

Tax Law Rewrite – Bill 6

Responses to Papers CC/SC (07) 43

Charitable Companies

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<http://www.hmrc.gov.uk/rewrite> [April] 2008

INTRODUCTION

1. In November 2007 we published Committee Paper CC/SC (07) 43 on the HMRC internet website www.hmrc.gov.uk/rewrite. The closing date for responses was 29 February 2008. The draft clauses rewrite the legislation concerning charitable companies.
2. The purpose of this response document is to provide details of the substantive technical points made and to explain our analysis and proposals in respect of them. Minor points, such as suggestions to improve punctuation, are not covered but all

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comments received have been carefully considered. Some respondents made useful suggestions about the explanatory notes. We have not commented on these in every case but we will revisit the explanatory notes with them in mind.

3. Several respondents made policy suggestions for reform. Such issues are outside the remit of the Tax Law Rewrite project but we have passed them to the relevant specialists for consideration. These will be dealt with separately and discussed with our Committees.

4. In particular, two respondents proposed a full review of the substantial donor rules. The Chancellor announced a consultation on these rules in his Budget on 12th March 2008.

5. One respondent proposed that the opportunity should have been taken to expand on the meaning of “applied for charitable purposes” or “applied to the purposes of the charitable company”. Our view is that this should be done in guidance rather than in statute as the latter would risk imposing a structure that is insufficiently flexible to respond to developments in the sector generally and to developments in charity law that underpin the term “charitable purposes”.

6. The legislation largely replicates the equivalent for income tax in sections 518 to 564 of ITA. We received a number of suggestions for minor drafting improvements which introduce differences between the wording for the income tax version of a provision and its corporation tax equivalent. Whilst we understand why the drafting change has been suggested in each case, we have as a general principle adopted the income tax wording, except where specific corporation tax considerations apply.

7. A number of minor changes were proposed in the Committee Papers, all but one of them replicating the changes made for the equivalent income tax legislation in ITA. Where no mention is made of these in this response document, they either received approval or were not mentioned in responses.

8. We received written responses from the following:

- The Chartered Institute of Taxation
- The Institute of Chartered Accountants in England and Wales
- The Charity Law Association
- Bircham Dyson Bell LLP
- Horwath Clark Whitehill

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- Three individuals

9. The following abbreviations for tax legislation are used in this response document:

- CAA Capital Allowances Act 2001
- FA Finance Act
- ICTA Income and Corporation Taxes Act 1988
- ITA Income Tax Act 2007
- ITEPA Income Tax (Earnings and Pensions) Act 2003
- ITTOIA Income Tax (Trading and Other Income) Act 2005

10. We are grateful for all the comments made, many of which were detailed, and we appreciate the time and effort that went into them. We are sending each respondent a copy of this response document.

Clause 2: Meaning of “charitable company”

Assuming the intention is to continue to apply the English definition of “charitable purposes” (as set out in the Charities Act 2006) it would be useful for the definitions applicable to clause 2 to make that point clear

11. The charitable tax exemptions have not historically linked the term “charitable purposes” to the usage in general charity law, and tax law has itself built up a body of case law in support of the terms used in charity taxation. Therefore, it is possible that adoption of the definition from the Charities Act 2006 might change the effect of the law as it stands.

12. *We do not propose to define “charitable purposes” by explicit reference to the definition in the Charities Act 2006 but will pass this comment to policy colleagues.*

Clause 3: Gifts entitling donor to gift aid relief: income tax treated as paid

We note the inclusion now (and in clauses 4(6) and 5(6)) of the National Endowment for Science Technology and the Arts within the meaning of “charitable company”. As this body is not listed in s507 ICTA it may be helpful to explain the authority for this in the Explanatory Notes.

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13. As explained in paragraph 70 of the Explanatory Notes, in relation to clause 20, the National Endowment for Science Technology and the Arts was added to the list of bodies granted exemption under section 507 of ICTA by section 24 of the National Lottery Act 1998. We agree that it would be helpful to make this point in the explanatory note for clause 3.

14. *We agree. We will include a reference to the source legislation in the explanatory note for clause 3.*

Clause 3(5) deems certain institutions to be charitable companies. The inclusion here of the British Museum and the Natural History Museum appears to be unnecessary as they have charitable status under charity law.

We note that Change 79 in ITA managed to omit references to these two bodies as they are statutorily defined to be charitable.

15. Paragraph 67 of the explanatory notes explains that the named bodies are treated as eligible for the charitable exemptions that would apply to a charitable company where the whole of the charitable company's income is applied for charitable purposes.

16. We interpret this as meaning that these bodies are deemed to have met this particular test. As a result, they are in a more advantageous position than if they relied simply on their own charitable status.

17. Therefore we concluded that removing these two bodies from the list could represent an adverse change in their eligibility for exemption.

18. Change 79 in ITA relates to Gift Aid. In that context, these two bodies' charitable status is sufficient for them to benefit from the legislation and there was no need to mention them specifically. As explained above, continued inclusion in clause 20 puts these bodies in a slightly more favourable position for the corporation tax exemption than if they had to rely solely on their charitable status.

19. *We do not propose to delete these two bodies from the list in clause 3*

Clause 4: Gifts entitling donor to gift aid relief: corporation tax liability and exemption

Clause 5: Gifts of money from companies: corporation tax liability and exemption

Would clauses 4(2) and 5(3) read better as "corporation tax is charged under this section on the gifts"?

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20. Clauses 4(2) and 5(3) replicate the wording of the equivalent income tax rules in sections 521(2) and 522(3) of ITA. Whilst we acknowledge that the suggestion has merit we feel that on balance the better course is to maintain equivalence between the income tax and corporation tax codes wherever possible.

21. *We do not propose to amend the clauses in the way suggested.*

Clause 4(4) requires the donations to be applied for charitable purposes which might be difficult for the non-charities (NHMF, NESTA, English Heritage and some SRAs) who we think are exempted from this requirement by the final part of sections 507 and 508(1) ICTA.

22. We agree. The source legislation in section 25 of FA 1990 treats these receipts as annual payments chargeable to tax under Schedule D Case III. Exemption for such receipts is given by section 505(c)(ii) of ICTA, and extended to specified bodies by section 507 of ICTA.

23. As explained in relation to clause 3 the source legislation confers potentially more favourable treatment on the bodies that fall within section 507 of ICTA in that it deems the test of applying the income for charitable purposes to be met.

24. The same point arises in relation to clause 5(5), except that in this case the extension also applies to scientific research associations by virtue of section 339(4) and section 508(1) of ICTA.

25. *We agree. We will amend the legislation to ensure that these bodies are in no worse position than under the source legislation.*

Clause 6: Payments from other charities: corporation tax liability and exemption

Clause 6(2) provides that the charging of payments received from other charities to corporation tax does not apply to payments arising from a source outside the UK. As a foreign charity is not currently recognised as charitable under UK law, and it is difficult to see how a payment from a UK charity could have a foreign source, this provision appears to be unnecessary.

26. This point was also raised in consultation on the equivalent income tax provision in ITA. We observed then that the probability of a charity making a payment from a source outside the UK is likely to be small. However, if a charitable company were to receive such a payment the effect of deleting subsection (2) would be that the payment could become subject to corporation tax. This effect could only be adverse to the taxpayer so, as with ITA, we think it appropriate to retain the subsection.

27. *We do not propose to delete clause 6(2).*

Clause 7: Exemption for profits etc of charitable trade

We note that the condition in this clause is that the profits must be applied to the ‘purposes of the charitable company only’. This is a slightly more restrictive condition than currently contained in s505(1) ICTA 1988. We suggest that the condition of applying the profits for ‘charitable purposes only’ be retained.

28. Whilst some parts of section 505(1) of ICTA use the term “charitable purposes only”, the source legislation for clause 7, contained in section 505(1)(e) of ICTA, requires that the profits of the trade must be applied solely to the purposes of the charitable company. Clause 7 is therefore faithful to the source and making the change suggested would represent a policy change.

29. ***We do not propose to amend the clause.***

The exemption for profits from a charitable trade also applies to post-cessation receipts which the charity receives or which the charity is entitled to receive if the profits or receipt are applied for charitable purposes only. How does a charity “apply” a post-cessation receipt that it is entitled to but has not physically received?

30. ***We do not propose to amend the clause but will pass this comment to policy colleagues who are responsible for the relevant guidance material.***

Clause 8: Meaning of “charitable trade”

Clause 8 provides for the apportionment of trading expenses and receipts and post-cessation receipts where different parts of a trade are to be treated as separate trades under clause 8(2) or (3). We consider that a just and reasonable apportionment should also be applied where the trade gives rise to adjustment income or capital allowances.

31. As explained in paragraph 20 of the explanatory notes, adjustment income is treated for corporation tax as a receipt or expense of the trade by section 64 of, and Schedule 22 to, FA 2002. Specifically, paragraphs 4 and 5 of Schedule 22 treat adjustment income as a receipt or expense of the trade. Therefore, the apportionment rule in clause 8(4)(a) covers adjustment income. We will add these specific references to the explanatory note.

32. Under section 2 of CAA, capital allowances are taken into account in computing profits of a trade. Whilst this is not as explicit as paragraphs 4 and 5 of Schedule 22 to FA 2002 it nonetheless contains a clear implication that capital allowances are to be dealt with as receipts or expenses of the trade.

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33. The equivalent rule for income tax is in section 525 of ITA. Specific mention is made of adjustment income because for income tax it is brought into account separately from the receipts and expenses of the trade. This is different from the corporation tax position. There is no specific rule for capital allowances in section 525 of ITA and none is necessary for corporation tax.

34. ***We do not propose to amend the clause but will provide further clarification in the explanatory notes.***

The word “primary” is arguably surplus in clause 8(1)(a) (although we appreciate the phrase “primary purpose trading” is commonly used).

35. The drafting reflects the source legislation and replicates the equivalent income tax rule in section 525 of ITA. The term is well understood in practice – for example the primary purpose of an educational charity is the delivery of education. Trading activities that do not meet this test will not qualify for the exemption, unless they fall within another specified exemption. Removing the word “primary” could have the effect of changing the substance of the law.

36. ***We do not propose to delete the word “primary” from clause 8.***

Clause 10: Exemption from charges under Case VI of Schedule D

We are unable to understand why section 776 ICTA 1988 is included in clause 10(2). Section 776 is an anti-avoidance section that applies where a capital gain is made from property development and the gain is reclassified as income taxable under Schedule D(VI). If the charity was trading in property the small-scale trading exemption would apply. There seems no reason for the small-scale exemption not to apply to property development gains.

37. The exclusion from the scope of the relief of income chargeable under section 776 of ICTA is explicitly stated in the source legislation at section 46(2A) of FA 2000. This is therefore a suggestion for a change in policy that is outside the scope of the project.

38. ***We do not propose to amend the clause but will refer this suggestion to policy colleagues***

Clause 11: Condition as to trading and miscellaneous incoming resources

The key change in the Bill is the substitution of the concept of “incoming resources”, the accounting concept used in the SORP, for “gross income”. However, many charities – in particular smaller charities – are not required to fully implement the SORP. The accounting term is less easy for charities to apply in practice and there is a risk that charities will fail to calculate their

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incoming resources correctly, thereby inadvertently exceeding the limits set down in the clause.

39. As explained in the explanatory notes to these clauses and the explanatory notes to ITA the change was intended to assist charities by linking the limits that apply to the exemption with the accounting concept that we anticipate the vast majority of charities will use.

40. In the case of charitable companies, although not all are required to fully implement the SORP, all are required to account on an accruals basis, and the model form of accounts provided for them on the Charity Commission website uses and explains the term “incoming resources”.

41. We do not therefore anticipate that charitable companies will encounter significant difficulties in applying this concept.

42. The term “incoming resources” was also used in the equivalent income tax legislation in section 528 of ITA. This applies to charities established in the form of trusts rather than companies and is likely to include many small charities applying a wider range of accounting standards where more issues of this nature might have arisen. Nonetheless, the change was welcomed in relation to that legislation and it is therefore appropriate to adopt the same approach for corporation tax.

43. ***We propose to retain the term “incoming resources” in clause 11***

Clause 11(6)(b) is unclear. On one reading it suggests that because the “requisite limit” must not be less than £5000, taxable income below this threshold is not exempt, because it can’t exceed the “requisite limit”.

44. Clause 11(1) stipulates that the charitable company’s incoming resources must not “exceed the requisite limit for the period”. The definition of “requisite limit” is in clause 11(6). The structure of clause 11(6) is that the words “must not be less than £5000” qualify the term “requisite limit”, but the respondent suggests that those words could be read as qualifying the term “incoming resources” in clause 11(6)(a).

45. The clause reproduces the equivalent legislation for income tax in section 528 of ITA. We think that the correct construction is clear enough, but will look at the explanatory notes to see if the point can be explained more fully.

46. ***We do not propose to amend the clause but we will provide further clarification in the explanatory notes.***

The formula might not always give rise to a reduction in the amounts (although it cannot give rise to an increase). For example, the accounting

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period might run from 1 March 2011 until 28 February 2012, a period of 365 days but short of 12 months. A varying denominator has been used in ITEPA: see for example section 143.

47. As explained in Change 652 the reason for adopting a set period of 365 days as the denominator is to provide certainty. Otherwise the denominator could be subject to debate, albeit with only a minor impact.

48. In contrast, provisions such as section 143 of ITEPA, mentioned by the respondent, take the tax year as the denominator, which can therefore only give a known period of 365 or 366 days – and this figure will never be in doubt.

49. ***We do not propose to adopt a variable denominator.***

Clause 12: Exemption for profits from fund-raising events

Clause 12 is intended to give statutory form to an exemption currently based on Extra-Statutory Concession C4. While the clause appears to preserve the nature of the concession in so far as it applies to events organised by charities, it is unclear whether HMRC now intends to withdraw the concession. If a non-charitable association organises one or more qualifying fundraising events for the benefit of a charity, the profits of those events would be taxable under current law in the absence of the concession. If the concession is withdrawn, it would be possible in principle for the association to eliminate its taxable profits by making a donation to the charity that qualifies for corporation tax relief. To be effective the donation would have to be made before the association's financial year end, i.e. before the accounts for that year are available and before the precise amount of profits has been determined, and be made in cash, shares or land. In these circumstances, the withdrawal of the concession might pose significant practical problems for such associations and would be undesirable.

50. ***We do not propose to amend the clause but will refer this point to policy colleagues.***

The exemption is linked to the definition of a VAT-exempt event per Group 12, Schedule 9 VATA 1994 and it may be helpful to include this text in full within this clause rather than having to refer separately to VATA 1994.

51. We do not usually reproduce material from other legislation, particularly where it is substantial. It would, for example, require that the inserted text is kept in line with amendments to the legislation.

52. ***We do not propose to include the suggested text in the legislation, but we will pass the comment on to policy colleagues who have responsibility for the relevant guidance material .***

Clause 14: Exemption for property income etc

Clause 14 defines the scope of the property income eligible for this exemption by reference to the corporation tax law definitions of trading income and property income proposed to be included in Bill 5. It appears that this approach effectively excludes Case VI income arising from transactions in land under section 776 ICTA 1988. Under current law section 505 (1)(a) ICTA 1988 exempts from tax under Schedules A or D “any profits or gains arising in respect of rents or other receipts from an estate, interest or right in or over any land” (whether situated in the UK or not). HMRC takes the view that the existing legislation does not exempt section 776 income, but some professional advisers dispute this. The issue has not been tested in a court or tribunal. Charities will be concerned that the Bill will remove their right to argue the point in an appropriate case. It is suggested that this proposal warrants explicit consideration and approval by Parliament.

53. ***We do not propose to amend the clause but will refer the point to policy colleagues***

Clause 14 relates to the exemption for income from interests in land, ie: rental income, where the estate, interest or right in land is “vested in any person for charitable purposes”. This is not a new concept, but the rewrite may be an opportunity to clarify what is meant by “vested” for charitable purposes.

54. This term derives from general charity and land law and its interpretation. Its use for tax needs to move in step. Putting in place specific tax interpretation in the legislation would risk imposing a structure that was insufficiently flexible to respond to developments in the sector generally and to developments in general law that underpin the term.

55. ***We do not propose to amend the clause but will pass this comment to colleagues who are responsible for maintaining guidance material.***

Clause 15: Exemption for investment income and non-trading profits from loan relationships

Clause 15 (2)(a) exempts charitable companies from non-trading profits on loan relationships. This exemption currently covers income from certain derivative transactions, such as interest rate swaps. However, there is currently no equivalent exemption for charitable trusts except to the extent that the income qualifies for the exemption for small-scale miscellaneous

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income. While we appreciate that this anomaly has resulted from the introduction of a tax regime that is specific to corporate loan relationships, we consider that it raises a tax policy issue in that the classification of an item of income as exempt or taxable in the hands of a charity should not be affected by the taxpayer's choice of legal form.

56. As the writer notes, this is a policy point and therefore outside the scope of the project.

57. *We do not propose to amend the clause but will refer the point to policy colleagues.*

Clause 16: Exemption for public revenue dividends

We repeat the comments made in the context of income tax and request that a policy decision is made to widen the scope of this exemption. Many faith buildings are used for a number of worthwhile community-focused purposes, for example day cares, schools, polling stations, blood donation clinics etc together with many faith-based social functions. However, with the exception of the predominantly Christian places of worship (cathedrals, colleges, churches or chapels) the exemption will not be available where the building has even occasional other uses. In addition, the term "college" could be given a broad meaning far beyond that of a place of worship.

58. *We do not propose to amend the clause but will refer the point to policy colleagues.*

Clause 17: Exemption for offshore income gains

Why does clause 17(2) refer to the "gain" in the singular when subsection (1) refers to "gains"?

59. Clause 17(1) replicates section 535(1) of ITA, which uses the plural to fit with the overall scheme of the legislation. That is, the exemptions are expressed in relation to the exclusion of certain income from the calculation of "total income". Therefore, the appropriate structure is for "gains" to be used to denote all such offshore income gains. We envisage that Bill 6 will have a similar structure for corporation tax and therefore "gains" in the plural is appropriate in clause 17(1).

60. Clause 17(2) involves the application of a test, which only makes sense in relation to each individual offshore income gain. Otherwise the exemption would require every single offshore income gain to meet the test, which would represent a change in the law that is adverse to taxpayers.

61. *We do not propose to amend the clause in the way suggested.*

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Unless it is contrary to drafting conventions, we would prefer the replacement of “applies if” in subsection (2) with “applies only if”.

62. As noted above, our preferred approach is to maintain parity with the equivalent ITA provision where possible. In this case the draft does not do this – we are grateful to the respondent for drawing this to our attention.

63. ***We agree. We will amend clause 17(2) to read the same as its ITA equivalent.***

Clause 18: Exemption for certain miscellaneous income

Question 10 states that the proposal is to reflect in the legislation exemption for income from intangible assets that is not covered by other exemptions. This is a little misleading in that it does not cover all income – for instance, income from non-charitable trading, so that some income from intangibles remains outside the exemption.

64. We recognise the point and will reflect it in the explanatory notes.

65. ***We will provide further explanation in the explanatory notes and Change note.***

Clause 18(3)(a) exempts charitable companies from non-trading gains and qualifying income on intangible fixed assets. This exemption currently covers income and gains arising on intangible fixed assets created or acquired after 31 March 2002. However, there is currently no equivalent exemption for charitable trusts which are therefore exposed to taxation on miscellaneous income arising on the disposal of patents. While we appreciate that this anomaly has resulted from the introduction of a tax regime that is specific to corporate intangible fixed assets, we consider that it raises a tax policy issue in that the classification of an item of income as exempt or taxable in the hands of a charity should not be affected by the taxpayer’s choice of legal form.

We would appreciate more guidance (perhaps on the HMRC website) as to what are trading and non-trading gains. The intangibles legislation is written very much with commercial companies in mind, and in our experience charities have a range of intellectual property that does not fit neatly within a commercial framework. HMRC must have debated these issues and come to some conclusions in particular with the university sector, and it would be useful for other charities to benefit from this experience.

66. Both of these points are outside the scope of the project. We will refer them to policy colleagues.

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67. *We do not propose to amend the clause, but will refer these points to policy colleagues.*

Clause 20: National Heritage Memorial Fund, Historic Buildings and Monuments Commission for England etc

Clause 20 provides for exemption from tax for certain listed qualifying bodies. The inclusion in the list of the Trustees of the British Museum and the Natural History Museum, both of which are recognised as charitable under charity law, appears to be unnecessary.

68. Paragraph 67 of the explanatory notes explains that the named bodies are treated as eligible for the charitable exemptions that would apply to a charitable company where the whole of the charitable company's income is applied for charitable purposes.

69. We interpret this as meaning that these bodies are deemed to have met this particular test. As a result, they are in a more advantageous position than if they relied simply on their own charitable status.

70. Therefore we concluded that removing these two bodies from the list could represent an adverse change in their eligibility for exemption.

71. *We do not propose to delete these two bodies from the list in Clause 20*

We would request confirmation that these bodies would, but for this clause, be assessable to corporation tax.

72. These bodies are all unincorporated associations that fall within the extended meaning of a company in section 832(1) of ICTA. They are, therefore, subject to corporation tax.

73. *These bodies are within the charge to corporation tax.*

Clause 21: Scientific research associations

Clause 21 provides similar exemptions for scientific research associations (SRAs). Whereas gifts of money to SRAs are deemed to be gifts to charitable companies under clause 5(6)(f), SRAs are not themselves deemed to be charitable companies but must instead meet the conditions specified in clause 21 to qualify for these exemptions. Under current law charitable SRAs can claim the charity exemptions independently of the relief for SRAs in section 508 ICTA 1988 if they wish to do so. We assume that the drafting of this clause is not intended to change the current position.

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74. Section 508 of ICTA provides for exemptions in the case of a Scientific Research Association (SRA) that meets the necessary conditions in section 508(1). The exemptions are the same as those provided for charitable companies in section 505 of ICTA, and for those purposes the SRA is deemed to have applied all its income to charitable purposes.

75. Where the SRA itself meets the charitable tests it can qualify for the exemptions available to charitable companies under section 505 of ICTA in its own right. In order to obtain exemption in this way it would have to meet the necessary requirements about the application of its income to charitable purposes.

76. It is possible that an SRA might qualify for exemption by one or other of these routes, or by both of them – although it would be rare for a charitable company to also seek recognition as an SRA. The legislation is not intended to preclude one of those routes simply because of the availability of the other. This is unchanged from the current position. We will clarify the point in the explanatory notes.

77. *We do not propose to amend the clause but will provide clarification in the explanatory notes.*

Clause 23: Requirement to make a claim

Clause 23 requires a charity to claim each of the exemptions from tax under this part of the Bill. In practice, most charities do not currently make formal claims for the exemptions to which they are entitled. Nor do most charities submit annual tax returns, unless required by HMRC to do so. We doubt whether HMRC seriously intends that all charities should submit formal claims, as it does not have the resources to handle this level of claims individually. If the reality of the situation cannot be addressed in the Bill, it would at least be useful for HMRC to produce explicit guidance on the claim mechanism for charities, and its interaction with self-assessment when no claim is actually filed.

78. The requirement to make a claim is clear in the source legislation. It is necessary to ensure that, where circumstances require, a formal claim is made to put in place the necessary appeals and decision procedure.

79. *We do not propose to amend the clause but will refer this point to colleagues who have responsibility for guidance material.*

Clause 24: Restrictions on exemptions

Clauses 24 to 27 relate to the restriction on charitable exemption and mirror the existing provisions. It would however be helpful if the provisions relating

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to the carry back of excess non-charitable expenditure (clauses 47 to 49) were included immediately after clauses 24 to 27.

80. These clauses replicate the equivalent income tax provisions in sections 539 to 542 of ITA. Clauses 47 to 49 replicate sections 562 to 564 of ITA. We acknowledge that the rearrangement suggested could have been a viable option for this part of the legislation but we have preferred as a general rule to maintain equivalence with the relevant income tax legislation wherever possible.

81. ***We do not propose to alter the placement of these clauses.***

Clause 28: Meaning of non-charitable expenditure

1 Clause 28 substantially expands the scope of the current definition of non-charitable expenditure, as recently amended by section 55 Finance Act 2006. Under current law, it is submitted that the issue of whether expenditure is charitable or non-charitable is properly determined by reference to charity law, save where tax law specifically provides otherwise. The Bill seeks to substitute a wide-ranging tax law based definition which will involve the classification as non-charitable of various categories of expenditure that would currently be regarded as charitable under charity law. In particular, the treatment of losses incurred in a non-exempt trade or business or miscellaneous transaction as non-charitable is controversial. It cannot be right that the classification of such expenditure as non-charitable depends on the financial outcome of the venture over each financial period. It is said that the change accords with current practice, but the practice of HMRC in this area is contested by charity advisers. The issue has not been tested in a court or tribunal. Charities will wish to retain the right to argue the point in appropriate cases.

As a result of the changes introduced by section 55 Finance Act 2006, each item of non-charitable expenditure reduces the value of a charity's income exemptions on a pound for pound basis. While this will not lead to a tax liability to the extent that the loss can be set off against the income that would otherwise be taxable, the charity is effectively being denied the ability to use a loss that would be available for relief if it had been incurred by other taxpayers. In cases where the charity cannot satisfy HMRC that the business has been carried on a commercial basis, no loss relief will be available and the charity will incur a tax liability. The adverse impact of this proposal on charities is potentially significant. It is considered that charity law is the appropriate test for determining whether expenditure is charitable. If HMRC wishes to change this, it should seek explicit consideration and approval by Parliament.

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2 *We do not support the blanket inclusion of all trading losses on non-charitable trading as non-charitable expenditure (clause 28(1)(a)). We raised this issue in our comments on the parallel trust legislation, but it is in fact more relevant for companies as in our experience it is more common for charities which are trading to be incorporated.*

We agree that in certain circumstances such losses might be non-charitable expenditure, if the Trustees were in some way negligent or did not seek to minimise losses. However, the losses may be planned, as in the early years of the trade, or they may be covered by profits from the same activity, either brought forward from earlier years or made in future years, or relieved against other profits from non-charitable trading. The proposed legislation is not flexible enough to take into account all these mitigating circumstances.

We therefore suggest the inclusion of a phrase into clause 28(1)(a)(iii) such as: “When all relevant circumstances are taken into account the loss is determined in the judgement of an Officer of Revenue and Customs not to be non-charitable expenditure”, and the judgement would be subject to review by the Special Commissioners. Alternatively, we suggest only treating non-charitable trading losses as non-charitable expenditure where there is no tax relief available for them under Part X, Chapters 2, 3 and 4 of ICTA 1988, which deal with loss relief for corporation tax and group relief.

The same adjustment should be made in relation to clause 28(1)(b).

82. There were two substantive responses to this clause, as set out above. They are couched in different terms but make essentially the same point. This point was made and considered in the consultation on the income tax legislation for charitable trusts in ITA, as noted by one of the respondents. In our response we stated:

in relation to a trade the consequence of not following the losses approach would be that the expenditure would be the debits or resources expended/costs and this would be funded by credits or incoming resources/turnover – and this would need to form part of available income. But available income (or “relevant income” as it is called in the source legislation) includes the profit not the turnover – so logic dictates that “qualifying expenditure” and “non-qualifying expenditure” in this context should take account of certain losses.

83. There is no reason for this analysis to be any different in the case of a charitable company chargeable to corporation tax, and we consider that it would be inappropriate for the legislation to differ between charitable trusts and charitable companies, unless there is a specific reason related to income tax or corporation tax, as that could potentially influence the behaviour of charities in adopting a particular structure for tax purposes.

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84. The second response set out above makes some specific suggestions, which are again policy issues outside the scope of the project, and which would also affect the equivalent income tax legislation.

85. ***We do not propose to amend the clause, but will refer these comments to policy colleagues.***

Should the clause be retained in its present form, the effect of the current wording of clause 28(1)(d) on expenditure in a non-exempt trade qualifying for capital allowances needs to be clarified. At present, most forms of capital expenditure that qualify for capital allowances attract allowances at rates substantially below 100%. In these circumstances, it appears that the amounts “required to be taken into account” in computing the profits or losses of a trade or business each year could be interpreted as the amount of the capital allowances given in the relevant year rather than the amount of the total capital expenditure shown in the charity’s accounts that is eligible for such capital allowances. We assume that this is not intended, but the drafting is unclear. Charities should at least have the option to treat such expenditure as charitable expenditure in the year in which it is incurred, instead of the expenditure being treated as charitable (or not being treated as non-charitable) when it is written off for tax purposes in accordance with the relevant rate of capital allowances.

86. Clause 28(1)(a) sets out the position for a loss computed for tax purposes. Clause 28(1)(d) deals with expenditure not taken into account in computing a loss for tax purposes, including capital expenditure. Clause 31 says that expenditure should be taken into account when GAAP requires it to be taken into account, even if the accounts are not drawn up on the basis of GAAP. Capital expenditure is taken into account by being included as an asset in the balance sheet for the full amount on purchase.

87. Therefore, the effect is that the full capital expenditure is taken into account under clause 28(1)(d) and not the amount of capital allowances.

88. ***We do not propose to amend the clause, but will refer the comment to colleagues who are responsible for guidance material.***

Clause 32: Section 28(1)(d): payment to body outside the UK

This relates to payments made by UK charities to bodies outside the UK and requires that the charity takes “such steps as are reasonable in the circumstances to ensure that the payment will be applied for charitable purposes”. This is not a new requirement but the rewrite may be an opportunity to explain what this actually requires.

89. *We do not propose to amend the clause but will refer the comment to colleagues who are responsible for guidance material.*

Clause 36: Non-charitable expenditure in substantial donor transactions

We do not support the inclusion of the substantial donor rules in this legislation because we believe that these rules apply too widely and too rigidly. We are not aware of any transactions with substantial donors which are caught by this legislation that would not be caught by the pre-existing legislation on non-charitable expenditure and non-charitable investments. The substantial donor rules do however apply to wholly innocent transactions where the charity is not disadvantaged and where no tax avoidance takes place. For instance, if a charity buys a property from a substantial donor who is not a property dealer, even if it is on the open market and at market value, the charity is penalised.

We therefore suggest that clause 36(1) should be deleted. We have no objection to clause 36(2) as this only applies where the charity is disadvantaged by a transaction.

Alternatively we suggest amending clause 36(1) so that it only applies to circumstances where there is actual tax avoidance.

90. The change suggested is a policy change that is outside the scope of the project. The Chancellor announced a consultation on the substantial donor rules in his Budget of 12 March 2008.

91. *We do not propose to amend the clause but will refer these to policy colleagues.*

Clause 41: Connected charities

We suggest that, as an aim of the Rewrite project is to make the legislation clearer, the opportunity should be taken to use a different word here than ‘connected’. The word is used with a different meaning in two other places within the substantial donor provisions. This can lead to confusion and is unnecessary. We also consider that the meaning of ‘connected’ in clause 41(2) is not clear and could usefully be expanded.

92. The definition is taken directly from the source legislation and is well understood in the charitable sector. The words “connected in a matter relating to the structure, administration or control of a charity” apply where there is, for example, a common board of directors or trustees overseeing two charities with different but related purposes. Some charities, for example, prefer to hold property in a separate charitable company.

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93. The distinctions between the two usages are clear from the drafting. In clause 41 the term “connected” refers to two or more charities, whereas in clause 42 it refers to “a substantial donor or other person”. Clause 41(2) clearly limits the meaning in clause 41 to that specific purpose only. The same definition applies for income tax in section 556 of ITA, and we do not think it would be helpful to introduce a different definition for corporation tax. However, we will revise the explanatory notes to draw attention to and clarify the different usages.

94. *We do not propose to amend the clause but will provide further clarification in the explanatory notes.*

Clause 42: Substantial donor transactions: supplementary

The meaning of ‘connected’ in clause 42(1)(a) appears to have been omitted. We assume it is meant to have the meaning in s839 ICTA 1988 as set out in s506C(7).

95. The source legislation makes explicit reference to the definition of ‘connected person’ in section 839 of ICTA, which applies only where it is specifically applied by the legislation. Section 1021 of ITA applies the definition generally unless it is specifically disapplied by the legislation. We are still developing the interpretation material for Bill 6 and will ensure that the correct link is made between the definition of “connected person” and the clause that rewrites section 506C(7) of ICTA.

96. *We will ensure that the link to the definition of “connected person” is maintained.*

As noted in relation to clause 41, we consider that the use of the word “connected” to have several different meanings within the substantial donor clauses is confusing.

97. *We will revise and expand the explanatory notes to clarify the use of the term “connected” in different contexts.*

Clause 47: Excess expenditure treated as non-charitable expenditure of earlier periods

It is not apparent why the definitions introduced in 2006 should need effective renaming. It is not clear, for example, why ‘available income and gains’ is a better name than ‘total income and gains’. It seems that people would just be getting used to the terminology before it was changed again.

98. We used the term “available income and gains” in the equivalent income tax legislation in sections 562 and 563 of ITA. This approach avoided the repetition of the term “total income”, which has a meaning across the income tax legislation (see

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section 23 of ITA). Where possible, our preferred approach is to maintain common terminology between the income tax and corporation tax legislation and we have therefore done so here, but we will keep the point under review as the terminology used in Bills 5 and 6 is finalised.

99. *We do not propose to amend the clause but will keep the point under review.*

Clause 48: Rules for attributing excess expenditure to earlier periods

The drafting at clause 48(2)(b) appears to have inverted the wording from the current provision – we consider that it should be that the non-charitable expenditure must exceed the available income and gains, not the other way around.

100. We think that the respondent may have confused the roles of clauses 47 and 48. Clause 47(1) sets out the basic condition for the period under consideration, ie: that a charitable company's non-charitable expenditure exceeds its available income and gains. This is the wording that the respondent expected to see.

101. Clause 48(2) refers to the earlier accounting period to which the excess is carried back. It unpacks section 505(5) by setting out the process of looking at each earlier period in turn to determine how much of the excess can be allocated to each period. In those earlier periods, excess non-charitable expenditure can only be allocated to the period if the available income or gains of that period exceeds the non-charitable expenditure of that period, hence the wording of clause 48(2)(b).

102. *We do not propose to amend the clause but will provide further clarification in the explanatory notes.*