

GIFTS IN KIND TO CHARITY: SOME TAX TIPS

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1 Introductory

1.1 Scope of the Article

In an article in Volume 3, Issue 3, page 139 of this *Review* entitled 'Gift Aid Relief for Gifts in Kind', I discussed the need for a change in the law to enable gifts in kind, as opposed to gifts of money, to qualify for Gift Aid relief and explained how this could be done. In this article, I consider what opportunities for tax planning exist within the present law and point out some value added tax traps. The advice should be borne in mind whenever property which is to be sold, whether by auction or otherwise, is being donated to charity and the property is worth at least £200.

There are certain complicating factors which are not discussed in this article. Firstly, special considerations apply where the asset to be gifted is part of a trader's trading stock or is tangible or intellectual property created by an "artist" in the course of his profession. This would cover the gift of a car by a car dealer, of a copyright by an author, or of a bronze by a sculptor. Secondly, if the asset is used for the purpose of a business which is registered for value added tax, the incidence of that tax on the gift must be taken into account. Thirdly, special planning may be needed where the donor is not an individual or a corporation resident in the United Kingdom, for example, the trustees of a family settlement or a Liechtenstein *Stiftung*.

1.2 The Need for Advance Planning

It cannot be sufficiently stressed that efficient tax planning normally needs to be taken *in advance* of a gift. Administrators of charities may accept a gift without

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appreciating that tax considerations may make it better for the gift to be sold by the donor and the proceeds then donated to the charity. Once a gift has been accepted, it will normally be too late. If, at that point, the tax adviser is greeted with the reaction: "Can't we say we did it some other way? Just tell us how", he should firmly point out that there lies the road to Pentonville. It is therefore of the utmost importance that every charity trains its executives not to accept a gift in kind of any value before taking tax advice.

2 The Strategy

2.1 The Problem: Limitation on Gift Aid Relief

A gift in kind to a charity does not qualify for Gift Aid relief, whether it is made by an individual or a company.² Where the gift is one which is intended to be retained by the charity, such as a painting to a museum, problems of obtaining any relief are formidable. While there are highly sophisticated methods of tax planning which may, subject to certain conditions, procure for the donor an income tax or corporation tax relief, specialist advice needs to be taken on a case by case basis.³

2.2 A Solution

Where the asset is to be sold, the scope for tax planning is much greater. From an income tax point of view, the sensible course would be for the donor to sell the asset himself and then to donate the net proceeds by way of a cash gift. This will qualify for Gift Aid relief. If for any reason the relief is unavailable or inappropriate, for example because the donor does not have sufficient taxable income in the year in question, or is not resident in the United Kingdom, then it may be preferable to make the gift by way of covenanted donations, either in a simple form or as part of a "deposit covenant" scheme.

² See Taxes Act 1988 section 339(1) for companies and Finance Act 1990 section 25(2)(a) for individuals.

³ One important problem is that the donor cannot sell the asset to the charity at the highest price consistent with his paying no capital gains tax and then donate the proceeds under Gift Aid. Quite apart from the possible application of the doctrine in *Ramsay v IRC* which might ignore the sale and treat the transaction as a simple gift of the asset, Gift Aid relief would be denied under Income and Corporation Taxes Act 1988 section 339(3E) in the case of a company and under Finance Act 1990 section 25(2)(f) in the case of an individual.

2.3 A Further Problem: Capital Gains Tax

Capital gains tax considerations, however, may militate the other way. If a person gifts an asset to charity, then he is deemed, for capital gains tax purposes, to receive such consideration as to ensure that he realises neither a gain nor a loss on the disposal.⁴ If the donor first sells the asset, then he will *prima facie* make a chargeable gain, calculated by reference to the sale proceeds, notwithstanding that he immediately donates them to a charity.

I would reckon that in the vast majority of cases, it will still be preferable to realise a chargeable gain if this is the price of an income tax relief. Firstly, the asset may be of such a type that any gain on its disposal is outside the scope of capital gains tax, for example, gilt edged securities or qualifying corporate bonds. Secondly, the donor may realise no or little capital gain on the disposal because his base cost is sufficiently high. Thirdly, he may be able to set-off annual exemptions and/or allowable losses against the gain arising on the gift, although obviously the possibility of this alternative must be taken into account. Fourthly, the donor may not be resident or ordinarily resident in the United Kingdom and thus in general outside the charge to capital gains tax in respect of the asset. Fifthly, although resident in the United Kingdom, the donor might be domiciled outside the United Kingdom and it may be possible to ensure that the gain is in effect exempt from capital gains tax.

The principal danger is to avoid the situation where a prior sale by the donor involves his realising a chargeable gain on which capital gains tax is payable, while not being able fully to utilise the Gift Aid relief arising from the gift of the net proceeds of sale.

3 Examples

3.1 Basic Example⁵

Suppose a donor has a taxable income of £200,000 for the current year. He has owned a manuscript for twenty years which, at 31st March 1982, was worth £10,000. He now proposes that it should be sold by auction, at which it is expected to realise £120,000 gross, £100,000 net after deduction of auctioneer's commissions and other expenses totalling £20,000. Would it be more

⁴ Taxation of Chargeable Gains Act 1992 section 257(2)(a).

⁵ This is set out in tabular form as Example A.

advantageous for him to sell the manuscript and donate the proceeds or to donate the manuscript to the charity and allow it to sell it?

If he simply donates the manuscript, his tax position is unchanged. He will not be liable to capital gains tax yet he will not obtain an income tax relief. The charity will realise the net proceeds of £100,000 on which it will not, subject to the usual conditions, be liable to capital gains tax or income tax, yet it will not be entitled to any tax credit.

If the donor sells the picture himself, he will realise a chargeable gain of £80,000, being the hammer price of £120,000, minus the cost of sale of £20,000, minus the base cost of £10,000 and minus, let it be assumed, 100% indexation relief of a further £10,000. On this, he would be liable to capital gains tax at his marginal rate of income tax, of 40%, involving a liability of £32,000.⁶

What sum of cash can the donor now afford to gift to the charity under Gift Aid? Clearly, he must retain £32,000 to pay the capital gains tax liability. Should he then gift the £68,000 cash in hand remaining after allowing for this liability? Not if he will obtain higher rate income tax relief on the gift. In the circumstances envisaged he will obtain higher rate relief on the whole of the gift. Higher rate relief is currently equal to 17/77ths of the net amount of the gift. It will be recalled that where a donor makes a Gift Aid payment of, say, £770, this is deemed for income tax purposes to be a gift of £1,000 from which £230 at basic rate tax has been deducted. If the donor is liable to tax at a higher rate on the £1,000, then he obtains a further relief equal to the difference between higher and basic rate tax, that is between 40% and 23%, i.e. 17%, of the grossed-up amount. Thus, his higher rate tax relief will on a net gift of £770 be £170. This is 17/77ths of the net amount of the gift.

The calculation must therefore take into account the value of higher-rate relief to the donor. In the example, the amount which the donor should give away is £87,267. (This is the £68,000 grossed up by 17/77ths.) On what amount will he obtain higher rate income tax relief? One must first ascertain the grossed up amount of the Gift Aid payment. This is £113,333, being £87,267 grossed up at the basic rate of 23%. Higher rate relief is at a rate equal to the difference between higher rate (40%) and lower rate (23%), i.e. 17%. The actual amount of the relief is £19,267. If one deducts that from the £87,267 paid one is left with the net cost to the donor of £68,000, which is equal to the net proceeds of sale after paying capital gains tax.

⁶ I assume for simplicity that his annual exemption for capital gains tax purposes has been otherwise utilised.

What, however, is the position of the charity? It will have received a net gift of £87,267, yet it will be able to recover basic rate income tax, so it will finish up with £113,333, a net gain of £13,333 as compared with the donor gifting the asset to the charity and the charity selling it. Hence, the donor will have increased the value of his gift by this amount.

3.2 First Variant: Capital Gains Tax Liability⁷

The lower the amount of the capital gains tax the donor has to pay, the greater the benefit of his selling the asset himself and donating the net proceeds to charity. If, for example, his capital gain were only £10,000 and his capital gains tax liability thus £4,000, he would be able to make a net Gift Aid gift of £123,200 and the charity would be able to recover £36,800 income tax. Thus, he would have increased the value of his gift from £100,000 to £160,000!

3.3 Second Variant: Insufficient Taxable Income

In the above, I have assumed that the donor has sufficient taxable income in the year of the gift to obtain Gift Aid relief. On the assumption that he had a taxable income of £200,000, the net gift of £123,200 would be grossed-up to £160,000, on all of which he would indeed be liable to income tax at the higher, as well as at the basic, rate. If the donor does not have sufficient taxable income fully to utilise his Gift Aid relief, then the position is very different. To take an extreme example, if, reverting to the original illustration, the donor had no taxable income, then the charity would be £32,000 worse off if the donor were to sell the picture himself and donate the net proceeds of sale than if he were simply to gift the picture to the charity and allow it to sell it. By selling the picture himself, the donor would have incurred a capital gains tax liability of £32,000.⁸ He would have to deduct this in its entirety from the net proceeds of sale of £100,000, because there would be no income tax relief available to him. As none of the payment would have qualified for Gift Aid, the charity would not be able to recover any tax so as to increase the amount of the gift.

The difficulty stems from the fact that it is not possible to set-off Gift Aid relief against one's capital gains tax liability. If one could, then there would never be anything to be lost, in terms of tax, by the donor selling the asset and gifting the net proceeds of sale. For the net proceeds of sale could never be smaller than the

⁷ This is set out in tabular form as Example B.

⁸ I am assuming for simplicity that he has realised other gains which would have fully utilised his annual exemption and lower rate band.

capital gain and so the amount of capital gains tax chargeable in respect of the sale could never be greater than the tax saved through Gift Aid relief.⁹

4 General Rules

While certain general principles can be laid down, in some cases a detailed calculation will need to be made before it is clear which is the better course. The general rules are:

- (a) Maximum benefit will be obtained where the income of the donor taxable at the higher rate is at least equal to 167% of the amount of the net proceeds of sale. In such a case a sale by the donor followed by a gift of cash will be appropriate.
- (b) The final sum the charity receives at the end of the day will increase in inverse proportion to the capital gains tax liability of the donor.
- (c) The relative advantage of a sale by the donor will diminish as the short-fall of his taxable income over the optimum amount of the gross Gift Aid payment increases. The cut-off point at which a sale by the donor is no longer advantageous depends on the amount of capital gains tax payable. If no capital gains tax is payable, it will never be disadvantageous for the donor to sell the asset and gift the proceeds. In performing the calculation, it should be borne in mind that the amount of capital gains tax payable will diminish once the donor's taxable income is reduced to such a level that his remaining taxable income does not fully exhaust the basic rate band.

5 Gifts by Companies

In the case of a company resident in the United Kingdom, the position is much simpler. Such a company can offset a Gift Aid payment ("qualifying donation") against its profits, which include both income and capital gains. Thus, it will not normally be disadvantageous for it to sell the asset and gift the proceeds. Quite the contrary, it will always be advantageous, the amount of the advantage increasing in proportion to the rate at which its profits bear corporation tax and in

⁹ For a suggested reform in the law, see my article in Volume 3, Issue 3, *Gift Aid Relief for Gifts in Kind*, section 9.

inverse proportion to the amount of the chargeable gain on which it will be taxable.

6 Conclusion

More often than not, it will be advantageous for a donor of an asset which is not intended to be retained by a charity to sell it and gift the proceeds, rather than to gift the asset and allow the charity to sell it.

Once a donor has gifted an asset, it will be too late to undo the damage.

Particular care is needed in the case of charity auctions, where, if the donor is the vendor, it must be made clear that the asset is being sold not by the charity but by a prospective donor who intends to gift the net proceeds of sale to the charity, but who does not legally bind himself to do so.

| EXAMPLE A - SALE BY DONOR FOLLOWED BY GIFT OF PROCEEDS | |
|--|--------|
| Capital Gain £80,000 | |
| Net proceeds of sale of asset | 100000 |
| Base cost + indexation Relief | -20000 |
| Chargeable Gain | 80000 |
| CGT liability, 40% of gain | 32000 |
| Cash in donor's hand post sale | 68000 |
| Amount of Gift Aid payment actually made | 87267 |
| Grossed up amount of payment (@ 23%) | 113333 |
| Charity recovers difference (equal to basic rate tax) | 26067 |
| Donor pays to charity | 87267 |
| Donor receives upper rate relief, 17% of gross gift | -19267 |
| Net cost to donor (equals cash in hand post sale) | 68000 |

| EXAMPLE B - SALE BY DONOR FOLLOWED BY GIFT OF PROCEEDS | |
|--|--------|
| Capital Gain £10,000 | |
| Net proceeds of sale of asset | 100000 |
| Base cost + indexation Relief | -90000 |
| Chargeable Gain | 100000 |
| CGT liability, 40% of gain | 4000 |
| Cash in donor's hands post sale | 96000 |
| Amount of Gift Aid payment actually made | 123200 |
| Grossed up amount of payment (@ 23%) | 160000 |
| Charity recovers difference (equal to basic rate tax) | 36800 |
| Donor pays to charity | 123200 |
| Donor receives upper rate relief, 17% of gross gift | -27200 |
| Net cost to donor (equals cash in hand post sale) | 96000 |