Gift aid payments from subsidiaries

Financial Reporting Standard 102 (FRS102) was updated in December 2017 to ensure that there is clarity and consistency in how gift aid payments by subsidiaries are reported. While the tax implications of this arrangement have not changed, there have been changes to the accounting standards which will affect the way this arrangement is presented in the statutory accounts.

In brief, gift aid payments can only be recognised in the subsidiary's accounts when paid, unless there is a deed of covenant in place, although no tax charge needs to be shown. Where a subsidiary makes the gift aid payment after the year end, we feel a better alternative is to show the gift aid payment the following year as:

- There is no need to go to the expense of putting a deed of covenant in place
- The subsidiary's accounts actually look healthier at the year end as assets are not reduced by the gift aid payment.

This is explained in more detail below.

What's the issue?

Subsidiary companies pay over their profits to a parent charity as a donation under gift aid. This is a tax efficient arrangement as the trading profits donated to the charity are not subject to corporation tax as long as the company pays over the donation within the financial year, or within nine months of the year end if the subsidiary is wholly owned by one or more charities. This is an accepted practice which is endorsed by HMRC.

Although such payments are donations for tax purposes, an ICAEW Technical release clarified that they are a distribution from the subsidiary to the charity for company law purposes (see ICAEW Technical release TECH 16/14BL REVISED Guidance on donations by a company to its parent charity). Since this Technical release was issued in October 2014 and updated in February 2016, there has been uncertainty over how gift aid payments and their tax effects should be reported in the subsidiary accounts. The amendments to FRS102 seek to clarify these matters.

What has changed?

FRS 102 now requires the gift aid payment to be accounted for as a distribution to the charity. As a distribution, it should be recognised as a movement in equity rather than expenditure.

In addition, the timing of the recognition should be similar to dividends. Therefore, an expected gift aid payment shall not be accrued unless a "legal obligation" to make the payment exists at the reporting date. FRS102 states that a board decision to make a gift aid payment to a parent charity, that has been taken prior to the reporting date, is not sufficient to create a legal obligation. FRS102 does not specify what does create a legal obligation, but the exposure draft, FRED68, which preceded the amendment to FRS 102 stated:

"this is likely to mean that unless a legal obligation for the subsidiary to make a payment to the parent has been created by, for example entering into *a deed of covenant*, no liability for expected gift aid payments can be recognised at the reporting date."

The final change relates to the tax implications. FRS102 now clarifies that even if the gift aid payment cannot be reflected in the accounts of the subsidiary, where it is probable that the taxable profits will not be subject to corporation tax as they will be paid over to the charity within nine months of the year end, the tax effects of the gift aid payment should be recognised. Thus there is no need to recognise a tax charge or a deferred tax liability in relation to such a gift aid payment.

When does this take effect?

The principal effective date for the FRS102 amendments is accounting periods beginning on or after 1 January 2019. However early application is permitted for these gift aid changes.

What does this mean for the accounts of a trading subsidiary?

There will be three changes:

- Where in the accounts the gift aid payment is reported
- When the gift aid payment is reported
- How the tax effects are reported

In the subsidiary accounts, the payment is no longer an item of expenditure, so cannot be shown as part of profit and loss. Instead, it is part of the changes in equity. This can either be reported in a separate "Statement of changes in equity" or be shown under the Profit & Loss account as a "Statement of income and retained earnings", as follows:

	Current year	Previous year
Changes in equity	£	£
Total equity brought forward	–	–
Total comprehensive income/(expense) for the year	–	–
Gift aid distribution to parent charity	–	–
Total equity carried forward	–	–

The timing of the distribution will depend on when there is a legal obligation to make the payment. A deed of covenant is considered to create a legal obligation, so if there is a deed of covenant in place, then the distribution can be reported in the financial year. If no legal obligation has been created, then the payment will be reported when it is paid. Therefore:

- A subsidiary that has a legal obligation to pay its profits to the charity (through a deed of covenant etc) will report the payment as a change in equity in the financial year
- A subsidiary that does not have a legal obligation to pay its profits to the charity will report the payment as a change in equity when the payment is made.

Regardless of when the payment is reported in the accounts, as long as the intention is to claim the tax relief afforded by a payment under gift aid, there is no tax charge at the year end. This means that even if there are accounting profits reported in the subsidiary, if it is probable that the distribution will be paid over within nine months, then there is no charge to corporation tax. The tax note should explain that the accounting profits will be paid to the parent charity within nine months of the reporting date and as such, there is no taxable profit.

What does this mean for the accounts of the charity?

The charity should recognise the gift aid payment as income when it has entitlement, it is measurable and the receipt is probable, in other words, more likely than not. Where there is a deed of covenant in place, there is deemed to be a legal obligation so all three criteria will be met.

Where there is no deed of covenant in place, the charity may still be able to demonstrate that the criteria are met, in order to recognise the income even if the subsidiary cannot recognise the expense. For example, if the subsidiary's directors have agreed to make the payment and communicated this to the charity before the year end, then this is a constructive obligation and gives the charity entitlement to the income. Alternatively if the custom and practice is to pay this over or if the articles of association require this then the charity will also be able to recognise the income.

Will this change require a prior period adjustment?

Probably, yes. For most subsidiaries, this will be a change in accounting policy. Under the previous accounting regime, the gift aid payment was expensed and reported when there was a constructive obligation. Now it will not be part of expenditure, but equity, and will require a legal obligation. Therefore, it will be necessary to restate prior periods as if this treatment had been in place then.

Should we have a deed of covenant?

Trustees need to decide this for themselves but this is a legal document so if you wish to have one in place you will need to obtain it with advice from your solicitors. However we feel that this is not necessary as the accounts of the subsidiary can explain the gift aid payment is to be made during the following year as shown in the example below. The subsidiary's net assets will include the unpaid gift aid.

Illustrative example for the subsidiary accounts – no deed of covenant

Profit and loss account (with early adoption of FRS102 revised):

	2017 £	2016 (as restated) £
Turnover	1,000	900
Profit before taxation	300	200
Taxation	–	–
Profit for the financial year	300	200

Statement of changes in equity:

	2017 £	2016 (as restated) £
Brought forward	200	150
Profit	300	200
Distribution	(200)	(150)
Carried forward	300	200

The profits for 2017 will be paid over to the charity under gift aid by [9 months after the year end] 201x.