

## **EXPLANATORY NOTES**

### **Part 1: Special rules about charitable trusts etc**

#### *Overview*

1. This Part [which is a revised version of Part 10 of the draft Bill] contains rules specific to charitable trusts. It is based mainly on sections 505 to 506C of ICTA, Schedule 20 to ICTA, part of section 25 of FA 1990 and section 46 of FA 2000.
2. The process of splitting income tax and corporation tax legislation means that the rules for charitable companies (charities set up in non-trust form) are not rewritten in this Bill, but will be rewritten in the context of the rewrite of corporation tax. This Bill accordingly makes appropriate consequential amendments to the rules (eg in ICTA) relating to charitable companies.
3. Clauses 7 and 8 set out the rules about exemptions for profits of charitable trades and the meaning of a charitable trust, taking account of the changes proposed in the Finance Bill.
4. Clauses 22 to 40 then set out restrictions which operate on the exemptions for gifts and other types of income, again taking account of the changes proposed in the Finance Bill. The restrictions apply where a charitable trust uses some of its incoming resources to fund non-charitable expenditure.
5. Clauses 45 to 47 then set out the rules which will apply as a result of the Finance Bill to deal with the carry-back of excess non-charitable expenditure to earlier tax years.

#### **Clause 7: Exemption for profits etc of charitable trades**

6. This clause sets out the exemption for trading profits of charitable trusts. It is based on section 505(1) of ICTA.
7. The exemption applies only if the trade is a charitable trade. This is defined in clause 8.
8. This clause makes it clear that adjustment income (arising from a charitable trade) is exempt, in line with practice. Adjustment income is defined by reference to ITTOIA. See *Change 86* in Annex 1.
9. This clause also makes it clear that post-cessation receipts (arising from what was a charitable trade) are exempt, in line with practice. Post-cessation receipt is defined by reference to ITTOIA. See *Change 86* in Annex 1.
10. *Change 86* also affects clauses 9, 14, 22 and 45.
11. Exemptions for “small-scale trades” are dealt with separately in clause 9.

**Clause 8: Meaning of “charitable trade”**

12. This clause defines the meaning of “charitable trade” for the purposes of the previous clause. It is based on section 505(1) and (1B) of ICTA.

13. The main rule, in *subsection (1)*, is that the trade must be exercised in the course of carrying out a primary purpose trade of the charitable trust, ie that it must form part of the primary purposes of the trust, as set out in the trust deed or other governing document. Or that the work in connection with the trade must be mainly carried on by beneficiaries of the charitable trust.

14. The source legislation in section 505(1)(e) of ICTA referred to the trade being carried on in the United Kingdom or elsewhere, and section 505(1)(e)(i) referred to it being exercised in the “actual carrying out of a primary purpose”. The words “in the United Kingdom or elsewhere” and “actual” have not been incorporated in this clause as they add nothing.

**Clause 14: Exemption for property income etc**

15. This clause sets out the exemption from income tax for property income and certain trading income arising from land, provided the income is applied to charitable purposes. It is based on section 505(1) of ICTA.

16. The exemption applies where income is chargeable to tax under Part 2 of ITTOIA as a result of section 261 of that Act, and provided the income is applied to charitable purposes.

17. Income chargeable to tax under Part 2 of ITTOIA means profits of a trade, adjustment income and post-cessation receipts. This means that the clause includes an exemption for adjustment income, and for post-cessation receipts, in line with practice. See *Change 86* in Annex 1 and the commentary on clause 7.

18. There is no requirement for the trade to be exercised in the course of carrying on a primary purpose of the charitable trust. But *subsection (1)* specifies that the income must be chargeable under Part 2 of ITTOIA, rather than Part 3, as a result of section 261 of that Act.

19. This makes the effect of the source legislation in section 505(1)(a) of ICTA, as amended by ITTOIA, explicit. There is no other income arising from land and chargeable to tax under Part 2 of ITTOIA which is exempt under that provision.

20. The exemption also refers to Part 3 of ITTOIA, rather than referring to profits or gains arising in respect of rents or other receipts from an estate, interest or right in or over land, to reflect the fact that such income is charged by ITTOIA as the profits of a property business.

21. The reference to Part 3 of ITTOIA means that the clause provides an exemption from income tax for adjustment income of UK property businesses, provided the

income is applied to charitable purposes. See *Change 86* in Annex 1. See also the commentary on clause 7.

22. The reference to Part 3 of ITTOIA also makes it explicit that the clause provides an exemption from income tax for post-cessation receipts of UK property businesses, provided the income is applied to charitable purposes.

23. *Subsection (2)(b)* requires that the estate, interest or right in or over land is vested in a person in trust for a charitable trust or for charitable purposes. A charitable trust has no legal personality and cannot hold land itself, so the land “belonging” to a charitable trust must be vested in the names of the trustees, or of another person (eg a nominee for the trustees). Hence the reference to the estate, interest or right being vested in any person.

24. The exemption applies where the income derives from land vested in trust for a charitable trust or for charitable purposes. But if some of the land is vested in trust for charitable purposes and some vested or held for other purposes (for example, as an investment to generate income for non-charitable purposes) it is necessary to allocate the profits of the single property business between the two parts. This reflects the position of the exemption in the source legislation that looked to particular interests in land, rather than to one overall property business.

#### **Clause 22: Restrictions on exemptions**

25. This clause restricts exemptions where income of a charitable trust is attributed to non-charitable expenditure. It is based on section 505(4) of ICTA.

26. A number of the exemptions have been extended to treat adjustment income and post-cessation receipts as exempt. As a result the restrictions apply to the extended exemptions. See *Change 86* in Annex 1 and the commentary on clause 7.

27. A statutory exemption has been introduced for profits of fund-raising events. The restrictions apply to this exemption. See *Change 87* in Annex 1 and the commentary on clause 12.

28. A statutory exemption has also been introduced for income from estates in administration. The restrictions apply to this exemption. See *Change 89* in Annex 1 and the commentary on clause 20.

#### **Clause 23: The non-exempt amount**

29. This clause specifies how the non-exempt amount is calculated. It is based on section 505(3) and (4) of ICTA.

30. The term “attributable income and gains” is defined in *subsection (3)*. This label replaces “relievable income and gains” as defined in section 505(3) of ICTA.

31. *Subsection (5)* specifies that section 256(4) of TCGA is to be ignored in applying subsection (3)(b). Section 256 of TCGA provides the exemption from capital gains tax for certain gains accruing to a charity. Schedule 1 to this Bill amends section 256, adding subsections (3) to (5). Schedule 1 also inserts sections 256A and 256B, to deal with the interaction between income tax and capital gains tax as regards attributing income and gains to the non-exempt amount.

**Clause 24: Attributing income to the non-exempt amount**

32. This clause specifies how income is attributed to the non-exempt amount. It is based on section 505(4) and (7) of ICTA.

33. It specifies that the non-exempt amount is to have attributed to it amounts of attributable income and/or attributable gains until it is “used up”.

**Clause 25: How income is attributed to the non-exempt amount**

34. This clause specifies that the charitable trust can decide the attribution of attributable (exempt) income or chargeable gains to the non-exempt amount, to determine which “items” of otherwise exempt income or chargeable gains should be treated as taxable. It is based on section 505(6) and (7) of ICTA.

35. Where the restrictions apply, an amount of income (or chargeable gains) equal to the non-exempt amount (of expenditure) must be identified (as calculated in accordance with the previous clause) in order to enable the charitable trust to complete its tax return and self-assess its tax liability. This clause provides the mechanism for the charitable trust to specify the “items” or “elements” of income (such as trading income or investment income) which lose the benefit of exemption.

36. But if the charitable trust has not provided the attribution within a period of 30 days from the day of a request for a specification of the attribution, an officer of Revenue and Customs can decide the attribution. References to the “Board” have been replaced with “an officer of Revenue and Customs”. See *Change 5* in Annex 1 and the commentary on clause 21.

**Clause 26: Meaning of “non-charitable expenditure”**

37. This clause defines “non-charitable expenditure”. It is based on sections 506 and 506A of ICTA.

38. In section 506(1) of ICTA charitable expenditure is defined as expenditure which is exclusively for charitable purposes. Expenditure itself is not defined. And neither is non-charitable expenditure. But by deduction non-charitable expenditure is expenditure other than charitable expenditure – that is expenditure which is not exclusively for charitable purposes.

39. The clause sets out the definition in a fair amount of detail, to reflect practice and HMRC guidance. See *Change 91* in Annex 1, which also affects clauses 27 and 28.

40. More specifically, *subsection (1)(a), (c) and (e)* refer to losses. This does not accord with the natural meaning of the term “expenditure”, but practice has been to interpret the term in this way. See *Change 91* in Annex 1.

41. Subsection (1)(a)(ii) specifies that non-charitable expenditure does not include losses sustained in a trade where a profit would be exempt under the provisions providing an exemption for certain profits from small trades, fund-raising events and lotteries. This differs from the source legislation, but is in accordance with practice. See *Change 91* in Annex 1.

**Q1. We welcome comments on the revision of subsection (1)(a) to exclude losses from small trades, fund-raising events and lotteries from the meaning of non-charitable expenditure.**

42. There is specific provision to ensure that “non-charitable expenditure” includes investments and loans made that are not approved charitable investments or approved charitable loans. But it is only the expenditure in the tax year on making new investments and loans, or expenditure to fund net increases in such investments or loans, that is included – see clause 31.

**Clause 27: Section 26: supplementary**

43. This clause applies relevant material located elsewhere (eg rules for computing trading losses and about basis periods) and provides interpretative material (eg about the meaning of expenditure). It is new.

44. This clause reflects some changes in the meaning of “expenditure”. See *Change 91* in Annex 1 and the commentary on clause 26.

45. HMRC accept that the profit or loss from a trade may be calculated taking account of a deduction for the notional market price of any goods or services provided to the charitable trust for free or at less than market value. HMRC also accept that a deduction may be allowed for a proportion of any fixed overheads or costs which relate both to trading activities and to the general administration of the charitable trust. However, any loss which takes account of such deductions will be restricted (but not so as to create a profit) by the amount of those deductions in calculating charitable expenditure or non-charitable expenditure. See HMRC Guidance Notes: Technical Annex “Trading by Charities”, Section G – IV28.

**Clause 28: Section 26(1)(f): meaning of expenditure**

46. This clause provides interpretative material about the meaning of “expenditure”, reflecting some changes in the meaning. See *Change 91* in Annex 1 and the commentary on clause 26. It is new.

47. *Subsection (1)* makes it clear that “expenditure” includes expenditure on the acquisition of capital assets. But expenditure on assets qualifying for capital

allowances is taken account of in determining, for example, a trading loss and so is not included in expenditure within clause 26(1)(f).

**Clause 29: Section 26(1)(f): tax year in which certain expenditure treated as incurred**

48. This clause specifies the tax year to which expenditure relating to commitments (whether or not contractual in nature) that have been entered into is to be allocated for the purpose of operating the restrictions. It is based on section 506(2) of ICTA.

49. This rule has been rewritten in terms which make explicit reference to United Kingdom generally accepted accounting practice. See *Change 92* in Annex 1.

**Clause 30: Section 26(1)(f): payment to body outside the UK**

50. This clause provides interpretative material about payments to a body situated outside the United Kingdom. It is based on section 506(3) of ICTA.

51. The clause makes it clear that the onus is on the trustees of the charitable trust to ensure that any payments to a body outside the United Kingdom are applied for charitable purposes. Otherwise the charitable trust must classify the payments as “non-charitable expenditure”.

**Clause 31: Section 26(1)(i) and (j): investments and loans**

52. This clause provides interpretative material about the making of investments or loans. It is based on section 506(5) of ICTA.

53. The clause makes it clear that it is only the expenditure in the tax year on making new investments and loans, or expenditure to fund net increases in such investments or loans, that is included in the calculation of non-charitable expenditure.

**Clause 32: Transactions with substantial donors**

54. This clause defines “substantial donor transaction” and explains when a person is a substantial donor to a charitable trust. It is based on sections 506A(1) and (2) and 506C(3) of ICTA.

55. It should be noted that references to a charitable trust include connected charities (see clause 39) and that references to a substantial donor include persons connected with the donor (see clause 40(1)(a)).

**Clause 33: Meaning of “relievable gift”**

56. This clause includes details of the sources of gifts that are “relievable gifts” for the purposes of the preceding clause. It is based on section 506C(1) of ICTA.

**Clause 34: Non-charitable expenditure in substantial donor transactions**

57. This clause specifies that certain amounts relating to substantial donor transactions are to be treated as non-charitable expenditure. It is based on sections 506A(3) to (5) and 506C(2) and (6) of ICTA.

58. The source legislation specifies that certain matters are to be determined by the Commissioners for Her Majesty's Revenue and Customs. References to "the Commissioners for Her Majesty's Revenue and Customs" have been replaced with references to "an officer of Revenue and Customs". See *Change 5* in Annex 1 which also affects clauses 37 and 40. The source legislation specifies that, on an appeal against an assessment, the Special Commissioners may review a decision of the Commissioners, so clause 40 specifies that the Special Commissioners may review a decision of an officer.

<p><b>Q2. We welcome comments on the replacement of references to the "Commissioners" with references to "an officer of Revenue and Customs".</b></p>
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**Clause 35: Adjustment if section 34(1) and (2) applied to single transaction**

59. The clause makes it clear that there can be no double counting. It is based on section 506C(4) of ICTA.

**Clause 36: Section 34: certain payments and benefits to be ignored**

60. This clause provides that payments or benefits arising from transactions, relating to gift aid donations made by individuals or qualifying donations by companies, are to be ignored if they do not disqualify the donations concerned from relief. It is based on section 506B(7) of ICTA.

**Clause 37: Transactions: exceptions**

61. This clause specifies exceptions to the transactions caught by clause 32. It is based on section 505B of ICTA.

62. In particular, the clause carves out of the substantial donor provisions transactions of an ordinary commercial nature.

63. References to the "Commissioners" have been replaced with references to "an officer of Revenue and Customs". See *Change 5* in Annex 1 and the commentary on clause 34.

**Clause 38: Donors: exceptions**

64. This clause specifies exceptions to the donors caught by clause 32. It is based on section 506B(8) and (9) of ICTA.

65. *Subsection (1)* concerns companies set up by charitable trusts, for example to carry on trading activities as a means of generating funds.

66. *Subsection (2)* concerns registered social landlords and housing associations, which often share services and accommodation with charities as a means of meeting charitable and non-charitable objectives, through complex group structures.

**Clause 39: Connected charities**

67. This clause extends, for the purposes of clauses 32 to 38, the meaning of “charitable trust” to include charities connected with the charitable trust. It is based on section 506C(5) of ICTA.

**Clause 40: Substantial donor transactions: supplementary**

68. This clause provides interpretative material for the previous two clauses. It is based on section 506C(7) to (9) of ICTA.

69. References to the “Commissioners” have been replaced with references to “an officer of Revenue and Customs”. See *Change 5* in Annex 1 and the commentary on clause 34.

**Clause 45: Excess expenditure treated as non-charitable expenditure of earlier years**

70. This clause treats “excess expenditure” in a tax year as non-charitable expenditure for earlier tax years. It is based on sections 505(3) and (5) and 506(5) of ICTA.

71. The “excess expenditure” is the amount of the non-charitable expenditure of the year in excess of the available income and gains of the tax year.

72. The term “available income and gains” is defined in *subsection (4)*. This label replaces “total income and gains” as defined in section 505(3) of ICTA.

**Clause 46: Rules for attributing excess expenditure to earlier years**

73. This clause specifies the earlier tax years to which the excess expenditure is to be attributed, later years taking priority to earlier ones. It is based on section 505(5) and (6) of ICTA.

74. The amount of excess expenditure that can be attributed to the year 2005-06 or earlier years cannot exceed the amount that would have been attributed if the change in the method of calculating excess expenditure resulting from section [55] of FA 2006 had not been introduced. See the transitional provision in Schedule 2.

**Clause 47: Adjustments in consequence of section 45**

75. This clause then specifies that any necessary adjustments (eg to tax, interest etc) for earlier years may be made. It is based on section 505(5) of ICTA.

**Schedule 1: Minor and consequential amendments: Finance Bill provisions  
Schedule 1: Transitionals and savings: Finance Bill provisions**

76. Details are included of the additional provisions, or amended provisions, necessary to take account of the changes to the source legislation as a result of the Finance Bill.

## Annex 1

### **Change 5: References to “officer of Revenue and Customs”: clauses ..., 21, 25, 34, 37, 40, 41, 44, ...**

This change replaces references to the “Board of Inland Revenue” in the source legislation with references to “an officer of Revenue and Customs”. It also replaces references to “the Commissioners for Her Majesty’s Revenue and Customs” in sections 506A to 506C of ICTA with references to “an officer of Revenue and Customs”.

References in the source legislation to the “Board of Inland Revenue” are treated by section 50(1) of CRCA as references to “the Commissioners for Her Majesty’s Revenue and Customs”. The rest of this note accordingly refers to the Commissioners for Her Majesty’s Revenue and Customs (“the Commissioners”) rather than to the Board of Inland Revenue.

The provisions affected by this change will in future authorise or require things to be done by or in relation to an officer of Revenue and Customs rather than by or in relation to the Commissioners. This reflects the way in which HMRC is organised and operates in practice. Section 13 of CRCA allows nearly all functions conferred on the Commissioners to be exercised by any officer. All of the functions affected by this change, which are in the main concerned with administrative processes, are in fact exercised by officers of the Commissioners, and the Commissioners themselves are not personally involved in their exercise.

Where the source legislation provides for a claim or election to be made to the Commissioners, this Bill does not expressly state to whom such a claim or election is to be made. Where a return has been issued, section 42(2) of TMA requires the claim to be made in the return if possible and the return must be made to the officer who issued it. Similarly, where the claim is made outside a return, paragraph 2(1) of Schedule 1A to TMA requires the claim to be made to an officer.

Where a claim was formerly to the Commissioners, this change has a further consequence. Under section 46C of TMA (claims in a return) and paragraph 10 of Schedule 1A to TMA (claims outside a return), appeals concerning such claims are to the Special Commissioners. This contrasts with the rules in sections 31B to 31D of TMA under which, in most cases, a taxpayer may appeal to the General Commissioners or elect under section 31D to appeal to the Special Commissioners. The abolition of the requirement that a claim must be made to the Commissioners means that the rules in sections 31B to 31D will generally apply to appeals affected by this change. But in a few cases, especially where the issue is likely to be complex, appeals remain reserved to the Special Commissioners.

This Bill also removes any unnecessary references to any claim or election being in a form specified by the Commissioners. In relation to a claim or election in a return section 113 of TMA provides that the return shall be in such form as the

Commissioners prescribe. Paragraph 2(3) of Schedule 1A to TMA makes parallel provision in relation to claims and elections made outside returns.

Section 113 of and Schedule 1A to TMA do not apply to the form of certificates, notices etc. Where the source legislation provides that the Commissioners determine the form of such documents, this Bill retains that approach, even though section 13 of CRCA means the work can be, and is, done by officers in practice. This is in order to indicate that such material is prescribed for HMRC as a whole.

Each provision affected by the conversion or omission of references to the Commissioners will be identified in the Table of Origins by a cross-reference to this change.

In ITEPA and ITTOIA references to “an inspector” in the source legislation which were converted to “the Inland Revenue” (meaning any officer) were also identified as a change. However, references to an inspector are treated by section 50(2) of CRCA as references to an officer of Revenue and Customs. It follows that it is no longer appropriate to identify the conversion of such references as a change.

***This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.***

#### **Change 91: Charitable trusts: meaning of non-charitable expenditure: clauses 26, 27 and 28**

This change alters the definition of non-charitable expenditure to give statutory effect to HMRC practice.

In section 506(1) of ICTA “charitable expenditure” is defined as:

expenditure which is exclusively for charitable purposes,

and “non-charitable expenditure” is not defined, but by deduction is:

expenditure which is not exclusively for charitable purposes.

Expenditure itself is not defined, although it is clear that it includes capital expenditure but does not include the making of investments or loans. But there is a specific provision in section 506(4) to ensure that “non-charitable expenditure” includes investments that are not “qualifying investments” and loans that are not “qualifying loans”. Clause 28 makes these things clear.

It is only the expenditure in the tax year on making *new* investments and loans, or expenditure to fund net *increases* in such investments or loans, that is included. In other words, if an unapproved loan of £10,000 were made, the expenditure would be £10,000. If a repayment of £4,000 were received it would be ignored for the purposes

of determining expenditure. If a repayment of £4,000 is received and a further loan is made of any amount up to £4,000, there would be no net increase and the expenditure would continue to be £10,000. If a repayment of £4,000 is received and a further loan of £6,000 is made, the net increase would be £2,000 and the expenditure would be £12,000.

Clause 28 makes it clear that expenditure does not include the repayment of loans made to the charitable trust.

More significantly, clause 26 makes it clear that expenditure includes losses from trading and other businesses, rather than the expenses incurred in arriving at a profit or loss. This clause also makes it clear that losses made in a charitable trade are not included in the meaning of non-charitable expenditure. And that losses made in a trade where a profit would be exempt as a result of the clauses providing an exemption for profits of small trades, fund-raising events and lotteries are also excluded from the meaning of non-charitable expenditure.

All this is consistent with existing HMRC practice.

Clause 27 includes signposts to relevant material elsewhere (eg rules for computing trading losses and about basis periods) and interpretative material (eg about the meaning of expenditure and of miscellaneous transactions). It supports the explicit definition of non-charitable expenditure introduced in clause 26.

***This change is adverse to some taxpayers and favourable to others in principle. But it is expected to have no practical effect as it is in line with current practice.***