in return for Gift Aid payments. The provisions for Gift Aid are now contained in the Income Tax Act 2007 which came into force on 6 April 2007. Tax relief will not be available if the benefits received in return for the donation 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, 5% of the gift up to a maximum of £500.

The limit for gifts over £1,000 was increased from 2.5% in the Budget 2007 when the overriding limit of £500 was increased from £250.

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

The Gift Aid limits will also apply to registered Community Amateur Sports Clubs ("CASCs") so that donations by individuals to CASCs will also qualify for tax reliefs.

With regard to admission rights linked to donations, a number of conditions must be satisfied in order for Gift Aid to be available.

1. The opportunity to make the gift and receive the right of admission as a consequence must be available to the public.
2. The right of admission must be granted by the charity for the purpose of viewing property (including buildings, grounds, plants, animals, works of art and artefacts) maintained by the charity for its charitable purposes. The admission cannot apply to performances.
3. The right of admission must apply during a period of at least 12 months at all times when the public can obtain admission. Access can be denied on up to five "event days".
4. As an alternative to the 12 month rule, the amount of the gift must exceed the normal admission charge by at least 10%.

Charitable Lotteries

The Finance Act 2007 will contain legislation to ensure that charities will continue to benefit from tax relief on the profits from lotteries. The existing law in the Lotteries and Amusements Act 1976 is due to be repealed by the Gambling Act 2005. If the legislation is not passed, the tax relief would have been lost. Large society lotteries will require a licence under the Gambling Act 2005. Large society lotteries are lotteries with proceeds that may exceed £20,000 in any one lottery or over £250,000 from lotteries in any 12 month period (paragraph 31, Schedule 11 Gambling Act 2005). The Gambling Act 2005 comes into force on 1 September 2007.

Indirect Taxes Update

The main indirect tax that affects charities and their day to day operations is that of VAT. This part of the note deals with changes involving:

1. Budget 2007 and the "change of use" charge.
2. Changes announced regarding the operation of "Lennartz accounting".
3. Selected VAT cases involving charities including:
 - the Church of England Children's Society
 - Michael Flemming t/a Body Craft
 - Ardenglen Developments Limited

Charities and the "change of use" charge

HMRC have announced a change in policy regarding the operation of Extra Statutory Concession 3.29 regarding the obtaining of zero rating for new buildings or construction services and a potential for a VAT charge when there is a change of use of the building within 10 years of the zero rate having been obtained.

A charity is entitled to zero rating of the supply of a new building or construction services to construct a new building or substantially reconstruction works of a listed building where the building is going to be used solely for a relevant charitable purpose. Under ESC 3.29 a charity was entitled to ignore non-qualifying use as long as a non-qualifying use did not exceed 10 per cent. The 10 per cent test could be applied on a basis of the total time the building is available for use, the floor space of the entire building or the head count of people using the building.

If the charitable use of the building fell below 90 per cent within 10 years of the zero rating the charity was subject to a change of use charge which involved a repayment of VAT in connection with the original construction costs.

With effect from 21 March 2007 HMRC would not enforce the self supply charge where there has been a change of use that was not anticipated at the time the zero rating was obtained under the ESC. This means that any charity will not be required to account for a self supply charge where the non-qualifying use subsequently exceeds 10 per cent within the 10 year adjustment period.

HMRC state that if it is apparent that, at the time that zero rating was obtained, it was intended that non-qualifying use would exceed 10 per cent within the 10 year adjustment period, HMRC would consider the original supply should never have been zero rated in the first place. This would mean that the original supply would be subject to VAT in the normal way.

If a charity has paid a change of use charge in the last 3 years it may be entitled to a refund of the VAT.

Lennartz accounting

Lennartz accounting derives from the positions of the European Courts of Justice ("ECJ") and the original decision involving Mr Lennartz in July 1991. Mr Lennartz was an employed and self employed tax consultant and sought to recover VAT on the purchase of his car in relation to his self employed business. Ordinarily where there was private use of an asset such as a car there was no right to the deduction of the VAT element of the purchase price. The ECJ held that taxpayers were entitled to treat a new asset as a wholly business asset, even if there would be some non-business use and even if the business use was very small. This means that the taxpayer can recover all the VAT incurred on the asset immediately and then account for VAT on any non-business use over the economic life of the asset. This spreads the cost of irrecoverable VAT over the economic life of the asset and results in a cash flow deficit for the tax authorities. If Lennartz accounting is not used the VAT is apportioned between the business and non-business use at the outset and there is no further adjustment.

In 2003 legislation was introduced which was intended to prevent Lennartz accounting on land and buildings in the UK. This legislation was rendered ineffective by the ECJ's decision in Charles and Charles-Tijmens (C-434/03). Subsequently HMRC accepted that Lennartz accounting could apply to land and buildings and adopted a policy that the economic life of the asset should be 20 years. Subsequently the ECJ decided in Wollney (C-72/05) that an EC member state could introduce legislation

to make the Lennartz accounting principle the same as a scheme for adjusting input tax on capital items (the UK's capital item scheme provides for a 10 year adjustment period).

The UK government has decided to act in relation to Lennartz accounting and the decisions of the ECJ. With effect from 1 September 2007 the ECJ'S decision in Charles and Charles-Tijmens will be implemented and the ineffective legislation will be repealed. In addition the ECJ decision in Wollney will be implemented and the period over which Lennartz accounting can occur will be limited to 10 years.

With effect from 21 March 2007 a loophole in the legislation will be closed to prevent anti-avoidance structures which could have enabled organisations to make a VAT saving of up to 50 per cent of the VAT initially incurred.

VAT cases

Church of England Children's Society ("CECS")

This was a case that was reported in 2005 but should still be considered by charities. CECS raised funds using professional fundraisers to secure regular donations from members of the public; these individuals are sometimes called "chuggers". Members of the public donating at least £5 per month received a copy of the charity's newsletter 3 times a year. The case involved the question of whether or not CECS could recover VAT charged on the fees paid to the professional fundraisers and the costs of publishing the newsletter. The High Court decided that the costs of recruiting the new donors related to the general business activity of CECS and should be treated as an overhead with the result that it was entitled to recover the related VAT. Therefore as the capital raised in transaction was for the purpose of the CECS's economic activity in general, the transaction has a direct and immediate link with the whole economic activity of a taxable person. The High Court also held that the newsletter was a deemed zero rated supply of printed matter and that the input VAT on the production and distribution costs could be recovered because it related to that deemed taxable supply.

Where the funds raised by the activities are used for wholly non-business activities i.e. not for the primary purpose of the charity, the VAT incurred on raising those funds would not be recoverable as allowable input VAT. Therefore any charity will have to carry out an apportionment of the income between charitable and non-charitable use. The rules regarding the gifts of business assets have changed and there is no longer a deemed supply when the total cost of production of any gifts does not exceed £50 in any 12 month period to any one donor. Therefore providing the cost of producing each newsletter does not exceed £50 the charity will be entitled to recover VAT incurred on the purchase or production of the newsletter.

Michael Flemming t/a Body Craft

This case was decided in 2006 by the Court of Appeal and may go all the way to the House of Lords. The facts of the case are rather complicated and involve the application of the statutory 3 year time limit on making claims for overpayment of VAT. The taxpayer had purchased 13 cars in 1989 and 1990 for the purposes of his business but failed to reclaim the input tax on 3 of the cars until 2000. In the meantime the 3 year time limit on claiming the VAT had been introduced. The Court of Appeal held on this case that the particular transitional rules were ineffective and the taxpayer should have been entitled to reclaim the VAT. HMRC accept that any claims for repayment of input VAT and error or mistake claims are not subject to the 3 year cap where the subject matter of the entitlement arose before 1 May 1997.

This case may have implications for charities and voluntary sector clients where they may have been entitled to reclaim VAT before 1 May 1997 but believed they had missed their right to reclaim due to the 3 year cap being introduced. As HMRC are appealing to the House of Lords any claims for VAT reclaims may wish to be delayed until the decision of the House of Lords is known. Full details of the claim including paperwork will need to be submitted and HMRC will not pay out the claim where they believe that the claim would result in unjust enrichment of the claimant.

Ardenglen Developments Limited

This case was reported in February 2007. Ardenglen Developments Limited was owned by Ardenglen Housing Association which wished to provide a building for the use of a charity called Fair Deal but was not eligible for European funding. Ardenglen Developments Limited leased the building to Ardenglen

Housing Association which sub-let it to Fair Deal. The question was whether the initial lease was the first grant of a major interest in land and therefore subject to zero rating. To qualify for zero rating the building had to be intended for the use solely for a relevant charitable purpose. HMRC denied zero rating because the lease and sub-lease were business transactions and consequently the building had not been used solely for a relevant charitable purpose.

The VAT tribunal allowed the appeal on the basis that it was clear that the intended use of the building was solely for the purpose of Fair Trade. The rents charged under the leases were not full market rents and were only intended to cover the costs of constructing the building. The tribunal held that the arrangement was designed simply to facilitate the use of a newly constructed building by a charity in a way which was consistent with the Housing Association's aims.

This briefing note is intended solely as an overview of the law. It was last updated on 5 April 2007. 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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