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Taxation of charities

A number of changes were introduced from April 2000 in charity taxation "to encourage more individuals and businesses to give more, and to make the taxation system simpler for donors and charities to use" (Cm 4479 November 1999 p 90). These measures grew out of a consultation exercise on charity taxation launched at the time of the July 1997 Budget, followed by the Treasury's publication of *Review of Charity Taxation: a consultation document* in March 1999.

This paper provides a summary of the tax reliefs charities now enjoy, and some background to the 1997 review.

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Summary of main points

There are approximately 300,000 charities in the UK employing over half a million people and contributing £12 billion of economic activity.

The total cost of tax reliefs for charities in the UK is estimated at over £2 billion, comprising £1.2 billion of direct taxes, about £200 million in VAT reliefs, and £600 million in business rate relief.[1]

Charities' investment income and capital gains are in general exempt from tax provided that they are applied for charitable purposes. In general the reliefs provided for charities are:

- Income/corporation tax: exemption in respect of income applied solely to charitable purposes. Profits of a trade are exempt, provided the profits are applied for charitable purposes only and either the trade is exercised in the course of carrying out a primary purpose of the charity or it is carried out by beneficiaries of the charity.

- Capital gains tax: exemption for gains of charities provided the proceeds are applied for charitable purposes.

- Inheritance tax: exemption of charitable trusts from the normal charges on discretionary trusts.

- Stamp duty: exemption of instruments effecting conveyances, transfers or leases to charities.

Tax relief for charitable donations is provided through two schemes which cover regular donations made out of one's salary (Payroll Giving), and one-off cash gifts (Gift Aid).

Under the Payroll Giving scheme charitable donations are wholly deductible for income tax purposes, the relief being given through the PAYE system. The employer deducts the appropriate sum from a participating employee's pay, and passes it to an agency who distributes it to the charity or charities of the employee's choice. There are no minimum or maximum limits for donations under the scheme (a maximum limit of £1,200 a year applied prior to 6 April 2000).

Gift Aid allows income tax relief for single donations by individuals and companies. When this relief was introduced in 1990, a minimum limit on donations was set at £600. Tax relief applies to a donation of any size, following the abolition of the minimum limit (then £250) from 6 April 2000. Tax relief for donations under a deed of covenant is no longer given, as the abolition of the Gift Aid minimum limit made this method of tax-privileged donation redundant.

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[1] Figures for 1997-98 HC Deb 22 March 1999 cc 96-97W

On the indirect tax side, there are four categories of VAT relief for charities:

- all charities are able to purchase some goods and services without paying VAT
- particular charities can purchase specific goods without paying VAT
- supplies such as welfare are exempt from VAT
- particular charities can make specific types of sales which are taxed at the zero-rate.

A number of changes were introduced from April 2000 in charity taxation "to encourage more individuals and businesses to give more, and to make the taxation system simpler for donors and charities to use."[2] These measures grew out of a consultation exercise on charity taxation launched at the time of the July 1997 Budget, followed by the Treasury's publication of a consultation document, *Review of Charity Taxation*, in March 1999.[3] In the wake of these changes, the Government has stated that it has "no plans to grant further concessions for charitable giving at this time."[4]

The Inland Revenue has published guidance for charities on these provisions,[5] as well as guidance for individuals and companies making charitable gifts,[6] and using the Payroll Giving scheme.[7] These publications may be obtained from one's local tax office, as well as being made available on the internet.

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2 Cm 4479 November 1999 p 90

3 This is published on the Inland Revenue's internet site

4 HC Deb 26 June 2000 c 428W

5 Inland Revenue, *Getting Britain Giving: Inland Revenue guidance note for charities*, November 2000

6 *Giving to charity by business. How businesses can get tax relief IR64*, September 2000; *Giving to charity by individuals IR65*, September 2000 Each of these is available from the Revenue's internet site: https://web.archive.org/web/20020601214246/http://www.inlandrevenue.gov.uk/menus/charity.htm

7 Further information is on the Revenue's site at https://web.archive.org/web/20010218045928/http://www.inlandrevenue.gov.uk/payrollgiving/index.htm

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[1] **contributed by Edward Wood, Home Affairs Section**

I Introduction

There are approximately 300,000 charities in the UK employing over half a million people and contributing £12 billion of economic activity. In September 1998, around 187,000 charities in England and Wales were registered with the Charity Commission. The Commission estimates that there are 80,000-100,000 other charities which are excepted or exempt from registration, such as churches, schools and museums. There are approximately 27,000 further charities in Scotland and 7,500 in Northern Ireland.[8]

Charities in the UK benefit from tax reliefs worth over £2 billion. A breakdown of this figure is provided in the following written answer:

> **Mr. Cox:** To ask the Chancellor of the Exchequer what is his estimate of the amount of tax foregone as a result of tax allowances granted to charities in England and Wales in the last financial year.
>
> **Ms Hewitt:** The total cost of tax reliefs for charities in the UK is estimated at over £2 billion for 1997-98. This comprises around £1.2 billion of direct taxes (including the reliefs given to donors and estates for gifts to charity), about £200 million in VAT reliefs, and £600 million in business rate relief. Information is not available on the total cost of tax reliefs for charities in England and Wales.
>
> However, of the approximately £730 million of direct taxes repaid to charities in the UK in 1997-98, around £680 million was repaid to charities in England, Wales and Northern Ireland. And of the approximately £250 million exemption from inheritance tax of transfers to charities on death in 1997-98, around £220 million was for estates in England and Wales. Of the approximately £600 million business rate relief in 1997-98, around £520 million was for charities in England and Wales.
>
> It is not possible to give a reliable breakdown of the remainder of the reliefs from direct taxes, nor of the estimated cost of £200 million for reliefs from VAT through a variety of zero rates and exemptions.[9]

It is estimated that charities receive between £5 billion and £6 billion each year in donations from individuals:

> **Mr. Spring:** To ask the Chancellor of the Exchequer what is the total amount which has been contributed annually to the charitable sector (a) overall and (b) through the gift-aid scheme since the scheme's introduction; what these are as

[8] HM Treasury, Review of Charity Taxation: a consultation document, March 1999 p 1

[9] HC Deb 22 March 1999 cc 96-97W Further data on tax reliefs for charities is given in *Inland Revenue Statistics 2000* pp 99-103

> proportions of the total turnover of the charitable sector; and what is the total cost to his Department of the tax refunds resulting from the gift-aid scheme.
>
> **Ms Hewitt:** Charities received some £760 million under the Gift Aid scheme in 1997-98, of which £177 million were repayments of basic rate income tax, on donations by individuals and companies. Additional relief claimed by higher rate taxpayers for donations under the Gift Aid scheme is provisionally estimated at £40 million for 1997-98.
>
> Consistent and reliable annual estimates for total donations to charities and for the income and expenditure of this sector are not available centrally. However, the Charities Aid Foundation estimates overall income donated by individuals to be around £5 billion to £6 billion per year. In addition to this charities also benefit from donations by companies and other organisations.
>
> The Charity Commission's Register showed at the end of March 1999 that the total annual income of all registered charities in England and Wales was about £21 billion. This does not cover charities in Scotland and Northern Ireland, nor does it include non-registered charities.[10]

At the time of the July 1997 Budget, the Government launched a consultation exercise on charity taxation, and in the light of the responses to this, it published a consultation paper setting out a series of proposals - *Review of Charity Taxation* - in March 1999. Part II of this paper examines the background to the review, before looking at the debate it engendered about direct tax reliefs, and the way in which they have been changed, first under the Millennium Gift Aid scheme in 1998, and second in the 'Getting Britain Giving' package of measures first announced in the Pre-Budget Statement in November 1999, confirmed in the March 2000 Budget, and which took effect from April 2000.

Part III of the paper discusses indirect taxation, and in particular, the demand made by many charities that they should be compensated for their irrecoverable VAT – although this proposal has *not* been taken up by the Government to date. It concludes by summarising those changes in VAT reliefs that were made in April 2000 under the 'Getting Britain Giving' package.

The review of charity taxation did not lead to any changes in two other aspects of charity taxation that have attracted considerable attention: the relief from business rates charities enjoy, and the abolition of reclaimable tax credits on dividend payments to charities in April 1999. Part IV and part V of this paper look at these two issues in turn. Part VI provides a short reading list.

[10] HC Deb 21 June 1999 c 310W

II The review of charity taxation

In his Pre-Budget Statement on 9 November 1999 the Chancellor, Gordon Brown, announced that a series of changes would be made in the tax treatment of charities:

> For too long the voluntary sector has been held back by outdated tax laws. We propose that, in future, for every £1 a British citizen donates to charity, the Government will contribute to that charity an additional 28p. For every £1 contributed through payroll giving, the Government will contribute 50p worth of tax relief. There will now be tax relief not just for cash donations but for gifts of quoted shares. The British people's willingness to give can give all our children a better chance, and all of us a better society.[11]

These provisions – the 'Getting Britain Giving' package – were introduced in April 2000, after some improvements made as a consequence of consultation with charities following publication of draft legislation. It is estimated that they are worth £400 million a year in tax relief.[12]

The changes were broadly welcomed by UK charities. Following the March 2000 Budget the Charities Aid Foundation described them as "the most radical and far-reaching set of tax changes ever announced."[13] Legislation was introduced under the *Finance Act 2000*[14] and, in the case of VAT, under two statutory instruments.[15]

These measures grew out of a consultation exercise on charity taxation, launched at the time of the Labour Government's first Budget in July 1997, followed by the publication of *Review of Charity Taxation: a consultation document* in March 1999.[16] The following paragraphs discuss the background to the review, before looking at the specific changes made to income tax and corporation tax.

A. Introduction

Following the General Election in May 1997, a series of policy reviews were launched in the Chancellor's departments, including a review of charity taxation "to explore the options for a simpler, more coherent system of tax reliefs which is better suited to the way

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11 HC Deb 9 November 1999 c 890

12 HM Treasury Budget press notice IR/C&E3, 21 March 2000

13 "Benefactors get relief extension", *Financial Times*, 22 March 2000

14 specifically sections 38-46 of the *Finance Act 2000*

15 specifically SI 2000/802 and SI 2000/805

16 HM Treasury, *Review of Charity Taxation: a consultation document*, March 1999 The paper is available on the Inland Revenue's internet site at http://collections.europarchive.org/tna/20031221151105/http://www.inlandrevenue.gov.uk/consult/rct.pdf

charities work today."[17] Charities were invited to submit views on how the tax system could be simplified, and made more consistent and coherent, by 1 December 1997, with the aim of working these into a consultation paper for publication in spring 1998. A press notice issued at the time gave further details:

> The review is an opportunity for Government and charities to work together to see if it is possible to create a system which:
>
> - is more coherent and consistent;
> - is simpler to administer;
> - reduces charities' compliance costs;
> - reduces the scope for the charity tax reliefs to be exploited for tax avoidance purposes;
> - is more receptive to the needs of today's charities.
>
> The main focus of the review will be the current VAT arrangements. However charities may also raise any concerns they have about direct taxes or business rates …
>
> UK VAT operates within a framework laid down in EU law (the Sixth VAT Directive as amended). There is not a complete 'fit' between the UK and EU VAT law affecting charities, but in broad terms the same types of activity benefit from relief. Many of the UK VAT reliefs affecting charities are covered by EU VAT exemptions, which include relief for education, health care and welfare services.
>
> The UK's zero rates can be retained (though not extended) until such time as there is unanimous agreement by EU Member States on alternative VAT arrangements to replace the 'transitional system' set up at the time of the Single Market. In 1996 the European Commission presented a draft programme of reviews and legislative reform aimed at producing a Common VAT system. The details and the timescale for any agreed changes are uncertain but as part of the Common VAT system programme, the VAT exemptions will be reviewed.
>
> The aims of the taxation review announced today are:
>
> - to see if there is scope for simplification of charities' taxation
> - to inform the Government's negotiation position in the forthcoming EC review of VAT social reliefs.
>
> It will be important to ensure that any outcome of the review does not unfairly advantage charities with regard to the commercial operators with whom they may compete. The Government is therefore inviting constructive comments on how the taxation of charities might be improved. Although the main focus of the

[17] HC Deb 28 July 1997 cc 15-16W

> review is likely to be on VAT, comments are invited on any aspect of the tax system.[18]

It was estimated at that time that charities benefited from tax reliefs worth £1.75 billion in total, consisting of £1 billion direct tax relief, £200 million VAT relief, and the balance on relief from business rates. This press notice also provided a useful summary of the then current structure of tax reliefs for charities, reproduced below:

> Arrangements on the direct tax side focus on relieving charities' income from tax and encouraging giving to charities. The main reliefs are currently as follows:
>
> - charities' investment income and capital gains are in general exempt from tax provided that these are applied for charitable purposes
> - some trading income is also exempt if the profits come from carrying out a primary purpose of the charity
> - individuals or companies donating to charity under a deed of covenant can claim tax relief for donations
> - gift aid provides tax relief for large, single cash gifts of at least £250
> - payroll giving allows employees tax relief on charitable donations made through their pay
> - inheritance tax relief on bequests to charities.
>
> On the indirect tax side, there are currently four categories of VAT relief for charities:
>
> - all charities are able to purchase some goods and services without paying VAT (eg, advertising for fund-raising purposes)
> - particular charities can purchase specific goods without paying VAT (e.g., medical equipment for medical research)
> - supplies such as welfare are exempt from VAT; this means that the charity does not charge VAT but cannot reclaim VAT on any goods or services it has to buy to make the supply
> - particular charities can make specific types of sales which are taxed at the zero-rate eg, sales of donated goods in charity shops. This means that VAT incurred in running the shop can be reclaimed.

At the time Stuart Etherington, chief executive of the National Council for Voluntary Organisations,[19] was quoted as saying the charitable sector was encouraged by this announcement as a review of charity taxation was "long overdue."[20] In an opinion piece published in the *Guardian* discussing the abolition of reclaimable tax credits on

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[18] HM Treasury Budget press notice HMT 5, *Charity taxation reviewed*, 2 July 1997

[19] NCVO, Regent's Wharf, 8 All Saints Street, London, N1 9RL tel. 020 7713 6161 The Council's internet site is: http://web.archive.org/web/20001206010500/http://www.ncvo-vol.org.uk/main/about/index.html

[20] "Hopes pinned on consolation prize of a full review", *Financial Times*, 3 July 1997

dividends,[21] Mr Etherington noted that the sector had been "thrown something of a lifeline in the form of a promised review of charity taxation, a move that was recommended by the Deakin Commission on the Future of the Voluntary Sector"[22] – an independent body set up by the NCVO in May 1995 to "provide a clear vision for the role of the voluntary sector in England over the next decade."[23]

The Deakin Commission published its report in July 1996. In its discussion of the fiscal environment it noted, "charities benefit from a range of tax reliefs and we believe that as a principle they should continue to do so." On the issue of charitable donations, the Commission recommended the following:

> We were interested by the potential for increasing charitable giving by amending the tax regime to provide benefits, to donors both individual and corporate, rather than the charity.[24] In view of the particular climate for charitable giving in the UK, we recommend research on the efficacy of tax relief schemes for donors in increasing charitable giving.[25]

As a companion volume to its report, the Commission published a survey of charities' views carried out in the course of its work – which included reference to charities' views about their taxation:

> Most respondents took the opportunity to argue for more flexible tax and legal arrangements for the voluntary sector, and to highlight particular areas of difficulty. The most common complaint related to the burden of irrecoverable VAT[26] … other suggestions made in relation to financial matters included: a lower rate of employers' National Insurance contributions; changes in the tax regime to promote new forms of charitable giving; changes to the benefits system to make it easier for people to volunteer and review of the position of charitable trading companies.[27]

In June 1997 the Institute for Fiscal Studies published a major study of UK households' charitable giving over the last twenty years. Using information from the Family Expenditure Survey, the authors looked at trends in giving across households by reference

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[21] This issue is examined in part V of this paper.

[22] "Voluntary sector out of pocket", *Guardian*, 23 July 1997

[23] "Terms of reference", Future of the Voluntary Sector Commission, *Meeting the challenge of change*, July 1996

[24] In the UK tax benefits in relation to charitable donations are enjoyed mainly by the donee charity, reclaiming the tax paid by the donor on their gift. In the United States, benefits are provided primarily to the donor. This is examined in more detail below.

[25] *Meeting the challenge of change*, July 1996 pp 9-10

[26] This issue is examined in part III.B of this paper. The Commission itself argued for "a scheme to enable charities to reclaim at least a proportion of VAT on non-business charitable expenditure" (*op.cit.* p 9).

[27] Future of the Voluntary Sector Commission, *Meeting the challenge of change: summary of evidence and selected papers*, July 1996 p 10

to income, age, occupation and region, a rather determinist approach to charitable giving as they admitted:

> There may be many reasons why households choose to give money to charity and only some of these reasons may relate to economic circumstances. The concept of treating charitable giving in the same way as other household consumption choices may be contentious. But setting household charitable giving in the context of their economic decisions and constraints highlights many important aspects of the way in which giving patterns vary systematically by household type. The fact that systematic patterns emerge allows insight into the effects of policy decisions and of changes in household circumstances on decisions about whether or not to give to charity and about how much to give.[28]

The authors found that there was a significant decline in total household giving which they attributed to a difference in attitudes across generations:

> The charitable giving behaviour of UK households has been changing over the last 23 years. In particular, patterns emerge in the types of households that are most likely to give to charity and how much they give, as well as the form in which they give. Over the last 23 years, the percentage of households giving to charity has fallen by over 5 percentage points although the average donation has risen such that total household donations have gone up in real terms. The generational aspects of this greater 'inequality of giving' show up clearly in our analysis. Not only do today's young households give less frequently than today's middle-aged, but they give less frequently than today's middle-aged did when they were young.[29]

In October 1999 the Government published research carried out by the Inland Revenue, the Charities Aid Foundation and the NCVO, which described the current pattern of charitable giving as follows:

> **Participation in giving :** 67% of the population gave to charity in the course of one month (July 1999) by all methods. These individuals are henceforward referred to as 'givers'. Givers tend on the whole to be older, more affluent, and are more likely to be women, as compared with the general population. Tax-effective giving is currently confined to about one-tenth of the population.
>
> **Use of tax-effective giving :** The proportion of the population giving by the different tax-effective methods are:
>
> - 5% Covenant
> - 3% Payroll deduction
> - 0.6% Gift Aid
> - 0.2% Millennium Gift Aid

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[28] IFS, *The state of donation: household gifts to charity, 1974-96*, June 1997 p 32

[29] *ibid.*

> Covenants are generally preferred by older, higher income individuals, payroll givers are spread across all age-bands with a majority in the 35-44 group. Whilst Gift Aid use is confined to those over 35 years of age, Millennium Gift Aid is largely taken up by its target audience - young people, the lowest paid and the oldest in the sample, though overall uptake is low.
>
> **Patterns of giving :** 17% of givers in the survey said they would prefer to give on a regular monthly basis. This is considerably higher than the proportion of the population who currently do so (approximately 10%), suggesting that there is some scope for extending regular giving, particularly in relation to higher incomes and social class bands.
>
> The youngest and oldest individuals are least likely to want to commit to regular giving. The most popular method of donation amongst younger lower paid individuals was spur of the moment street collections. Although the majority of respondents had bank accounts, they had not used direct debits or standing orders for charitable giving, and said they did not intend to do so.[30]

Following the publication of the IFS report, *The state of donation*, the chief executive of the Charities Aid Foundation,[31] Michael Brophy, was quoted as saying, "these findings confirm our view that, if the voluntary sector is to meet its increasing role in society, it will not be able to rely solely on existing sources of funding."[32] The Charities Aid Foundation joined with four other organisations – the Charities' Tax Reform Group,[33] the Charity Finance Directors' Group,[34] the Institute of Charity Fundraising Managers,[35] and the NCVO – to make a joint submission to the charity tax review (the five set up a single co-ordinating body – the Charities Joint Fiscal Working Group – in 1996). A press notice provided a summary of their position:

> The Group points out the significant benefits the voluntary sector provides to the country, both in economic and social terms, and as a major employer, and goes on to highlight the impact of the shift from direct to indirect taxation on the sector's ability to raise funds, and the difficulties faced by charities in administering the complex tax relief procedures currently in place.
>
> The Group recommends a number of measures which could help to alleviate the difficulties faced by charities, and to help reverse the income stagnation currently faced by the voluntary sector. Among the recommendations are a compensation

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[30] Inland Revenue, *Research briefing charity tax review*, October 2000

[31] CAF, Kings Hill, West Malling, Kent ME19 4TA tel. 01732 520000 The Foundation's internet site is: http://web.archive.org/web/20000304003949/http://www.cafonline.org/

[32] "Charities worried as fewer people make donations", *Guardian*, 30 June 1997

[33] CTRG, 12 Little College Street, London SW1P 3SH tel. 0207 222 1265

[34] CFDG, Calmelford House, 87-89 Albert Embankment, London SE1 7TP tel. 020 7793 1400 The Group's internet site is http://collections.europarchive.org/tna/20120107052603/http://www.cfdg.org.uk

[35] ICFM, Market Towers, 1 Nine Elms Lane, London SW8 5NQ tel. 020 7627 3436 The Institute's internet site is: http://web.archive.org/web/20000822102701/http://www.icfm.org.uk/

> scheme for charities, which currently faces a £400 million annual bill for irrecoverable VAT, the introduction of a measure whereby all donations to charities should qualify for tax relief, including those from public collections.
>
> In an accompanying letter, Ian Macgregor, the Group's Chairman, writes: 'The Charities Joint Fiscal Working Group welcomes the Government's review as an opportunity to both reconsider charities' tax burden and reinvigorate the environment for charitable giving.' He continues: 'The current system of charity taxation is complex and costly to charitable organisations. It is estimated that the charity sector spends as much as £100 million per annum on professional advice in order to mitigate its tax burden. The aim of each member of the CJFWG is to simplify the arrangements and maximise charitable income for the benefit of those who are reliant on charities.'[36]

In the event the Government received over 3,000 replies to the Review,[37] and clearly this contributed to a severe delay in publishing a consultation paper, which, as mentioned above, was issued at the time of the March 1999 Budget.

B. 'US-style' tax relief on donations

In December 1998, the Institute for Fiscal Studies published a report on charity taxation, looking in particular at the possibility of amending the tax relief for charitable donations so that the primary benefit was enjoyed by the donor rather than the donee, which is the system used in the United States:

> In the US, almost all donations are tax-free to all taxpayers, who can deduct charitable donations from their taxable income. All individuals who claim itemised deductions (and corporations) are allowed a federal income tax deduction up to 50 per cent of their taxable income. Non-itemisers can claim up to a certain threshold or choose to become itemisers.
>
> In effect, the US system is identical to the operation of payroll giving in the UK for those employees working for an employer participating in the scheme. The two differences are, first, the lack of binding upper limits on deductible gifts and, second, that the tax deductibility, of donations is not dependent on the money being channelled through an employer. This would allow those such as the self-employed to benefit.
>
> It is important to draw a distinction between the administrative features and the practical consequences of US-style tax deductions. The UK has a very different tax administrative structure from the US. This means that simply implementing the administrative features of the US system would not achieve the same end

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[36] NCVO press notice, *Charities' joint submission to Government tax review recommends action on VAT and individual giving*, 5 December 1997

[37] HC Deb 8 December 1998 c 139W

> result. Writing from a US perspective, Gale (1997) commented that 'the most interesting aspect of the British income tax is that very few citizens actually have to file tax forms.'[38] Applying the US system to the UK would not make almost all donations tax-free to all taxpayers. Only those who filed tax returns - mainly the self-employed and higher-rate taxpayers - would benefit. Currently, this group represents approximately one-third of all taxpayers.[39]
>
> The practical consequences of US-style tax deductions for the minority of taxpayers who do file tax returns would be to extend tax-free giving to almost all types of giving.[40] These individuals can currently give tax-free, but only if they want to give to the same charity for four years or give more than £250 (or have access to payroll-giving schemes). The introduction of US-style tax deductions would benefit those who currently give, or want to give, one-off donations of less than £250 …
>
> It may be argued that US-style tax deductions have an additional psychological effect, but we are unaware of any evidence for this one way or the other. There may also be an information effect associated with government backing for a new scheme, but this is not unique to the nature of US-style tax deductions: the argument applies equally to increasing the level of information about the current ways of giving to charity.[41]

In the report's conclusions, the authors argued that there was a case for introducing tax relief for charities in certain circumstances:

> This Commentary has assessed the economic arguments relating to tax reliefs on individual donations to charity. We have taken as our starting-point that the government wants to support charities. Whether this is true of all 'charities' as currently defined is relevant to the debate, but is beyond the scope of this report. The taxation of and the role of government in the provision of charitable services are areas where it is important to distinguish economic and non-economic arguments and debate.
>
> Our arguments have focused on whether tax relief (as opposed to direct grants of revenue (for example) is the most effective way for the government to support charities. We would argue that there is a case for introducing — or extending — tax relief when one or more of the following conditions hold:
>
> i. If tax reliefs have a big positive effect on individual donations. In this case, tax relief may be more effective than government grants at delivering increases in charities' incomes. There is a danger, however,

38 W.Gale, "What can America learn from the British tax system", *Fiscal Studies*, vol 18 1997 pp 341-370

39 Basic-rate taxpayers can always request to file tax returns, although the extent to which the numbers doing this would increase just to claim a tax deduction on small irregular gifts is debatable.

40 Presumably there would be a minimum and/or maximum donation to reduce costs and keep the scheme administratively feasible.

41 IFS, *Taxing charitable giving*, December 1998 pp 18-19

that givers will actually reduce their donations, knowing that the government is providing a top-up.

ii. If the government wants to let individuals decide to which charities the pot of revenue should be allocated. Note, however, that this is likely to lead to a different distribution of resources within the charitable sector from the allocation of the same amount of money through government grants.

iii. If the government wants to commit more resources to the charitable sector in aggregate, holding government grants constant.

iv. If there are strong non-economic arguments, such as wanting to avoid potentially controversial grant-making decisions, believing that people react positively to tax reliefs for psychological reasons (regardless of the change in the 'price' of giving) or trying to create a society in which individuals are engaged with the charitable sector.

The authors went on to suggest that this had implications for any decision as to whether the UK should move toward 'US-style tax deductions':

> The evidence from the US suggests that the responsiveness of individual donations to the financial incentive offered by tax reliefs is small (and probably not enough to offset any revenue-neutral cut in government grants). Also, the current UK government has ruled out an increase in total resources allocated to the charitable sector. This leaves the second and fourth arguments as possible rationales for extending tax relief. The former argument is one about government preferences; the latter is essentially about government beliefs, since we are unaware of any evidence for or against such effects.
>
> The government should be clear which, if any, of these arguments is motivating reform. It is important to have clear goals, particularly since the nature of the goals will affect the relevant policy prescriptions. For example, a desire to 'let individuals decide' would suggest widening the scope of existing tax relief to enable more people to give tax-free. Non-economic arguments, on the other hand, may be consistent either with raising more money for the charitable sector or with encouraging more people to give.
>
> This clearly influences the debate over the introduction of 'US-style tax deductions'. We could not achieve a scheme equivalent to a US-style tax deduction by having a system where individuals deduct gifts to charity from their taxable income on the tax form. After all, only a minority of individuals currently fill in tax returns. We could, however, achieve a system equivalent to a US-style tax deduction (ie, a system that encompassed all potential givers) by making Gift Aid or covenants less restrictive. Possibilities would be, for

> example, widening the types of charities covered by Millennium Gift Aid or reducing the time restrictions on covenants.[42]

In this context it is interesting to note the comments made by Nicholas Deakin – the chair of the 1996 Independent Commission on the Future of the Voluntary Sector – writing in the *Financial Times* in May 2000, on the extent to which the UK could draw on the American experience:

> Mr Brown's approach suggests a strong US influence in his attempts to build a culture of charitable giving …
>
> However, there are good grounds for disputing the relevance of the US parallel. First, charitable donation in the US takes place in a different context, culturally as well as legally. Second, charitable action is driven by different imperatives within a Federal system where welfare has never been a key state function and a society in which religion plays a far more prominent part.
>
> So when the Chancellor's campaign gets under way, he should not allow himself to be too readily persuaded to follow US models. To judge from past experience in this country, tax-cutting in itself does not appear to have significant positive effects on the level of charitable donation. …
>
> In the parallel universe of the arts world (the focus of so much US philanthropy), [encouraging philanthropy] means promoting forms of giving that generate more than credits in the programme and free seats for the partners. Internet-based charity, too, can take more imaginative forms than simply levying a notional rent on windfall profits from the current investment frenzy. The alienation of the young from traditional voluntary action and philanthropy must be addressed, but in such a way as to unlock the potential for imaginative action in that age group.[43]

Unsurprisingly, the issue of 'US-style' deductions was raised in the *Review of Charity Taxation* document published in March 1999, when the Government asked for views on whether tax relief for charitable donations should be remodelled on the American system, so that the primary tax benefit was enjoyed by the donor rather than the donee:

> A US-STYLE RELIEF FOR GIVING
> 2.21 In the United States donors make 'gross' payments to charity and claim all of the tax relief in their tax return. The US system limits the amount of tax-effective donations that can be made by an individual in any tax year to 30 per cent or 50 per cent of their adjusted gross income, depending on the type of donation and the type of organisation to which the donation is made. This contrasts with Deeds of Covenant and Gift Aid in this country, where the benefit of the basic rate tax relief goes to the charity and where there are no maximum limits for donations. Payroll Giving … does, however, operate in such a way that

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[42] IFS, *Taxing Charitable Giving*, December 1998 pp 20-21

[43] "The giving age begins at home", *Financial Times*, 2 May 2000

all of the tax relief goes to the donor, and has a maximum limit for donations (£1,200 a year).

2.22 The idea of moving to a US-style relief was raised by a number of respondents. The key issue is whether moving to such a relief, where all of the tax relief goes to the donor, would encourage more people to give to charity, and would encourage them to increase the amount that they give. We received conflicting responses on whether a US-style relief would achieve these objectives. Many respondents were concerned that people would not increase the amount that they give sufficiently to compensate charities for the loss of the benefit of the basic rate tax relief.

2.23 Moving to a US-style relief across the board would in any event not be practicable in the UK because far fewer people receive an annual tax return here. It might, however, be practicable to introduce a US-style system as a further option, alongside Deeds of Covenant, Gift Aid and Payroll Giving, for people who receive a Self Assessment tax return – such as the self-employed and higher rate taxpayers. So we want to consider whether offering a US-style relief alongside the existing reliefs would achieve the objective of encouraging more people to give more.

2.24 We propose to do more research into the likely effects of such a relief on the motivation of donors. In the meantime, we want to hear from as wide a range of donors and charities as possible whether they think such a relief would be a useful addition to the range of tax-effective ways to give to charity.[44]

The Revenue received some 500 responses to the document; generally, most respondents were opposed to a move towards a 'US-style' system of taxing charitable donations:

Only a small number of respondents, mainly charities appealing to affluent donors, wanted to see a US-style relief for charitable donations (where all of the tax relief goes to the donor). Most charities had real anxieties about such a relief. They feared that switching the basic rate tax relief from the charity to the donor would adversely affect their income, because donors would not increase the amount of their donations to compensate for the switch. Some respondents also considered that a US-style relief running in parallel with the existing reliefs would add unwelcome complication to the tax system.[45]

In the event the Government did not pursue this option in reshaping tax relief for donations.

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[44] *Review of Charity Taxation: a consultation document*, March 1999 pp 8-9

[45] Inland Revenue, *Review of Charity Taxation: Summary of Responses to the Government's Consultation Document*, October 1999 p 2 :

C. Direct taxation: Millennium Gift Aid

One important change in the scope of charities' tax reliefs was announced in the March 1998 Budget, a year before the Government's consultation paper on charity taxation was published: an extension of the Gift Aid scheme to encourage charitable donations for the world's poorest countries. The measure presaged later changes in Gift Aid introduced from April 2000.

Gift Aid was introduced by the then Chancellor, John Major, in his 1990 Budget: one off charitable donations could be made free of tax, on or after 1 October 1990, for gifts of £600 or more.[46] Mr Major argued that the existing reliefs provided exclusively for a regular pattern to donors' giving, despite the fact that many people gave money to charities on a one off basis:

> These reliefs are focused mainly on regular giving, which is of great importance to charities. However, they are ill suited to encourage the one-off gift which, for a variety of reasons, many people find more convenient. Over the years, this has been a persistent source of concern to charities ... I propose a gift aid scheme that will, for the first time, give tax relief for large money donations. It is simply not practical to operate a relief for all small one-off gifts - and in any event, I do not wish to undermine regular giving ... therefore, this scheme applies to larger donations.[47]

In effect the scheme was a 'single year' covenant, and proved popular with both charities and donors. Gifts qualify for full income tax relief. However, if the payment is not made out of taxed income, tax has to be paid by the *donor* to the Inland Revenue.[48] This point may be worth emphasising: non-taxpayers should not use Gift Aid as a method of making donations to charity. Indeed the Government resisted amendments proposed in the course of the Finance Bill in May 2000 to have any basic rate tax on gifts made by non-taxpayers met out of public expenditure.[49] Initially an upper limit was placed on gifts from one donor - set at £5 million - but this was abolished from 19 March 1991. The minimum limit was reduced to £400 from 7 May 1992, and was further reduced to £250 from 16 March 1993.

At a seminar in December 1997 to discuss progress on the Mauritius Mandate to reduce Third Word debt, the Chancellor Gordon Brown stated that the Government were considering a new form of tax relief to encourage donations by both individuals and

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[46] The scheme was introduced under section 25 of the *Finance Act 1990*.

[47] HC Deb 20 March 1990 c 1021

[48] Tax relief only applied to gifts of money and not to gifts in kind. Nor did gifts qualify if they were linked with any purchase of property or if they were payments in return for services. It was thought this would prevent abuse, for example, by parents paying private school fees through Gift Aid.

[49] Standing Committee H 23 May 2000 cc 343-370

businesses to help education and anti-poverty projects in the world's poorest countries.[50] In his 1998 Budget speech the Chancellor announced the introduction of Millennium Gift Aid (MGA):

> I have had many Budget representations, including many widely publicised campaigns, pressing for new tax reliefs. I have decided that there is a case for one new tax relief, for giving. I want British citizens to be able to contribute more to poverty relief and education through charitable work in the developing countries ... I want the millennium to be remembered, not just nationally but internationally, for the redemption of debt and the reduction of world poverty. This new tax relief will allow individuals to make their contribution to the reduction of world poverty.[51]

In effect the scheme cut the minimum donation for Gift Aid from £250 to £100, for donations made between the start date of the scheme (31 July 1998) and 31 December 2000, to any eligible charity.[52] Eligible charities had to be working for one or both of two purposes in a list of designated countries, those purposes being 'the relief of poverty', and 'the advancement of education'.[53] Regulations were laid on 31 July 1998 specifying the 80 poor countries to which donations could be made under the scheme. Countries within the scope of the scheme were those eligible for lending either by the International Development Association (IDA), or jointly by the IDA and the International Bank for Reconstruction and Development, both organisations of The World Bank.[54]

On 18 March 1999 the Government launched an advertising campaign to promote the scheme, especially among young people: to this end, an internet site with details of participating charities was set up, and a direct debit telephone line for donations. In addition, it was announced that legislation would be introduced in the forthcoming Finance Bill to amend the provisions dealing with the timing of tax relief: [55]

> At present donations made by instalments are aggregated and treated as a single donation, made on the date of the last instalment. Charities get tax relief at the basic rate in force at that date. The rules are being changed in this year's Finance Bill so that the tax that charities can reclaim will be calculated at the basic rate of

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[50] Inland Revenue press notice, *Tax relief for giving to encourage education and anti poverty projects in the world's poorest countries*, 17 December 1997

[51] HC Deb 17 March 1998 c 1111

[52] The scheme was introduced under section 48 of the *Finance Act 1998*; it was the subject of a short debate at the Committee stage of the Finance Bill (Standing Committee E 21 May 1998 cc 369-374).

[53] Inland Revenue Budget press notice IR4, 17 March 1998

[54] SI 1998/1868 The 80 countries were listed in a press notice issued at the time (Inland Revenue press notice 111/98, 31 July 1998). For further details see the relevant appendices to the *World Bank Annual Reports 1997 & 1998* (Appendix 5, 1997 report pp 157-158; Appendix 6 1998 report pp 154-155).

[55] under s 57 of the *Finance Act 1999*. This provision was the subject of a short debate at the Committee stage of the Finance Bill (Standing Committee B 25 May 1999 cc 459-461).

> tax for the year in which the first instalment is paid. This way, donors and charities will know from the outset at what rate tax relief will be available.[56]

On 6 April 1999 the Chancellor announced that the scheme would be extended to cover donations to charities helping Kosovan refugees, regardless of where the refugees are situated, with immediate effect.[57] As a consequence the scope of MGA was extended to cover "the relief of poverty in the case of persons from any country or territory designated [for this purpose] … who are refugees or who have suffered displacement as a result of organised intimidation or oppression or of war or other armed conflict." [58] Subsequently Kosovo was designated as a territory for these purposes by Order; tax relief applies to all donations made on or after 6 April 1999.[59]

Details on the operation of the Gift Aid 2000 helpline were given in a written answer:

> **Mr. Fallon:** To ask the Chancellor of the Exchequer if he will ensure that telephone inquiries in respect of the gift aid scheme are given information about smaller and regional charities.
>
> **Ms Hewitt:** The Gift Aid 2000 campaign is designed to raise awareness of the Millennium Gift Aid scheme, which provides tax relief for donations to UK charities to support education and anti-poverty projects in the world's 80 poorest countries. It is proposed to extend the scheme to provide also for the relief of poverty of refugees from designated countries and to designate Kosovo. People who ring the Gift Aid 2000 telephone number can choose up to three charities to benefit from their donation. If a donor requires assistance in choosing a charity, the operator will suggest some for the donor's approval. These are randomly selected by computer, either from a list of charities working in a part of the world or on a charitable activity nominated by the donor, or from the complete list of participating charities. All participating charities have an equal chance.[60]

Generally the view among charities was that MGA showed what could be done to encourage a greater level of donations, and a more regular pattern in gift giving, but that its take-up had proved disappointing.[61] In particular some charities argued that the promotional campaign was at fault, and that MGA had failed to sustain a significant increase in donations from young people.

A second connected change was made at this time to the tax treatment of gifts in kind by companies. Businesses are entitled to deduct against tax a donation of equipment to

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[56] HM Treasury press notice 51/98, 18 March 1999

[57] HM Treasury press notice 58/99, 6 April 1999

[58] under s 56 of the *Finance Act 1999*. This provision was introduced at the Committee stage of the Finance Bill (Standing Committee B 17 June 1999 cc 698-700)

[59] SI 1999/2118

[60] HC Deb 15 April 1999 cc 332-333W

[61] for example, "Izzard fails to lift gloom over Third World gifts", *The Mail on Sunday*, 17 October 1999

educational establishments,[62] and in the March 1998 Budget it was announced that this relief would be extended for the same period as MGA to assist educational projects in those countries covered by MGA.[63] Following debate on this provision at the Committee stage of the Finance Bill that year,[64] the Government introduced an amendment at the Report stage to extend this relief to gifts in kind for medical purposes.[65] In the March 1999 Budget the Government announced this relief would be extended to cover donations of equipment for *all* charitable causes.[66] Further details were given in the *Review of Charity Taxation* document published at this time:

> Gifts of assets
> 3.13 We want to encourage gifts of assets. These gifts can provide valuable support for charities. As with gifts by individuals, businesses can get full relief from tax on any capital gains arising when they give assets to charity. The difficulty involved in valuing assets, and the potential for tax avoidance, means that businesses cannot get tax relief for the costs of some kinds of asset that they give to charity.
>
> 3.14 However, businesses can get tax relief for the costs of gifts of trading stock and equipment which they sell or use in the course of their business. This can include items such as computers, photocopiers, minibuses and furniture. The relief does not, however, apply to gifts to all charitable causes. It has long been available for gifts to schools and colleges in the UK. And in last year's Budget it was extended to gifts to charities to be used for medical purposes or by schools and colleges in the world's poorest countries.
>
> 3.15 We propose to extend the scope of the tax relief to cover any charitable cause, as part of the Chancellor's Budget measures this year.[67]

This provision was introduced under section 55 of the *Finance Act 1999*; when it was scrutinised in Standing Committee, the then Economic Secretary, Patricia Hewitt, presented this change as part of the Government's general approach to charity taxation:

> Through the tax review the Government have put forward an exciting series of options, which have been warmly welcomed by the charities sector, for the simplification, modernisation and substantial increase in the generosity of, tax incentives. Those options will incentivise giving by businesses, individuals and employees through the payroll giving system … The clause introduces a welcome extension of an existing tax relief for business gifts in kind. It is part of a broader

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[62] under section 84 of the *Income and Corporation Taxes Act (ICTA) 1988*, introduced under section 68 of the *Finance Act 1991*.
[63] This provision was introduced under section 47 of the *Finance Act 1998*.
[64] Standing Committee E 21 May 1998 cc 345-369
[65] HC Deb 1 July 1998 c 374
[66] HM Treasury Budget press notice HMT10, 9 March 1999
[67] *Review of Charity Taxation: a consultation document*, March 1999 pp 14-15

> strategy which will unfold in the years ahead to encourage a greater number of people to give more.[68]

The following section of this paper looks at the March 1999 consultation document in detail.

D. *Review of Charity Taxation* – March 1999

In his March 1999 Budget speech the Chancellor announced the publication of the Government's consultation document on charity taxation:

> I now turn to our review of charities. A Britain of strong families is also a Britain of strong communities. Each year, more than 1 million people give up their time in voluntary work. Millions more give money to our national charities. The Prime Minister has rightly called for our age to become a giving age.
>
> I want to mark the millennium in the best way by making 2000 the giving year. In the last Budget, we introduced millennium gift aid. For every £100 a British citizen donates to third world causes before the end of the year 2000, the Government will contribute £30. When millennium gift aid is launched on 18 March, I urge British people to give more to those who have too little. As Governments make their contribution to third world debt relief, all of us can make a contribution to third world poverty relief.
>
> Today, in our consultation document on tax and charities, we propose extending the tax advantages of millennium gift aid. We propose that every charity, national and international, should be able to benefit from this new tax relief. We propose in future for every £100 a British citizen donates to any charity, through tax relief the Government will contribute £30. Instead of charities seen in the old way, the rich bestowing favours on the poor, I want a democracy of giving where all those who can, help all those who cannot. [69]

The paper made a number of recommendations, summarised in a press notice:

- improve Gift Aid to make it a more accessible means of tax-effective giving by reducing the minimum limit for donations from £250 to £100 and allowing that limit to be reached by instalments - to take effect when the current Millennium Gift Aid scheme finishes at the end of next year;[70]

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[68] Standing Committee B 25 May 1999 cc 457-459

[69] HC Deb 9 March 1999 c 186

[70] In addition it was also suggested that by making improvements in Gift Aid, the system for making donations under a deed of covenant could be abolished; this is discussed in detail in part II.F of this paper.

- make the Payroll Giving scheme more flexible by removing the maximum limit for donations and allowing employers to distribute employees' donations directly to charities;

- encourage greater take-up of the Payroll Giving scheme through a "kick start" supplement from the public purse to add an extra 10 per cent to donations made over a limited period, backed by a campaign to encourage more employers to set up schemes;

- modernise the existing VAT reliefs for charities to make them simpler and more consistent, including the relief for advertising costs;

- simplify the tax system for charities, for example, by exempting from direct tax the profits of small charity businesses, extending and aligning the direct and indirect tax reliefs for fund-raising events, and providing a single telephone helpline that charities can ring for advice on all aspects of tax.

- In addition, to encourage more giving by businesses, the number of good causes to which businesses can donate equipment and get tax relief against their profits is being widened to cover all charitable causes. The necessary legislation will be brought forward in the forthcoming Finance Bill.[71]

The initial response to the document was positive, although charities were disappointed that no fundamental change was proposed in charities' VAT treatment:

> The Government's efforts to raise charitable support will be welcomed throughout the voluntary sector. But there was disappointment the Government is concentrating on raising charitable giving, rather than addressing structural financial problems. Top of this list is an estimated £400m a year that charities pay in irrecoverable VAT … Stuart Etherington, chief executive of the National Council for Voluntary Organisations, said failure to act on VAT meant the Government's proposals would receive 'two rather than three full cheers' from the sector.[72]

Two tax professionals writing in *Accountancy* in June 1999 argued there had been a shift in Government policy toward charity taxation, since the consultation exercise began:

> When the consultation document was published, it revealed a changed agenda. The emphasis was now on direct tax, particularly on personal-giving structures. The VAT refund approach was comprehensively rejected because of European law and public spending constraints. Proposals for the reform of charity taxation in the business and trading areas have more the flavour of tinkering than of a reform that can take us several decades into the next century. The document

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[71] HM Treasury Budget press notice HMT10, 9 March 1999 As mentioned above, the last measure on this list was implemented under section 55 of the *Finance Act 1999.*

[72] "Better incentives may boost charity coffers", *Financial Times*, 10 March 1999

> narrows down considerably the issues that the Treasury is willing to consider further, and many people in charity finance must be wondering whether it is worth the struggle of continuing to press for the narrower range of options that are now open, and to continue to take part in a detailed consultation exercise to ensure that any changes to legislation do reflect their views.
>
> Such fatigue is understandable, and if it results in charities failing to respond by the deadline of 31 August 1999, then one can feel only sympathy. But it seems vital that charities draw on their reserves of strength once again, and contribute their views. This will be the last chance.[73]

Generally speaking there was widespread support for the specific proposals made in the paper, and, in the case of Gift Aid, many respondents argued that the minimum limit for donations should be lower than the Millennium Gift Aid limit of £100:

> There was widespread support from respondents for the proposals to reduce the minimum limit for Gift Aid donations and allow donations to be paid by instalments. Some respondents were content with a reduction to £100 (the amount which currently qualifies for Millennium Gift Aid) but many favoured a lower limit. Amounts of £50 or £20 were commonly suggested. A number of respondents questioned the need for any limit at all, particularly for regular giving by standing order, direct debit, etc. These respondents felt that withdrawal of the limit would encourage new donors, especially young people, into charitable giving.[74]

As mentioned above, in October 1999 the Government published research carried out by Inland Revenue, the Charities Aid Foundation and the NCVO, on current patterns of charitable giving and the role of tax reliefs to encourage the level of donations. A press notice issued at the time summarised the conclusions to this research:

> Nearly 70 per cent of the UK population give to charity in a typical month but less than 10 per cent use the tax breaks for charitable giving … Key findings [of the research] show that only 43 per cent of the population are aware of the tax incentives for charitable giving. 13 per cent did not know how to use them and 11 per cent thought they would be too difficult to use …
>
> There are issues for employers too. Less than 20 per cent said their employer offered a Payroll Giving scheme, even though giving through the pay packet is popular, especially with young people and those on lower incomes. Over 20 per cent of those whose employer did not offer this facility said they would give through their pay packet if they got the chance.[75]

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[73] "Charity tax consulting fatigue – can we go the last mile?", *Accountancy*, June 1999

[74] *Review of Charity Taxation: Summary of Responses to the Government's Consultation Document*, October 1999 pp 2-3

[75] HM Treasury press notice 174/99, 28 October 1999

The survey looked at the specific question whether tax incentives had a positive impact on the level of charitable donations:

Do tax incentives motivate people to give?

General attitudes : Focus group discussions suggested that in deciding whether to give or not, givers are more guided by the cause they are asked to support than by considerations of tax-effectiveness or other concerns. Individuals are divided between those who favour a high level of involvement in their giving and those who want giving to be quick, easy and low profile.

Attitudes to using tax-effective schemes : Although basically in favour of tax-effective giving, people have some misgivings about its perceived impersonality, perceived costs, and whether it might influence Government to raise taxes or cut services. Although some people had expressed a preference for regular giving, when asked why they did not use tax-effective schemes 7% of the general population sample said they did not want to commit to regular tax-effective giving, as they preferred to give spontaneously. 6% said they could not afford it, and 3% did not give enough money for it to be tax-effective.

Despite this, almost half of the sample of givers (49%) felt that it was *important* or *very important* to give donations that are tax-effective to charity. These attitudes were concentrated among higher social classes and higher income groups, although there did not appear to be an age effect. Only half this proportion (23%) felt that it was *important* or *very important* to them to be able to reduce their own tax bill by giving.

One-third (33%) of givers said that they would be *very* or *quite likely* to use tax-effective methods in future. Likelihood of future use is more likely amongst younger and more affluent individuals. In order to make a tax-effective donation 42% of givers were happy to fill in paperwork and send off a form with their name, address and confirmation of their tax status, 19% were happy to do this by telephone, and 5% were happy to do this through the Internet.

Younger People – how they give and why they don’t give more : The small sample of interviews with younger, lower income earners revealed that lack of disposable income, a desire to spend all the money they earned on themselves, and a feeling that charities lacked relevance to their own experience, were all advanced as reasons why young people donate less to charities than other age groups. The younger, lower earners felt that charity advertisements should be targeted more to give information and feedback about how the money is used, and information should be made more relevant and exciting to young people if charities want to attract them to donate more regularly.

Use of tax returns for donations : One-third of the higher income sample thought that a reminder on the tax return would encourage more giving, and a further 23% thought it probably would.

> **Donor tax benefits :** Just under one-quarter of the sample thought donors would give more if the benefit went to the donor (as in the US), but more than half of these would not donate the additional 30% needed to compensate charities for the loss of tax benefits entailed in such a system.[76]

In his Pre-Budget Statement in November 1999 the Chancellor announced a number of "reforms to support the community organisations that are closest to people and where dedicated staff and volunteers can offer one-to-one help" as part of its campaign to abolish child poverty in Britain, including certain changes in charities' taxation:

> For too long the voluntary sector has been held back by outdated tax laws. We propose that, in future, for every £1 a British citizen donates to charity, the Government will contribute to that charity an additional 28p. For every £1 contributed through payroll giving, the Government will contribute 50p worth of tax relief. There will now be tax relief not just for cash donations but for gifts of quoted shares. The British people's willingness to give can give all our children a better chance, and all of us a better society.[77]

Details were published in a press notice issued at the time.[78] Among these proposals possibly the most important was the abolition of the £250 minimum limit for donations under Gift Aid, and the £1,200 maximum limit for payroll giving. The *Financial Times* reported that charities generally welcomed the Chancellor's statement:

> The announcement … gained a warm reception from the Charities Aid Foundation … 'These are radical measures which we estimate will lead to £350m extra per annum in tax relief,' said Simon Hebditch, the Foundation's policy director. Oxfam, Britain's biggest charity, was also in celebratory mood with Simon Collins, its head of fundraising, describing the Chancellor's speech as a 'clear, positive, and imaginative proposition to the public to give more.'[79]

One commentator writing in *The Tax Journal* commented, "not everything that was asked for has been given … however, it is probably fair to say that this Pre-Budget Report does introduce a totally new way of tax-efficient giving. The Government has left it to charities to increase donations and boost their income by offering greater tax incentives to do so."[80] In a briefing note published in December 1999, the IFS questioned whether the increase in direct tax relief would lead to a rise in charitable giving:

> A more difficult question to answer at this stage is what effect the increase in tax relief will have on individual donations to charity. Giving tax-relief is not a free

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[76] Inland Revenue, *Research briefing charity tax review*, October 2000 The document is available on the Revenue's internet site at: www.inlandrevenue.gov.uk/feedback/research.htm

[77] HC Deb 9 November 1999 c 890

[78] HM Treasury Pre-Budget Report press notice HMT 8, *Getting Britain giving in the 21st century*, 9 November 1999

[79] "Tax incentive package aims to boost charities", *Financial Times*, 10 November 1999

[80] "Charity taxation review", *Tax Journal*, 13 December 1999

> lunch for charities. The opportunity cost may be most clearly seen as the government giving up tax revenue which it could pass on to charities as grants. But tax relief may be a more effective way of using government revenue to support charities if there is a knock-on effect of tax relief increasing individual donations. The possible danger is that tax relief may cause givers to reduce the size of their donations knowing that the government is providing a top up.[81]

E. Direct taxation: changes in the *Finance Act 2000*

In his March 2000 Budget speech the Chancellor confirmed that the Government would introduce the measures for extending direct tax reliefs first set out in the March 1999 consultation paper, and in certain respects, it would extend the scope of these new reliefs to what had been proposed in the November 1999 *Pre-Budget Report*. Part of his speech is reproduced below:

> All voluntary organisations and charities will benefit from the tax reforms we are announcing to make it easier to give money and to give time. From 6 April this year for every pound any taxpayer gives to charity, the Government will add an extra 28 pence. To encourage payroll giving, for every pound contributed through the pay packet, the Government will add up to 50 pence worth of tax relief. Tax relief will be available not just for cash donations, but for gifts of shares. To encourage corporate giving, any company, from 1 April, can receive tax relief on the full amount of any donation.[82]

Guidance notes published by the Inland Revenue at the time provided a full summary of these changes, and this is reproduced below:

Gift Aid

- abolish the £250 minimum limit for Gift Aid donations, so that the scheme will apply to any donation, whether large or small, regular or one-off
- withdraw the separate tax relief for payments made under a Deed of Covenant and give all relief for such payments in future under the Gift Aid scheme[83]
- replace the requirement for donors to give the charity a Gift Aid certificate with a requirement to give a new, simpler and more flexible Gift Aid declaration
- allow donors to give a Gift Aid declaration over the phone or over the Internet if they wish, without having to complete and sign a paper declaration
- remove the requirement that donors must pay income tax at the basic rate equal to the tax deducted from their donations – in future donors will simply have to pay an amount of income tax or capital gains tax, whether at the basic rate or some other rate, equal to the tax deducted from their donations
- allow donors to claim higher rate tax relief for their donations against either income tax or capital gains tax
- allow

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[81] IFS, *Pre-Budget Report: review of charity taxation: Briefing Note 2/99*, December 1999

[82] HC Deb 21 March 2000 c 866

[83] This is discussed in more detail in part II.F of this paper.

  - Crown servants and members of the UK armed services serving overseas,
  - other non-UK-resident individuals who make donations out of income or gains charged to UK tax, and
  - non-UK-resident companies

  to use the Gift Aid scheme

- remove the requirement for companies, including companies owned by a charity, to deduct tax from their donations and give a Gift Aid declaration to the charity

Payroll Giving

- abolish the £1,200 a year ceiling for Payroll Giving
- as part of a Government campaign to promote the Payroll Giving scheme, pay a 10 per cent supplement on top of all Payroll Giving donations for three years
- tighten the regulations for the time limit within which Payroll Giving agencies must distribute donations to charity

Shares and securities

- introduce a new tax relief for gifts of certain shares and securities to charity

Settlor-interested trusts

- introduce a new income tax relief for people who settle property on UK-resident trusts where beneficiaries include a charity – the income on which the settlor of a settlor-interested trust is chargeable to tax under Part XV of the Taxes Act will be reduced by an amount equal to the income that is paid by the trust to the charity.[84]

All of these measures took effect from April 2000. Taken with the changes made in charities' VAT reliefs introduced at this time,[85] it was estimated that these measures represented an extra £400 million a year in tax relief.[86]

Provisions relating to the changes in direct taxation were contained in the Finance Bill 2000, and scrutinised in Standing Committee,[87] prior to the Bill receiving Royal Assent.[88]

As noted above, one of the changes made to Gift Aid involved the requirement previously placed on donors to give the charity concerned a signed certificate. This has been replaced with a new, simpler and more flexible Gift Aid declaration; a short description is taken from the Revenue's guidance for charities:

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[84] Inland Revenue, *Getting Britain Giving*, March 2000 para 2 An updated version of this guidance is available on the Revenue's internet site at https://web.archive.org/web/20020611062523/http://www.inlandrevenue.gov.uk/charities/index.htm

[85] These measures are set out in part III.C of this paper.

[86] Inland Revenue Budget press notice IR/C&E3, 21 March 2000

[87] Standing Committee H 23 May 2000 cc 341-386

[88] They are now contained in ss 38-46 of the *Finance Act 2000.* In addition two Orders have been made under these provisions: *Donations to Charity by Individuals (Appropriate Declarations) Regulations* SI 2000/2074; *Charitable Deductions (Approved Schemes) (Amendment No 2) Regulations* SI 2000/2083 – both of which came into force from 21 August 2000.

Before a charity can reclaim tax on a donation by an individual, it must have received a Gift Aid declaration from the donor containing certain information and confirming that the donation is to be treated as a Gift Aid donation. Without this declaration, a donation from an individual will not qualify under the scheme.

Donors will be able to give the charity a declaration:

- in advance of their donation, at the time of their donation, or at any time after their donation (subject to the normal time limit within which tax can be reclaimed – normally around six years)

- to cover a single donation or any number of donations
- in writing (e.g. by post, by fax or electronically through the Internet) or orally (e.g. over the phone or face to face) …

All Gift Aid declarations must contain:

- the donor's name
- the donor's address
- the charity's name
- a description of the donations to which the declaration relates
- a declaration that the donations are to be treated as Gift Aid donations

and, except in the case of a declaration given orally:

- a note explaining the requirement that the donor must pay an amount of income tax and/or capital gains tax equal to the tax deducted from his or her donations.

There is **no** statutory requirement for a declaration to be signed and dated. A date is needed on the declaration only where it serves to identify that a particular donation or donations are to come within the scheme. For example, if the declaration stated that *"all donations I make from today"* were to be Gift Aid donations, clearly a date would be required. A date would not be required, however, where the declaration stated, for example, *"all donations I make to the charity from 6 April 2000."*

In the case of a written declaration, the charity may wish to pre-print most of the information on the declaration form. For example, the charity's name might be pre-printed. Charities need to bear in mind, however, that a donor might later wish to deny that he or she made a declaration. If there is no part on a written declaration completed by the donor, the charity will find it difficult to prove that the declaration was genuine.[89]

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[89] Inland Revenue, *Guidance notes for charities*, November 2000 para 3.10-3.11

Further guidance for both individuals and companies making Gift Aid donations is published by the Revenue, and available from its internet site.[90]

In November 2000 the Government announced a £1 million grant to support a charity sector-led campaign to boost charitable giving, led jointly by the National Council for Voluntary Organisations (NCVO) and the Charities Aid Foundation (CAF).[91] Following this in March 2001 the NCVO and CAF published a survey of charitable giving which found that twelve times as many donors are now using Gift Aid since the introduction of the 'Giving Britain Giving' package in April 2000.[92] An extract from this survey is reproduced below:

> In April 2000 the government relaxed the rules so that any gift, small or large, regular or one-off, could qualify for Gift Aid … CAF and the NCVO have estimated that these changes could net an extra £200-£400 million per annum for charities if a much wider range of gifts is made through new Gift Aid.
>
> To monitor any change, regular NOP surveys have been jointly commissioned by NCVO and CAF since July 1999 ... The surveys use a sample of 1,000 individuals selected to be representative of the adult population of Great Britain.
>
> **Numbers of donors using new Gift Aid since April 2000**
> Figures from these surveys show that currently two-thirds of the adult population in Britain give money to charity. The October 2000 survey showed that 6 months after the introduction of the new tax reliefs in April, almost one quarter of donors (23%) had been asked by charities to confirm their tax status when giving through a wide variety of methods, and 17% actually confirmed their tax status to charities.
>
> Adjusting for the number of non-tax payers in the sample who confirmed their tax status, however, means that a final figure of 12% for new givers through Gift Aid was reached. This represents one-fifth of all tax-paying donors who could still be brought into the scheme and 12 times as many tax-effective givers as before the tax changes.
>
> The actual proportion of individual gifts elected to be made through new Gift Aid in October 2000 was 7%. This represents one-fifth of the total amount given to charity in a year, or £1 billion. … It could also mean that in effect one third (30%) of the amount which is potentially convertible to new Gift Aid and eligible for the new tax reliefs has actually been converted – as long as charities themselves actually reclaim the tax eligible.

The survey went on to examine what evidence there was that the changes made to Gift Aid had encouraged new donations:

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[90] https://web.archive.org/web/20020601214246/http://www.inlandrevenue.gov.uk/menus/charity.htm
[91] HM Treasury press notice 132/00, 21 November 2000
[92] "Charities benefit as Brown lures us into extra giving", *Observer*, 25 March 2001

Have the tax changes attracted new donors?
So far it is impossible to tell how much of this increase is due to donations from new donors (previous non-givers). The lack of any significant overall increase in the total number of givers in the population suggests they may not have. It is also difficult to conclude yet whether more people are giving more this month than previously. More long-term research, currently being conducted by CAF /NCVO/ Inland Revenue should help to determine such impacts.

Have the tax changes attracted different donors?
Compared to previous tax-effective givers, those using new Gift Aid are more evenly spread between the sexes (compared to a more male dominated group before (51% female versus 42% female)); more likely to be from social class C1 (50% compared with 34% previously) rather than from AB; and more likely to be middle-aged (31% were aged 45-54 compared with 21% of previous tax-effective givers). The picture so far then is one of partial democratisation of tax-effective giving although it has yet to significantly increase donations from younger and lower-income individuals.

The potential value of the increased tax reliefs to the sector
It is tentatively concluded at this stage that the bulk of new Gift Aid donations are from people who previously gave about the same amounts non tax-effectively. If this is true then the main benefit to the charity sector at this point is the additional amount of tax reclaimable on these newly tax-effective donations (3% of the total amount given in this survey) and may contribute an extra £150 million in a year to the sector if all this tax is reclaimed in a timely way.

In the light of these findings, the authors made a number of conclusions:

New Gift Aid is clearly already having an effect on charities' fundraising tactics. However, much more needs to be done to turn a minority of tax-effective gifts into a situation where most gifts to charity are made tax-effectively.

The main messages to come out of this research are threefold:

Firstly, to charities: the greatest trigger to getting people to convert to tax-efficient methods of giving is to ask them, and the majority of donors remain unasked. The potential for greater income from new Gift Aid is enormous.

Secondly, to donors: new Gift Aid and other tax-effective ways of giving allow charities to claim back an extra 28% on top of your donation at no extra cost to you, and all you have to do is to confirm to the charity that you pay enough income tax in the UK to cover the cost of this basic rate relief.

> Thirdly, to policymakers: people need to be made more aware of the opportunities to give more effectively to charity. The Giving Campaign is the ideal vehicle for doing this.[93]

F. Deeds of covenant

A deed of covenant is a legal document by which an individual or a company promises to pay a fixed sum to a specific charity each year. Prior to April 2000 covenantors received relief from income or corporation tax on their covenanted donations to charities, provided the covenants could run for more than 3 years, though in practice most covenants are written for 4 years. No restrictions were placed on the amounts donated this way.

The amount paid by the donor was treated as a 'net' amount after deduction of basic rate income tax, which the charity could claim back from the Inland Revenue. Deeds normally contained words to the effect that the donor would pay "such an amount as after deduction of tax equal £x." So, the amount paid by a covenantor did not change with changes in the basic rate of income tax. However, some covenants provided for payment of a fixed gross amount, so that the net payment varied with changes to the basic rate. Donors who paid income tax at the higher rate could claim higher rate tax relief in their tax return (at the difference between the higher rate and the basic rate). Donors who paid income tax at a rate below the basic rate, or who paid no income tax at all, had to pay basic rate income tax in respect of their donation so that, overall, the correct amount of tax relief was given.

The March 1999 consultation paper on the taxation of charities touched on the problems created by this system of tax relief:

> **DEEDS OF COVENANT AND GIFT AID**
> 2.5 The Deed of Covenant scheme has existed for many years. It involves the donor entering into a legally enforceable commitment – in a deed – to make regular, fixed donations to a charity for a period exceeding three years. There is no minimum or maximum limit on the amount that can be given. The scheme can be quite complex. For example, the deed has to comply with a number of formalities of general law, and there are some tax rules – which have been

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[93] CAF press notice, *Giving comes of age*, 14 March 2001. The full text of this press notice is available on CAF's internet site at

http://web.archive.org/web/20010410120842/http://www.cafonline.org/news/pr/2001/pr20010314_9.cfm

> developed by the courts in judicial decisions and supplemented in statute – that can be difficult to understand and apply …
>
> **IMPROVING DEEDS OF COVENANT AND GIFT AID**
> 2.11 It is clear that many respondents find the Deed of Covenant scheme complex and archaic. They have suggested that with more modern forms of regular giving – such as bank standing order and direct debit – there should no longer be a need for donors to have to make a legal commitment in a Deed of Covenant in order for these kinds of donation to qualify for tax relief. Some also said that the requirement to give for a period exceeding three years deters many potential donors, while others said they valued the commitment that donors make under this requirement. Charities commented on the problems they face in getting donors to increase the amount of their donations while the deed is still running or to renew the deed on its expiry.
>
> 2.12 The Government agree that the Deed of Covenant scheme is complex and can be off-putting for potential donors. Over the years a number of steps have been taken to simplify the way the scheme operates, but we think there is little scope for significant further improvements. Instead, we believe that the best way of addressing many of the concerns that have been expressed about Deeds of Covenant is by improving the Gift Aid scheme so that it offers an alternative, modern, flexible relief which donors and charities find attractive and user-friendly, and which is within the reach of the vast bulk of donors and which, over time might become the preferred choice of donors and charities.[94]

In responses to the consultation document, some churches raised concerns about withdrawing the provisions for donations under a covenant scheme:

> There was widespread support from respondents for the proposals to reduce the minimum limit for Gift Aid donations and allow donations to be paid by instalments ... A number of respondents questioned the need for any limit at all, particularly for regular giving by standing order, direct debit, etc ... Churches were concerned that if the Deed of Covenant scheme was to be abolished, any new tax relief for regular giving should cover cash giving through the collection plate, as well as standing order, direct debit, etc. [95]

As a consequence of the Government's proposal to abolish the minimum limit for donations under Gift Aid from April 2000, the rationale for this separate tax relief disappeared. Legislation to abolish tax relief for covenanted donations was introduced under section 41 of the *Finance Act 2000*.[96] In the light of the concerns mentioned above,

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[94] *Review of Charity Taxation: a consultation document*, March 1999 pp 6-7

[95] *Review of Charity Taxation: Summary of responses to the Government's consultation paper*, October 1999 pp 2-3

[96] The provision was adopted with debate at the Committee stage of the Finance Bill (Standing Committee H 23 May 2000 c 376).

it may be helpful to reproduce the Inland Revenue's guidance on the transitional arrangements that are to cover existing covenants drawn up *before* 6 April 2000:

> **Deeds of Covenant – transitional arrangements**
> From 6 April 2000 there is no longer a separate tax relief for payments made by an individual (or a company) under a Deed of Covenant – in future all tax relief for such payments is under the Gift Aid scheme. As a transitional measure, charities do not have to get a Gift Aid declaration in respect of payments under a Deed of Covenant that is already in existence before 6 April 2000. The Deed of Covenant will stand in place of the Gift Aid declaration. However, any donations made outside the terms of the Deed, or after expiry of the Deed, must be covered by a separate Gift Aid declaration.
>
> Payments made under a Deed of Covenant executed on or after 6 April 2000 must be covered by a Gift Aid declaration. Where a charity wishes to continue with the use of Deeds of Covenants for donors, these can also be used as declarations provided all the information required in the declaration is given on the Deed.
>
> The abolition of a separate tax relief for payments made under a Deed of Covenant to a charity does not mean, of course, that such deeds will cease to exist. It does mean that they are no longer required so that a charity can reclaim tax on the donations. Some charities may decide to continue to obtain Deeds of Covenant from their supporters in order to secure a regular flow of income. If they do so, they will need to make sure they also obtain a Gift Aid declaration from the donor, or ensure the Deed contains the necessary elements required in such a declaration.
>
> *Example*
> *Mrs Jones has a Deed of Covenant in force with her local church to pay £2 weekly. The Deed commenced on 1 January 2000, and will cease on 31 December 2003. On 1 September 2000 she increased her weekly donations to £3 per week. Mrs Jones will need to make a Gift Aid declaration in relation to the additional £1 a week she is giving, if she wants the amount to come within the scheme. Even if she does not, she will need to make a declaration after December 2003 if her original donations of £2 are to continue to be tax effective.*
>
> *Alternatively, if Mrs Jones is willing, the church may decide to cancel the covenant with effect from 6 April 2000 and replace it with an open Gift Aid declaration in relation to all donations made by her on or after 6 April 2000. Mrs Jones can make a Gift Aid declaration from 6 April 2000, even if the covenant remains in force, to cover the deed payments and any other donations she may make to the church.*[97]

[97] Inland Revenue, *Guidance notes for charities*, November 2000 para 3.16

III VAT

Turning to indirect taxation, it is worth examining one aspect of charity taxation that did *not* see any change as a consequence of the Government's review – charities' difficulties with irrecoverable VAT – before looking at those changes that have been made. As an introduction to this topic, the following paragraphs give a summary of how VAT works.

A. Introduction

VAT is charged on the supply of all goods and services made *in the course of a business* by a taxable person, unless they are specifically exempt. All businesses must register for VAT if their turnover of taxable goods and/or services is above a given threshold, which is currently £54,000.[98] VAT is charged either at the basic rate - currently 17½% - or the zero rate.[99]

VAT is charged on the additional value of each transaction, and is collected at each stage of production and distribution. A business pays VAT on its purchases - known as input tax, and charges VAT on its sales - known as output tax. It will settle up with HM Customs and Excise for the difference between the two. In the end the cost of the tax is borne by the final consumer.

It is important to underline the difference between supplies exempt from VAT, and those that are zero-rated. Zero-rated supplies are technically taxable, though no actual tax is paid on them. They count as part of the taxable turnover of a business for registration purposes, and VAT charged on inputs related to zero-rated activities can be reclaimed. This is not the case with exempt supplies, which are outside the tax system. Businesses which make exempt supplies do not charge output tax, and cannot reclaim input tax. In effect, a business making exempt supplies has to absorb the VAT charged to it by its suppliers.

In the UK, the VAT rules apply equally to charities and commercial organizations in determining what is a supply in the course of business. In the simplest terms, anything done in return for consideration in money or something else is a business activity. This distinction is important because for their business activities charities can recover the VAT they incur on purchases relating to taxable (standard rate or zero rated) supplies, but not in relation to VAT exempt supplies.

Examples of exempt-supplies that charities often carry out as part of their business activities include:

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[98] With effect from 1 April 2001.

[99] There is one exception to this: a reduced rate of 5% is charged on the supply of domestic fuel and power, and the installation of energy saving materials, under schedule A1 to the *Value Added Tax Act (VATA) 1994.* The reduced rate was extended to sanitary protection from 1 January 2001.

- The provision of care, treatment or instruction for the mental or physical welfare of the elderly, sick, distressed and disabled; as well as the provision of services directly connected with the protection of children and young persons.[100]

- Education as provided at schools or universities, together with incidental goods and services.[101]

- The supply of goods and services by a charity in connection with a fundraising event - say, a fête, bazaar or performance - organised for charitable purposes by a charity, or jointly between charities, provided that the event is separate from, and does not form any part of a series or regular run, of like or similar events.[102]

Charities are also unable to recover the VAT they incur on the things that they buy in order to carry out their *non-business* activities, as these lie outside the scope of VAT.[103]

Although there is no general relief from VAT for charities *purely* because of their charitable status, there are a number of specific VAT reliefs which benefit many charities. For example, certain supplies are charged the zero rate, including the supply, by a charity or its trading subsidiary, of any goods donated for sale; and, the export of any goods by a charity.[104]

B. Irrecoverable VAT

Charities have long argued that although their trading and fund-raising activities might be subject to VAT, there should be a grant scheme from public expenditure to compensate charities for the VAT they incur on goods and services used in their exempt and non-business activities.[105] Over the last 20 years Governments of both parties have opposed such a scheme for two reasons. First, a general VAT relief scheme would be indiscriminate in its effects, "benefiting not only those charities which do valuable work in the community but also - and sometimes disproportionately so - many other bodies with very limited or controversial aims which do not command public support," as the then Chancellor Sir Geoffrey Howe stated during his 1983 Budget speech.[106]

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[100] Under schedule 9, group 7 (item 9) of *VATA 1994*

[101] Under schedule 9, group 6 of *VATA 1994*

[102] Under schedule 9, group 12 of *VATA 1994*

[103] Some examples of non-business activities include providing supplies for the relief of distress consistently made at below cost; and, voluntary services given free of charge in accordance with the objects of the charity.

[104] These are set out in group 15 to schedule 8 of *VATA 1994*. In addition certain goods and services, when supplied *to* a charity, can be zero-rated; these are also included in schedule 8 to *VATA 1994*.

[105] It is often pointed out that local authorities in this country are entitled to a full refund of their irrecoverable VAT incurred for non-business purposes - under section 33 of *VATA 1994*. This provision was originally enacted so that VAT did not fall as a burden on local taxpayers.

[106] HC Deb 15 March 1983 c 145

Second, it has been argued that it is a more efficient use of public resources to design fiscal incentives for charities that have a 'double dividend' effect – reducing charities tax liabilities, while at the same time encouraging personal and corporate giving. From this perspective, providing tax relief on charitable donations can be seen as a preferable method for the Exchequer to support charities, to channelling help through the VAT system.

Finally, some charities have proposed a substantial extension in the coverage of zero-rating, as an alternative to a grant-in-aid scheme. Unfortunately this would be contrary to European VAT law. Briefly, all Member States have limited discretion in amending the structure and rates of VAT under EU VAT law. In the case of zero rating, although EC VAT law allows Member States to continue to charge those zero rates already in force, no Member State is able to introduce any new zero rates of VAT.[107]

As mentioned above, the Government published its consultation paper on reforming charity taxation at the time of the March 1999 Budget, and among the issues it discussed was charities' irrecoverable VAT:

> CHARITIES AND VAT
> 5.3 Charities in the UK currently benefit from some £200 million per year in reliefs from VAT through a variety of zero rates and exemptions. Many of these reliefs are special zero rates for charities, which were introduced by Parliament in recognition of the important part that charities play in our society.
>
> 5.4 Charities made clear to us the value to them of the existing VAT reliefs but they also said that VAT reliefs can complicate the tax system and increase their compliance costs …
>
> IRRECOVERABLE VAT
> Charities told us: "Charities should be allowed to reclaim 100 per cent of the input VAT incurred on their non-business expenditure on goods and services used in fulfilment of their charitable objectives."
>
> 5.7 Some charities argued that they should receive the same treatment as local authorities under Section 33 of the VAT Act 1994. This provision allows local authorities a full refund of their irrecoverable VAT incurred for non-business purposes. It was originally enacted so that VAT did not fall as a burden on local taxpayers. The only bodies added to Section 33 since 1972 have been those undertaking what are, or were formerly, local authority functions, and who have the power in law to precept on local taxes. Charities have no such power and so it is inappropriate in our view to consider extending Section 33 to include them.
>
> 5.8 We have looked closely at the case for a UK grant scheme from public expenditure to compensate charities for the VAT they incur on goods and services used in their exempt and non-business activities. Having given this very

[107] This issue is examined in a Library Research paper: *VAT harmonisation 97/31*, 27 February 1997.

> careful consideration we have concluded, for reasons of principle and of cost, that this is not an idea we wish to pursue.
>
> 5.9 A fundamental principle of VAT is that organisations and individuals can only recover VAT to the extent to which they make taxable supplies. If individuals or organisations are not making taxable supplies, they cannot recover VAT on the things that they buy. This includes charities providing services for no charge and those making exempt supplies. To give charities this tax back would be contrary to this fundamental principle.
>
> 5.10 Moreover, any such scheme would mean a large rise in public spending on charities. Charities have estimated that their VAT bill relating to their non-business activities and exempt activities is in the region of £460 million per year. The figure would continue to rise in proportion to the size of the sector and its range of activities. We would therefore be faced with a permanent, high and rising demand on annual public expenditure, which would need to be found from elsewhere in the Government's budget, and would inevitably compete with other public spending priorities. A grant scheme would also increase administrative costs for charities and Government. It would add further complexities to the system, and run counter to our objectives of simplifying the tax system for charities and helping to minimise their compliance costs.[108]

Recently the Economic Secretary, Melanie Johnson, summarised the Government's position on charities' irrecoverable VAT in a written answer, reproduced below:

> **Mr. Wigley:** To ask the Chancellor of the Exchequer if he will make a statement on the Government's policy on relieving charities of some or all of the costs of VAT on transactions directly related to their charitable objectives.
>
> **Miss Melanie Johnson:** Charities already benefit from a range of special VAT reliefs. Systems for relieving charities' irrecoverable VAT were given very careful consideration during the recent Review of Charity Taxation. In the Review's consultation document, published in March 1999, the Government made it clear that for reasons of principle and cost these were not ideas that it wished to pursue.[109]

The consultation paper went on to make a number of recommendations to "modernise the existing VAT reliefs for charities to make them simpler and more consistent."[110] Generally responses to these individual measures were positive, although charities continued to argue that their main concern had not been addressed:

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[108] Review of Charity Taxation: a consultation paper, March 1999 pp 21-22 The paper also summarises the current EC VAT legal requirements, mentioned above (*op.cit.* paras 5.11-5.12).

[109] HC Deb 28 July 2000 cc 1032-3W

[110] HM Treasury Budget press notice HMT10, 9 March 1999

> Many respondents continued to request a grant scheme to compensate for charities' irrecoverable VAT. Some charities continued to press for equal treatment with local authorities by extending Section 33 of the VAT Act to include charities, although others accepted that this is not a realistic option … In the absence of a VAT grant scheme, many wanted a reduced rate of VAT of 5% for all supplies to charities … Some of the main representative bodies pressed for a reduced rate below 5% (the current minimum permitted) for supplies by charities, to achieve a neutral result overall if the European Commission develops proposals to remove the existing exemptions. Nevertheless, they recognised the need for further research in this area.[111]

C. Changes to VAT reliefs

In the November 1999 *Pre-Budget Report* a number of changes were proposed in the scope of existing VAT reliefs:

> More measures to simplify and modernise the tax system for charities include: …
>
> - extending and aligning the income tax and VAT exemptions for charity fund-raising events. In future these exemptions will apply to a wider range of events. Also charities will no longer have to operate two sets of rules and deal with two Government Departments;
> - a significant extension to the VAT zero rating of advertisements bought by charities;
> - raising from £250 to £1,000 the de minimis limit below which charities and other businesses do not have to account for VAT when they de-register; and
> - other VAT changes which will make life easier for charities, such as VAT relief for bathrooms in day centres, and relief for donated goods sold to disabled people and those on low incomes.[112]

These proposals do not appear to have received much attention, no doubt, as the *Guardian* reported, because charities continued to argue that the review represented a missed opportunity:

> Charities had hoped for compensation for the abolition of Advanced Corporation Tax (ACT) which has cost the sector £350m in lost income. They also wanted measures to address the £400m that charities pay in irrecoverable VAT.

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[111] *Review of Charity Taxation: Summary of Responses to the Government's Consultation Document*, October 1999 p 5

[112] HM Treasury Pre-Budget Report press notice HMT 8, 9 November 1999

> Instead, the government has enhanced tax-efficient giving, with the onus on charities to encourage donations, rather than pro-actively relieving the tax burden. Charles Watton, head of finance at the Royal National Lifeboat Institute, says: 'The historical reason for the charity tax review has been forgotten or overwritten.' And Nick Kavanagh, marketing accountant at Save the Children Fund and vice-chair of the Charities Tax Reform Group (CTRG), sums up the view of many charities: 'We are delighted by tax-effective giving measures but hugely disappointed by the continued tax burden.' Chief executive of the National Council for Voluntary Organisations, Stuart Etherington, agrees: 'Although the measures are a step in the right direction, it is unlikely that they will compensate for the loss of income incurred by the abolition of ACT.'
>
> 'What the government hasn't grasped,' says Helen Donoghue of CTRG, 'is the more the public gives, the more charities have to spend and the more tax they have to pay. This is a nonsensical anomaly which must be addressed.'[113]

In January 2000 HM Customs & Excise published draft legislation on four measures affecting charities' VAT position, to come into effect from 1 April 2000. Details were given in a press notice:

Guide to Proposed VAT Changes for Charities

> **Introduction** This is a brief explanation of the 2000 VAT Budget measures for charities which were announced in the Pre-Budget Report …
>
> **Charity fund-raising**
> This measure extends the number of reliefs for which VAT relief is available. Direct relief will follow the same rules. The existing restrictive list of events will be replaced. The measure contains key features to:
>
> - allow any type of event to be relieved from VAT when the public are aware that the purpose of the event is to raise funds;
> - include virtual events on the internet;
> - enable participation events and games of skill to qualify;
> - allow each charity or branch thereof to conduct up to four events each of up to four days in any one category of event in any 12 month period;
> - give VAT relief to frequent small scale events, such as jumble sales and coffee mornings, provided they take place no more than weekly and each event takes no more than £200 in gross takings; and
> - exclude from relief holidays, that are not covered by the Tour Operators Margin Scheme (TOMS), where the board and accommodation exceed 30% of the cost of the holiday.
>
> **Charity advertising**
> This measure extends the zero-rating to all advertising time and space (including for recruitment advertising) in all media when supplied to charities. The relief

[113] "Hand in pocket", *Guardian*, 17 November 1999

will also cover the design and production costs of the advertisement. The measure contains key features to exclude from relief supplies that are: addressed to selected individuals; produced by the charity itself; used for a charity's home website (adverts on other websites will be covered by the new measure).

Bathrooms
Under current VAT law, bathrooms which are built for charities are only VAT free if they are provided, extended or adapted for disabled people living in a residential or nursing home. The extension will mean that charities will now also get zero-rating where builders provide, extend or adapt bathrooms for disabled people in: day-centres used by disabled people; or flats and houses rented by disabled people, from charities such as sheltered housing.

Sales of donated goods
This measure extends the VAT zero rate for donated goods sold by charities or by other organisations covenanting their profits to charity. At present the VAT relief applies when donated goods are sold as a result of being made available to the general public, for example, in a charity shop. However, some charities sell donated goods only to disabled people or to people on means-tested benefits. The Government's proposals will extend relief to include such sales.[114]

Subsequently in the March 2000 Budget the Government announced that it would extend VAT exemption to more fund-raising events than previously announced, and broaden the VAT zero rate for the sale or hire of donated goods. Details were given in a press notice:

VAT exemption for fund-raising events
It was announced last November that the existing VAT exemption for fund-raising events will be widened to include more types of events, including participative events and events on the Internet. The measures announced today reflect the views of charities that more events should benefit from exemption: the number will be increased to up to 15 of each type or kind of event in any one location in a 12 month period. For small-scale events the exemption will apply to any number of events, provided the gross weekly income does not exceed £1,000.

The Inland Revenue will in future use the VAT rules to decide whether an event comes within their extra-statutory concession for fund-raising events for charity. Charities will benefit from only having to face one set of rules, which will ease administration. These changes will not affect charity law, which may require charities to undertake fund-raising events through a wholly owned trading company.

Donated goods sold or hired VAT free to the general public or people who are disabled or on means tested benefits
As announced in November, charities, as well as other organisations giving their profits to charity, will be able to sell donated goods VAT-free to people who are

[114] HM Customs & Excise Business Brief 1/00, 7 January 2000

> disabled or on means tested benefits. Currently goods have to be offered to the general public as a whole for zero-rating to apply. This has excluded supplies by charities that deal only with target groups. Relief will now also apply to the hire of donated goods in the same circumstances as for sales.[115]

To this end two statutory instruments were laid before the House on 21 March 2000 to come into effect from 1 April 2000.[116] Both were negative instruments, and were not debated in the House.

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[115] Inland Revenue Budget press notice IR/C&E3, 21 March 2000 To date HM Customs & Excise do not appear to have published updated guidance for charities on their VAT position in the light of these changes, the most recent version being VAT Notice 701/1/95, 1 January 1995 (this is available from Customs' internet site at: www.hmce.gov.uk/notices/701-1.htm)

[116] the *Value Added Tax (Fund-Raising Events by Charities and Other Qualifying Bodies) Order* SI 2000/802; and, the *Value Added Tax (Charities and Aids for the Handicapped) Order* SI 2000/805

IV Business rates & charity shops[117]

Local authorities are required to give 80 per cent rates relief on any property which is occupied by a charity and is wholly or mainly used for charitable purposes.[118] The authority has the discretion to extend rates relief for charities to 100%.[119] In order to qualify for rates relief, a charity shop must fulfil the following conditions (*emphasis added*):

a) it must be wholly or mainly used for the sale of goods *donated to a charity;* and

b) the proceeds of sale of the goods (after any deduction of expenses) must be applied for the purpose of a charity.[120]

The first condition is designed to restrict relief to shops predominantly selling second hand goods. It is not intended that shops owned by charities which are to all intents and purposes trading commercially should be eligible for rates relief. The large charities insist that this is how the law is interpreted in practice. Oxfam, for example, aims to ensure that its charity shops stock no more than 25 or 30 per cent new goods. Charities may also operate trading shops which mainly sell new third world goods. These are not eligible for rate relief.

It is worth noting that commercial shopkeepers who are facing financial difficulties may also be able to obtain rates relief. Local authorities have the discretion to reduce or remit rates bills for *any* ratepayer if he or she would otherwise “sustain hardship”, provided this is in the interests of local council taxpayers (they must subsidise 25% of the cost of any hardship relief given).[121]

In its report on the rating system published in January 1996, the Royal Institution of Chartered Surveyors’ National Committee on Rating observed that rate relief provided some charity shops with an unfair competitive advantage:

> Charity shops have come a long way since the first Oxfam shops were set up. Many charity shops are now seen as sophisticated operations, sometimes occupying premises on commercial leases, in direct competition with other shops. The trade of such charity shops is often in the "small business" category. It is arguable that it is unfair in such circumstances that they should benefit from relief whilst other businesses have to pay the full rate. Other businesses not only have

[117] contributed by Edward Wood, Home Affairs Section
[118] under section 43 of the *Local Government Finance Act (LGFA) 1988*
[119] under section 47 of *LGFA 1988*
[120] under section 64(10) of *LGFA 1988* In Scotland, similar provision exists under section 4 of the *Local Government (Financial Provisions etc) (Scotland) Act 1962*.
[121] under section 49 of *LGFA 1988*

> to compete against charity shops for custom, but also have to pay higher rate bills than the charity shops.[122]

The committee noted that prior to the introduction of the uniform business rate in 1990, the level of mandatory relief given to charities was 50%: "We accept that it could be difficult to draft legislation excluding charity shops from any scheme of rate relief applying to charities in general, but a reduction to 50% in the mandatory relief available to charity shops would adjust the overall balance." It therefore recommended that "Ministers should consider the extent of mandatory relief given to charity shops."[123]

In January 1996 Patrick Nicholls MP raised the concerns of local commercial shopkeepers about the proliferation of charity shops in a Wednesday adjournment debate.[124] The former junior Environment Minister, Sir Paul Beresford, pointed out that the decision of the House to increase the mandatory component of rates relief for charity shops from 50% to 80% was taken 'in response to enormous pressure.' He went on to argue that there was insufficient evidence to suggest that a change in the existing law was needed. Part of the Minister's speech is reproduced below:

> Rate relief for charities predates the non-domestic rating system. Rate relief of 50 per cent. was mandatory for property wholly or mainly used for charitable purposes under the provisions of the General Rate Act 1967. Rate relief for charity shops is not a recent innovation; it has existed for some time. Specific legislation was introduced to provide rate relief for charity shops in the Rating (Charity Shops) Act 1976. Those provisions were carried through to the new system in the Local Government Finance Act 1988.
>
> Initially, the Government proposed that the provisions from the earlier legislation be repeated in their entirety. They specified, as now, that to qualify for relief a charity shop had to be wholly or mainly used for the sale of goods donated - it is worth emphasising that - to the charity. If a shop met the criteria, 50 per cent. rate relief had to be given by local authorities: that was mandatory. The amount could be increased to as much as 100 per cent. if the authority saw fit. If it felt that the charity was particularly deserving of local support, it could top up the relief, but the extra cost would be borne by local ratepayers.
>
> At the time of the passage of the 1988 Act, it was feared that the new rating system might impose an unacceptably high rates burden on charity shops, and interfere with their ability to raise funds. In response to enormous pressure, the House increased the mandatory element of the relief from 50 per cent. to 80 per cent. The cost of the mandatory part is borne by the non-domestic rating pool. If a billing authority decides to give discretionary relief, it can, as under the previous

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[122] Royal Institution of Chartered Surveyors (National Committee on Rating), *Improving the Rating System*, January 1996 p 33 The report is generally known as the Bayliss report, after its author Jeremy Bayliss.

[123] *op.cit.* p 36

[124] HC Deb 31 January 1996 cc 975-980

> legislation, top up the relief to 100 per cent., but 75 per cent. will be borne by council tax payers; the remaining 25 per cent. will be borne by the pool …
>
> To qualify for relief, charity shops must sell donated goods. That generally seems to mean old clothes, old toys and second-hand ornaments, but - anticipating the fierce case put by my hon. Friend - I decided to visit some charity shops in my area, as did some officials in the Department. They had the impression that the shops that they visited would have accepted unwanted Christmas presents: indeed, there seemed to be a fair display of those on the premises. I was reminded of a Conservative association bring-and-buy stall, and beat a hasty retreat. I saw nothing that quite fitted the pattern suggested by my hon. Friend. I suspect that, in fact, the shops I visited contained genuinely donated goods …
>
> Ultimately, I do not feel that my hon. Friend's concern is justified to the extent that a change in the existing law is needed. Charity shops that wholly or mainly sell goods bought from wholesalers are not entitled to relief. If the charities choose to raise revenue through such means, they too must pay rates on the shops, just like their neighbours … As I think my hon. Friend will accept, the issue pivots on the action of the local authority, not on a blunderbuss, across-the-board treatment by central Government through legislation or direction. There is a horses-for-courses arrangement, in which the local authority has the ability and the expertise, and can visit each premises and judge for itself.[125]

Backbench concern about rates relief for charity shops resurfaced in another Wednesday adjournment debate on 2 July 1997.[126] The then Minister for Small Firms, Trade and Industry, Barbara Roche, acknowledged that "the small retail sector has certainly had to bear the burden of [the rating] system" and said she understood the strength of feeling among small retailers "who regard charity shops as unfair competition."[127] However the Minister went on the say that the Government had no plans to change the rules on rates relief for charity shops although it would continue discussions with interested parties.

When the Government's review of charity taxation was announced in the July 1997 Budget,[128] the main focus was to be the current VAT arrangements – although charities were invited to raise concerns about direct taxes or business rates.[129] At this time Nick Raynsford, then Parliamentary Under-Secretary of State at the DETR, confirmed that rates relief for charity shops would be looked at as part of the review.[130] The consultation document - *Review of Charity Taxation* - published in March 1999 made the following observations:

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[125] *op.cit.* cc 978-980
[126] HC Deb 2 July 1997 cc 215-231
[127] *op.cit.* c 229
[128] The review is discussed at length in part II.A of this paper.
[129] HM Treasury Budget press notice HMT 5, *Charity taxation reviewed*, 2 July 1997
[130] HC Deb 28 July 1997 c 42W

> We recognise the value to charities of the business rate relief for their general premises. We also recognise the important part that charity shops play in raising funds and the contribution of business rate relief to making these shops viable. So, we have no plans to withdraw these reliefs. However, we also acknowledge the real concerns of small independent shopkeepers that business rate relief gives charity shops that sell new, bought-in goods a competitive advantage. It was never the intention that charities should have relief on business premises that are predominantly used to sell new, bought-in goods and we do not want to extend the relief in this way.
>
> Many local authorities, charities and others told us that the rules about what constitutes 'wholly or mainly' are not clear, so that there is inconsistent treatment up and down the country. This lack of clarity makes it difficult for charities to comply with the rules and causes problems for local authorities seeking to apply them. We are considering whether local authorities and charities should have clearer guidance about the meaning of 'wholly or mainly' and whether there should be more assurance checking of compliance with the rules.
>
> In deciding whether a charity shop 'wholly or mainly' sells donated goods, local authorities currently take all the following relevant factors into account:
>
> - the percentage of sales space occupied by donated goods
> - the percentage of turnover and profit represented by the sale of donated goods
> - the percentage of individual items sold which are donated goods.[131]

The paper asked if local authorities and charities would welcome clearer guidance on the meaning of 'wholly or mainly' and, if so, what factors need to be taken into account. In responses to the consultation document, there was a broad welcome for this proposal:

> Many respondents, including local authorities, said they would welcome guidance on the rules for business rate relief to ensure greater consistency of treatment across the UK, although most did not believe there was a significant problem. Some representatives of high street traders voiced their concerns about what they see as the unfair competitive advantage enjoyed by charity shops, although other respondents did not believe that charity shops posed a serious threat to commercial traders and were anxious to retain the existing tax and rating advantages.[132]

In September 2000 the Government published a green paper on local government finance; amongst other issues, the paper sought views on whether the 1989 guidance on discretionary rate relief for charities and non-profit making organisations should be

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[131] *Review of Charity Taxation: a consultation document*, March 1999 pp 27-28

[132] Inland Revenue, *Review of Charity Taxation: Summary of Responses to the Government's Consultation Document*, October 1999 pp 4-5

reviewed to promote a more consistent approach by local authorities.[133] The guidance referred to is presumably Non-Domestic Rates Practice Note G, on *Mandatory and Discretionary Rate Relief*, which does not cover the issue of how a local authority should decide whether a charity shop 'wholly or mainly' sells donated goods. Responses to the green paper are still being considered and no decision has yet been taken on whether to reissue the guidance, but if revised guidance is published it is likely to address this issue.

[133] DETR, *Local Government Finance: A Green Paper*, September 2000 para 5.28 This document is published on the DETR internet site at https://web.archive.org/web/20020607141331/http://www.local.detr.gov.uk/greenpap/index.htm

V Advance corporation tax & tax credits

One concern that charities have had about their tax position relates to changes in the way dividends are taxed introduced under the *Finance (No.2) Act 1997*.[134] Briefly, prior to April 1999 there were two rates of income tax on dividends: the lower rate of 20%, and the higher rate of 40%. When anyone received a dividend cheque, they also received a tax credit, which matched the tax charge of 20%. In general charities' investment income and capital gains are exempt from tax, provided they are applied for charitable purposes. Charities were therefore entitled to claim the value of the tax credit from the Inland Revenue as a cash payment, in addition to their dividend income.

From April 1999 the tax credit was cut to 10%, and, in line with this, the rate of income tax on dividend income for both lower and basic rate taxpayers was cut to 10% as well, leaving them no worse off than before (this rate is called the Schedule F ordinary rate). The rate of income tax on higher rate taxpayers - the Schedule F upper rate - was cut to 32.5%, to compensate them for the cut in the tax credit. At the same time cashable tax credits were abolished for both charities and other investors with no income tax liability - including those holding Personal Equity Plans and those with incomes below the tax threshold. Unlike other non-taxpayers, charities are to receive compensation for this loss over a five year period – up to 2003-04 – through public expenditure.[135]

Although the withdrawal of tax credits has been controversial,[136] the Government has ruled out any change in its position on this issue. On 10 December 1998 Dawn Primarolo, then Financial Secretary to the Treasury (now Paymaster General), stated in a written answer that "having listened carefully to all interested parties, the Government confirm the arrangements set out in the July 1997 Budget for phasing out payable credits in order to correct a bias in the tax system against the retention of profits for investment."[137] The following paragraphs provide a short background to the Government's decision to abolish tax credits on dividends, before looking at the implications of this measure for charities.

In his Budget speech on 2 July 1997 the Chancellor of the Exchequer, Gordon Brown, announced two changes in the taxation of company profits and dividends: first, a cut in the main rate of corporation tax from 33% to 31% to apply from April 1997;[138] second, the abolition of tax credits paid to pension funds and companies when they received dividend income net of advance corporation tax (ACT). The Chancellor also announced that tax credits would be withdrawn from other dividend recipients exempt from income tax - notably, charities and non-taxpayers - although not until April 1999. In 1997-98

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[134] specifically ss 19-36 of the *Finance (No.2) Act 1997*

[135] under ss 30 & 35 of the *Finance (No.2) Act 1997*

[136] for example, "Abolition of ACT promises to be bad news for charities", *Times*, 25 March 1999

[137] HC Deb 10 December 1998 c 296W. Ms Primarolo was appointed to the post she now holds - Paymaster General - on 31 December 1998.

[138] In his March 1998 Budget the Chancellor announced a further percentage point cut in the main rate of corporation tax to 30% from April 1999.

payments of tax credits before taking account of these changes would have been about £5.2 billion, of which tax credits to charities and non-profit making institutions accounted for £350 million.[139] As it turned out, this was the first part of a wider reform in corporate taxation when the Chancellor announced in the *Pre-Budget Report* in November 1997 the abolition of ACT and the introduction of a system of quarterly payments of corporation tax from April 1999.[140]

The Chancellor set out his reasons for abolishing reclaimable tax credits in his Budget speech:

> Too often British companies have invested too little and too late in the economic cycle. Because I want companies to get the benefit now, the 2 per cent. corporation tax cut will apply from April 1997. This tax cut is the first component of this Budget's investment strategy. The second is a structural reform that will also encourage investment. The present system of tax credits encourages companies to pay out dividends rather than reinvest their profits. That cannot be the best way of encouraging investment for the long term, as was acknowledged by the previous Government. Many pension funds are in substantial surplus and at present many companies are enjoying pension holidays, so this is the right time to undertake a long-needed reform. The previous Government cut tax credits paid to funds and companies, so with immediate effect I propose to abolish tax credits paid to pension funds and companies.
>
> In all the consequential changes I will make, I have been, and I will be, fair. For PEP holders, for individuals who do not pay tax and for charities, tax credits will continue to be paid until April 1999. By that time, the introduction of the individual savings accounts will ensure that individuals have the opportunity to continue to be able to save with tax advantages. So they will continue to have favourable tax incentives to invest in equities. Basic and lower-rate taxpayers do not pay any extra tax on dividends that they receive and that will remain the position, and we shall ensure that higher rate taxpayers will pay no more than they do now on their dividends.[141]

There is a long-running argument that the structure of corporation tax and ACT distorted the pattern of investment in the UK: in particular, that it resulted in equity finance being disadvantaged relative to debt finance, and that it created a clear incentive for institutional shareholders to pressure companies to pay out dividends, rather than retain profits. It is the Government's position that in abolishing reclaimable tax credits, it tackled the second of these problems. However, the implications for the level of dividend income received by institutional investors has meant the decision remains controversial.

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[139] Inland Revenue Budget press notice IR2, 2 July 1997

[140] HC Deb 25 November 1997 c 775. Legislation was introduced to this effect under ss 30-36 of the *Finance Act 1998*.

[141] HC Deb 2 July 1997 cc 306-307

At this point it may be helpful to set out how ACT worked before it was abolished. Briefly, when a company paid a dividend, it was required to pay ACT: a tax charge equivalent to one part of the income tax that shareholders would pay on this income. In effect, the Inland Revenue ‘imputed’ the income tax due on dividends to the company paying those dividends. All shareholders received a tax credit, along with their dividend cheque, to compensate for the income tax the company had paid on their behalf.

In fact, the ACT charge was set to equal exactly what basic rate taxpayers would have to pay, so that for basic rate taxpayers, dividends were distributed tax paid. Higher rate taxpayers could use the tax credit to partially offset the tax they owed on their dividend income. For example, following the March 1993 Budget, the rate of tax charged on dividends up to the basic rate limit was cut from 25% to 20%. The higher rate of 40% was charged on anything above this limit.[142] In effect the ACT charge represents one ‘bite’ that the Exchequer took out of company profits. Companies set the ACT which had been paid against their liability to corporation tax.[143] This avoided company profits being taxed twice.

Tax credits are calculated with reference to the principle that dividends are distributed net of tax at the basic rate. For example, when the basic rate of tax on dividend income was 20%, if someone received a dividend cheque for £80, they were given a tax credit of £20. The value of the credit is 20% of a notional dividend (in this example, £100) that the shareholder would have received if ACT had not been deducted previously.[144]

Prior to July 1997, shareholders who were not liable to income tax or exempt from ACT (such as charities and pension funds), were entitled to reclaim all or part of this credit as a cash payment from the Inland Revenue, in addition to their dividend. In the example given above, the repayment would be worth £20. In effect, the charity or pension fund paid a tax rate of 13% on distributed profits, compared to one of 33% on retained profits.[145] Clearly this was a significant incentive for these shareholders to prefer companies to pay out dividends over retaining profits, and some commentators argued this forced companies to focus on the short term, harming profitability in the long run.[146] This analysis, incidentally, is not universally accepted.

When the tax credit was cut from 25% to 20% in 1993, charities were given compensation over a four year period for the consequent loss in their dividend income.

[142] Generally speaking, dividend income is treated as the top slice of an individual’s income.

[143] This was usually nine months after the end of the company’s accounting period.

[144] In computing the tax credit, one can use the following formula: Value of Tax Credit (VTC) = 20 per cent of [Dividend payment + VTC].

[145] Retained profits were liable to corporation tax at the rate of 33% at this time.

[146] The then Chief Secretary to the Treasury, Alistair Darling, set out the case for ending reclaimable tax credits during a debate on pensions in July 1997 (HC Deb 9 July 1997 cc 974-975). Interested readers are referred to the discussion of how this policy was developed by Geoffrey Robinson MP in his memoirs (Geoffrey Robinson, *The unconventional Minister*, 2000 pp 85-88). Mr Robinson was Paymaster General following Labour’s General Election victory in May 1997 until December 1998.

Payments were public expenditure, and calculated on a sliding scale.[147] Broadly they represented the difference between the new tax credit – payable on the basis of the lower 20% rate – and the amount of the tax credit which would have been payable if the appropriate rate of tax was 24% (for dividends paid in 1993-94), 23% (for 1994-95), 22% (for 1995-96) or 21% (for 1996-97).

From April 1999 the tax credit was cut to 10%, and, in line with this, the rate of income tax on dividend income for both lower and basic rate taxpayers was cut to 10% as well (leaving them no worse off than before). The rate of tax for higher rate taxpayers was cut to 32.5%, to compensate them for the cut in the tax credit. As mentioned above, from this date the tax credit for shareholders with no income tax liability – including those holding Personal Equity Plans, those with incomes below the tax threshold, and charities – was withdrawn.[148]

Charities receive compensation for their loss of the tax credit through public expenditure. This is in the form of a payment to a charity of a percentage of the dividends it receives, and is to be phased out over five years from 6 April 1999. The percentage is to be:

1999-2000	21 per cent
2000-2001	17 per cent
2001-2002	13 per cent
2002-2003	8 per cent
2003-2004	4 per cent[149]

Legislation to abolish tax credits was introduced in the *Finance (No.2) Bill 1997/1998*: the potential impact on charities was discussed in the relevant section of the Treasury's *Notes on Clauses* to the Bill:

> The tax credit will no longer be payable to pension funds and UK companies from Budget Day, or to other UK residents, including charities, from 6 April 1999. This will have widely varying effects on charities: some get little or none of their income from UK dividends, but are funded by donations, legacies, and other sources of investment income; for others dividends are much more important. To help charities adjust to the new regime and in recognition of the special role they play in society they will have compensation payments for a transitional period. These scale down from about 85 per cent of the current value over a five-year period.

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[147] under section 80 of the *Finance Act 1993* The payments were one-fifteenth of the dividend for 1993-94, one-twentieth for 1994-95, one-thirtieth for 1995-96, and one sixtieth for 1996-97. This provision was scrutinised by Standing Committee on 15 June 1999 (Standing Committee A cc 397-414).

[148] In November 1997 the Chancellor announced that ACT itself would be replaced with a system of quarterly payments for corporation tax from April 1999, though without any further significant change in the taxation of shareholders' dividends (HC Deb 25 November 1997 c 775).

[149] For comparison the tax credit had represented 25 per cent of the dividend prior to this reform.

The financial impact on charities of withdrawing cashable tax credits was the subject of a recent PQ, reproduced below:

> **Mr. St. Aubyn:** To ask the Chancellor of the Exchequer what has been the change in registered charities' receipts since the ending of the dividend tax credit in each year since 1997-98; and what is the estimated average in the current financial year and each of the next three financial years.
>
> **Miss Melanie Johnson:** The withdrawal of payable tax credits on charities' dividend income did not come into effect until April 1999. In recognition of their special position, charities will receive generous compensation through public expenditure in the form of a payment of a percentage of the dividends they receive. This will apply for five years from 6 April 1999 on a tapering basis.
>
> The Charity Commission reports £19.75 billion of total annual income at the end of December 1998 in England and Wales (an average of £122,000, although nearly three-quarters of registered charities have an income of £10,000 or less). The latest available figures from the Register show that at the end of September 1999 total annual income had risen to £22.4 billion (an average of £139,000). Forecasts of annual income are unavailable.[150]

When the relevant legislation was debated at the Committee stage of the Finance Bill, the then Economic Secretary to the Treasury, Helen Liddell, made the following points in opposing a proposal to give charities permanent monetary compensation for the withdrawal of tax credits:

> The Government spent much time considering the position of charities. I do not pretend that the changes that we are introducing will not affect charities … However, I disagree with what Opposition Members have said … in that the amendments would offer charities a permanent subsidy from public funds to replace their present tax credits. At the most conservative estimate, that would cost at least £300 million, and we must take account of the impact of such sums on the general taxpayer. The changes that we propose to ACT must apply across the board, or, frankly, they make no sense at all and the full benefits of the reform that we propose would not be felt, so no sector can be permanently left out.
>
> The impact of the changes will vary between charities. We considered a broad raft of charities to measure that impact. The impact will depend on the extent to which their income comes from United Kingdom dividends. Many charities do not depend on such dividends for their incomes, but we were always conscious that some charities would be hard hit in the short term if the loss of tax credits were to apply immediately.
>
> The hon. Member for Witney drew attention to the fact that, in the previous changes in tax credits, allowances were made for charities. However, the

[150] HC Deb 16 February 2000 cc 615-6W

> Government are going further this time. We are taking two steps to help charities. First, unlike any other United Kingdom exempt body, charities will retain tax credits for a further two years until April 1999. Furthermore, we propose additional compensation which will taper off over a further five years, which will cost the Exchequer almost £1 billion.
>
> We have not proposed compensation for any other sector; we regard charities as a special case. Everyone in the country appreciates the valuable work of our mainstream charities, and all hon. Members are alert to that fact from experience of our constituencies … We have no hidden agenda of seeking to suggest to charities that they change the way in which they do business. It is not up to me as a Minister to say how charities should adjust their future portfolios; some may choose to do so at the margin, but in many cases dividends are only one element of their returns. Charities, like pension funds and other investors, have recently found all-in yields from United Kingdom equities most satisfactory. If they choose to adjust their portfolios, they will have to take into account what happens to markets during the seven-year period.
>
> **Mr. Woodward:** If, in the course of the prolonged review that the Government will perform during the next few months, they were to discover that there were grant-making trusts that had substantial amounts of equities and which, as a result of the Bill, would suffer a significant fall in the amount of money that they could give away, would the Government consider whether it might be appropriate to make future legislative changes? …
>
> **Mrs. Liddell:** We recognise that some grant-making charities will be badly hit; that is why we have decided on the two-year delay and the five-year transitional period, which is an extremely generous period, to allow them to adjust how they carry out their business. Any wider review of charities may also affect them. However, I have again to make the point that we cannot cherry pick in proceeding with the abolition of ACT credits. Many charities will suffer little or no impact from the package—those that rely on fund raising or have their capital resources invested in other ways.
>
> However, that does not detract from our recognition of the difficulties that grant-making charities will experience. I also remind the hon. Gentleman of my earlier point about the impact of corporate performance on charities' holdings. If companies are performing well and returns to charities are good, they will also have to take that into account, which returns us to the point about their rebalancing of portfolios in the long term.[151]

The issue has been debated several times in the House: for example, during the Committee stage of the *Finance Bill 1999* the Government successfully opposed a new clause (NC 4) to restore tax credits for non-taxpayers.[152]

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[151] Standing Committee A 22 July 1997 cc 364-366
[152] Standing Committee B 22 June 1999 cc 720-736

The then Economic Secretary to the Treasury, Patricia Hewitt, summarised the Government's position on this issue in March 1999:

> **Mr. Flight:** To ask the Chancellor of the Exchequer what assessment he has made of the impact of the ending of ACT recovery on the finances of charities; and if he will make a statement.
>
> **Ms Hewitt:** The withdrawal of payable tax credits will be completed from 6 April 1999. We recognise the special position of charities and provided generous compensation for them through public expenditure, for the withdrawal of their payable tax credits. This compensation takes the form of a payment to a charity of a percentage of the dividends it receives, and will apply for five years from 6 April 1999 on a tapering basis, giving charities an opportunity to adjust to the withdrawal of payable tax credits.[153]

Many charities used the opportunity of the Government's consultation on charity taxation to make representation about the abolition of tax credits:

> **Mr. Gibb:** To ask the Chancellor of the Exchequer how many representations he has received from charities about the abolition of the repayment of dividend tax credits; and if he will list the individual organisations, indicating how many (a) supported and (b) opposed the policy.
>
> **Dawn Primarolo:** About 250 charities, many in response to the Charities Taxation Review, have written asking for changes to the current treatment of dividend tax credits. We have made generous transitional arrangements to help charities adjust to the withdrawal of payable tax credits.[154]

The consultation document - *Review of Charity Taxation* - did not discuss reclaimable tax credits at any length, though an insight into the Government's thinking on this issue may be gleaned from the foreword, written by the then Economic Secretary, Patricia Hewitt:

> This Review is concerned with one strand of the Government's relationship with the sector: the tax system for charities. It is not Government's responsibility to tell charities how to do their job. Our responsibility is to help create a culture of giving. That requires a tax system that will encourage more people to give more; a tax system that offers effective incentives and is as simple as possible for donors and charities to operate.[155]

The argument for withdrawing reclaimable credits might be put as follows. The tax credit for taxpayers ensures that tax is not paid twice: once by the company in the form of

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[153] HC Deb 1 March 1999 c 501W
[154] HC Deb 31 July 1998 c 653W
[155] "Foreword", *Review of Charity Taxation: a consultation document*, March 1999

corporation tax and once by the taxpayer in the form of income tax. If the non-taxpayer is not liable to pay tax there is no double taxation. By giving non-taxpayers money to repay a tax they have not paid in the first place, the tax credit system could be thought to be doing something for which it was never intended: supplementing the income of non-taxpayers.

Turning to charities, clearly these organisations benefit financially from a wide range of tax reliefs funded by the public purse. Some of these tax reliefs - such as Gift Aid - can be thought of as having a 'double dividend' effect: they encourage individuals and companies to make charitable donations, boosting the growth of charities' income, as well as supplementing that income by restoring to charities the tax paid on those donations. From this perspective, the relief provided by reclaimable tax credits might be thought to be a relatively inefficient way of supporting charities, as their position as shareholders in a company is unlikely to be a major influence in dividend policy.

As it is, the Government clearly believes that companies have been overly concerned with making dividend payments, at the cost of their long term growth. Moreover, the provision of tax credits rewards charities to the extent their income derives from those equities they hold, if any. One might think that this is a rather capricious way to allocate those limited public funds available to support charities between individual organisations and causes.

In this context, it is not surprising that several recommendations made in the consultation paper – and later followed up in the 'Getting Britain Giving' package – capitalised on this double dividend effect; for example, the abolition of the minimum limit for donations under the Gift Aid scheme.[156]

[156] The changes made in the Gift Aid scheme from April 2001 are discussed in part II.E of this paper.

VI Sources and further reading

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