

Personal allowances and Gift Aid donations

Budget 2009

As you will have read, the budget made a number of changes to income tax and income-related reduction of the personal allowance.

As well as the additional higher rate of 50 per cent for taxable income above £150,000 with effect from the tax year 2010-11, there will also be a tapered reduction in the basic personal allowance for income tax from the same date. The personal allowance for individuals whose *adjusted net incomes* (see explanation below) are above £100,000 will be gradually reduced to nil.

These changes replace the announcements made at the 2008 Pre-Budget Report. While the new tax rate affects only those with incomes of over £150,000, the tapered reduction of personal allowances is more pervasive and affects anyone with an income of over £100,000.

However Gift Aid donations can reduce an individual's adjusted net income and may be used to enable someone with an income in excess of the new threshold to "reclaim" their personal allowance.

The detail

For the tax year 2009-10, there are two main rates of income tax. The 20 per cent basic rate of income tax applies to taxable income up to

£37,400. The 40 per cent higher rate applies to taxable income above £37,400. From April 2010, a 50 per cent additional rate of tax will apply to taxable income above £150,000.

The basic personal allowance provides an amount of tax free income, and all individuals entitled to the basic personal allowance receive the same amount – currently £6,475.

From the tax year 2010-11, the basic personal allowance will be subject to a single income limit of £100,000. So, where an individual's *adjusted net income* does not exceed the £100,000 limit, he or she will continue to be entitled to the full amount of the basic personal allowance. However, where an individual's *adjusted net income* is above the threshold of £100,000, the amount of the allowance will be reduced by £1 for every £2 above the income limit. This means that, for those earning more than £112,950, the personal allowance will be reduced to nil.

"Adjusted net income"

This is the measure of an individual's income that is used for the calculation of the existing income-related reductions to personal allowances. It is the total of the individual's income subject to income tax, less specified deductions (such as payments made gross to pension schemes) and reduced by the grossed-up amount of the individual's pension contributions which have

received tax relief at source and – importantly for charities – the grossed-up amount of the individual's Gift Aid contributions.

We understand from HMRC that the formula for calculating the grossed-up amount of a donor's Gift Aid contributions for the purposes of calculating his or her adjusted net income is the same as is generally used at present.

In other words, donors who are higher rate taxpayers can claim back the difference between the higher rate of tax at 40% and the basic rate of tax at 20% on the total value of the donation – a total of 20%. So the grossed-up value of a donor's Gift Aid contributions will be the actual sum donated plus an additional 25 pence in every pound donated.

Effect of Gift Aid donations

Those individuals whose adjusted net income exceeds £112,950 will not benefit from any part of the personal allowance. However, since a donor's Gift Aid contributions will be taken into account in determining his or her adjusted net income, a donation with a grossed up value of £12,950 to charity by Gift Aid would enable a donor with an income of £112,950 to receive the personal allowance in full.

Example 1

Mr A Taxpayer has a gross income of £112,950. He donates nothing to charity during 2010-2011. He will not benefit from the personal allowance and (assuming no other deductions or allowances) will pay £37,700 in income tax.

Gross income	£112,950
Adjusted net income (reduction of the personal allowance to nil)	£112,950
Taxable income	£112,950
Tax on first £37,400 at 20%	£7,480
Tax on next £75,550 at 40%	£30,220
Total income tax payable	£37,700

Example 2

Mr A Donor also has a gross income of £112,950. He makes a Gift Aid donation of £10,360 to a charity during 2010-2011. This has a grossed up value of £12,950.

The charity can reclaim tax on the "gross" equivalent of the donation – its value before tax was deducted. This is currently 20%, with an additional three pence for every pound donated

until 5 April 2011. So the charity receives £13,338.50.

The donation enables Mr Donor to claim his personal allowance and, as a result, he will pay only £32,520 in tax – £5,180 less than Mr Taxpayer.

Gross income	£112,950
less grossed-up value of Gift Aid donation	£12,950
Adjusted net income	£100,000
No reduction to personal allowance	
Gross income	£112,950
less personal allowance (assuming 2009-2010 amount)	£6,475
Taxable income	£106,475
Tax on first £50,350 at 20%	£10,070
<i>(NB the basic rate band is extended by the grossed-up value of the donation)</i>	
Tax on next £56,125 at 40%	£22,450
Total income tax payable	£32,520

As we have seen, Mr Donor made a donation of £10,360. In enabling Mr Donor to claim his personal allowance, the donation results in Mr Donor paying £5,180 less tax than he would otherwise have paid. In this way, a donation with a grossed up value of £12,950 – from which the charity will receive £13,338.50 – will effectively "cost" Mr Donor only £5,180, due to the income tax saving.

An opportunity for charities?

As noted, taxpayers whose adjusted net income is between £100,000 and £112,950 will lose part of the personal allowance, while those whose adjusted net income exceeds £112,950 will not benefit from it at all.

However, since a donor's Gift Aid contributions will be taken into account in determining his or her adjusted net income, a Gift Aid donation that reduced the donor's taxable adjusted net income to £100,000 or less would enable that donor to receive the personal allowance in full.

The use of Gift Aid payments to restore the personal allowance may well prove attractive to donors – particularly those earning between £100,000 and £112,950, or a little over £112,950 – and charities will want to publicise this.

On the other hand, the fact that the changes to the personal allowance will not take effect until 2010 may lead some donors to defer making payments to the charities they support until after that date.

If you require further information on anything covered in this bulletin please contact Julian Smith (020 7917 7432, jas@farrer.co.uk). © Farrer & Co