

Substantial Donor Rules - a new beginning?

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CATEGORY:
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1. Introduction

The substantial donor rules are a controversial set of anti-avoidance provisions that were introduced surreptitiously in the 2006 Budget. They apparently aim to seek to prevent “abusive” transactions between charities and those who have donated substantial amounts of money to them. The rules were drafted in a very wide-reaching manner and for the last two years charities and their professional advisers have increasingly found many anomalous results arising from the operation of the rules which can effectively penalise entirely innocent transactions.

The good news is that HMRC has at last responded to the extensive lobbying that has been taking place, and issued revised draft legislation for consultation on 15 July 2008. The new draft legislation does attempt to deal with some of the anomalies identified but there remain many issues still to be addressed.

2. An overview of the rules as they currently stand

The rules were originally introduced because HMRC appear to have become concerned that the various tax reliefs available for donations to charities could be open to abuse where the donor enters into a subsequent transaction with the charity on terms beneficial to the donor. It is not at all clear that such abuse has been widespread and the rules can potentially impinge upon many perfectly legitimate transactions. The rules have had the greatest impact on charities established by private individuals and families, but they have also been of wider application.

Effect of the measures

The rules aim to prevent the perceived abuse by putting the onus on the charity to regulate its dealings with any of its ‘substantial donors’ (defined below) and denying the charity its usual reliefs against income and capital gains tax to the extent that the rules are infringed. There are a number of exemptions for transactions on full arm’s length terms, but these apply in an inconsistent manner and do not adequately cover all the relevant scenarios.

Definition of ‘substantial donor’

For the purposes of the rules as drafted at present, a ‘substantial donor’ is defined as a person who makes “relievable gifts” to a specific charity in excess of:-

1. £25,000 in any 12 month period; or
2. a total of £100,000 over any six year period.

‘Relievable gifts’ include gifts qualifying for gift aid, CGT relief on the gift of an asset, payroll giving, or the income tax exemption on gifts of quoted shares or land.

Any person who qualifies as a substantial donor under these tests will continue to be treated as a substantial donor of that charity for a further five tax years.

The rules cover donations made by a company or a trust as well as by an individual. However, significantly, in addition, the definition of ‘substantial donor’ includes anyone connected to that donor. The definition of ‘connected’ is the usual one used in tax legislation, which covers spouses, siblings, ascendants and descendants, and also trusts and companies associated with the individual concerned. This provision in particular casts the net broadly and means that the rules can impinge on a potentially huge range of transactions.

Relevant transactions

Unless specifically exempted, any of the following transactions can be caught by the new rules:-

1. The sale or letting of property (not confined to land) by a charity to a substantial donor or vice versa.
2. The provision of services by a charity to a substantial donor or vice versa.
3. The exchange of property between a charity and a substantial donor.

4. The provision of financial assistance by a charity to a substantial donor or vice versa (and for these purposes financial assistance includes the provision of any loan, guarantee or indemnity)
5. The investment by a charity in the business of a substantial donor (although not if the business is listed on a recognised Stock Exchange).

Effect of infringement

If a charity infringes the rules by entering into any of these transactions (unless specifically exempted) with one of its substantial donors, the charity will be penalised by denial of its tax relief. The mechanism for achieving this provides that any payment made by the charity to the donor as part of the transaction, or any benefit received by the donor from the transaction (to be determined by HMRC), will be treated as non-charitable expenditure by the charity. This will mean that tax relief will be denied to the charity by restricting its income and gains eligible for tax relief by £1 for every £1 of non-charitable expenditure incurred.

Exceptions

Generally, where a transaction is on arms-length terms, it will not be caught by the rules. Specifically, the following transactions will be exempt:-

1. The sale or letting of property to a charity and the provision of services to a charity, provided the transaction is on arms-length terms and not part of another arrangement for the avoidance of tax (as determined by HMRC).
2. The provision of services by a charity to a substantial donor, as long as the services are provided in carrying out the primary purpose of the charity and are on arm's length terms as above.
3. The provision of financial assistance to a charity on arms-length terms as above.
4. Investment by the charity in the business of a substantial donor where this involves the purchase of shares or securities listed on recognised stock exchanges.
5. A disposal by the donor of an asset at an undervalue to a charity (although the level of the donation involved will qualify for determining whether the donor is a substantial donor for that period).
6. Remuneration of a substantial donor which is 'approved remuneration' (meaning remuneration for acting as a trustee of the charity where this is permitted in the governing document or has been approved by the Charity Commission, the Court or another regulatory body).
7. Any transaction within the de minimis limit (where the value of payments or benefits received by the donor are less than 2.5% of the amount of the gift).

In addition, a wholly-owned subsidiary of the charity will not be treated as a substantial donor for the purposes of these new rules so that it will still be possible for the usual structure of using a charitable subsidiary to gift aid its net profits to the parent charity to continue.

3. Anomalies

The exceptions contained in the rules are helpful, but they do not cover a large number of entirely 'innocent' transactions. Some of the key anomalies that have been identified by charities and their advisers have included the following:

- 3.1 The onus is placed on the charity to police the rules, as the penalty is payable by the charity rather than the donor.
- 3.2 This can involve a very high level of compliance, with charities in some cases being obliged to retain records of substantial donors for an 18 year period.
- 3.3 Because of the breadth of the connected persons definitions, these records should in theory attempt to cover not only substantial donors themselves but an array of potentially connected parties.
- 3.4 Particular concern relates to the impact of "financial assistance", the definition of which encompasses grants made by charities to other entities (eg overseas charitable bodies). When taken in conjunction with the broad definition of connected parties, this can lead to great difficulties for family foundations wishing to make entirely valid charitable grants to other family charities overseas, for example.

4. The new draft legislation

The new draft legislation appears to be an attempt to relax the rules somewhat and deal with some of the most obvious anomalies. In particular, the draft legislation suggests:

- 4.1 A revised definition of 'substantial donor', based on more generous thresholds for qualifying donations – of £50,000 in any one year (instead of £25,000) and £125,000 in any three year period, (instead of £100,000 over a six year period).
- 4.2 A new de minimis limit on the definition of 'relievable gifts' so that any gift of £1,000 or less in any one year would be ignored for the purposes of the rules.
- 4.3 A new de minimis limit on the value of benefits that can be returned to the donor without triggering the operation of the rules, set at a level of £500 per annum.
- 4.4 A new exemption for payments to employees of the charity, provided this is arm's length remuneration and the donor or connected person is a

genuine employee of the charity.

4.5 A new exemption to address the problem of charitable grants paid to other charities or charitable causes connected with the original substantial donor. This is potentially of particular value in ensuring the rules do not apply to innocent transfers of funds between related charities. However, the draft legislation specifies that such transfers would need to be in the course of the 'primary purposes' of the charity – and this may need to be reviewed further to ensure it will cover all relevant scenarios.

Conclusion

The new draft legislation is to be welcomed in that it attempts to deal with some of the worse excesses of the old rules. However, the framework taken by HMRC remains substantially the same and of itself is deeply flawed. The consultation ends on 7 October 2008, and Withers LLP will be submitting a response. We would welcome contributions to this, and please do send any suggested responses to [David Goepel](#) by 1 October.