Cap on income tax relief for charitable giving

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Background

In the Budget 2012, the Chancellor announced controversial plans to introduce a general cap on the amount of income tax relief an individual can claim.

This cap will apply to donations to charity, including Gift Aid.

The cap will restrict the amount of income that can be offset by relief to £50,000 or 25% of a person's income, whichever is higher.

In this note we focus on the potential impact of this change on Gift Aid. (We use 45%, which applies from next year, as the higher rate of income tax throughout for consistency.)

This proposed change represents the first general restriction to the amount of tax relief available for gifts to charity since the 1990s when Gift Aid relief was introduced. For many philanthropists and charities this may have a major impact on donations.

There have been several motives touched on by Government when discussing this policy move.

1. *Responsibility to pay tax*

   The Government's information release on the measure indicates that it believes that tax reliefs are used by the wealthy to reduce their income tax to an artificially low percentage of income, and that those individuals should contribute more to Government costs.

2. *Leakage of UK wealth into the EU*

   Some commentators have cited the concern that donations to EU charities now qualify for UK income tax relief. As donations to EU countries can achieve UK tax relief the UK could be seen to be losing out on both tax and the value of the donation.

3. *Donations not worthy of relief*

   It has also been reported that this measure is a reaction to the wealthy using "piggy-bank" charities where little of the donation makes its way to charitable causes.

The first of the above three is the most commonly cited.

Underlying these reasons is the general sense that the Government continues to be concerned about the abuse of the charity tax system by a minority of taxpayers and charities.

Whatever the correct reasoning is, as the consultation opens on this proposal, it is important to understand the key facts relating to Gift Aid and to avoid unhelpful rhetoric in the debate.

We set out below some of the options for dealing with the concerns that could be the driving force for the proposals. A full understanding of the motives may be key to working with the Government to find an alternative, less harmful way to resolve its issue.

How Gift Aid and the cap works

Current system

Individuals making donations to charity can reduce their tax bill.

Although the mechanics are complex, the effect is that a higher rate tax payer taxes an amount of income equal to the gross gift at 20% instead of at 45%.

The charity reclaims the basic rate tax from HMRC, assuming it is registered to do so.

So, if a higher rate tax payer makes a donation of £1,000, his tax bill reduces by £312.50. The charity can reclaim £250.

One important point to note is that even if he gives all his income away, it is not possible for an individual to reduce his income tax to £nil using Gift Aid without further more complex arrangements being involved. If someone with an income of £10m makes a cash Gift Aid payment of £8m (treated by HMRC as a gross payment of £10m), his tax bill remains at c£2m, leaving him with a £nil after tax position. The charity should be able to claim back the £2m of tax paid. If the individual made a cash Gift Aid payment of £10m, he would still have a tax charge of c£2m, but without any income to pay the tax.

Overall, HMRC retains nothing - the tax benefit is split between the charity and the individual.

Proposed cap

The fears in the charity sector are that a cap would deter people from giving large donations to charities if they do not receive tax relief for the entire donation.

The following illustrates the position for an individual earning £2 million who gives £1.2 million to charity. The detailed workings that support these calculations are available from BDO's website.

	Under Existing Gift Aid rules			With Cap - Making the Same Gift			With Cap - Keeping the Same "Walk Away" income		
	Individual	Charity	HMRC	Individual	Charity	HMRC	Individual	Charity	HMRC
Gross income	2,000,000			2,000,000			2,000,000		
Donation to Charity	(1,200,000)	1,200,000		(1,200,000)	1,200,000		(950,000)	950,000	
Individual's Tax	(510,626)		510,626	(760,626)		760,626	(760,626)		760,626
Charity Tax Reclaim		300,000	(300,000)		300,000	(300,000)		237,500	(237,500)
"Walk away" income	289,374	1,500,000	210,626	39,374	1,500,000	460,626	289,374	1,187,500	523,126
Effective tax rate for individual	26%			38%			38%		

Based on the above example, assuming the donor would adapt their giving to keep their income after tax the same, the charity would be £312,500 worse off under the new rules whilst the Government would receive this instead of the charity.

Other charitable giving reliefs

As well as tax relief for cash donations to charity under Gift Aid, gifts of listed shares, securities and land also appear to be within the scope of the proposed cap.

Under current rules, income tax relief is available for an amount equal to the value of the gift. In addition, no capital gains tax is payable on the gift. A large donation of one of these assets could, therefore, bring an individual's income tax to £nil in a given year under current rules.

The high profile Vantis case from earlier this year, in which abuse of charity tax reliefs was proven to have taken place on a complex series of transactions, involved the use of the gifts of shares relief. HMRC may refer to this case as evidence of how the proposed cap would have prevented the loss of tax.

Protections already in place

At the start of this note we commented on some of the possible reasons for introducing this cap. The primary focus appears to be on it being appropriate for wealthy individuals to pay an appropriate proportion of their income as tax, irrespective of how they have applied that income. Earlier discussions also referred to continuing concerns over charity tax abuse.

If the concern is that donations to the EU can result in reduced UK tax with no benefit to the UK economy, then a cap on the level of relief would be a method of limiting the effect of this. However, the effect on the charity sector as a whole seems disproportionate to the level of offshore giving which could give rise to such a loss, and other options to counter this may be more appropriate.

Where abuse of the charity system is the concern, there already exist a wide range of powers within both tax and charity law to tackle this. These include those set out below.

HMRC does not appear to use the existing legislation to counter offensive transactions on a regular basis. One option may be for the Government to fund HMRC to take some cases to Court to test the use of the existing powers and set precedents as to how the Courts will react to scenarios HMRC considers a problem. The knowledge that HMRC can be successful in using current legislation could be a helpful factor in preventing further abuse.

Tax legislation

Non-charitable expenditure (Section 496, CTA 2010)

Where a charity incurs non-charitable expenditure (that is expenditure made otherwise than for charitable purposes only) this gives rise to a tax charge in the charity.

If the concern of the Government is that so-called "piggy-bank" charities are used by the wealthy to gain tax relief but the income is not spent on charitable causes, this legislation enables HMRC to clawback the tax relief given to the charity.

Tainted donations (Schedule 3, FA 2011)

The anti-avoidance legislation introduced in the 2011 Finance Act is specifically aimed at scenarios where individuals are giving to charity with the sole or main intention of receiving a financial advantage from the charity.

This legislation allows the clawback of the tax relief granted to the individual from the individual, or from the charity if it were complicit with the arrangements.

New charity definition (Schedule 6, FA 2010)

As a result of the Persche ruling in the EU courts, HMRC brought in a new definition of charity to include EU charities. Donations to EU charities can now attract tax relief in the UK.

Where HMRC is concerned that EU charity donations find their way to sham charities and eventually back to the donor then HMRC could exercise its powers within the new charity definition to insist that the EU charity meets the registration condition as well as the management condition (known as the fit & proper persons test).

Donor benefit rules (Section 418, ITA 2007)

Within the Gift Aid legislation there is a requirement that the donor does not receive substantial benefit from making the donation. These rules can prevent attempts to route money through a charity, attracting tax reliefs, with the benefit returned to the donor or people connected to them.

Non-tax requirements

In addition to tax powers, there are also duties on the charity trustees, auditors and the independent examiners, in addition to a range of powers available to the Charity Commission and other regulators.

Trustees

The trustees, if they are aware that the charity has incurred non charitable expenditure (i.e. if it has failed to meet the HMRC tests that qualify the charity for tax free status), must file accounts under self assessment demonstrating their liability. Failure to do so can result in penalties.

Auditors and examiners

Firstly, auditors and examiners should be considering whether the nature of the charity's activities generates a tax liability in the charity itself.

Secondly, the Charities Act requires them to report matters to the charity regulators where they have reasonable suspicion that a matter is of material significance. It is up to the relevant charity regulators to stipulate whether or not such activity would fall within such reporting. Auditors and examiners also have an additional public interest right to report.

Charity Commission

The Charity Commission in England and Wales can at any time enquire into the charity's affairs. In addition it has an additional little used power to order some charities to be audited where it considers it appropriate.

Possible alternatives / changes to the cap

A number of options have been proposed moving forward. The preference of the Charity Finance Group is option 1 from the below:

1. The Government continues with the overall policy of capping tax reliefs, but charitable giving reliefs are excluded from the cap. This is in recognition of the unique nature of receiving tax relief on giving and the important role that a strong charitable sector has in society.

2. Raising the cap for charitable giving. This option will be more complex and will reduce even further the revenue that this policy is worth to the Government. The impact on charitable giving may reduce, but this option would still be a marked change in tax incentives for giving and so will continue to have a behavioural impact.

3. Allowing individuals to roll over unused tax. This would not necessarily be useful for donors currently making yearly contributions and may lead to the deferral of donations. This would also make it more complex and difficult to give large sums to charity.

4. Changing the system so that the higher rate relief available to the donor is always re-directed to the charity along with the Gift Aid reclaim. This would remove any benefit to the donor but would not raise the amount of tax paid to HMRC. The donor may reduce the amount they give in order to make up for this change. There may also be a significant cost to HMRC, as currently the vast majority of higher rate tax payers are not claiming the tax relief they are entitled to.

Contacts

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