



PROMOTING BEST PRACTICE
IN CHARITY FINANCE

The Tax Implications of Charity Trading

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Third Sector Leaders

ACEVO



[improvingsupport.org.uk/income](https://www.improvingsupport.org.uk/income)

A joint initiative to strengthen support services for the third sector

Foreword

New trading and fundraising initiatives offer many opportunities to grow your charity and diversify its income streams.

The Charity Commission's regular surveys on the impact of the economic downturn indicate that almost half of charities say that trading and fundraising, in one form or another, is their most important source of income. Our surveys show that an emphasis is being placed on fundraising at a time of growing uncertainty over the security of funding from the public sector. So I am pleased to see the development of this comprehensive and well written analysis, which is both a reference book and a source of practical tips and advice.

There is a helpful question and answer section for each chapter. Charity Commission, HM Revenue and Customs and other resources are signposted throughout. A case study called 'Green Schemes' illustrates the issues in a well considered way. Complex areas such as working overseas and the sale of property, as well as more day-to-day issues such as fundraising events and celebrity fundraising auctions are covered with attention to the important details. For example, I was interested to note that the proceeds of the auction of a football signed by members of the Arsenal football team would not be eligible for gift aid!

I commend this excellent publication to you as a very practical and comprehensive guide.

Andrew Hind

Chief Executive, Charity Commission

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1 Introduction

- 1.1 Who is this book intended for?
- 1.2 What is trading and why do a book on it?
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1.1 WHO IS THIS BOOK INTENDED FOR?

This book is a practical guide for charities that raise funds through trading. An organisation can be a social enterprise and a charity but not all social enterprises are charities.

Charities include registered charities but also include some charities which are exempt from registration, such as most universities, certain private and public schools, housing associations and many community sports clubs. Student unions are increasingly taking up charitable status.

Social enterprise is a popular term for trading activities that in some way benefit the community. The borders between what social enterprises and charities do are often blurred, but for tax purposes a social enterprise is generally treated in the same way as most commercial businesses, i.e. it cannot usually avail itself of the tax exemptions that are available to charities. (see Chapter 12).

This book is not intended to be a technical treatise on the tax, legal and accounting implications of charity trading. Instead it aims to provide guidance for lay users on the tax aspects of the main areas of trading activity that charities get involved in. If a more detailed knowledge is required you should take professional advice.

The desired outcomes of this book are:

- 1 An increase in the **capability** of support providers to provide support and advice to frontline organisations on the tax implications of their trading and enterprise activities.
- 2 An increase in the capability of frontline organisations to **identify** the tax implications of trading and enterprise activities at the planning stage.
- 3 An increase in the **capacity** of support providers to provide support and advice to frontline organisations on the tax implications of trading and enterprise activities.

1.2 WHAT IS TRADING AND WHY DO A BOOK ON IT?

Many charities are looking for innovative means of income generation. On the voluntary fundraising side charities are trying to increase their slice of the fundraising cake as well as increase the size of the cake itself. However, many charities have also recognised that in addition to tapping the altruistic side of society there is potentially a large source of income that can be motivated through a mix of altruism and some personal advantage. Charities are increasingly looking for the opportunities to 'sweat their assets'.

Hence charities get involved in charity shops, commercial sponsorship, affinity card schemes and other activities charity income generation. Many charities are providing products and services for a fee on a regular basis and these arrangements often develop into trading with consequential tax implications. In the move to a contract culture for health care and welfare provisions many charities previously funded by grants are finding themselves operating by way of business.

Surprisingly, a number of charities continue to be unaware of the tax and legal ramifications of trading. In the extreme, trading activities can threaten the charitable status of a charity since the fundraising per se, albeit for charitable purposes, is not in itself a charitable objective.

Charities are not automatically exempt from tax. The aim of charity trading is usually to generate income and it is important to manage the arrangements so that funds are not reduced by unnecessary exposure to taxation.

Tax law has a very wide, circular and unhelpful definition of a trade. It states that a trade is "every trade, manufacture, adventure or concern in the nature of trade". Even a one-off event or transaction can be a trade in some circumstances.

This means that a charity may be carrying out a trade even if it was not actively intending to do so. Usually if a charity provides some kind of service or goods to a person or organisation for reward it will be deemed to be trading.

The intention of the charity is not what decides whether the activity is trading. The commercial character of a transaction is normally determined objectively by the nature of the transaction itself. That is, is it a transaction of a kind similar to transactions of the same nature in the commercial world and carried out in a similar way? So selling advertising space in a brochure can

be trading and receiving a payment for publicising a corporate supporter on a charity's web site can also be trading. However, not all trades are subject to income or corporation tax and there are certain statutory and extra statutory concessions available to charities (discussed in Chapter 2).

WHAT ARE THE MAIN TAXES THAT CHARITIES CAN BE EXPOSED TO?

1. Direct tax – Income or corporation tax is payable on the taxable profits of a trading activity. If the charity is a trust it will be assessed under the income tax regime. A trust is a charity set up by a will or a trust deed or a Scheme of the Charity Commission. All other charities such as charitable companies, Royal Charter bodies and unincorporated associations are liable to pay corporation tax. The charity trading rules and tax exemptions apply in the same way to both income and corporation tax, which in this context are referred to as direct tax or taxes.

2. Indirect tax or VAT – The VAT burden arises in two ways. First, VAT is charged on much of the expenditure that a charity incurs and often cannot be recovered. Second, a charity may carry out business activities and make VATable supplies which requires having to charge VAT and pay it over to the tax authorities.

Understanding these two types of taxes is important and there is often confusion in this area. An activity may be liable to direct tax even if it is not liable to VAT and vice versa.

It is important to recognise that there are different rules for income and corporation tax and VAT. In particular the term "exempt" has very different meanings for direct and indirect taxes.

1.3 DIRECT TAX AND THE CALCULATION OF TAXABLE PROFITS

Most charities are able to structure their affairs so that they do not pay direct tax. Statutory and extra statutory exemptions are available so that direct tax liability for most charities is unusual. However, understanding the types of activities that are liable to direct tax is important since, if a charity does not carry out its activities in a way that properly falls within the exemptions, a tax liability will crystallise.

Where a trading activity is taxable, direct tax is payable on the charity's taxable profits. In arriving at these the charity can deduct all direct costs of the trading activity. For example in the case of a mail-order catalogue the direct costs would include the purchase cost of the goods sold, postage and

packing, and printing the catalogue. The charity can also deduct a share of indirect costs, such as staff time and overheads, computer and telephone costs, and premises costs such as heating, lighting and a share of rent. The calculation should be on a reasonable basis. If the trade uses an insignificant amount of resources, a very crude allocation might be made on the basis of turnover.

There may well be some donations included in the trading receipts which can be excluded.

HM Revenue and Customs (HMRC) accept a notional deduction for volunteers' time, or where goods are supplied at below market value.

HMRC'S GUIDELINES ON GOODS OR SERVICES PROVIDED AT AN UNDERVALUE:

It is common for charities to receive goods or services in their trades at no cost, or at less than their full market price. For example:

- a supplier might sell trading stock or equipment to a charity at cost price
- a professional adviser might provide services for no charge
- helpers and beneficiaries might do work on a voluntary basis.

Where a charity (but not a charity subsidiary) has received goods or services free, or at less than

their full market price, the charity may deduct a notional cost/ market price when computing the profits of the trade. Notional costs/market price should be calculated on a reasonable basis. For example, were a celebrity to act as a volunteer waiter at a gala dinner, the notional cost would need to be restricted to the going rate for the employment of a waiter, not that of the celebrity. Market price will be the wholesale or trade price at which the charity could reasonably have expected to buy the goods or services in, not the retail value of those goods or services.

1.4 DIRECT TAX EXEMPTIONS

Charities can have a wide range of different types of income. Broadly speaking, charities are exempt from tax on the following sources of income, provided that they are applied to charitable purposes only:

- Trading profits in certain limited circumstances (see Chapter 2)
- Rental income being income from furnished and unfurnished lettings (see Sections 8.6 and 10.2)
- Interest and other annual payments, such as royalties and fees for the use of logos (see Section 3.8)
- Income from non-trading intellectual property rights
- Gift Aid receipts
- Dividends (although tax credits are not generally recoverable)
- Lottery income where the charity is registered as the promoter (see Section 2.10)
- Capital gains.

“Applied to charitable purposes” means:

- Funds spent directly on charitable activities and the charity’s beneficiaries
- Administrative activities and costs of governance
- Fundraising costs (this means the costs of managing supporters and donations, not the costs of running fundraising events).

Under tax law some expenditure is specifically treated as non-charitable expenditure:

1. Investing in non-Qualifying Investments (see Section 4.6)
2. Making losses on trading activities that do not fall within the exemptions (see Section 11.2)
3. Some transactions with Substantial Donors (see below).

The rules relating to Substantial Donors are under review at the time of writing and have not been included in this book. In essence a Substantial Donor is a “person”, whether company or individual, that has made gifts of a certain value that qualify for tax relief. Transactions with a Substantial Donor need to be identified as the charity can suffer a tax liability on the value of transactions that fall within the rules. The legislation is designed to withdraw tax relief from charities where a donation effectively returns to the donor in cash or in kind. It is not designed to hamper the legitimate activities of charities or donors and there are exceptions to make sure the rules do not catch some arm's length transactions. Up to date guidance is available on HMRC’s website.

1.5 DIRECT TAX RATES

When trading profits are taxable, the tax payable depends on whether the charity is a trust or a company for tax purposes.

A trust pays income tax at the basic rate on trading profits. The basic rate of income tax is currently 20%.

A charitable company pays corporation tax on trading profits at various rates depending on the charity's level of profits. Current and recent rates of corporation tax are set out in the following table:

Table of corporation tax rates

TAXABLE PROFITS	Year to 31 March 2012	Year to 31 March 2011	Year to 31 March 2010	Year to 31 March 2009
£1- £300,000	22%	21%	21%	21%
£300,001- £1,500,000 (marginal rate band)	29.5%	29.75 %	29.75 %	29.75%
Over £1,500,000	28%	28%	28%	28%

It is unusual for charities to have taxable profits that are in excess of the lower rate band, so that if charities are subject to corporation tax it will usually be at the lower rate, currently 21%.

However, if a charity is a member of a group the rate bands are divided by the number of active companies in the group, including overseas ones. So if a charity has two subsidiaries, there will be three companies in the group including the charity. Any profits over £100,000 for each company will be taxable at the marginal rate, and profits over £500,000 will be taxed at 28%.

1.6 INDIRECT TAX - VAT

In comparison to the tax privileges that charities enjoy under the direct tax regime the VAT treatment imposes considerable burdens on charities and has been aptly described as a fiscal nightmare. The basic requirements of the VAT legislation apply equally to charities as to commercial businesses. There are some concessions in the form of zero rating but in the main there are considerable problems for charities with the recovery of their input tax.

VAT is a tax on consumption that is charged on goods and services. When a charity provides these in return for a consideration (in cash or kind) it is generally seen to be carrying out a business activity. Not all business activities are subject to VAT (VATable or taxable) but

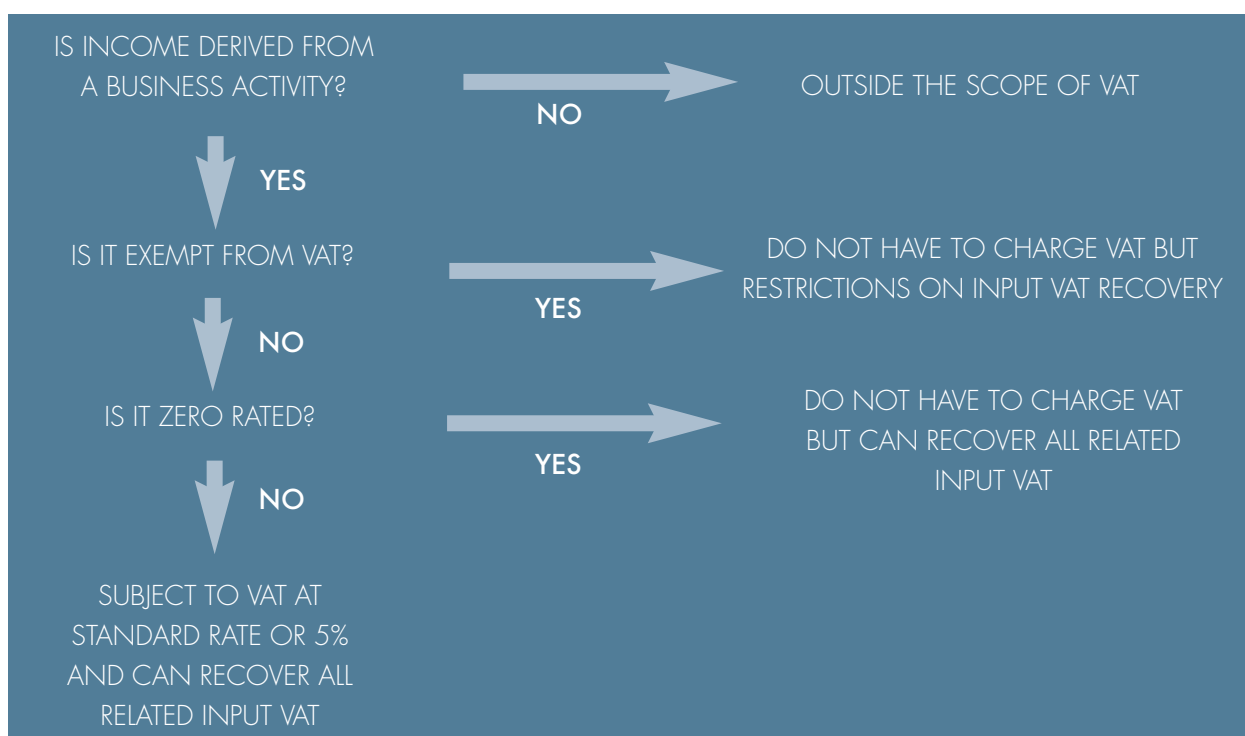
even though they may be exempt from VAT they still fall under the VAT regime.

Activities which are non-business are outside the scope of VAT. Income from donations and grants is non-business income.

In general terms, VAT charged to the charity by its suppliers is called input VAT or tax and VAT charged by a charity on any VATable supplies that it makes is called output VAT.

The following flow-chart summarises the VAT treatment of a charity's activities and this is explained in more detail in the rest of this section.

VAT treatment of business/non-business activities



When is an activity a business activity for VAT?

For VAT purposes there is some established guidance as to what constitutes a trading or business activity. The usual questions that need to be considered when determining whether an activity is business for VAT purposes or not are:

- Is the activity a serious undertaking earnestly pursued? (This considers whether the activity is carried on for business or daily work rather than pleasure or daily enjoyment)
- Is the activity an occupation or function which is

actively pursued with reasonable or recognisable continuity? (When considering this test the charity should consider how frequently the supplies will be made)

- Does the activity have a certain measure of substance in terms of the quarterly or annual value of taxable supplies made?
- Is the activity conducted in a regular manner and on sound and recognised business principles?
- Is the activity predominately concerned with the making of taxable supplies for a consideration?

- Are the taxable supplies that are being made of a kind which, subject to differences of detail, are commonly made by those who seek to profit from them?

When should a charity register for VAT?

If a charity's turnover from taxable (i.e. non-exempt) business activities exceeds the VAT registration threshold the charity must register for VAT. The VAT registration threshold is currently £68,000 (from 1 May 2009) and is reviewed each year in the Budget.

Charging output VAT

If a charity is VAT-registered, when making a taxable supply it has to add output VAT to its invoices when VAT is applicable.

If a supply is taxable the tax is due at one of three rates:

1. zero (0%)
2. reduced (5%) or
3. standard (17.5%).

The standard rate was temporarily reduced to 15% between 1 December 2008 and 31 December 2009. The reduced rate applies in limited circumstances depending on the product itself and the circumstances of the sale. The reduced rates apply for supplies such as domestic fuel and power, installing energy-saving materials, sanitary hygiene products and children's car seats.

If a business supply is **exempt** no VAT is added to the charity's invoices.

Most businesses that a charity trades with are likely to be registered for VAT and will be able to recover the VAT that a charity may have to charge. So charging them output VAT should not disadvantage the business. However, some organisations such as banks, insurance companies and other charities may not be able to recover all the VAT and this will be an "extra" cost to them. Also, most individuals and others who are not registered for VAT will not be able to recover the VAT that is charged to them. It goes without saying that the beneficiaries of charities in the care and welfare sector are effectively consumers for VAT purposes.

Recovering input VAT

Even when VAT is not chargeable on a supply by a charity, it has to be remembered that irrecoverable VAT on expenditure is a cost to the charity.

A charity is generally charged VAT by its suppliers unless reliefs or exemptions apply. It can recover the input VAT that is charged on purchases relating to its taxable business activities (including zero rated supplies).

Usually, the more output VAT as a proportion of overall sales that a charity charges, the more input VAT it can recover. The difference between the output VAT and the input VAT is paid over to or recovered from HMRC. However where there are significant amounts of VAT on expenditure that relate to non-business activities and/or exempt activities (see below) the input VAT cannot be recovered in full. This is known as partial exemption (see below). Charities are well advised to take advice on how to minimise this irrecoverable VAT.

Exempt supplies fall within the scope of VAT law but no VAT is charged when making supplies. Similarly, subject to certain limits (see below), generally no VAT can be recovered on expenditure incurred in making those supplies.

This is to be contrasted with zero rated supplies. These are VATable supplies, albeit at a rate of 0%. No VAT is chargeable on the making of these supplies but, since they are treated as taxable supplies, the VAT incurred in making these supplies can usually be recovered. For example when a charity sells goods donated for resale to the public VAT is added at the zero rate. This means that there is no extra charge to the customer but it also means that the charity can recover the input tax incurred in making the supply (see Section 5.5).

Partial exemption and business/non-business apportionment

VAT incurred can only be recovered by a VAT-registered organisation to the extent that it can be attributed to taxable income. VAT incurred that is attributable to non-business activities (e.g. the free supply of services) or exempt supplies (e.g. the provision of welfare services for a charge) is not recoverable. If the VAT paid on purchases can be directly attributed to these activities it is a straightforward enough process to restrict the

recovery on the costs concerned. However, where expenditure cannot be directly attributed to specific transactions (e.g. general overheads) the VAT incurred must be apportioned between the amount that can be recovered and the amount that is not recoverable by use of a business/non-business apportionment or partial exemption method.

A business/non business apportionment is used to calculate the recoverable proportion of VAT incurred in respect of business and non business activities. There is no set method of doing this; any calculation can be used providing it produces a fair and reasonable result.

A partial exemption method is used to calculate the recoverable VAT in respect of expenses incurred that are attributed to both taxable and exempt transactions. The standard method (the default method set out in VAT law) of calculating recoverable VAT uses the formula below to determine the proportion of VAT recoverable.

$\frac{\text{Residual input tax} \times \text{Value of taxable supplies}}{\text{Value of all supplies (taxable + exempt)}}$

Other methods of partial exemption can be used (a partial exemption special method) but only with the written agreement and approval of HMRC.

1.7 USING THIS BOOK

This book is structured around activities typically undertaken by charities. A charity is thought of as developing from simple basic fundraising and trading activities to more sophisticated ones. The earlier chapters deal briefly with certain aspects (e.g. Xmas cards) which are developed more fully in later chapters (merchandising). This inevitably leads to a certain amount of repetition, so that all the information relevant to an activity can be found in the same place.

Each chapter has a list of key facts at the end and contains numerous examples and Frequently Asked Questions which relate to areas where charities find difficulties in practice.

A case study runs through the book illustrating a single charity trying to cope with these issues. The charity is called Green Schemes and its charitable purpose is “to

General comments

Although VAT is a relatively young tax it remains a fact that when the VAT legislation was drafted it did not envisage the significant societal changes that have occurred in the last 40 years. There is very much a catch up process in action as VAT law is updated and case law develops. A good example of this is in the area of digital downloads and the difficulties in identifying the place of supply of digitised products and services.

It is also important to bear in mind that VAT is a European tax and the rulings from the European Court of Justice in respect of VAT disputes in other EU member states may have a bearing on the UK position.

There is also currently a culture of anti-avoidance legislation which often blocks arrangements that could be sensibly adopted for charities without the intention of avoiding tax.

protect the environment and to encourage people and businesses to adopt good environmental practices”.

HMRC have detailed tax guidance on their web site. This material is subject to Crown copyright which requires it to be reproduced accurately and not used in a misleading context. This book quotes from this useful guidance extensively. In the main, the sections are identified in separate text boxes and referring to the original guidance can be helpful to understand the wider context.

The Charity Commission has many useful publications which include the fundraising, trading and public benefit guidance referred to in this book. To view their guidance access the website:

<http://www.charitycommission.gov.uk>

1.8 COMMON TERMS AND ABBREVIATIONS

Charity Commission – the Government Department responsible for regulating the charity sector. It is primarily responsible for registered charities.

Direct taxes – income and corporation tax

FA – Finance Act

Gift Aid – Tax relief for monetary gifts. Gift aid may be claimed on payments to a charity by individuals and companies. Gift Aid payments by individuals must be supported by a valid Gift Aid declaration and are treated as being paid net of basic rate income tax, which the charity can then reclaim from HMRC. Gift aid paid by companies is treated as paid gross, no reclaim is made by the charity and the amount paid is available as a deduction against corporation tax

HMRC – Her Majesty's Revenue and Customs, responsible for administration and collection of taxes. Before 2005 income and corporation taxes were dealt with by the Inland Revenue, and VAT by HM Customs and Excise

HMRC Charities – the HMRC department responsible for charities and trading subsidiaries, based in Bootle

ICTA - Income and Corporation Taxes Act

Indirect tax – VAT but also Stamp taxes, Insurance Premium Tax, Landfill Tax, Aggregates Tax and Climate Change Levy

Input tax – VAT on purchases. This is VAT that is suffered by charities and is often irrecoverable unless the purchases directly relate to VATable supplies

ITA – Income Tax Act

Intangible assets – assets such as goodwill and intellectual property rights (IPR)

IPR – intellectual property rights. IPR represent copyright, trademarks, databases, patent rights, design rights, know how and other similar intangibles

Option to tax – Normally the supply of land and buildings is exempt from VAT. However, in certain circumstances a business can elect to waive this exemption on commercial property, or "opt to tax". Where an option to tax is made, the input tax relating to the property costs can be reclaimed

Output tax – VAT on sales. If a charity has to charge output VAT on supplies that it makes it can usually recover the corresponding input VAT on purchases relating to those sales

SOFA – Statement of Financial Activities – a charity's Income and Expenditure Account

SORP – Statement of Recommended Practice on Accounting and Reporting by Charities

Trust - A trust is a charity set up by a will or under a trust deed or a Scheme of the Charity Commission. Trusts are subject to income tax on their profits and capital gains tax on their gains. Charities which are not trusts will generally be taxed as companies, and subject to corporation tax on their profits and capital gains

VAT – Value Added Tax

VATA – VAT Act

2 Fundraising and the basic tax exemptions

- 2.1 Fundraising inside or outside of the charity
- 2.2 What are the implications?
- 2.3 The direct tax exemptions for charity trading activities
- 2.4 Primary purpose trading
- 2.5 Ancillary trades
- 2.6 Mixed trades
- 2.7 Trades carried out by beneficiaries
- 2.8 Small Scale (or *de minimis*) trading
- 2.9 Fundraising events exemption
- 2.10 Lotteries
- 2.11 The impact of the public benefit test
- 2.12 When to use a subsidiary company
- 2.13 Frequently asked questions
- 2.14 Key facts

This chapter considers the basic rules regarding charity trading and the direct tax exemptions that are available. It touches on some key areas of fundraising but these areas are considered in more detail in the following chapters. Finally it outlines the decision process of when to use a trading subsidiary. This chapter includes some comment on VAT but this is not the primary focus of the chapter.

2.1 FUNDRAISING INSIDE OR OUTSIDE OF THE CHARITY

A key aspect is where and by whom a fundraising activity should be carried out. In the typical charity context there are a number of possible ways that this can be done, none of which are mutually exclusive.

FUNDRAISING MAY BE CARRIED OUT:

1. **directly by the charity itself** – this is the most common way and is usually done by the charity's staff and directly controlled by the charity. Many of the following chapters deal with this structure.
2. **by a branch of the charity** - this usually involves volunteers who operate through a branch that is part of the charity. The activities may be their own initiatives but they are supported by the charity and for tax purposes are treated as if they are carried out by the charity.
3. **by a subsidiary of the charity** – this is usually a wholly owned subsidiary set up specifically to carry out non-charitable trading activities. Chapter 4 discusses this in more detail).
4. **by a separate group of volunteers (Friends)** – this is usually an autonomous group of people or an entity that may or may not have charitable status.
5. **by an unconnected third party** - this third party raises funds and passes them over to the charity, for example a corporate supporter.

2.2 WHAT ARE THE IMPLICATIONS?

The advantages to the charity of keeping the fundraising outside the charity as in points 4 or 5 above is that the trustees do not need to involve themselves in the minutiae of the trading activities, and can gratefully receive the donated profits.

Fundraising is often carried out by Friends or supporters groups, that then donate the profits to the charity. Typically a separate Friends or supporter group will be an unincorporated association, which would normally have a short written constitution and a bank account. The use of a separate organisation keeps any VATable supplies separate from the charity's own tax position and may allow the activities to be below the VAT registration threshold.

For direct tax purposes the implications are generally the same if the fundraising is carried out by an individual, a separate Friends group (if they are not themselves a charity) or by another unconnected third party such as a corporate supporter.

There are however a number of practical and tax disadvantages to keeping fundraising outside of the charity.

- The direct tax exemptions for trading that are available to charities will not be available to the individual fund-raiser or the separate group or organisation, so that profits will be taxable
- In particular, the fundraising exemption for both direct tax and VAT (see Section 2.9 below) may not apply. HMRC have stated in their guidance that: "Where an individual or an independent group holds events as part of a national fundraising campaign such as Comic Relief, Children in Need and Blue Peter Appeals, it is unlikely that they will have charitable status or be a qualifying body. If the group does not have charitable status or is not a qualifying body the exemption would not apply to such events and the group should see VAT Notice 700/1 'Should I be registered for VAT?'. Input tax incurred on expenditure cannot be reclaimed if the individual or independent group is not registered for VAT"
- Typically the individuals or independent group are not aware of the need to complete a direct tax return annually or to make sure that a Gift Aid payment is

made equal to the taxable profits of the accounting period in of the profits are earned

- The individuals or independent group may well decide to use their profits to buy assets which they then donate to the charity. This is not tax-effective, as a Gift Aid donation needs to be made
- Similarly a direct tax deduction is not available for payment of the charity's expenses by the individuals or independent group
- Donations to the individuals or independent group by the general public will not be made under Gift Aid, unless it is clear that the Friends are acting as agents for the charity and Gift Aid declarations are completed in the name of the charity
- With regard to VAT the individuals or independent group will not be able to acquire the assets with the benefit of any zero rating relief that the charity could obtain
- The individuals or independent group are under no obligation to support only one charity, and depending on their constitution they may raise funds for a number of different charities.

If it is decided to keep supporters' fundraising activities outside the charity, the charity should still monitor what is happening and make sure that the individuals or independent group take advice on their own tax and VAT position.

If a supporters group comes within the charity, it becomes a branch. Key practical and tax issues for branches are:

- Whether Head Office is kept informed of fundraising activities, and has any control over whether and how they take place
- Whether branch staff have the training and tools in order to identify tax issues
- Making sure that potentially taxable activities go through a trading subsidiary
- Effects of branch activities on the small scale/*de minimis* exemption (see Section 2.8 below)
- Effects of branch activities on the fundraising exemption, i.e. whether they breach the limit of 15 events in one location, or take the total amount

raised from very small scale events to over £1,000 in a week (see Section 7.3). This will have an effect on VAT as well as direct tax

- Effect of branch activities on the registration threshold for VAT, and whether the charity is obliged to register and account for VAT.

CASE STUDY

One of Green Schemes's supporters, Brian, is a convert to the idea of social enterprise, and has started buying ecologically friendly household cleaners and other goods in bulk and selling them on a well known internet auction site. In the first year he makes a turnover of £5,000 and a profit of £2,000 which he donates to Green Schemes.

As he is trading in his own right, he needs to record the profits in his own tax return, and make a Gift Aid donation. He needs to be careful to record the takings in the relevant tax year, and then make the Gift Aid payment by the 5th April in that tax year. If he wants to donate only £2,000 to the charity, he will need to make a Gift Aid donation of £1,600, as the charity then reclaims £400 (20% of the grossed up donation) from HMRC. If Brian is a higher rate taxpayer, he will get another 20% tax relief when he submits his tax return, and he can donate this additional amount to charity.

In the next year Brian is so enthusiastic about the scheme that he inspires several of his friends to set up a Friends group to do similar activities. Brian is no longer selling in his own name, but as Friends of Green Schemes. The Friends make a profit of £5,000 on turnover of £15,000. They will be treated as a company for tax purposes, and if they wish to donate all their profits to Green Schemes they must do it before the end of the Friends group's accounting period or they could be liable to tax on the trading profits.

In the third year the activity is expected to double its turnover and profits, but Brian is finding that the activity is taking up too much of his time. He asks if the charity will take on the Friends as a branch, and provide some management time to help while he reduces his commitment.

Green Schemes's trustees will need to consider:

- a) whether this trading activity is a primary purpose activity (see Section 2.4) or
- b) whether the trade falls within the small scale exemption (see Section 2.8)
- c) whether there is need to use a trading subsidiary (see Section 2.12)

In any case, once the trade becomes part of Green Schemes's own business activities and if Green Schemes is registered for VAT then VAT will be chargeable on the sales.

If Green Schemes is not registered for VAT then this activity may take it over the registration threshold and mean that the charity will have to charge VAT not only on these but possibly on other supplies as well.

2.3 THE DIRECT TAX EXEMPTIONS FOR CHARITY TRADING ACTIVITIES

There are a number of different trading tax exemptions which are listed below. Each of these is dealt with in a separate section:

- Primary purpose trading (Section 2.4)
- Ancillary Trades (Section 2.5)
- Mixed Trades (Section 2.6)
- Trading by beneficiaries (Section 2.7)
- Small scale (*de minimis*) trading (Section 2.8)
- Fundraising events (Section 2.9)
- Lotteries (Section 2.10).

2.4 PRIMARY PURPOSE TRADING

Charities are exempt from direct tax on the profits of “primary purpose” trading activities. A primary purpose trade is one which is carried out as part of the charity’s primary charitable purpose or purposes.

A charity’s primary charitable purpose or purposes are the objectives for which it was set up, and a charity can have more than one. They will be set out in the charity’s governing document. For instance, the

primary purposes of a theatre charity will usually include the advancement of the theatrical arts and of education, and a museum’s will be the advancement of education and the preservation of its collections.

The primary purpose exemption is the main charity direct tax trading exemption. HMRC have provided the following examples of where it applies:

HMRC’S EXAMPLES OF PRIMARY PURPOSE TRADES:

Some trading undertaken by charities may, in itself, amount to a primary purpose activity and therefore qualify for exemption. Examples of such trading include:

- the provision of educational services by a school or college in return for course fees
- the holding of an exhibition by an art gallery or museum in return for admission fees
- the sale of tickets for a theatrical production staged by a theatre
- the provision of health-care services by a hospital in return for payment
- the provision of serviced residential accommodation by a residential care home in return for payment
- the sale of certain educational goods by an art gallery or museum

In each of these examples the organisation carrying on the activity is a charity and it is part of the organisation’s charitable objects to undertake the activity described.

When considering primary purpose trading a distinction must be made between activities which are directed to the achievement of the charity's objectives and other activities, which although supporting the charity, cannot be described as actually carrying out its charitable purposes. Even if a charity uses the proceeds of the trade on its charitable activities this does not mean that the trade itself is primary purpose.

For example, a church that has charitable status with the objective of advancing religion would find that the

sale of religious books qualifies as part of its primary purpose, however, the sale of other books would not qualify. This is despite the fact that the profits from both types of sales are used exclusively for its charitable objects. See Section 2.6 for further details on mixed trades.

When considering whether an activity is primary purpose trading charities must also consider whether the activity passes the public benefit test (see Section 2.11)

2.5 ANCILLARY TRADES

In some cases a trade may be ancillary to the carrying out of a primary purpose. An ancillary trade is one that by itself would not be primary purpose but that a charity would be expected to or obliged to carry out as part of carrying out its primary purpose. This trading can still be said to be exercised in the course of the carrying out of a primary purpose. It is therefore part of the primary purpose trade and will be exempt from direct tax.

HMRC EXAMPLES OF TRADES ANCILLARY TO THE PRIMARY PURPOSE

Examples of trading which qualifies as primary purpose because it is ancillary to the carrying out of a primary purpose are:

- the sale of relevant goods or provision of services, for the benefit of students by a school or college (text books, for example)
- the provision of a crèche for the children of students by a school or college in return for payment
- the sale of food and drink in a cafeteria to visitors to exhibits by an art gallery or museum
- the sale of food and drink in a restaurant or bar to members of the audience by a theatre
- the sale of confectionery, toiletries and flowers to patients and their visitors by a hospital.

The word "ancillary" is not in the tax legislation, and for this reason HMRC are moving away from the term. Their view is that either a trade is primary purpose or it is not. In their view trades described as

ancillary should properly be described as primary purpose. Nevertheless the word is in common use and has been used in this book as it encapsulates the concept well.

2.6 MIXED TRADES

Where there is a mixed trade that is partly primary purpose and partly non-primary purpose HMRC deems each part of the trade to be a separate trade. The primary purpose part of the trade is exempt, as long as its profits are used for charitable purposes. The non-primary purpose part is taxable unless the exemption for small scale trading (see Section 2.8 below) can apply to this trade.

Before April 2006 HMRC used to operate a concession for mixed trades. If the turnover from the non-charitable part of the trade was less than both:

- 10% of the turnover of the whole trade; and
- £50,000

2.7 TRADES CARRIED OUT BY BENEFICIARIES

Beneficiary trading encompasses trades which are non-primary purpose but are carried out mainly by beneficiaries (e.g. the manufacture and sale of items by residents of a home run by a charity caring for blind people).

In certain cases the trade may be carried out by both beneficiaries and others. So for example paid employees may be used to manage or help the beneficiaries. In such cases there are two scenarios to consider.

1) Where it can be shown that the greater part of the work in connection with the trade is carried out by beneficiaries of the charity the tax exemption will apply.

The trade could be treated as primary purpose.

New legislation on mixed trades was brought in by Finance Act 2006, and after April 2006 HMRC ceased to operate the mixed trade concession. The current rules provide that a mixed trade should be treated as two trades, one of which is primary purpose and the other non-primary purpose. The income and costs must be allocated to each part of the trade on a reasonable basis, including both direct and indirect costs. See Section 11.1 for further details on cost allocation.

2) Where the work is carried out partly but not mainly by beneficiaries the activity will follow the rules for mixed trades. The part carried out by beneficiaries is deemed to be part of the charity's exempt beneficiary trade and the part carried out by the non-beneficiaries will be taxable. Income and expenditure relating to the overall trade should be apportioned to the separate parts on a reasonable basis and there may be an opportunity to use the small trades exemption discussed below.

If the beneficiaries are also employees because the charity pays them a wage the exemption will still apply so long as they can still properly be regarded as beneficiaries of the charity.

EXAMPLES OF TRADES CARRIED OUT BY BENEFICIARIES INCLUDE:

- An agricultural college with a farm shop where the college's farm produce is sold
- A sixth form college teaching hairdressing and catering courses. As part of the courses the students provide hairdressing at a reduced rate, and run a restaurant
- A charity supporting visually impaired people sells goods manufactured by them.

All of these would be beneficiary trading, although the first two would also fall within the primary purpose exemption.

2.8 SMALL SCALE (OR *DE MINIMIS*) TRADING

There is an exemption for profits from small scale non-charitable trading, under Section 46 of Finance Act 2000. This applies when the turnover is below either:

- £5,000, or
- 25% of the charity's total incoming resources, with an overall upper limit of £50,000.

These limits are sometimes called the "*de minimis*" limits. The term is used when something is so small or minimal in scale that the results do not matter and can be ignored. The limits can be summarised as shown below.

TOTAL INCOMING RESOURCES OF THE CHARITY	MAXIMUM PERMITTED TURNOVER FROM NON-CHARITABLE TRADING
Under £20,000	£5,000
£20,000 - £200,000	25% of total gross income
Over £200,000	£50,000

A charity's "total incoming resources" is simply the figure from its published accounts, which can be found in the top half of its Statement of Financial Activities (SOFA), and includes grants, donations and trading income.

This is an all or nothing exemption. If the trade does not qualify, then all the profits are taxable. The table below sets out some examples of how this works:

TURNOVER OF NON PRIMARY PURPOSE TRADE (<i>BEFORE</i> EXPENSES)	TURNOVER OF THE TRADE (<i>AFTER</i> EXPENSES)	CHARITY'S TOTAL INCOME (INCLUDING THE TRADING TURNOVER)	TAXABLE AMOUNT
£4,500	£2,000	£30,000	Nil, because the turnover from the trade is less than £5,000
£20,000	£18,000	£200,000	Nil, because the turnover from the trade is less than 25% of £200,000
£40,000	£20,000	£150,000	£20,000, because the turnover from the trade is more than 25% of £150,000
£100,000	£30,000	£400,000	£30,000, because the turnover from the trade exceeds the upper limit of £50,000

The turnover limit applies to the turnover from all the charity's non-charitable trading activities. Quite often a charity has a number of different trading activities, each of which is small-scale in itself, but together the turnover exceeds £50,000 so the total profits are taxable. This regularly happens where branches run their own fundraising activities. Some will fall within the fundraising events exemption (see Section 2.9 below), but some do not and these must all be taken into account.

If a charity inadvertently breaches the limit in one year it may still have an exemption if the trustees had a

"reasonable expectation" that the turnover would be less than the limit. HMRC have explained that they will consider the circumstances to establish whether the charity had reasonable grounds to consider that it would not fall outside the exemptions. For example, this could be established by budgets and forecasts or past trends. Fairly obviously, if a charity breaches the limit for a second year running, the trustees would be very unlikely to be accepted as having a reasonable expectation for that or future years.

2.9 FUNDRAISING EVENTS EXEMPTION

Recognising that many fundraising events that are carried out by charities could be seen to be trading for direct tax and also a business activity for VAT there is a tax exemption for fundraising events which fulfil certain conditions.

If the exemption applies the profits from the events will

not be subject to income or corporation tax. In addition VAT is not charged on the income from the events, but neither can it be recovered on any costs.

This area is complicated and has been covered in more detail in Chapter 7 on Events.

2.10 LOTTERIES

Charities are exempt from tax on the profits from lotteries that fall under Part 1 or 4 of Schedule 11 to the Gambling Act 2005, or are promoted in

accordance with a lottery operating licence within the meaning of part 5 of the Act.

THE EXEMPTION COVERS:

- Lotteries that are incidental to non-commercial events, where none of the funds raised are appropriated for the purpose of private gain. The tickets must be sold on the premises and at the same time as the event. Clearly a lottery associated with a fundraising event would be covered by this, but it is in fact wider than the fundraising exemption
- Small society lotteries, which are promoted wholly on behalf of a non-commercial society. A lottery is small if its proceeds will not exceed £20,000
- Any other lottery which is conducted under the provisions of the Gambling Act 2005, and where the charity holds a lottery operating licence under the Act.

For VAT purposes income from lotteries including raffles and instant bingo tickets is treated as exempt. This exemption applies both to charities and trading companies alike.

The VAT exemption applies to:

- The provision of any facilities for the placing of bets or the playing of games of chance
- The granting of a right to take part in a lottery.

2.11 THE IMPACT OF THE PUBLIC BENEFIT TEST

When considering which trading activities are allowable as part of the charity's primary charitable purpose charities now also need to consider the public benefit test. The Charities Act 2006 has for the first time set out in legislation charitable objectives and established the over-arching requirement to demonstrate that the activities provide public benefit.

In particular the law requires charities which advance education, religion or relieve poverty to demonstrate explicitly that they deliver public benefit.

The Charity Commission has emphasised that there is a particular focus on fee charging and this is of relevance when considering the issue of trading. They have stated that charities which charge relatively high fees must demonstrate accessibility to those facilities or services for people who cannot afford the fees. It will not normally be possible to demonstrate public benefit through indirect benefits alone, such as savings in public expenditure through the provision of a service like education or health.

They go on to explain that the public benefit requirement can be broken down further into four principles which show whether an organisation provides benefit to the public.

- There must be an identifiable benefit
- Benefit must be to the public, or a section of the public
- People on low incomes must be able to benefit
- Any private benefit must be incidental.

This is particularly relevant when considering primary purpose trades. So for example a charity may have the primary purpose of providing education but if it runs closed courses (see Section 8.3) or carries out research activities (see Section 8.5) that do not pass the public benefit test those parts of the trade will not be primary purpose.

For further information see the Charity Commission's guidance on Charities and Public Benefit and Public Benefit and Fee Charging.

2.12 WHEN TO USE A SUBSIDIARY COMPANY

Direct Tax

When a charity's taxable trading activities are not covered by one of the charity tax exemptions the trustees need to consider setting up a trading subsidiary.

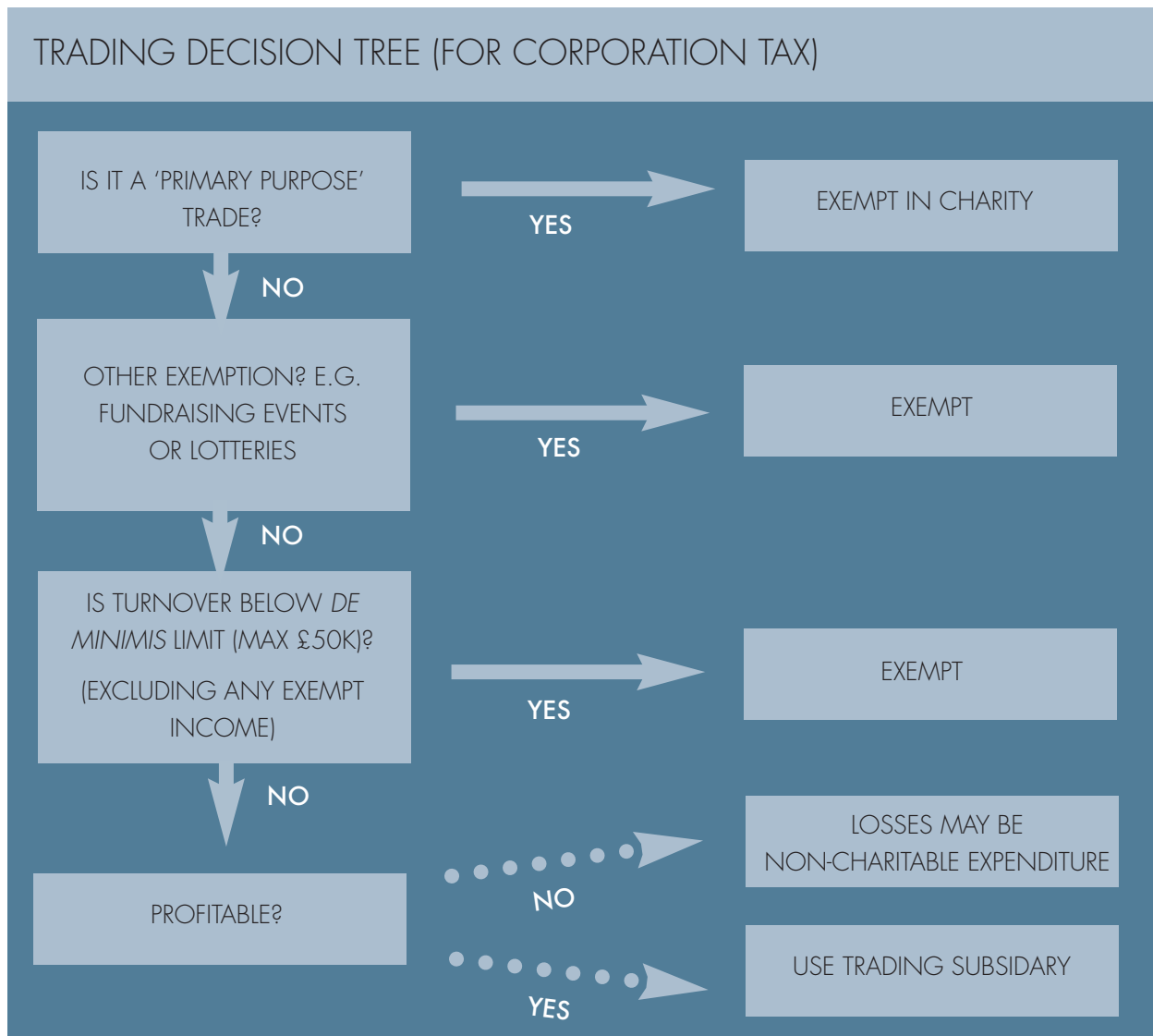
A trading subsidiary can carry on non-charitable trading and Gift Aid the profits to the parent charity. The donation is tax-deductible in the subsidiary's hands. In the charity's hands the receipt is treated as donation income and is exempt if applied to charitable purposes.

Therefore a trading subsidiary can be used to house non-charitable trading activities, so that tax is not payable on the profits. For tax purposes a subsidiary is only needed if the trading does not fall within one of the charity's tax exemptions for trading, which have been discussed above.

When entering into a non-charitable trading activity it is crucial to prepare a draft budget, with best and worst case estimates, so that the activity can be properly structured from the start.

The budget should include all direct and indirect costs that are expected to arise from the activity. It is possible that after allocating all direct and indirect costs the activity may be forecast to make a very small profit, or even a loss. HMRC consider that making a loss on non-charitable trading is a non-charitable use of the charity's funds. It may still be worth the charity carrying on this activity, if it makes a contribution to fixed costs, but the tax position can be complicated and a trading subsidiary may not be the best route. In this situation professional advice should be taken.

The decision process can be summarised as follows:



Where the loss is non-charitable expenditure there may be issues that mean that the charity loses certain tax exemptions (see Section 11.2). Advice will need to be taken in these situations.

VAT

It may be possible to improve VAT recoveries by transferring certain activities to a trading subsidiary.

In general the VAT position for a trading subsidiary is similar to that of a charity for fundraising purposes provided that the company has agreed in writing to transfer its profits to a charity or the profits are otherwise payable to a charity.

However, some activities are exempt from VAT if carried out by a charity, but when carried out by a trading subsidiary they become taxable. If carried out by the trading subsidiary, therefore, the related input tax can be reclaimed and the charity's overall VAT recovery can therefore be improved.

There is more detail on the VAT position of trading companies in Chapter 4.

Risk

Typically a charity will set up a trading subsidiary to

minimise tax liabilities, or to improve VAT recoveries. However, the trustees may choose to trade through a subsidiary even when it is not required to save tax, but to minimise risks. Trading activities are by their nature financially risky and it may be desirable to use a subsidiary company to protect the charity's assets from being used to fund trading losses. There are also particular risks associated with hazardous fundraising activities such as a sponsored parachute jump, in which using a trading subsidiary to run the event might reduce the risks of a substantial insurance claim.

The brutal truth is, however, that the charity can only protect itself by letting the subsidiary go bankrupt. This may not be an acceptable decision to the trustees, but it may be preferable to letting the charity go down. In the event the trustees would need to consider the damage to the charity's reputation before taking the decision. Moreover some of the trustees would probably be directors of the subsidiary, and the insolvency of the company could also have an effect on them personally. Notwithstanding this, the Charity Commission see the ring fencing of risk as an important reason to use a non-charitable trading subsidiary.

2.13 FREQUENTLY ASKED QUESTIONS

We are selling goods and we will be using all the profits from these sales to support our primary purpose activities – surely this means that the profits will not be taxable?

Short answer

It is not the destination of the profits alone but the activity that is carried out that has to be considered.

In more detail:

For the profits to be exempt from direct tax the trade itself must be exercised in a way that furthers the primary purpose of the charity. In effect the main purpose of the trade is to help meet the charitable purposes. However, even where this is not the case the small scale exemption may apply.

Our trading profits are less than £50,000 – does the small scale exemption apply?

Short answer

Not necessarily. You need to look at the **turnover** from the non-charitable trade to decide whether the exemption applies, not the **profits**.

In more detail

The relief is from tax on profits where there is a reasonable expectation that turnover is either below:

- £5,000, or the lower of
- £50,000, and
- 25% of the charity's total incoming resources

If a charity inadvertently breaches the thresholds it will have to establish that the trading turnover and/or total incoming resources were different from its 'reasonable expectation'. HMRC would expect there to be documentary evidence such as a budget prepared in advance to support the expected figures.

We have a lot of small-scale trading activities that may breach the £50,000 limit in total. These are negligible compared to our charitable activities. It seems like a lot of work to set up a trading subsidiary – should we bother?

Short answer

Unfortunately the trustees need to account for any tax liabilities that the charity has, however small. If they don't want to pay tax they need to consider setting up a trading subsidiary.

In more detail

The trustees need to:

- Identify all potential non-charitable trading activities;
- Work out what the turnover from them is;
- If the turnover is more than £50,000, calculate all direct and indirect expenses;
- If the activities are making a profit, work out the tax liability
- Was there a reasonable expectation for this year that the turnover would be below £50,000? If so, there should be no tax liability for this year
- Decide for the future whether to use a trading subsidiary or to pay the tax.

It may well be that when all direct and indirect expenses are taken into account the tax liability is negligible. In that case the trustees may decide to pay the tax liabilities on an annual basis rather than setting up a trading subsidiary. However they will need to keep the position under constant review in case the activities and profits increase.

2.14 KEY FACTS

Primary purpose trades

Not all trades are taxable – the main exemption from direct tax is when the trade is exercised in carrying out a primary purpose of the charity.

In deciding whether a trade is a primary purpose trade due regard will need to be taken of the public benefit test.

Trades which are ancillary to the primary purpose are also exempt.

Mixed trades (partly primary purpose and partly not) are treated as two separate trades and taxed accordingly.

Beneficiary exemption

There is a direct tax exemption for trades where the work is mainly carried out by beneficiaries.

Small scale (*de minimis*) exemption

The exemption applies to turnover from non-charitable trading, not to profits.

There is only one exemption to cover all a charity's different non-charitable trading activities. It does not apply to each activity separately.

Fundraising exemption

The VAT and tax exemptions cover the same activities, but do not apply to the same bodies. A trading subsidiary is covered by the VAT exemption but as it donates all its profits to the charity it is not covered by the corporation tax exemption.

Friends and supporters groups may not be covered by the exemption.

Lotteries

Lotteries at events or small scale lotteries are automatically exempt.

For larger lotteries to be exempt the charity must be registered as the promoter.

If the trading subsidiary is registered as the promoter the income must go through the trading subsidiary and be Gift Aided to the charity.

Trading Subsidiaries

Where none of the exemptions apply many charities use non-charitable trading subsidiaries to provide shelter from direct tax or to attempt to ring fence risk.

3 Business Sponsorship

- 3.1 What is sponsorship?
- 3.2 Is it trading? The direct tax implications
- 3.3 Is it a business activity? The VAT implications
- 3.4 Table of direct tax and VAT treatment
- 3.5 Sponsoring a primary purpose trade
- 3.6 Website links
- 3.7 Affinity products
- 3.8 Logos and cause related marketing
- 3.9 Corporate partnerships and chosen charity schemes
- 3.10 Making a payment and a donation
- 3.11 Corporate sponsorships using Gift Aid
- 3.12 Frequently asked questions
- 3.13 Key facts

3.1 WHAT IS SPONSORSHIP?

Sponsorship covers a number of different arrangements between charities and businesses, under which charities receive funding or other support and the sponsors receive some tangible benefits. HMRC has explained that it can involve payment in the form of goods and services as well as money. The payments may also be described as something else, for example as a donation.

SOME EXAMPLES OF SPONSORSHIP ARRANGEMENTS

Example 1

A fashion museum puts on an exhibition of Victorian costumes. A major retailer pays £30,000 towards the costs, and its name and logo are published on posters and leaflets advertising the exhibition. Five of the retailer's executives are invited to the opening night party.

Example 2

A charity holds a fun-run to raise funds. A major sports manufacturer donates £10,000 towards the costs, and gives a pair of branded trainers to everyone who raises more than £1,000. The manufacturer also gives a free branded T-shirt to every participant, with the name and date of the event printed on it.

Example 3

A small arts and disabilities charity receives support in kind from a major computer manufacturer, and a local printing company. Both are thanked in the charity's annual report, and links to their websites are published on the charity's website.

In practice many innovative means of raising funds can have undesirable tax and VAT implications for the charity if the arrangements are not properly structured and planned.

As explained in Chapter 1 the direct tax (corporation

tax or income tax) and indirect tax (VAT) rules are different. So a sponsorship arrangement may be exempt from corporation tax but may still be subject to VAT.

3.2 IS IT TRADING? THE DIRECT TAX IMPLICATIONS

Section 1.4 explains that not all a charity's revenue-earning activities are trading. Some are regarded as investment income, which is broadly exempt from direct tax. Some may be taxable as sundry non-trading income. Donations are generally exempt from direct tax, but when significant benefits are provided in return for sponsorship, this may turn the sponsorship into a trading activity.

HMRC GUIDANCE ON DIRECT TAX AND SPONSORSHIP.

Just because a sponsor derives good publicity or public relations benefits from payments to charity, does not automatically mean that payments by the sponsor are trading income in the hands of the charity.

If the charity provides some goods or services in return for the sponsorship payments they may be treated as trading income. Most commonly a charity will play a part in publicising the business sponsor's affinity with the charity by including references to the sponsor in publications, posters, etc. and at events organised by the charity. Provided that such references amount to no more than acknowledgements of the sponsor's contributions they will not cause the payments to be regarded as trading income. However, references to a sponsor which amount to advertisements will cause the payments to be treated as trading income. HMRC Charities will regard a reference to a sponsor as an advertisement if it incorporates any of the following:

- large and prominent displays of the sponsor's logo,
- large and prominent displays of the sponsor's corporate colours, or
- a description of the sponsor's products or services.

For example, if a project organised by a charity is sponsored by a well-known company, and acknowledgement of the support of this company is in the form of its name and logo inserted in the corner of a project report, this would not be considered to be advertising. However, if the name and logo was substantially and widely displayed throughout the report, this might be considered to be advertising in return for the sponsorship payment.

There are other services that a charity might provide in return for sponsorship payments that will be factors in determining whether the payments are trading income. Examples of such services are:

- use of the charity's mailing list
- use of the charity's logo
- endorsement of the sponsor's products or services
- links to the sponsor's sales website from the charity's own website
- exclusive rights to sell goods or services on the charity's premises.

3.3 IS IT A BUSINESS ACTIVITY? THE VAT IMPLICATIONS

A sponsorship payment may still be within the scope of VAT even if it is exempt from direct tax. Care should be taken in particular in considering the VAT treatment of the provision of a charity's name and logo or the provision of publicity to the sponsor as described above.

HMRC'S VAT GUIDANCE ON SPONSORSHIP

Where you receive sponsorship or some other form of support you will normally be making taxable supplies if, in return, you are obliged to provide the sponsor with a significant benefit.

HMRC have provided some examples and have said that:

Significant benefit might include any of the following:

- naming an event after the sponsor;
- displaying the sponsor's company logo or trading name;
- participating in the sponsor's promotional or advertising activities;
- allowing the sponsor to use your name or logo;
- giving free or reduced price tickets;
- allowing access to special events such as premieres or gala evenings;
- providing entertainment or hospitality facilities; or
- giving the sponsor exclusive or priority booking rights.

This list is not exhaustive and there are many other situations in which your sponsor may be receiving tangible benefits. What matters is that the agreement or understanding you have with your sponsor requires you to do something in return.

You may receive financial or other support in the form of donations or gifts. Provided they are freely given and secure nothing in return for the donor they are outside the scope of VAT. A taxable supply is not created where you provide an insignificant benefit such as a minor acknowledgement of the source of the support.

The examples of insignificant benefit that HMRC provide include any of the following:

- giving a flag or sticker;
- naming the donor in a list of supporters in a programme or on a notice;
- naming a building or university chair after the donor;

or

- putting the donor's name on the back of a seat in a theatre.

For the charity this area is fraught with difficulties of interpretation and HMRC's guidance published in November 2006 appears to be taking a stricter view. It states:

HMRC's further VAT guidance on sponsorship

Where a sponsor receives any benefits in return for a sponsorship payment all of the payment for the sponsorship is consideration for a taxable business supply for VAT purposes.

However it is recognised that there will be situations where the "benefit" amounts to no more than a mere acknowledgement of support, given gratuitously by the charity to the sponsor and is not directly linked to the payment made by the sponsor. Where this is the case the payments are considered to be a donation and therefore outside the scope of VAT.

A charity should be careful when trying to argue that it has not “done anything” to create a VAT supply. HMRC have explained that the granting of the right for a sponsor’s logo or name to appear in a charity’s publication or on their website is a supply of services for VAT purposes. It is the granting of the right that makes the supply taxable for VAT purposes rather than any activity (or lack of it) undertaken by the charity or the size and/or prominence of the logo. The same principles apply when a charity grants the right to a business sponsor to use the charity’s logo. See Section 3.8.

Given the potential uncertainties, therefore, it is advisable for charities to include a clause in their sponsorship agreements stating that if VAT is deemed

to be chargeable it will be in addition to the net amounts that the corporate may be paying.

Sometimes, as explained in Chapter 1, charging VAT can work to the charity’s advantage as it may increase the VAT the charity is able to recover on its own costs. In most cases the VAT charged to the commercial organisation will not be an additional cost as the organisation should be able to recover it. However some organisations such as banks may not be able to recover the VAT.

In other cases the charity may not want to register for VAT and the risk is that VATable sponsorships can push it over the VAT threshold.

3.4 TABLE OF DIRECT TAX AND VAT TREATMENT

To be trading for direct tax purposes, the charity needs to be active in providing the goods or services, and not just be a passive recipient of income. The rules to decide whether an activity is a business activity for VAT are similar but not identical.

The following table lists some different types of sponsorship arrangements, and comments on the direct tax and VAT treatment:

SPONSORSHIP ARRANGEMENTS	DIRECT TAX TREATMENT	VAT TREATMENT
The sponsor receives a simple acknowledgment on the charity's website, or in its annual report, along the lines of "we would like to thank the following businesses for their support"	Not trading	Not a business activity: outside the scope of VAT
The sponsor has a page or a half page in the annual report or other publication, detailing its products and giving its address and contact details	Trading – the charity is providing an advertising service	Business activity subject to VAT at the standard rate
Incorporation of the sponsor's name and logo into the charity's stationery	Likely to be trading, as the charity is promoting the sponsor	Business activity subject to VAT at the standard rate
Use of the sponsor's name and logo on the charity's publicity material, e.g. a flyer for a theatre production	Trading, but may be primary purpose – see Section 3.5 below	Business activity subject to VAT at the standard rate
Links to the sponsor's sales website from the charity's website	Likely to be trading	HMRC take the view that this is a business activity with income subject to VAT but this may be subject to challenge and advice should be taken.
If the charity is allowing its name and logo to be passively exploited	Not trading	If there is income from a sponsor then this is a business activity subject to VAT at the standard rate
Use of the charity's name and logo on the sponsor's products with active support by the charity e.g. mailshots to supporters, attendance of staff or volunteers at marketing events etc.	Trading if the charity is actively promoting the products in addition to the use of the name and logo	Business activity subject to VAT at the standard rate
Use of the charity's database for mailing purposes by the sponsor	May be trading as the charity actively manages its database	Business activity subject to VAT at the standard rate in most cases but possibly exempt if used by an insurance organisation

3.5 SPONSORING A PRIMARY PURPOSE TRADE

As explained in Section 2.4 some trades are exercised in the course of the carrying out of the primary purposes or charitable objects of the charity. Profits from such trades will be exempt from direct tax. For example:

- a theatre charity selling tickets for a stage production
- a charity for the support of young artists selling their artworks
- an arts charity charging a fee for attendance at exhibitions
- an awards ceremony which is seen to be a primary purpose activity where the audience pay to buy a ticket (also see HMRC guidance below).

In some cases a sponsor might wish to support such a trade and the question is whether sponsorship receipts

from such trades are taxable in the hands of the charity.

Before the Finance Act 2006, where sponsorship income arose in connection with a primary purpose trade HMRC regarded it as part of that trade, and therefore the income was not taxable.

Finance Act 2006 brought in the mixed trade rules that “when a trade is exercised partly in the course of the actual carrying out of a primary purpose of the charity and partly otherwise, each part shall be treated as a separate trade”. Therefore, HMRC might try to argue that the sponsorship could be treated as a separate non-charitable trade for tax purposes. This would be difficult for the charity to cope with because of issues relating to cost allocation (see Chapter 11 for more detail).

HMRC'S GUIDANCE PUBLISHED IN NOVEMBER 2006, NOW STATES:

Once it has been determined that sponsorship payments are trading income in the charity's hands the next step is to consider whether the sponsorship arrangement falls into the primary purpose or non-primary purpose parts of the charity's trade.

It is recognised that where a sponsor's funding is tied to a particular event or project, it may not be practical to confine the charity's response to a mere acknowledgement. However, any arrangement in which the charity's response is on such a scale that it appears to be a main purpose of the donation (sic) may be challenged. In such a case, HMRC will want to consider the possibility of non-primary purpose trading by the charity and whether there has been a breach of the donor's benefits limits.

HMRC provide two examples that illustrate how they interpret the rules.

Example 1

A charitable theatre group's production is sponsored by a local business 'X'. X's logo is placed discreetly within the event programme. An executive of X appears on stage on the final night and is thanked. One sign of moderate size is positioned prominently in the hall stating that the event is sponsored by X.

In this case it could not reasonably be argued that a main purpose of the production is advertising X, and there would be no loss of direct tax reliefs for charity or donor.

Example 2

An arts organisation's broadcast national awards ceremony is sponsored by a nationally well-known brand 'Y'. The event is named 'The Y Awards', which brings Y's name up on television frequently in trailers and programme breaks. Y's logo features prominently in the programme. An executive of Y appears on stage and thus on television and is thanked. There are many prominent signs advertising Y in the venue.

In this case it could reasonably be argued that a main purpose of the event is advertising Y, and there is the possibility of a loss of direct tax reliefs for charity and donor.

It appears from this guidance that HMRC will not usually take the view that sponsorship should be treated as a separate non primary purpose trade. Charities will however need to review each activity carefully to make sure that the whole activity including the sponsorship is not treated as non-primary purpose.

The last sentence in Example 2 is worth considering closely and it seems that HMRC's concern is that the event is not really being carried out to further the objects of the charity but is seen to be an event to publicise the donor and raise sponsorship income.

In correspondence with the authors HMRC have explained, "If a trade such as putting on theatrical performances is a primary purpose trade then

sponsorship of those productions will fall to be treated as receipts of that trade and within the exemption. Our comments are intended to add a qualification that would, in all probability, only apply in extreme circumstances such as where the supposedly primary purpose activity was little more than a vehicle for generating advertising income. In such a situation we would have to question whether the activity really was carried on in furtherance of the charity's objects i.e. whether or not it really was primary purpose".

For VAT purposes sponsorship in these circumstances will be a business supply and subject to VAT as set out in Sections 3.3 and 3.4 above.

3.6 WEBSITE LINKS

HMRC’s guidance states that a link to the sponsor’s sales website from the charity’s website will be a factor in deciding whether the payment by the “sponsor” is trading or business income in the hands of the charity. However, it is not the only factor.

The following case study illustrates the different direct tax and VAT treatments arising from a number of different sorts of website links

CASE STUDY		
Green Schemes is a charity whose primary purpose is “to protect the environment and to encourage people and businesses to adopt good environmental practices. It has a number of links on its website:		
TYPE OF LINK	DIRECT TAX TREATMENT	VAT TREATMENT
Links to other environmental charities from its home page	Even if the other charities pay for this, it should be primary purpose trading, and exempt	If there is payment then HMRC take the view that this is a business activity and subject to VAT. This will be at the zero rate if it can be demonstrated that this is advertising on behalf of the other charities. However, just linking to another charities website may not meet the definition of “advertising”
Links to government funders from its home page	The government isn’t a business in this sense, so it wouldn’t be a trading activity	Non-business activity and outside the scope of VAT
A separate page listing the charity’s major sponsors, and linking directly to their home pages, but without their logos	It’s likely that such links by themselves would be treated as a simple acknowledgement – particularly if it’s in fact the charity that benefits more from the association rather than the companies	HMRC take the view that this is a business activity and subject to standard-rated VAT but this may be challenged and advice should be taken
Links to and logos of the sales websites of companies where products can be bought	Non-charitable trading – and profits would be taxable, unless it can be argued that the sales in some way advanced the charity’s primary purpose	This would form trading income subject to VAT at the standard rate

In cases of doubt it is usually simplest to assume that the sponsorship is non-charitable trading, and use a trading subsidiary. However, the charity needs to take care that the subsidiary has the right to use the charity's website for its trade, and this needs to be carefully structured to avoid a tax liability arising in the charity (see Chapter 4 on Trading Companies). The contract for the sponsorship also needs to be between

the sponsor and the subsidiary, and the invoicing needs to follow this. In some cases there may be a need for a tripartite contract including the charity, the trading subsidiary and the sponsor.

The VAT treatment of such income will be the same whether the supply is made by the charity or by the subsidiary.

3.7 AFFINITY PRODUCTS

Affinity products allow supporters to channel funding to charities by organising their activities (typically financial) through a particular organisation.

For instance if a supporter takes out an affinity credit or debit card with a particular bank, the bank will make a small one-off payment to the charity (typically £5 or £10) and then it will pay a small percentage of purchases made on the card (typically 0.25% but this can be up to 1.25%).

In a similar arrangement, supporters may buy goods on-line via a particular website which again pays a percentage of sales turnover made to the charity.

VAT

With regard to affinity cards, HMRC have agreed by concession that for VAT purposes a percentage of the initial sum and the whole of the percentage on the sales may be treated as a donation. Their guidance is as follows:

HMRC GUIDANCE ON THE VAT TREATMENT OF AFFINITY CARDS

A charity may receive payments from a bank, building society or other financial institution in return for the charity endorsing that institution's credit card and recommending its use to the charity's members or supporters. This is a business activity and the payments would normally be treated as standard-rated as being in return for marketing services provided to the financial institution.

However, we recognise that a large element of these payments could be a contribution towards charitable funds and not payment for services rendered so we allow charities to treat part of these payments as standard-rated and the remainder as outside the scope of VAT.

Charities may treat income from affinity credit cards as follows, as long as they are not acting as an intermediary between the card provider and the applicant. [Further guidance on intermediaries is available in the notice]

A typical qualifying agreement between the charity and the card provider will provide for the supply by the former (or its trading subsidiary) to the latter of the following services:

- access to the charity's membership or mailing lists and/or mailing of the card provider's promotional literature to members
- endorsement of the card and marketing of the card by the charity to its members/supporters
- the right to use the charity's name and logo on the card and on the card provider's promotional literature

Subject to the agreements between the charity and card provider being structured in a qualifying manner, the bulk of the monies received by a charity from the card provider can be treated as outside the scope of VAT

To benefit from this treatment there must be two separate agreements:

- One agreement, between the charity (or its trading subsidiary) and the card provider should provide for the supply by the charity (or its trading subsidiary) of the necessary marketing and publicity services, access to membership lists and other promotional activity for the card (marketing services). These supplies are taxable at the standard rate.

- A second and separate agreement between the charity and the card provider should provide for contributions to be made by the card provider in respect of the use only of the charity's name and/or logo. Contributions made under this agreement can be treated as outside the scope.

This being the case, part (at least 20%) of the initial payment can be treated as the consideration for the standard-rated business supplies by the charity. The remaining 80% or less of the initial payment, and all subsequent payments based on turnover will be outside the scope of VAT.

It should be noted that many charities now treat their income from affinity cards as exempt from VAT but this is only possible if the charity is acting as a financial intermediary. HMRC have explained that they will see a charity as acting as an intermediary in arranging a contract between its members and a credit card provider where it

- stands between the parties to a contract in the performance of a distinct act of negotiation, without having any interest of its own in the terms of the contract;
- brings the two parties to the contract together; and
- undertakes preparatory work, such as completing or

assisting with completion of application forms, forwarding forms to the credit card company, and making representations on behalf of either party.

It is important to take care on the terms of the agreement and the services being provided by the charity. HMRC do not see clerical tasks (e.g. providing a list of names or access to a database) as intermediary services.

Direct tax

While there is no similar agreement relating to the direct tax treatment of affinity cards, HMRC have issued the following guidance:

HMRC GUIDANCE ON THE DIRECT TAX TREATMENT OF AFFINITY CARDS

Treatment for tax purposes is likely to be similar to that for VAT purposes. Any payment accepted as a true donation for VAT purposes would normally be accepted as such for tax purposes. Anything else paid to the charity in relation to the affinity card is likely to be taxable non-primary purpose trading income. It is recommended that separate payments are made under carefully drafted legal agreements, in order to make the position clear. The commercial payment should be at a market rate.

This guidance is specifically restricted to income from affinity credit cards and does not extend to any other financial products. Charities should particularly note that if they become involved in promoting other financial products, such as insurance, they will need to comply with FSA and other regulatory regimes.

Commission

In particular there are no agreements with HMRC with regard to commission received on trading through particular websites, and the income from the website will be treated as taxable trading and be subject to VAT at the standard rate.

CASE STUDY

Green Schemes enters into an agreement with Mega Bank plc to provide a range of affinity credit and debit cards to its supporters. The supporters will have a choice of pictures of fragile environments to go on their cards, and each card will bear the Green Schemes logo as well as the bank account and financial details.

Green Schemes receives £5 for every card taken out and 0.5% of purchases made by the supporters. Green Schemes earns some other income from non-charitable trading, so it is decided to use a separate trading subsidiary to avoid any possible tax liability arising.

An agreement is made between the charity and Mega Bank plc for the use of the Green Schemes logo. The agreement is structured so that Green Schemes provides no other services to the bank other than the use of the logo. This covers £4 of each initial payment and the 0.5% of purchases. No VAT is charged on these payments and they are exempt from corporation tax.

Green Schemes sets up a subsidiary trading company, Green Schemes Enterprises Ltd. A second agreement is made between Green Schemes Enterprises Ltd and Mega Bank plc to cover the use of the charity's database and marketing services to be supplied by the trading subsidiary. This covers £1 of each initial payment, which includes VAT at the standard rate.

There will need to be a separate agreement between Green Schemes and Green Schemes Enterprises Ltd for the use of the charity's database and the services of staff and other costs used by the subsidiary. The charges for these services will need to be considered very carefully (see Chapter 4 on Trading Companies).

The supply of staff and other services by the charity may be standard-rated for VAT, and the trustees will need to consider setting up a VAT group covering the charity and its trading subsidiary. A VAT group usually simplifies administration, but overall VAT recoveries may be increased if a group is not used. See Chapter 4 on Trading Companies (Section 4.9).

3.8 LOGOS AND CAUSE RELATED MARKETING

Cause-related marketing often involves a business leveraging its brand by associating it with a charity. For instance, a wine merchant could sell wine whose labels state "50p from the sale of each bottle of organic wine goes to the charity Green Schemes". The Green Schemes logo will be printed on each organic wine label. What is the tax effect of such arrangements?

VAT

For VAT purposes the treatment is clear cut. Any payment relating to the use of a logo is VATable at the standard rate.

Direct tax

For direct tax the answer is more complicated

If the charity is a trust, or if the logo came into existence before 1 April 2002, the payment is taxable in the charity's hands unless it is structured as an annual payment. To be treated as an annual payment the payment must be:

- applied solely for charitable purposes; and
- made under a legal obligation; and
- recurring (the payments must be capable of recurring each year but the obligation may be contingent); and
- treated as pure income profit in the hands of the charity. (A sum is 'pure income profit' if it comes to

the charity without the charity having to do anything or incur any expenses in return).

If the charity is a company and the logo came into existence on or after 1 April 2002, then the logo is treated as an intangible asset, and the tax treatment depends on whether it is regarded as a “trading intangible asset” or a “non-trading intangible asset”. Receipts from non-trading intangible assets are exempt if applied to charitable purposes.

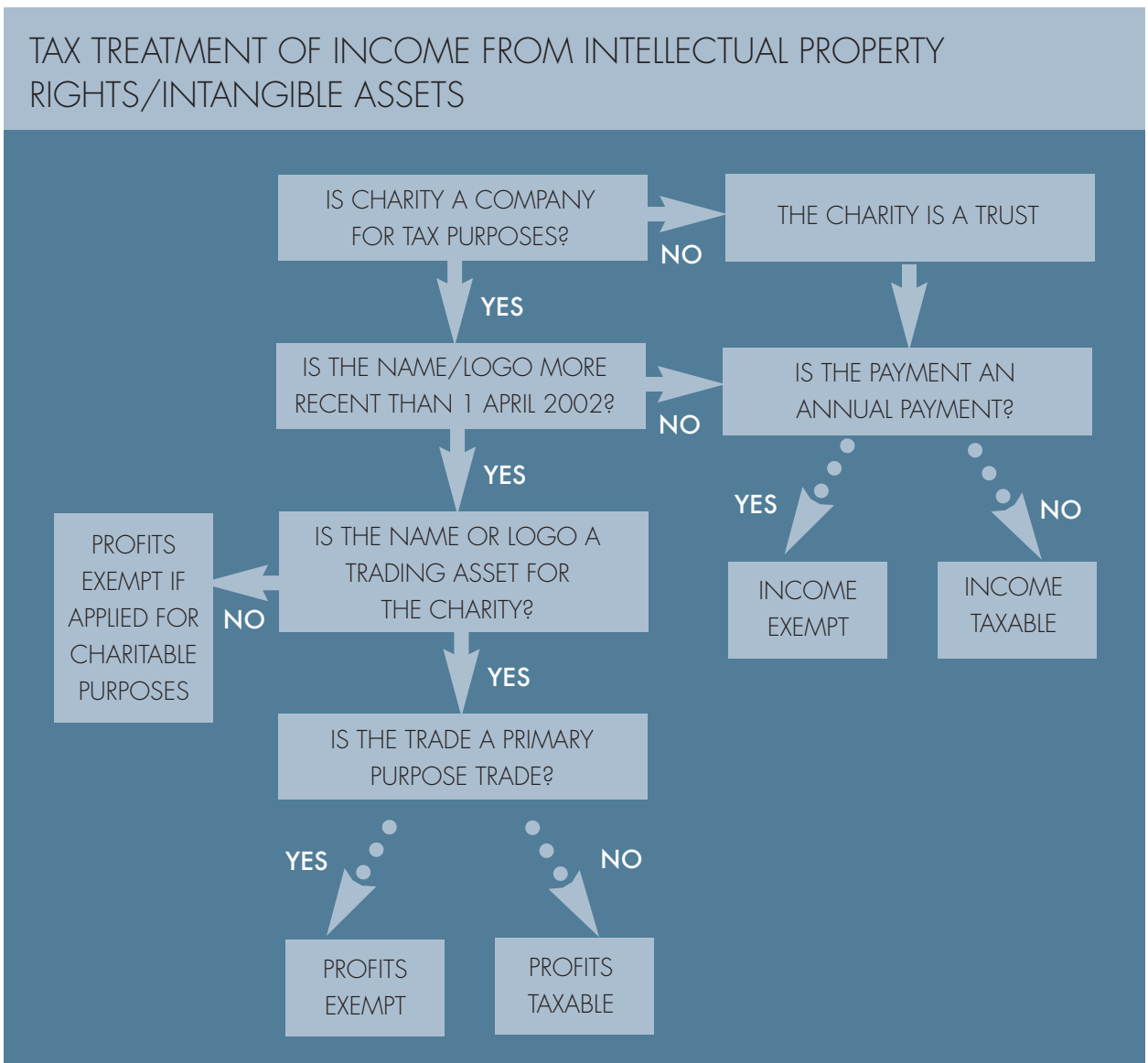
Whether or not the logo is regarded as a trading asset or a non-trading asset will depend on the relationship with the sponsor. If the charity is passively receiving income, the logo is likely to be a non-trading asset, and the income exempt.

If the charity is carrying out activities in return for the

income, then exploiting the logo is more likely to be a trading activity, and the logo will be a trading asset. The sorts of activities that the charity might undertake are:

- Providing support for the company’s publicity activities such as photo shoots, by sending staff and/or volunteers to participate in them
- Sending mailings to its own supporters encouraging them to buy the products or visit the company’s website
- Putting links on its own website (See Section 3.6).

The trustees would then need to consider whether the trade was part of its primary charitable purpose. The following decision tree explains the process for direct tax.



Note: All charities that are not trusts are treated as companies for tax purposes

CASE STUDY

The object of Green Schemes is to preserve the environment. To that end it has developed an accreditation scheme for suppliers of ecologically sound products, called "GreenLight". The idea is to use an eco-labelling certification programme to help reduce global warming.

Products will be assessed against a rigorous science based standard defined and developed by Green Schemes. The supplier pays a third party certification body to carry out the assessment rather than Green Schemes itself as it is felt that this would compromise the process. However, when the products successfully pass the assessment the supplier is then allowed to use the GreenLight logo and pays Green Schemes a royalty for this.

The use of the logo is critical and by identifying products that reduce global warming the GreenLight logo empowers consumers to make the best environmental choices. The growing demand for credible, certified and labelled purchasing choices in turn encourages more suppliers into the assessment process. Many of these suppliers may not initially meet the standard and will use their engagement in the programme to identify where they need to make improvements.

In this case it is important to consider what the charity is being paid for and what it has done to receive the payment. It could be argued that the development of the standard and the marketing of this through the use of the logo is a taxable trade. If however, the charity is able to show that it is in fact a passive recipient of income the payment for the logo could be seen as an annual payment which would not be taxable. In any case Green Schemes would want to argue that marketing the logo in this way furthers its primary charitable purpose and therefore any profits should not be taxable.

3.9 CORPORATE PARTNERSHIPS AND CHOSEN CHARITY SCHEMES

As with sponsorship generally, corporate partnerships can cover a number of arrangements. Typically a business will nominate the charity as its partner for a period of time, usually a year.

sponsor may arrange a number of events or activities over the course of the partnership. It may support its staff in volunteering for the charity, or arranging fundraising events for the charity.

Under the umbrella of a corporate partnership a

TYPE OF ACTIVITY	TAX TREATMENT FOR CHARITY AND SPONSOR	VAT TREATMENT
Staff volunteering	There is no direct tax consequence for the charity and even if the staff carry out charitable activities in working hours the sponsor does not have to disallow the relevant part of their salaries	No VAT issues
Matching staff donations	The corporate partner should get Gift Aid relief for matching donations paid to the charity. The tax relief is for donations provided out of its own funds, but not on donations from staff or customers that it collects and passes on to the charity	No VAT issues
Donations of trading stock or plant and machinery, perhaps for a raffle	Direct tax relief is available for the donor's costs in that there is no disallowance for donations of these assets As long as the charity is not doing something for sponsor in exchange there is no tax liability and this is treated as any other donation	Donations of goods for sale, letting or export by a charity or a trading subsidiary are zero rated for VAT. This means that the donor can recover the VAT on the cost of the gift. This does not apply to goods used by the charity where there is a deemed supply by the donor which will be subject to VAT. See Chapter 5 on charity shops
Setting up a payroll giving scheme	Direct tax relief for costs, and staff of corporate partner	No VAT issues
Fundraising events (see Chapter 7 on fundraising events)	If the charity organises an event (which qualifies for the VAT exemption), the profits will be tax-free in the charity's hands If the corporate partner organises the event the profits will be taxable in its hands but it can Gift Aid the profits to the charity and obtain tax relief. The Gift Aid must be paid over in the accounting period in which the profits are earned	VAT exempt for the charity if it fulfils the requirements. VAT exemption will not apply if the corporate partner organises the event. Supplies will be VATable at the standard rate

TYPE OF ACTIVITY	TAX TREATMENT FOR CHARITY AND SPONSOR	VAT TREATMENT
Links to sponsor's website	Tax as described in Section 3.6	VAT as described in Section 3.6
Use of charity's name and logo by sponsor	Tax as described in Section 3.8	A payment relating to the use of a logo is VATable at the standard rate
Costs incurred by trading subsidiary, e.g. fundraising packs for the corporate sponsor's employees	Costs relating to the charity's fundraising activities or seeking charitable donations need to be in the charity. If costs are in the subsidiary when they properly belong to the charity, they will be disallowed in the subsidiary's corporation tax computation and could create taxable income in the subsidiary	Trading companies cannot obtain the zero rating VAT reliefs available to charities for certain goods used in collecting monetary donations
Donations by the sponsor that make the sponsor a Substantial Donor	It is possible that the charity could incur a tax liability on any transactions that it undertakes with the sponsor	Not a VAT issue
Gift Aid payments by the sponsor to the charity	Benefits received by the sponsor must not exceed the benefit limits, otherwise the payment will not receive tax relief (see Section 3.11). In addition the provision of benefits by the charity is likely to mean that it is trading. Whether this is taxable or not depends on a number of factors discussed in Chapter 2	Gift Aid is outside the scope of VAT

The important thing before entering into any corporate partnership arrangements is to consider the tax consequences before any agreements are signed. In

this way the charity can be protected from any unexpected tax liabilities.

3.10 MAKING A PAYMENT AND A DONATION

A sponsorship arrangement may be an entirely commercial transaction, but more often it includes an element of gift. If that element can be separated out, it will not be subject to income or corporation tax in the charity's hands, and it will also be outside the scope of VAT.

Where a receipt for a charity's name and logo is entirely passive in the charity's hands that too can be exempt from direct tax. It would however be liable for VAT. This is summarised in the following table:

	ADVERTISING SERVICE	NON-TRADING INTANGIBLE/ANNUAL PAYMENT	DONATION
Charity's direct tax position	Trading activity - profits taxable	Exempt from direct tax	Exempt from direct tax
Sponsor's direct tax position	Deductible as trading expense	Deductible as trading expense	Gift Aid - deductible as a charge on profits
VAT position	VAT at standard rate	VAT at standard rate	Outside the scope of VAT

The sponsor will usually get direct tax relief however the payment is structured.

Sometimes charging VAT can work to the charity's advantage as it may increase the VAT that the charity is able to recover on its own costs. In most cases the VAT charged to the commercial organisation will not be an additional cost as the organisation should be able to recover it. However, some organisations such as banks may not be able to recover the VAT and may therefore prefer the payment to be structured so as to include an element of donation.

There may also be considerations for the sponsor as to which budget the payment should come out of – is it the advertising budget, or is there a separate budget for charitable donations and corporate social responsibility (CSR) activities? However this in itself does not determine the tax treatment.

Split payments

As explained above a charge can be split between a payment for services and an element of gift. This applies for both direct tax and for VAT purposes.

There must however be a specific price for the services (which will bear VAT) and the balance of the payment

must be totally discretionary (a gift, which will not bear VAT). If this is not done at the outset then VAT and direct tax could be due on the whole payment. It is key that the donation element must be given freely.

In order to minimise risk for the charity it is advisable for charities to include a clause in their sponsorship agreements stating that if VAT is (unexpectedly) deemed to be chargeable it will be in addition to the net amounts that the corporate may be paying.

How much should be allocated to the contract, and how much to the donation?

Under charity law a charity should get best value for its assets, so the charity should charge market value for any advertising services provided.

Moreover, if the sponsor does not pay full market value for any advertising benefit it receives, this could be treated as a benefit provided in return for a donation, which might fail to qualify for Gift Aid. Having said this, a market value can be difficult to determine. It is likely to depend on the amount of money that the sponsor can make by associating itself with the charity. There is likely to be a range of market values reflecting:

- The potential income to the sponsor (depending on the amount of business it is expecting to attract)
- The value of the charity's name (assuming that better known charities will bring more benefits)
- Any natural affinity between the charity and the product – in the Case Study association with our Green Schemes charity will be of more value to a company trying to sell environmental products

For VAT purposes the value of a supply of services is the consideration received. Therefore the charge made to the sponsor is the amount that is subject to VAT. There are no specific rules applying to how small or how great the charge should be unless the two parties are connected.

3.11 CORPORATE SPONSORSHIPS USING GIFT AID

If the donor is not receiving a benefit as described above, the payment will be a donation and to benefit from a tax deduction the company will make a Gift Aid payment. Only outright gifts can qualify and payments in return for goods and services cannot be made under Gift Aid.

In order to decide whether a donation can qualify under the Gift Aid Scheme, the charity needs to determine whether the donor, or a person connected with the donor, receives any benefits in consequence of making the donation. If benefits are received, which exceed the limits in the donor benefit rules shown below then the payment will not qualify for Gift Aid.

AMOUNT OF GIFT	AMOUNT OF ACCEPTABLE BENEFIT
£0-100	25% of the aggregate donations
£101-1,000	£25
£1001-10,000	5% (2.5% before April 2006) of the aggregate donations
£10,001+	£500 (£250 before April 2006)

The first three items on the list are what HMRC calls the "relevant value" test and these limits apply separately to each donation. The last item on the list covers the "aggregate value" test. In essence, the value of the benefits plus the value of any benefits received in consequence of any Gift Aid donations made by the same donor to the same charity earlier in the same tax year should not exceed £500.

No declarations are required for corporate Gift Aid, but the company needs to keep evidence of the donation.

3.12 FREQUENTLY ASKED QUESTIONS

How much should we charge for the use of our name and logo?

Short answer

The charity should charge a market value for the use of its intangible assets.

In more detail

In principle, if the charity is charging an unconnected business a fee for the use of its name and logo, then whatever it charges is the market rate.

Where a charity is licensing its name and logo to a trading subsidiary, there are a number of options. For example it can either charge a fixed fee or an amount related to turnover (e.g. 1% of the subsidiary's turnover). Again, it should charge a market value, but this could be related to the value of the charity's name. The logo of a large well-known charity with a lot of public goodwill will be proportionately more valuable than that of a small charity with only a local presence. A fixed fee for a smaller charity might range from £1,000 to £5,000. In the case of a well-known national or international charity, a percentage of turnover related to the use of the logo will probably be appropriate.

In all cases, the licensing agreement should be structured to avoid the payment becoming taxable in the charity's hands.

For VAT purposes the value of the supply is the consideration received.

How much should we charge the trading subsidiary for the use of the charity's database? The subsidiary runs a mail-order catalogue.

In brief

If the charity and its subsidiaries form a large group (see Section 11.3 on transfer pricing) the charity should charge a market value for the use of its database. In any case under charity law it should charge a fair price for the use of its assets.

In more detail

It's difficult to say what a market value would be. It should be borne in mind that HMRC do not accept that a database can be passively exploited, as the charity will be continually managing the information. Therefore it is likely that any charge would be taxable income in the hands of the charity, subject to the *de minimis* exemption.

However, the database is an asset that is needed for the charity to manage its relationships with its supporters. Sending the catalogue to the charity's supporters also reminds the supporters about the charity and gives them an opportunity to donate. It is arguable that the charity could charge a smaller amount in recognition of the benefit that it receives. As a minimum the charge should cover an appropriate proportion of the costs of managing the database.

3.13 KEY FACTS

- A corporate supporter can get a payment to a charity allowed as deduction against tax if it is a Gift Aid payment or a genuine business expense such as advertising that is allowable as a tax deduction
- There are special rules that must be followed with Gift Aid payments. Only outright gifts can qualify and payments in return for goods and services cannot be made under Gift Aid
- The provision of benefits to the sponsor from the charity can mean that the sponsorship is no longer a pure donation and this could make the payment subject to VAT and also corporation / income tax
- The taxable element can be minimised by separating, at the outset, the donation from any payment for the benefit. The donation payment needs to be voluntarily given and must be entirely separate from the sponsorship payment. Any benefits that the sponsor receives should not be conditional on the making of the donation or gift
- Income subject to corporation tax can be sheltered through the use of a non charitable subsidiary that transfers its taxable profits to the charity by Gift Aid
- There are special rules for sponsorships of primary purpose trades and fundraising events.

4 Trading Companies

- 4.1 Non-charitable trading
- 4.2 Other reasons to use a trading subsidiary
- 4.3 What form of company should be used?
- 4.4 Governance and conflicts of interest
- 4.5 Financing the subsidiary
- 4.6 Investment and Qualifying Investments
- 4.7 Profit shedding - Gift Aid
- 4.8 Accounting versus taxable profits
- 4.9 Operating at arm's length
- 4.10 Consolidated bank accounts
- 4.11 Transfer of activities
- 4.12 Frequently asked questions
- 4.13 Key facts

This chapter considers in more detail the use of trading subsidiaries, when they are needed, and the advantages and disadvantages of using them.

4.1 NON-CHARITABLE TRADING

If a charity carries on significant amounts of non-charitable trading, it will have to pay income or corporation tax on its profits from those activities. The main reason for setting up a trading subsidiary is to avoid paying direct tax on these profits.

When a charity has a trading subsidiary, the subsidiary carries on the trading activity and donates its taxable profits to the charity under Gift Aid. A Gift Aid payment is tax deductible for the subsidiary and not subject to direct tax (and outside the scope of VAT)

in the charity's hands. Thus, by using a trading subsidiary a charity can reduce the direct tax liability on potentially taxable income and gains to £Nil.

If a charity's trading activities fall within the charity's direct tax exemptions (see Chapter 2 above) then there is no need to set up a trading subsidiary for tax purposes. There are often other reasons such as the risk profile of the trading activity which can affect the decision to use a subsidiary (see Section 4.2 below).

EXAMPLES OF THE USE OF A SUBSIDIARY

Example 1:

A sports charity receives money from corporate sponsorship, and it publishes the sponsors' names and logos on its website, with a link to the sponsors' own websites. While HMRC say that these are indicators of trading, they are not conclusive. (See Chapter 3). To avoid any risk of a tax liability arising it may be advisable to put the activity through a trading subsidiary.

Example 2:

An arts charity has entered into website shopping arrangements with retailers, so that the charity's supporters can click through to the retailers' websites when making purchases. The charity receives a tiny fraction (1/4%) of the amount spent by the supporters. The amounts here may well be small, but the charity will have no idea in advance of how much will be earned from this activity. Again, it may be safer to put this through a trading subsidiary.

Example 3:

A major animal welfare charity has a network of local branches and supporters groups, many of which carry out small scale trading activities. For instance, one group recently made £5,000 by selling items on eBay. Head office don't always find out about these activities until after they have taken place. In this case it would seem sensible for the charity to put all the non-charitable trading activities of which Head Office are aware through the trading subsidiary, so that the £50,000 limit is used to mop up sundry small scale activities. And of course Head Office needs to provide guidelines and training for the branches!

In all the above examples, the element of uncertainty makes the use of a trading subsidiary advisable.

4.2 OTHER REASONS TO USE A TRADING SUBSIDIARY

Section 2.12 discussed circumstances when it might be appropriate to use a trading subsidiary. The main one of these was to avoid direct tax, given that non-primary purpose trading was not a charitable activity. At the risk of repetition, this section highlights other reasons for using a subsidiary.

Risk

Trading is by its nature risky and the charity could make losses instead of profits. A subsidiary can be used to reduce the charity's exposure to losses from a non-charitable trade.

However, in practice the reputation risk of allowing a closely linked trading subsidiary to fail owing money to others often means that the risk shelter argument is questionable.

VAT savings

Some VAT exemptions depend on the status of the organisation delivering the service. In certain cases if income generation is through the charity the income may be exempt from VAT. As discussed in Chapter 1 this means that input VAT recovery is restricted. In some cases it may be advisable for the income to be standard rated for VAT so that input VAT can be reclaimed. This is usually worth doing when the recipient of the services can recover the VAT charged.

For instance, welfare services (as defined) supplied by a charity are exempt from VAT. Welfare services supplied by a trading company are only exempt from VAT when the trading company is required to be state-regulated. When the supplies are to a body such as a local authority that can reclaim all its VAT, it makes

sense for the subsidiary to provide these services and charge output VAT on them so that it can recover input VAT on its costs. Therefore it would make sense to use a trading company although the income is likely to be primary purpose trading and not liable to direct tax.

Certain other services gain exemption when they are delivered by an "eligible body". These services are supplies of education, cultural services, sporting services and fundraising services. There are variations in the definition of eligible body for each category affected but the general principle is that the organisation cannot and must not distribute its profits. (Gift Aid is not viewed as a distribution of profits for this purpose.)

As a company limited by shares can usually distribute its profits, such a company may not satisfy this criterion and therefore a company limited by guarantee may be necessary in order to obtain VAT benefits. Different types of company are discussed in Section 4.3.

Is the activity making profits?

The reason for having a trading subsidiary is to save the charity paying direct tax on non-charitable profits. This raises the question of whether the charity will actually be making taxable profits. It is of fundamental importance that the trustees prepare a budget for the trading activities, including all direct and indirect costs, to decide whether to set up a trading subsidiary. As noted in Section 2.12 above, if a trading activity is projected to make a loss after allocation of all costs, (even if it makes a contribution to fixed costs), using a trading subsidiary may not be the answer.

4.3 WHAT FORM OF COMPANY SHOULD BE USED?

There are a number of different possible structures for a subsidiary trading company.

Company limited by shares

The most common vehicle is a company limited by shares. This is the standard form for a commercial trading company. The share structure means that dividends can be declared easily, and each shareholder's voting rights can be precisely calculated according to the number of shares that they hold. Shareholders also have rights to the company's assets in a winding up. In most cases the charity or its nominees (if the charity is not incorporated) will be the sole shareholder or shareholders.

If the charity is a company, a subsidiary limited by shares will be a member of a corporation tax group with the charity and any other subsidiaries. This means that group relief is available for losses and assets can be transferred between group members without tax liabilities arising.

It should be noted that a company limited by shares may not be an eligible body for VAT purposes, and a company limited by guarantee or a Community Interest Company (CIC) may be more appropriate in such cases.

It is also possible for a corporate charity to form a VAT group with one or more of its subsidiaries. A charity which is a trust cannot be in a VAT group.

Company limited by guarantee

A company limited by guarantee may sometimes be used as a subsidiary. This can have VAT advantages (see Section 4.2 above). The members are usually the directors, and they do not own any capital, although they guarantee to contribute a sum of money, often no more than £1 each, if the company is in difficulties. Typically members have no rights to dividends or to a share in the assets of the company. If this structure is used the charity would be the sole member and would thus have all the voting rights. The charity would be able to appoint and remove the directors, who would not be members.

A subsidiary limited by guarantee would not be part of a corporation tax group, and so would lose some tax advantages on loss relief and intra-group transfers. It could still, however, be VAT-grouped with a corporate charity.

A company limited by guarantee must have provisions in its Memorandum or Articles of Association that "every person who is beneficially entitled to participate in the company's profits, or share in the net assets at a winding-up is or must be a charity or a company wholly owned by a charity" (Section 339 (7AA) ICTA 1988).

Without this provision a subsidiary limited by guarantee would not be able to benefit from the nine month extension to the Gift Aid payment deadline (see Section 4.7 on Gift Aid).

Community Interest Company (CIC)

The subsidiary can be a CIC. CICs are limited companies which have special additional features that can make them attractive where a charity wants to demonstrate clearly that the business or other activity is for community benefit. This is achieved by a "community interest test" and "asset lock", which ensure that the CIC is established for community purposes and the assets and profits are dedicated to these purposes. Registration of a company as a CIC has to be approved by the CIC Regulator who also has a continuing monitoring and enforcement role.

CICs can be limited either by shares or by guarantee. Although they are set up for community benefit CICs do not have the tax exemptions that are available to charities.

CIC REGULATOR GUIDANCE

Community Interest Test

The CIC must be able to demonstrate that it is carrying on its activities for the benefit of the community. It must:

- (when it is set up) make a community interest statement declaring that its activities will be carried on for the benefit of the community and how this will be achieved;
- satisfy the Regulator that a reasonable person might consider that the CIC's activities are or will be carried on for the benefit of the community;
- continue to meet this test throughout its life.

Asset lock:

CICs may not transfer assets at less than full market value unless they are transferred to another asset locked body (such as to another CIC or a charity).

- If its constitution allows a CIC to pay dividends (other than to another asset locked body – essentially another CIC or a charity) these will be subject to a cap that limits the amount of dividend payable. A similar cap applies to interest payments on loans where the rate of interest is linked to the CIC's performance
- On dissolution of a CIC any surplus assets must be transferred to another asset locked body.

CICs are less popular than a normal trading company because they are relatively new and as discussed above there are restrictions on how they can be operated. Having said this, however, it is accepted that payments or transfers to a charity would be for the benefit of the community. The CIC structure would probably make it more difficult to dispose of the trading subsidiary to a third party at a future date if the charity ever wanted to do that.

A normal company can be converted to a CIC at a future date, if required. A CIC, however, cannot give up its CIC status.

Further information can be obtained at the CIC regulator's website.

<http://www.cicregulator.gov.uk/guidanceindex.shtml>

4.4 GOVERNANCE AND CONFLICTS OF INTEREST

The trustees will need to review the charity's governing document and consider whether it is legally allowed to own and invest in a trading subsidiary. If not, it will be necessary to change the governing document to allow it to do so.

Even though the charity would wish to maintain control (and usually does so by having 100 per cent of the shares, or being the sole voting member) there should

be some independent board members of the trading subsidiary in order to ensure that the interests of the subsidiary can be clearly considered separately from the interests of the charity without conflicts of interest.

It is not possible to use a subsidiary to circumvent the rules regarding payment to trustees and a payment to a trustee from a trading subsidiary will be treated as if it was a payment from the charity.

CASE STUDY

Fortunately Green Schemes's Memorandum and Articles do permit it to invest in a subsidiary trading company. The subsidiary will be called Green Schemes Enterprises Ltd (GSEL).

The trustees decide on a small number of directors, who are not to be remunerated by the subsidiary. One of the Trustees (the Treasurer) is to be a director, along with the Finance Director of Green Schemes, and the staff member whose title is "Social Enterprise Manager". To meet the Charity Commission's recommendations for independent directors two other directors are chosen from the charity's supporters, one of whom is an accountant and the other a marketing executive.

4.5 FINANCING THE SUBSIDIARY

The trading company will usually require working capital that could be made available by any of the following ways:

- borrowing from the charity
- issue of share capital to the charity or externally
- borrowing from a commercial source.

THE REGULATORS' PERSPECTIVE ON FINANCING BY LOANS OR SHARE CAPITAL

HMRC

Most commercial companies use their profits to maintain and develop their business. If a company intends to distribute all of its profits every year, this may leave it without these necessary funds. To avoid this problem, when a charity sets up a trading company, it should ensure that it provides the company with enough capital to enable it to shed its profits every year and stay in business.

Charity Commission

A shareholder in a trading subsidiary is not, as such, a creditor of the company. Share capital can normally only be repaid in the event of the company's dissolution, and then shareholders will only get a distribution in respect of their share capital if all the company's creditors have been repaid in full. As a shareholder, the parent charity has no absolute right to receive dividends or gifts from its trading subsidiary.

Normally, the attraction of a share capital (as compared with loan capital) investment is that it gives (or increases) a right to participate in the profits of the company in the form of dividends as and when declared. This justifies the greater investor risk when compared with loan capital. But that attraction clearly does not exist if the trading subsidiary is already wholly owned by the parent charity.

However, there are valid reasons why a parent charity might choose to capitalise a trading subsidiary by means of share capital rather than loan capital. For example:

- the subscription by a parent charity of substantial share capital in its trading subsidiary can give confidence to suppliers, customers, creditors, prospective creditors and others with whom the trading subsidiary has a business relationship; or
- where a trading subsidiary would be exposed to the risk or actuality of insolvency if it were to be capitalised by loan, trustees will have little choice but to invest share capital.

The fact that share capital subscribed by the parent charity in a trading subsidiary might not be repaid in full, or even in part, on the dissolution of the subsidiary, is only one factor which the charity's investment adviser should consider when deciding whether to recommend the trustees of the parent charity to subscribe for share capital. The adviser would have to consider the overall economic return to the charity, balancing Gift Aid payments and any anticipated distributions against the risk of capital loss.

Note however that there are special rules and “clearances” that need to be obtained under the Qualifying Investment rules when a charity invests in or loans funds to a trading subsidiary (see Section 4.6 below).

In their guidance on investing in a trading subsidiary the Commission and HMRC have explained that they would expect the charity to consider carefully issues such as the:

- investment powers of the charity
- need to diversify investments
- risk profile of the trading activity
- financial viability and business prospects of the subsidiary
- suitability of the investment.

In all cases it must be seen that making the investment is expedient in the interest of the charity.

In the past the Charity Commission also stated that if funds are needed to sustain or expand the activities of the trading company they should normally be obtained from commercial sources.

There are however many problems with obtaining money from a commercial lender who will almost

certainly want a guarantee from the charity. In the first instance the charity must have the constitutional powers to give such a guarantee.

As a general rule it is a fundamental tenet of charity law that the charity should not give away its own assets except in the furtherance of its charitable purposes. The giving of a gratuitous guarantee of this nature could be tantamount to giving away assets if the guarantee was called. However case law has shown that in certain cases the giving of such a guarantee would be within the powers of a corporate charity but this would only apply if the company on whose behalf the guarantee was given was a wholly owned subsidiary of the charity **and was carrying out the objects of the charity**. The first condition is not difficult to achieve but the second may be a stumbling block.

At any rate, the Charity Commissioners would look very closely at any guarantees given on behalf of a trading subsidiary. They have explained that “Such guarantees, if given, will often be unenforceable against the charity and may expose trustees to personal liability”.

4.6 INVESTMENT AND QUALIFYING INVESTMENTS

Most trading subsidiaries are set up to undertake taxable (i.e. commercial and non exempt) trading, in which case any financing by the charity must be a 'Qualifying Investment' under the tax legislation.

Qualifying Investments are listed in Schedule 20 to the 1988 Taxes Act and include 'safe' investments such as quoted shares and securities, interests in land, bank or building society accounts. To be a Qualifying Investment an investment in a trading subsidiary either by loan or by share capital must satisfy the following further conditions:

The Board of HMRC must be satisfied **in a claim made to them:**

- that the loan or other investment is **for the benefit of the charity**
- and not for the avoidance of tax by the charity or any other person". (Paragraph 9 Schedule 20 ICTA 1988).

The conditions in bold are discussed in separate sections below.

It is important to note that the charity's direct tax exemptions are only available to income and capital gains which are applied to charitable purposes. Non-Qualifying Investments are treated as non-charitable expenditure, and therefore the charity's tax exemptions can be lost on income and gains up to the

amount of the non-Qualifying Investment.

Investments will normally be regarded as made for the benefit of the charity if they are commercially sound, i.e. if a good return can reasonably be anticipated in the light of the risks involved. Before setting up a trading subsidiary the charity's trustees must prepare budgets and cash flow forecasts on a fully costed basis to determine whether investing in the subsidiary is an appropriate use of funds.

Under charity law, charities are required to bear in mind the following requirements:

- objectivity in the selection of investments;
 - the need to avoid undue risk – or even speculation;
- and
- the need for a proper spread of investments suitable for that charity/fund.

However, where the aim is to use the subsidiary only to carry out primary purpose trading activities (perhaps to protect the charity's special trust funds by ring-fencing the trading risks involved), these special rules do not apply and the charity has a much freer hand to invest in the trading subsidiary. It is in these circumstances that the trustees might be interested in using a CIC (see section 4.3) as a vehicle for the trading subsidiary.

CASE STUDY

Green Schemes Enterprises Ltd (GSEL) is going to have to pay for the costs of printing and posting the mail order catalogue up-front. The other costs will be allocated from the charity at the end of the year, through the accounting process, but the subsidiary will require some initial funding. The directors estimate that £30,000 will be needed. As the charity's year end is 31 December, its income should all be received before the year end.

It is possible that the directors may decide to borrow funds externally, but a bank would be unlikely to lend £30,000 to a new company, without a track record. They might ask for a guarantee from the parent charity, which the trustees would be very unwise to give (see Section 4.5 above). Moreover, if interest (or a guarantee fee) is paid outside the group, this is a real cost to the subsidiary and, ultimately, to the charity. The trustees decide to fund the £30,000 from the charity.

They now have to ensure that this meets the rules for Qualifying Investments.

Claims to HMRC

Investment in an unquoted company, such as a trading subsidiary, is technically only a Qualifying Investment if it is approved by HMRC. HMRC have said that because of self-assessment they will not comment in advance on whether an investment is a Qualifying Investment. Where a charity is investing in a trading subsidiary, the trustees need to be able to demonstrate that the investment is for the benefit of the charity and not for the avoidance of tax. The charity would therefore need to prepare and keep the documentation to support such a claim.

There are two ways of making a claim that an investment is a Qualifying Investment.

1. Complete a charity tax return for the year in question and put a cross in box E26. HMRC may then ask for further details of the investment and why it is considered to be a Qualifying Investment.

2. Write directly to HMRC. It should be noted that HMRC will refuse to comment in advance of the charity making the investment, so that claims can only be made after the charity has invested its funds. Moreover often there is no response to a claim that an investment is a Qualifying Investment.

Investing in the subsidiary may therefore seem quite risky, particularly in view of the risk of a tax liability of up to 28% of the amount invested if the claim is refused by HMRC. However, so long as the trustees have taken professional advice and can demonstrate that they had good financial grounds for making the investment HMRC should have no reason to deny that the investment is a Qualifying Investment.

Investment by way of a loan

HMRC have said that a loan to a trading subsidiary is likely to be a Qualifying Investment if it fulfils the following three conditions:

- a) the charity charges a market rate of interest; and
- b) the loan is secured; and
- c) there is a formal loan agreement with binding and clear repayment terms.

Moreover, the trustees will need to consider how such a loan is to be repaid. Profits used to repay the loan cannot be gift-aided to the charity, and therefore such profits would suffer tax.

Investment in shares

Share capital (or a loan which does not fulfil the conditions above) may still be a Qualifying Investment if it is supported by a business plan for the subsidiary that demonstrates that the subsidiary will be gift-aiding profits to the charity that will represent a reasonable return on the investment.

Funding via a current account

There will often be a current account in operation between the charity and the trading subsidiary. Care should be taken to clear this current account on a regular basis. If the subsidiary owes money to the charity which is not regularly paid over, the current account could be regarded as the charity making a Non-Qualifying Investment in the subsidiary.

CASE STUDY

At first the trustees decide that Green Schemes will simply pay the expenses for its trading subsidiary, GSEL. The costs will sit on current account for a few months, and then be paid off by the mail order sales income, which the charity will receive. It will then pay over the balance to the subsidiary.

However, the accountants point out that the charity shouldn't be funding the subsidiary via a current account, as HMRC could argue that this is a non-Qualifying Investment. The Finance Director says that as the year end is 31 December all the mail order transactions will have been put through and the current account will have cleared, so that the accounts will not show any outstanding balances. Nevertheless the accountants prefer to err on the side of caution and recommend that an amount of working capital is provided to the subsidiary.

The trustees then decide to lend £30,000 to the trading subsidiary. However, this idea runs up against problems. For a loan to be a Qualifying Investment, HMRC requires three criteria to be satisfied:

- a. a market rate of interest (Note 1),
- b. security (Note 2), and
- c. a formal loan agreement with set (reasonable) repayment terms (Note 3)

Note (1) The interest can be charged by Green Schemes, and will have to be paid by GSEL, thus further reducing its profits. At a rate of (say) 7%, this is a further expense of £2,100 per year. However, the interest will be tax-free in the hands of the charity, so there is no overall loss to the group.

Note (2) The second problem is security. Once the loan has been made and the monies spent, GSEL will have few assets for the charity to secure the loan on, although there could be a floating charge over the stock and debtors.

Note (3) Thirdly, there must be a formal loan agreement with reasonable repayment terms. But how is GSEL going to repay the loan? The trustees suggest that it will be paid out of the subsidiary's profits, but the concern is that if the profits are used to repay the loan, they won't be available for payment under Gift Aid. In essence the trading subsidiary is always going to need a sum of money to fund its working capital requirements

Having thought about these options, the Green Schemes trustees decide to invest £30,000 in share capital in the subsidiary. This will have the added advantage that third parties may be more inclined to trade with GSEL if it has some capital on its balance sheet.

4.7 PROFIT SHEDDING - GIFT AID

The direct tax advantages of the trading subsidiary are realised by the payment of its taxable profits to the charity under Gift Aid. Gift Aid from companies works differently from Gift Aid for individuals. The subsidiary pays the gross amount of its taxable profits to the charity, and does not deduct basic rate tax. The charity does not reclaim income tax on the donation, as it would do if the Gift Aid payment was made by an individual.

Nine month deadline

Companies which are wholly owned by a charity (see

below) can have up to nine months after the end of the relevant accounting period to make Gift Aid donations. In other cases the payment must be made before the end of the relevant accounting period.

Long period of account

Care needs to be taken where the subsidiary has a long period of account, as this can accelerate the Gift Aid payment deadline. Effectively the subsidiary has two Gift Aid payment deadlines.

CASE STUDY

Green Schemes has a 31 December accounting date, so its next accounts will be made up to 31 December 2009. GSEL starts to trade on 1 October 2009, and its first accounts will be drawn up for the 15 months to 31 December 2010. It will have until 31 December 2011 to prepare its first tax return.

However, the return will actually be in two parts, for the first 12 months to 30 September 2010 and the last 3 months to 31 December 2010. There will be two sets of computations, one for each period. GSEL's profits will be split pro-rata between the two periods, and Gift Aid payments will be due nine months after each period.

Tax accounting period to	Tax return due	Tax payment due (if any)	Gift aid payment due
30 September 2010 (12 months)	31 December 2011	30 June 2011	30 June 2011
31 December 2010 (3 months)	31 December 2011	30 September 2011	30 September 2011

Wholly owned

A company is wholly owned by a charity if it is a company limited by shares which are 100% owned by the charity. Shares held by nominees count for this purpose, but there should be documentary evidence that the shareholders are nominees and not the beneficial owners. One method of doing this is for the nominees to complete share transfer forms which are then held by the charity, so that they can be immediately executed by the charity as necessary.

A company limited by guarantee can be treated as wholly owned by a charity, but it must have specific provisions in its Memorandum and Articles of Association relating to participation in the company's

profits, and sharing in the net assets on a winding-up (see Section 4.3 above).

Payment of Gift Aid

A Gift Aid payment is defined in the tax legislation as the payment of a sum of money. It is therefore essential for a trading subsidiary to have its own bank account, and to be able to demonstrate the payment of funds from this bank account to the charity before the deadline (see FAQs below for issues that can arise in practice).

A book entry, i.e. crediting the amount of Gift Aid payable to a current account with the parent charity is not generally regarded as payment but there can be

exceptions. These usually apply when the charity owes the trading subsidiary money and an offset has been agreed before the payment deadlines.

Under and over-payments

It is not possible for the company to make a top-up payment after the end of the nine month period, should the final taxable profits exceed the payments made

before the deadline. In that case any excess of profits over the Gift Aid payments made will be taxable. However, according to HMRC guidance notes, a company may make an estimated Gift Aid payment and if it is an overpayment the excess can be returned to the subsidiary by the charity.

HMRC GUIDANCE ON ESTIMATED GIFT AID PAYMENTS

A company may make an estimated Gift Aid donation which may subsequently prove to be excessive, for example, where the payment exceeds the actual taxable profits of the company once the tax return has been finalised. Such an overpayment may be repaid to the company by the charity provided that the company has documentary evidence that the intention was to pay over the annual profits (for instance), but that the amount paid was clearly provisional or loaned until the profits were finalised. If there were a need for the charity to repay some of the money, again HMRC would look for evidence that this was the purpose of the payment by the charity. Supporting documentary evidence, such as board minutes, must be in place

It should be noted that this guidance, which is effectively an HMRC concession, is soon to be replaced with a narrower statutory provision. With effect from 1 April 2010 the repayment by the charity will have to be made within 12 months of end of the relevant accounting period. As a trading subsidiary normally has until 9 months after the year end to make the Gift Aid payment, it appears that estimated Gift Aid payments will be of very restricted use in the future.

4.8 ACCOUNTING VERSUS TAXABLE PROFITS

Taxable profits may differ from accounting profits due to disallowable items such as entertaining, or capital allowances claims that differ from the depreciation charge.

If a subsidiary's taxable profits are higher than its accounting profits, it will often have insufficient funds to pay up all its taxable profits to the charity under Gift Aid. The directors will then have to decide whether to pay up all the taxable profits to the charity and possibly show a deficit in the balance sheet, or to pay up the accounting profits and incur a tax liability.

It is therefore recommended to keep disallowable items in the trading subsidiary to a minimum. In particular it is preferable so far as possible to keep capital items in the charity. If the asset is one on which capital allowances can be claimed, a reversible timing difference may not in practice cause too much of a problem, but items such as buildings on which capital

allowances cannot be claimed in full should be kept off the subsidiary's balance sheet.

There is a view that a trading subsidiary can not make a payment to the charity if it has negative reserves. This matter is addressed by the Charity Commission in their guidance on charities and Trading (CC35). They say

"If a trading subsidiary earns, in an accounting period, taxable profits in excess of its profits for accounting purposes, it may pay to its parent charity a greater sum in Gift Aid than it has profits for accounting purposes, in order to eliminate its corporation tax liability. As a result, all or part of the Gift Aid payment may be made out of the company's subscribed share capital, including any share premium account.

"Although there are differences of legal opinion on this issue, it is considered that such Gift Aid payments may

be made out of the trading subsidiary's subscribed share capital, provided that the objects of the trading subsidiary authorise such gifts. The parent charity can, by subscribing additional share capital in the trading subsidiary, enable the subsidiary to do this, without making the subsidiary insolvent.

"It is possible that the trading subsidiary may prefer to acquire the resources needed to make the full Gift Aid payment out of funds borrowed from the parent charity. However HMRC Charities take a critical view of any apparently circular arrangements. Parent

4.9 OPERATING AT ARM'S LENGTH

Relations between the charity and the trading subsidiary should be conducted on an arm's length basis. Under charity law a charity should not use its resources to benefit a commercial company. Therefore, all transactions with a trading subsidiary should be at market value.

The detailed rules on management charges, cost allocation and transfer pricing are discussed in Chapter 11.

The paragraphs that follow deal with the typical areas to consider in cases where a charity and its subsidiary are likely to share resources.

Shared premises – direct tax

A market value rent should be charged for the use of premises.

If the subsidiary is using the charity's land, there may need to be a formal lease between the parties. In a normal rental situation there would be an annual rent charge although in certain cases there may be a lump sum paid in the form of a premium. This is usually where the rentals are believed to be below the market rate and the landlord tries to compensate by charging a lump sum.

A premium is treated as being wholly or partly capital, and to that extent it is not deductible against trading profits. Therefore, it is preferable for a rack rent to be charged (i.e. an annual rental with no lump sum or premium) as the subsidiary will not be able to claim a full corporation tax deduction against profits for any premium paid.

Rental income is exempt from direct tax in the hands of the charity if it is applied to charitable purposes (see Section 10.2).

charities and their trading subsidiaries contemplating such a course of action should take professional advice, and take into account the investment propriety and insolvency issues."

It is worth recognising that a subsidiary may have negative reserves at the balance sheet date, but a subsidiary that is wholly owned by a charity has up to 9 months after its year end to make the Gift Aid payment. By that time it may have earned more profits which may mean that there is no negative reserve at the time of the payment.

Shared premises - VAT

Property income from leasing or renting, is normally exempt from VAT. This means that no VAT is payable, but the charity making the supply cannot normally recover any of the VAT incurred on related expenses.

However, a charity can opt to tax (see Section 10.2). If this is done all the supplies made relating to the charity's interest in the land or buildings will normally be standard-rated. The charity will then normally be able to recover any VAT incurred in making those supplies.

Therefore the charity will need to consider whether it should opt to tax the rent to the subsidiary. An option to tax has the effect of changing an exempt rental charge into a VATable rental charge and has the benefit of enabling VAT recovery in respect of the opted building or part of the building.

The option to tax has no effect on residential property or property used by a charity for non-business purposes.

If there is a group VAT registration then there is no VAT chargeable between members of the group (see the discussion on VAT groups below). There is also anti-avoidance legislation that may be invoked to prevent an option to tax

Staff – direct tax

The supply of staff or other management services should be based on the charity's costs of providing these. The provision of management services could be regarded as non-exempt trade for direct tax so that any profits made by the charity could be subject to tax. Care should therefore be taken in setting the amount charged.

Additionally, from the direct tax point of view, if any facilities are provided by the charity at below commercial rates this transaction could be deemed to provide a benefit to the trading subsidiary. This could negate the tax benefit of any Gift Aid donations paid by the subsidiary to the charity. It could also lead to the position where the charity could be seen to be subsidising a non-charitable trading company and non-charitable activities.

Staff - VAT

The supply of staff is subject to VAT at the standard rate. The value of the supply is the total amount charged. Therefore if the charity employs the staff and makes a management charge to the subsidiary it will have to charge VAT, unless there is a VAT group in place (see below).

If there is no VAT group and staff are working jointly for the charity and for the trading subsidiary, it may be preferable to have joint contract of employments between the charity and the subsidiary. If a joint contract of employment is in place there is no supply between the charity and the subsidiary in respect of supplies of staff. Many charities do not like joint contracts as they can lead to adverse employment law implications.

There is also a concession operated by HMRC for charities and non profit-making bodies that allows staff seconded from one charity to another to be treated as non business and outside the scope of VAT. However, the conditions are narrow:

- The employee can only be working in the non-business activities of both organisations, (i.e. they cannot be undertaking commercial activities)
- The recharge must only be of the normal remuneration i.e. salary, NI, pension costs etc
- There must be no profit element to the charge.

In practice the trading subsidiary's activities will usually by definition be business activities, so the concession will have limited application.

There is a further concession for general secondments for businesses other than employment businesses. The secondment to another organisation may be outside the scope of VAT if the following criteria can be fulfilled:

- The recipient business exercises exclusive control over the member of staff in terms of the performance of his or her duties; and
- The recipient business is responsible for paying the employee's remuneration directly to the employee, any PAYE and NI liability to HMRC and any other third party costs e.g. pension contributions; and
- The employer must not derive any direct or indirect financial gain from the secondment. Any mark up or charge for administration would be subject to VAT.

Where the employee's contract of employment with the charity is temporarily suspended and the trading company temporarily becomes the employer or vice versa there is no supply for VAT purposes providing the temporary posting is at the employee's own initiative and the second employer issues a new contract of appointment.

If the subsidiary has no staff itself then the question arises as to whether the charity is making a supply of staff or a supply of services to the subsidiary. It is possible that the supply of services could be exempt from VAT whereas the supply of staff would be standard rated. This is a particularly grey area of VAT and advice should be taken.

Intellectual property rights (IPR) – direct tax

If the trading subsidiary has the right to use the charity's name and logo, its website or its mailing list there should be a contract or contracts drawn up for the intellectual property rights. These will need to be structured so as to avoid the charity incurring a direct tax liability on the income. See Section 3.8 on the use of the charity's logo.

IPR - VAT

VAT will generally be chargeable at the standard rate on income from IPR.

International services - VAT

Normally, the supplier of a service is the person who must account, to the tax authorities, for any VAT due on the supply. However, in certain situations, it is the customer who must account for any VAT due. This is referred to as a reverse charge. Reverse charge is not a complicated accounting procedure. Where it applies to services which an organisation receives that organisation as the customer must act as if it is both the

supplier and the recipient of the services.

Where an organisation can attribute the input tax to taxable supplies, and can therefore reclaim it all, the reverse charge has no net cost. If the customer cannot recover the VAT the effect is to make the customer pay VAT on the supply at the rate applied in the jurisdiction where the reverse charge applies. This puts the customer as the recipient of the services in the same position as if the customer had received the supply from a supplier based in the same jurisdiction rather than from one in another jurisdiction.

There may be an advantage in having a trading subsidiary where a charity is importing international services. From 1 January 2010 there are changes to the VAT place of supply of services that will have a significant impact on a charity that buys in services from overseas.

Where a UK charity which is engaged in business activities receives particular services from overseas it will be required to charge itself VAT on these services under the "reverse charge" arrangement. This is even if the charity has non-business activities and the services relate solely to these. VAT accounted for in respect of services received for non-business activities will not be recoverable. Subject to any business/non-business apportionment or partial exemption restriction on VAT recovery the same amount can be recovered as input tax.

The changes to the place of supply rules from 1 January 2010 mean that nearly all services will be covered by a general rule that the service is supplied where the customer belongs. Therefore under this general rule supplies by UK businesses to overseas charities will be outside of the scope of UK VAT, even if the services relate to the charity's non-business activities, providing that the charity has some business activities.

Similarly, where a UK charity which is engaged in both business and non-business activities receives what will from 1 January 2010 be deemed "general rule" services, it will always be required to account for reverse charge VAT on those supplies, even if they relate solely to the charity's non-business activities. VAT accounted for in respect of services received for non-business activities will not be recoverable.

A number of charities have business activities but are

not VAT registered because their taxable turnover is below the VAT registration limit. They will now be required to register if they receive overseas services that together with other taxable income then exceed the limit. This applies even if the overseas services are used in support of the charities' non-business activities.

However, the change will not affect charities that are engaged solely in non-business activities. In consequence, a trading subsidiary can be used to isolate business activities, which means that the charity can then be treated as engaged solely in non-business activities, and escape the need to register.

VAT groups

A group VAT registration may overcome some of the problems created by charges between the charity and its subsidiaries, particularly that of staff recharges. Supplies between members of a VAT group are disregarded for VAT purposes.

There are certain conditions that apply for the formation of a VAT group registration, not least of which is that all members of a VAT group must be corporate bodies under the Companies Act or incorporated by Act of Parliament, Royal Charter or company law of another country. If the charity is a trust it cannot be part of a VAT group. Also, as noted below not all forms of trading subsidiary will be able to join a VAT group.

Two or more legal entities are eligible to be treated as members of a VAT group if they are established in the UK and they are under common control. In the case of a charity and its trading companies this test would be satisfied if the charity controls the trading companies.

There are anti-avoidance provisions to stop abusive arrangements that can be obtained from including a body in a VAT group.

Charity VAT groups are usually partially exempt from VAT and will also have business / non-business considerations. It is recommended that advice be taken on the position for VAT recovery before the decision to form a group is made.

When considering VAT grouping the payment status of each of the companies to be included in the group must be considered. A VAT group may not be appropriate, for example, if the charity is making monthly repayment claims for VAT and a trading

company is making quarterly payments of VAT. The overall position of the VAT group may be that of a payment business on quarterly returns and the cash flow advantage of monthly returns by the charity will be lost.

4.10 CONSOLIDATED BANK ACCOUNTS

The general rule is that the subsidiary needs a separate bank account in order to make the Gift Aid payments to the charity. It will also need to make and receive payments for contracts that it enters into.

However, if the subsidiary receives cash in advance of incurring expenses, for instance if it is running courses, the funds may sit in its bank account for months without earning a very good rate of interest. It may be in the charity's interest to operate the group's bank accounts on a consolidated basis in order to improve its overall income.

4.11 TRANSFER OF ACTIVITIES

A charity may have been carrying on non-charitable trading activities for some time before it becomes necessary to transfer them to a trading subsidiary. If the activities are profitable there may be assets such as goodwill or property that are associated with the activity or trade and which also need to be transferred or used by the subsidiary.

Consideration will have to be given as to how the subsidiary is to fund the acquisition of such assets, given that a market value should be paid under charity law. Depreciation or amortisation of capital assets may not be deductible for tax purposes by the subsidiary. The subsidiary may therefore need additional capital investment by the charity for this purpose.

Direct tax

A capital gains charge may arise on the transfer, unless the charity exemption applies, and if there is a transfer of property Stamp Duty Land Tax may also be payable.

VAT

The VAT consequences of the transfer of activities can be complicated, especially where it involves the transfer of non-business activities.

The first question that needs to be decided is whether

Payments from the subsidiary will generally be reflected in the inter-company account, and if this shows the subsidiary funding the charity rather than the other way round this should not be a problem. A question arises of whether the subsidiary should charge interest on amounts effectively lent to the charity. They would form part of its taxable profits. It may be simplest for the subsidiary to waive any interest that would accrue to it under such arrangements.

there has been a transfer of business. This would be the case if a business activity was operated in the charity and then terminated on the transfer to the trading subsidiary. If it was, the transfer will be subject to VAT.

However, if the transfer is by way of a transfer of a going concern (TOGC) it is "disregarded" for VAT purposes if all the criteria for this treatment are satisfied.

The conditions are, in brief, as follows (but they are subject to more detailed requirements):

- That the assets are to be used by the purchaser in carrying on the same kind of business, whether or not as part of an existing business, as that carried on by the seller
- Where the seller is a taxable person (i.e. VAT registered or liable to be VAT registered) the purchaser must already be a taxable person or immediately become a taxable person as part of the transfer
- If part of a business is transferred, that part must be capable of separate operation
- The purchaser must not only acquire the assets but be in a position to operate the business.

- The business must be a going concern at the time of transfer but this does not mean that it has to be profitable
- There must not be a series of immediately consecutive transfers – i.e. transfer from A to B then to C where B does not carry on the business
- There must be no significant break in the normal trading pattern before or immediately after the transfer. It would be acceptable to have a break if a seasonal business had closed for off season. It would also be acceptable to have a short break for redecoration etc.

If the transfer is not a TOGC it may include the transfer of assets and activities for a consideration and if this is the case VAT will be due on the value concerned. It should be noted that there are rules which deem the free transfer of business assets to be supplies for VAT

purposes and a value for VAT is attached to such deemed supplies.

If the transfer is by way of business the assets sold will have their normal VAT liability. However, the transfer of goods where the VAT on purchase has not been recovered (either because it was irrecoverable under a business/non business apportionment, partial exemption method or blocked under VAT rules) will be exempt from VAT. A transfer of property may be either exempt from VAT or taxable if the option to tax has been made. Where there is a transfer of tenanted property this may also constitute a TOGC but professional advice should be taken on this complex matter.

The position is simplified where a VAT group is in place as there is no supply for VAT purposes between group entities.

4.12 FREQUENTLY ASKED QUESTIONS

Does the subsidiary need to employ its own staff and operate its own payroll?

Short answer:

No, staff can be employed by the charity and their time recharged to the subsidiary. Even if staff are directly employed by the subsidiary, the charity can still act as a payroll agent for the group.

In more detail:

The supply of staff is a taxable supply for VAT purposes. Therefore if the charity is not VAT-registered, the recharge of staff costs may bring it into the VAT net. This may be advantageous as it can improve overall VAT recoveries. However, it adds considerably to administration to have to raise monthly VAT invoices to and from the trading subsidiary. Having a VAT group with the charity and the subsidiary can save considerably on this administration.

A VAT group is only possible if:

- the charity is a company. If the charity is a trust it cannot be in a VAT group with its trading subsidiary;
- the charity controls the subsidiary or both are under control of the same person.

Joint contracts of employment should also be considered.

In practice how much should the charity charge the subsidiary for management services?

In brief:

Under charity law the charity should charge an arm's length rate for resources used by the subsidiary. However, if the charity charges more than its costs it is likely to end up with a taxable trading profit. In practice it should be very careful to identify all relevant costs including an allowance for overheads and recharge these.

In more detail:

HMRC's guidance states: "If the charity's premises, staff and services are shared with the trading company an appropriate allocation of the costs should be included in the company's accounts. The amount charged by the charity for the shared resources should generally not exceed the cost. However, where the charity is demonstrably trading in the services etc which it is providing, then there should be an appropriate mark-up. Any profit in the hands of the charity may be taxable as non-exempt trading income."

In short, HMRC will generally accept a recharge of costs without requiring a (taxable) mark up. However, if the charity is large enough to have to apply transfer pricing rules, then it needs to be able to demonstrate

that it is not acting as an enterprise in providing services to the subsidiary.

We put the Gift Aid payment through the charity and the subsidiary's current accounts, but the subsidiary didn't make the payment by the deadline. Does this matter?

Short answer:

Yes, it does matter. The tax legislation defines Gift Aid as "the payment of a sum of money", and if HMRC ask for evidence of the payment they will want to see the subsidiary's bank statement, showing the payment leaving its account before the deadline.

In more detail:

The law relating to what actually constitutes a payment, however, can be unclear. One tax case says that an entry in bankers' books relating to a bank account is a payment (e.g. as when interest is credited to an account). Another case says that an entry in the books of a company (not being a bank) does not constitute payment.

Where there are two pre-existing cross demands for money, and these are set-off by agreement, it is accepted that this constitutes payment. A judge made the point by saying: "You need not pass cheques backwards and forward across a table". However, to satisfy this condition the charity would have to owe the trading subsidiary money, and it would have to agree formally with the subsidiary that the debt would be satisfied by the Gift Aid.

In order to avoid problems trading subsidiaries should always make sure that the Gift Aid payment goes through the bank account. If in practice the payment is not made through the bank a current account entry may be accepted by HMRC.

The Gift Aid payment deadline is coming up, but the subsidiary doesn't have the cash to make a payment. Can the charity lend it to the subsidiary?

Short answer:

The charity should only provide funds to the subsidiary on a proper basis, as a Qualifying Investment. If the subsidiary requires working capital then the charity should make formal arrangements to provide it, either

as a formal loan or on the basis of a business plan and cash-flow statement.

In more detail:

It is relevant to consider why the subsidiary does not have funds to make the Gift Aid payment. If it is making profits then the usual reason is that the funds are tied up in working capital (stocks and debtors).

HMRC are not happy about arrangements where Gift Aid is paid to the charity and then immediately cycled back to the subsidiary. An arrangement for repayment in fact could invalidate the Gift Aid payment.

However, it is necessary to look at all the facts. It may be that the subsidiary is in fact owed funds by the charity. This can happen because the subsidiary may be paying for joint costs or the subsidiary's income may be banked by the charity (a common occurrence in the charity shop case). In such circumstances the charity can settle its liabilities to allow a Gift Aid payment to be made.

The trustees and directors need to plan for the subsidiary's requirements so that it is not caught out close to the deadline.

We paid the Gift Aid by cheque on the deadline, but it didn't clear until afterwards. Is it a valid Gift Aid payment?

Short answer:

HMRC have stated that: "*Donations by cheques are only valid pending clearance of the cheque. If the cheque is not honoured a donation has not been made.*" Therefore if the cheque is paid in on or before the deadline and clears subsequently it would be treated as Gift Aid for the relevant period.

In more detail:

If the cheque is actually banked on or before the deadline and clears subsequently then it would count as being made by the due date. If the cheque is signed and passed to an official of the charity, who does not bank it until later, it may also count as being made, as the subsidiary has done everything in its power to make the payment. If the cheque is drawn but not handed over until after the deadline it would not count as payment.

The best advice for payments near the deadline is to

arrange to make them by bank transfer, rather than relying on cheques.

What documentation does the trading subsidiary need in order to make a Gift Aid payment?

Short answer:

Unlike Gift Aid from individuals, no documentation is prescribed in the tax legislation.

In more detail:

The tax legislation states that any payment by a company to a charity is a Gift Aid payment, unless it is either:

- a distribution (i.e., a dividend) or
- deductible in computing the company's taxable profits.

This leaves the directors with a certain amount of latitude in designating payments from the subsidiary to the charity as Gift Aid payments. Assuming that the directors wish to identify a particular payment to the charity as a Gift Aid payment, they could draft a directors' minute or write a formal letter to the charity. There is, however, no statutory requirement for them to do so.

If a subsidiary wishes to make an estimated Gift Aid payment it should follow HMRC guidance on documentation (see Section 4.7)

4.13 KEY FACTS

Non-charitable trading is taxable and can jeopardise charitable status. To prevent this certain activities should be channelled through a trading subsidiary.

There are special rules that must be observed when making loans to or investing in a subsidiary.

There may be other reasons to use a trading subsidiary, for example to ring-fence risk or to secure a favourable VAT result.

A direct tax charge can be avoided by making a Gift Aid payment to the charity.

Subsidiaries that are wholly owned by a charity have up to nine months after their year end to make this payment. There are special rules for estimated payments.

To avoid differences between accounting profits and taxable profits disallowable costs and ownership of assets should be structured so that there are no items that are disallowed for tax in the subsidiary.

The charity and the subsidiary should operate on an arm's length basis. This means that there should be proper cross-charges.

5 Shops and cafes

- 5.1. What is being sold?
- 5.2. Bars and cafés as ancillary trades
- 5.3. Mixed trades
- 5.4. VAT
- 5.5. Sales of donated goods – high street charity shops
- 5.6. Gift Aid and donated goods
- 5.7. Sale of bought-in goods
- 5.8. Should charity shops be owned by a trading subsidiary?
- 5.9. Frequently asked questions
- 5.10. Key facts

Charity shops are often the first thing that comes to mind when people think about charity trading. The following chapter deals with merchandising more generally.

Trading activities through shops and cafés need to be reviewed in accordance with the principles that have been explained in Chapter 2.

5.1. WHAT IS BEING SOLD?

For direct tax purposes it is important to separate out and classify the different areas of trading between non-taxable and taxable trading.

The fact that the shop or café makes a profit is not relevant. The trading profits will not be taxable so long as it can be shown that the charity is fulfilling its primary purpose in operating the shop or café. Therefore a charitable art gallery whose primary purpose is to foster the appreciation of art can run

a shop and sell books on art without the profits being taxable. However, if a gallery or museum sells non-educational items such as gifts and souvenirs, this element will be non-primary purpose trading, and the profits will be taxable. See Section 5.3 below on Mixed Trades.

5.2. BARS AND CAFÉS AS ANCILLARY TRADES

Running a bar or a café is not by itself a charitable activity. Nevertheless, it can still be treated as if it is a primary purpose trade, where it is ancillary to the charity's primary purpose. An ancillary trade is a

trade which is not by itself primary purpose, but which the charity is expected to or obliged to carry on as part of carrying out its primary charitable purpose.

Example 1

A charitable theatre sells tickets for performances, and it also sells refreshments at the intervals to members of the audience.

The theatre's primary charitable purposes will be to advance education and appreciation of the dramatic arts. While selling refreshments isn't itself either educational or artistic, it supports the theatre's activity by enhancing the experience of theatre-goers. If the refreshments are only sold to people attending the performances, the trade will be treated as primary purpose.

However if the theatre runs a restaurant that is open to the general public and not just the patrons then the profits will be taxable.

5.3. MIXED TRADES

Mixed trades are partly primary purpose and partly not. For direct tax purposes, each part is treated as a separate trade. The primary purpose part is not taxable, the non-primary purpose part is taxable.

In the case of a shop it is possible to determine on an item by item basis which sales are primary purpose and which are not, and therefore to determine which profits are taxable, and which are not.

Example: A profit and loss account for a railway museum shop

	PRIMARY PURPOSE	NON-PRIMARY PURPOSE	TOTAL
Turnover	£	£	£
Sales of books and educational items	20,000		
Sales of gifts and souvenirs		£30,000	
Total turnover			£50,000
Cost of sales			
Books and educational items	7,000		7,000
Gifts and souvenirs	7,000	10,000	17,000
Gross profit	13,000	20,000	33,000
Allocated costs			
Salaries	3,500	4,500	8,000
Heat and light	1,000	1,500	2,500
Postage and telephone	500	750	1,250
Accountancy and legal fees	500	750	1,250
Depreciation	1,000	1,500	2,500
Net profit	£6,500	£11,000	£17,500

In this case the profits from the non-primary purpose trade are £11,000. When depreciation is added back, the taxable amount is £12,500. In fact, if this is the only non-charitable trade carried on by the museum, it may fall within the small scale (*de minimis*) exemption, depending on the museum's overall income, as the turnover from the non-primary purpose part of the trade is only £30,000 (see Section 2.8).

In many cases, however, it is not possible to divide up the trading profits in this way.

Example of a café with a mixed trade

As well as selling refreshments to the audiences at

performances, a theatre has a café whose entrance opens onto the street, so that so the general public can also buy food and drink. Some of the patrons will be audience members and some will not.

This therefore is a mixed trade, but it is not possible for the charity to determine what the income is from the general public as opposed to audience members. Unfortunately in this case the whole trade has to be treated as non primary purpose, and the whole of the profits will be taxable so the activity should be channelled through a subsidiary.

5.4 VAT

Sales from cafés are supplies of catering and are subject to VAT at the standard rate. There are zero rating reliefs for the sale of cold take-away food.

The VAT position of sales of bought-in goods will follow the normal liability of those goods. See Chapter 6 on merchandising.

5.5 SALES OF DONATED GOODS – HIGH STREET CHARITY SHOPS

Direct tax

Neither the Charity Commission nor HMRC treat the sale of donated goods as trading. They regard the sale of donated goods as the mere conversion of donated gifts into cash. As a result donated goods can be sold by a charity without fear of endangering its charitable or tax status.

HMRC have explained that this applies even if the donated items are sorted, cleaned and given minor repairs. However, they have warned that if the goods are significantly altered or processed so that they are sold in a different state from that in which they were donated, the sale proceeds may be regarded as trading income. For example, if a charity makes donated fabric into clothes for sale, this will amount to a trade.

VAT

The VAT rules are even more favourable and offer the best possible VAT situation. The sale of donated goods is zero rated provided that the goods are made available to the general public. This applies to charities as well as to any 'taxable person' who has covenanted by deed to give all the profits of the supply of donated goods to a charity. Consequently, it is possible to reclaim all the input VAT associated with the supply without having to charge any output VAT.

HMRC do not allow zero rating where goods donated for sale are diverted for use in the charity and then

subsequently sold. For instance one could imagine a donated computer being used by the charity for a period and then sold. Similarly where goods are donated for the charity's own use and are subsequently sold on zero rating is not possible.

Zero rating does not apply where donated goods are not sold but used to make other goods for sale. For example where wool is donated and is used to knit blankets for sale.

Ordinarily the sale must be to the public, but by way of concession zero rating is allowed for poor quality goods that are sold to third parties e.g., 'rag and bone' merchants.

Letting on hire of donated goods

Some charities arrange for hiring of goods for a fee, e.g. furniture.

For direct tax purposes the letting of donated goods would probably be a non-charitable trade and consideration should be given to putting this through a trading subsidiary.

For VAT purposes zero rating applies to the hiring of such goods provided that the goods were donated for this purpose or for sale or letting. The charity or trading subsidiary should therefore make sure that this purpose was possible from the donor's point of view before letting the goods on hire.

5.6 GIFT AID AND DONATED GOODS

In recent years there has been a movement for charities to claim Gift Aid in conjunction with donations of goods. Such an arrangement has numerous tax implications.

Typically, the way these schemes work in broad terms is as follows:

- The donors do not give the goods to the charity.
- Instead the donors appoint the charity as their agent to sell the goods on their behalf.
- At this point the donors fill out Gift Aid declaration forms without specifying the amount of the gift.
- When the charity receives the proceeds it notifies the donors and asks them to confirm if they want the proceeds to be Gift-Aided.
- The donors confirm that they want the proceeds to be Gift-Aided, or fail to respond within a specified period of time (e.g. 3 weeks).
- The charity processes the declaration forms and claims income tax relief.
- The donors claim Gift Aid on their tax returns (if higher rate taxpayers).

Due to the way this is structured the sale is no longer a sale of donated goods. The person selling the goods is in fact the donor. The charity selling goods as agent would not be regarded as carrying out a charitable purpose for rates relief, so these sales would fall into the non charitable activity grouping.

The donor's tax position will also need to be considered. They are unlikely to have a tax liability on the disposal unless the goods are sold for more than they originally paid for them, and they are also unlikely to be VAT registered, but either of these could be the case.

As the charity is acting as agent it may take a commission from the sale, and this would be both

taxable trading income and subject to VAT. Normally the position is that this commission goes through a trading subsidiary. The commission would not be eligible for Gift Aid and this must be made clear to the donors

In practice the charity will need to have a written contract with the donors explaining the scheme and how it affects them.

HMRC have said that the costs of actually selling the goods would not be regarded as charitable expenditure. This means that the charity could incur a direct tax liability on the relevant amount. Some of the overall costs of the scheme must relate to increasing the charity's Gift Aid receipts and so should be a fundraising cost. However, the charity should be careful to allocate the actual costs of selling the goods, both direct and indirect, against the commission income and if necessary put income and costs through a trading subsidiary. See Chapter 4. A similar position exists in relation to the VAT on expenditure incurred by the charity.

As well as tax there are administrative difficulties with these schemes. These include:

- The need to track all the goods that the charity is selling as agent so that the charity can inform the donor when the goods are sold
- The need to notify the relevant donor after every sale
- Giving the donor a reasonable time to decide whether to allow the proceeds to be Gift Aided
- Only making the Gift Aid claim when the donor has confirmed that they wish the charity to claim Gift Aid, or the time period has elapsed.

For these reasons charities tend only to claim Gift Aid on larger items and not bother if the sale proceeds are below a certain *de minimis* limit.

5.7 SALE OF BOUGHT-IN GOODS

Typically, shops selling donated goods will also sell bought in goods. This may be on a small scale, for instance selling Christmas cards and calendars in the last three months of the year, or it may form a significant proportion of the shop's income. In either case, selling bought-in goods is regarded as a trading activity and separate profit and loss accounts must be drawn up for the sales of donated goods and the sales of bought-in goods.

5.8 SHOULD CHARITY SHOPS BE OWNED BY A TRADING SUBSIDIARY?

In some cases charity shops are operated through a subsidiary and whilst this structure can be made to work, there are problems associated with it and it is cumbersome. Some of these problems (e.g. ownership of the goods, loss of tax relief on business rates etc.) are discussed in more detail below. It is generally advisable that where most of the goods sold are donated, the shops should be operated through the charity with the trading subsidiary accounting for the new goods and costs associated with those.

Sales of bought-in goods

When a charity sells new goods it is trading and unless this trading qualifies for the statutory trading exemptions the profits will be taxable. Significant non-charitable trading can jeopardise charity status.

The decision will depend on the charity's individual circumstances, but it is usually preferable for the bought-in goods to be bought and sold by the subsidiary and for the donated goods to continue to be sold by the charity. This does mean, however, that shop staff need to be trained in procedures for accounting for two sets of sales, and the tills will need to be modified accordingly.

VAT

For VAT purposes there is no special concession and the VAT treatment would follow the type of goods, for example the sales may be standard rated or zero rated.

In particular, the sale by, and the supply to, a charity of donated goods is zero rated.

VAT zero rating on the supply of donated goods now also applies to a 'taxable person' who gifts all the

In the example of a shop it is relatively easy to allocate income and direct costs between primary and non primary purpose trading. However, indirect and fixed costs also need to be allocated on "a reasonable basis".

Detailed guidance on cost allocation can be found in Chapter 11.

profits of that supply to a charity. These provisions mean that donated goods can be zero rated even if they are sold by a trading subsidiary so long as the company concerned gifts the profit of that supply to the charity. However, running the shop through the subsidiary does lead to certain problems, as explained below.

Who owns the goods?

Charities that sell donated goods through the trading subsidiary (which then transfers the profits up to the charity) need to consider how the goods became the property of the trading company.

For example when goods are collected "house to house", collection licences are granted in the name of the charity. This means that goods are being collected by the charity and, in the eyes of the donor, for the charity. Similarly, when a donor donates goods at a shop surely their belief is that they are donating to the charity and not a separate non-charitable trading company.

How then are these donated goods transferred to the trading subsidiary to sell?

There are, of course, complicated agency agreements that might allow this (e.g. if the subsidiary is acting as agent for the charity) but then the profits of the sales must appear in the charity's books and not in the trading subsidiary's.

Under charity law the charity must not give away its assets for no charge to a commercial company, even if that company is its wholly owned trading subsidiary. It might, for instance, be possible to charge a percentage of the ultimate sale proceeds (say 50%) to

the subsidiary, but this does require more administration.

There is an argument that the gift of the goods is given in exchange for the trading subsidiary Gift Aiding back the profits. This is however a dangerous argument, as it would invalidate the tax effectiveness of the Gift Aid payment, which must be a donation and not made in exchange for something. It has been suggested that the goods are being donated directly to the subsidiary but this causes other problems.

The rates issue

Charities are entitled to mandatory relief from non-domestic rates where the rate payer is a charity or trustees for a charity and the property is wholly or mainly used for charitable purposes. This means that channelling all the shop activities through a non-charitable trading company would fail the conditions for this relief, as the premises would then be used wholly for non-charitable purposes.

Where the rate payer is the trading company itself, again it is not a charity and the property being used by the trading company is not used wholly or mainly for charitable purposes. The fact that the trading company subsequently passes profits up to the charity does not strictly allow it to obtain this relief. This point is being taken by local authorities that are then denying rates relief.

Use for charitable purposes is stated to include the sale of goods donated to a charity if the proceeds of sale of the goods (after any deduction of expenses) are applied for the purposes of a charity.

Some advisors believe that this allows the sale of donated goods to be taken through the subsidiary and that the shops should be run through the subsidiary but it should be noted that the goods must be donated to a charity – in which case the proceeds should be recognised by the charity.

The VAT issue

As explained above, the law allows zero rating for goods sold by a trading company so long as it covenants all the profits of that supply to the charity. Interestingly, despite the specific reference to covenants in the legislation, in practice HMRC appear to accept that if a charity subsidiary transfers its profits by Gift Aid or dividend this will suffice.

However, HMRC are being fairly strict in the interpretation of the words “all the profits of that supply”. For example, consider a case where the trading subsidiary makes profits from the supply of donated goods of £100,000 and the trade of bought in goods has resulted in a loss of £10,000. In effect the trading subsidiary will have a composite profit of £90,000. In this case if it gifts the £90,000 to the charity it will not be gifting ‘all the profits’ of the supply of donated goods. This point is not currently being taken in practice but HMRC do recognise it and say that they would expect that all the profits of the subsidiary are passed to the charity to allow zero rating.

The capital gains tax issue

If the shop property is owned by the trading company and is then sold at a gain the gain could be taxable. The exemption from tax on capital gains for gains made by charities is available only to charities and not trading subsidiaries. As noted above Gift Aid can be used to cover capital gains as well as trading profits.

However, it should be noted that capital gains are computed in a different way from trading profits and there may not be sufficient reserves in the trading subsidiary to pay up the chargeable gain under Gift Aid. For this reason it is not generally advisable to transfer property ownership to the trading subsidiary.

The solutions

Clearly there are a number of problems associated with using the non-charitable trading subsidiary to sell all the goods. Consequently where the charity primarily sells donated goods the shops should normally be owned by the charity and the ‘spare capacity’ in the shops can be used to sell bought-in goods for the trading company. This means that the charity must make an appropriate charge for overheads, rent and other costs including staff to the trading company.

Of course, direct costs of the purchase of new goods would be charged to the trading company in any case. Other costs can be apportioned in a fairly straightforward way. Many charities use a method based on turnover, for example if a shop sells 40% bought-in goods and 60% donated goods then costs which are not directly attributed are simply divided on a 40/60 basis. HMRC have become tougher on the

issue of cost allocation and the law now requires that costs are properly allocated.

For VAT purposes all input VAT relating to the shop should usually be recoverable since the shop will, in the main, be either selling zero rated goods via the charity or standard rated goods via the trading company. Thus even if the charity has to charge VAT to the trading subsidiary on the 'management charge' the subsidiary should be able to recover it.

On the rates issue the law states that a property will pass the "wholly or mainly used for charitable purposes" test if it is used wholly or mainly for the sale of goods donated to a charity and the profits of sale are applied for the purpose of a charity. When a shop sells both donated and bought-in goods it should qualify for rates relief so long as more than half the goods are goods donated to a charity for resale.

Some rating authorities take the view that "mainly" requires a much larger percentage but the commonly accepted view is that it means more than half. Clearly, the ratepayer must be a charity selling goods donated to the charity.

Most charities have adopted the structure where the charity owns the shops and is the ratepayer. This will also ensure that all donated goods collected in the charity's name are sold by the charity and all bought-in goods purchased by the trading company are sold on behalf of the trading company. Income and related expenditure on the sale of donated goods should directly flow through the charity's accounts and turnover and costs associated with the bought-in goods should go through the trading company which would transfer these profits the charity by Gift Aid. This is the way that most of the large charity shop chains operate.

5.9 FREQUENTLY ASKED QUESTIONS

Most of our shops sell mainly bought-in goods. It would make it a lot simpler to run the whole operation through a trading subsidiary. Can we do this?

Short answer

Yes, but you will need to work out a way of getting the donated goods into the hands of the subsidiary. Selling them to the subsidiary at a reasonable mark up would be acceptable, and this would still not be regarded as trading for direct tax and would be zero-rated for VAT.

In more detail

If the shops are selling mostly bought-in goods the rates relief would not be available in any case to the charity.

However, unless the shops are rented at a rack rent (an annual market value rental with no premium) the premises themselves should be kept in the charity as capital assets should generally be kept off the subsidiary's balance sheet.

The charity is also likely to have to make some recharges to the subsidiary unless it is a completely separate operation, and both the tax and VAT position need to be considered.

We've seen a lot in the charity press recently about charity shops claiming Gift Aid on donated goods. Is this worth doing?

Short answer

It can be worth doing, but the arrangements are complex and there are significant initial set up costs. The Gift Aid saving is reduced by additional administration costs and some additional VAT.

In more detail

A fully computerised sales system makes the administration of these schemes feasible. Staff and volunteers also have to be trained to operate the system. It is probably only worth setting up these schemes for a sophisticated organisation with modern computer systems and staff who are willing to learn to operate the new processes.

5.10 KEY FACTS

Shops and cafés often carry on mixed trades. A mixed trade must be split for direct tax purposes. The primary purpose part is exempt from direct tax, but the profits from the non-primary purpose part are taxable.

Where the activities cannot be split, the trade must be treated as a single non-primary purpose trade.

Sales of donated goods are not treated as trading for direct tax purposes and are zero rated for VAT, which is the most favourable treatment for both.

Where a shop sells bought-in goods as well as donated goods, this is a mixed trade for direct tax purposes and should be split into the two component parts.

If the profits from the bought-in goods are taxable (i.e. turnover over the *de minimis* limit) then these sales should be put through a trading subsidiary.

It is not usually recommended to sell donated goods through a subsidiary, as this can cause a number of legal and tax problems.

The charity should generally remain the ratepayer for a charity shop unless the shop is selling more than 50% bought-in goods.

Some charities have set up systems whereby they can claim Gift Aid in relation to donations of goods. These systems are complex and should not be implemented without taking advice.

6

Merchandising

- 6.1 Christmas cards
- 6.2 Other bought-in goods
- 6.3 Website sales
- 6.4 Selling souvenirs
- 6.5 Mail order and catalogue merchandising
- 6.6 Charity products
- 6.7 Publications, DVDs etc
- 6.8 Suggested donation sales
- 6.9 Frequently asked questions
- 6.10 Key facts

6.1 CHRISTMAS CARDS

Selling Christmas cards is often a charity's first step towards trading. Cards are typically sold in the following ways.

Direct Sales

The charity commissions the cards itself, buys them and sells them to its supporters. This is a straightforward trading activity. It takes place over a number of weeks or months so does not count as a fundraising event.

Selling Christmas cards will not usually be part of the charity's primary charitable purpose and therefore the profits will be subject to direct tax, unless they fall under the small scale exemption.

If the cards are manufactured by the beneficiaries, e.g. cards made by disabled people for a disabilities charity, then HMRC will accept that the activity is mainly carried on by the beneficiaries and the profits will be exempt.

Licensing Agreement

The second main way of selling Christmas cards is where a third party, often a retailer or other commercial body, manufactures and sells the cards in aid of the charity. The commercial partner will expect to receive a significant proportion of the profit from the activity.

The charity receives a payment which can be related to the number of cards sold (e.g. 10p from the sale of every card), the value of the sales (e.g. 10% of the sales proceeds) or the profits (e.g. 50% of the profits). The charity's name and logo will be printed on the cards and because of this, the payment to the charity will not be a pure donation, but may be treated as trading income.

It was explained in Chapter 3 that receipts from licensing the charity's name and logo could be exempt if the receipts are entirely passive in nature and the charity must provide no other services to the retailer. This is generally true but there are some additional complexities that need to be considered and charities need to take advice before entering into such arrangements. It may be safer for the licensing activity to go through a trading subsidiary. If so, the charity would need to license the name and logo to the subsidiary under a long term licence which itself would

be structured so as not to create a tax liability in the charity.

It should be noted that the third party will be a "commercial participator" for these purposes under the Charities Acts. Charities should refer to Charity Commission guidance RS2 - Charities and Commercial Partners on structuring agreements with commercial participators.

Example 1

A charity enters into an agreement with a major retailer to license its name and logo for Christmas card to be sold in 2010. The charity will receive 10p from the sale of each card, and its name and logo will be printed on the back. The charity is expecting to receive around £70,000 from this activity. As this is a commercial activity and VAT will be chargeable the charity decides to put it through its trading subsidiary.

- *The charity enters into a licensing agreement with the subsidiary for the use of its name and logo*
- *It charges £10,000 for this, which will not take the charity over the VAT registration threshold*
- *The charity is providing no services other than the use of its name and logo, and therefore the income will be exempt from direct tax in the charity's hands*
- *The subsidiary enters into a licensing agreement with the retailer*
- *The retailer notifies the subsidiary of sales within an agreed timescale*
- *The subsidiary invoices the retailer together with VAT*
- *The subsidiary Gift Aids its profits (net of the £10,000 licence fee) to the charity.*

E-cards

E-cards are becoming a more popular way of sending Christmas cards directly. The charity does not need to use the services of a commercial participator, and it therefore gets to keep all the income. There are no costs of manufacturing or posting the cards, although the charity will incur costs in changing its website. Moreover there is an opportunity to ask for a donation from the purchasers at the same time as payment.

It has to be remembered that this is a trading activity and the profits will be taxable unless they fall within the *de minimis* exemption. For this reason the charity may decide to sell e-cards through the trading subsidiary. The subsidiary must have the right to use the charity's website, and would probably have its own page or

pages, the costs of which will need to be recharged to it.

VAT

The sale of Christmas cards in any form is standard rated for VAT. Licensing income is standard-rated.

6.2 OTHER BOUGHT-IN GOODS

The sale of bought-in goods is a trading activity and the profits will be taxable unless they fall under one of the exemptions. The primary purpose exemption may be in point, if selling the goods is directly within the

charity's objects (see Section 2.4).

The following table lists some examples of the types of sales that are within or outside different charities' primary purposes.

OBJECTS OF CHARITY	PRIMARY PURPOSE SALES THAT WILL NOT BE LIABLE TO DIRECT TAX	SALES OUTSIDE THE CHARITY'S PRIMARY PURPOSE
Teaching first aid procedures.	First aid kits, booklets, resuscitation dummies and other aids	Christmas cards and gifts. Clothing with the charity's name and logo
The charity is a school with a primary purpose of education	Textbooks and other educational materials, including CDs for language teaching and videos Sales of food and drink to students in a tuck shop or cafeteria (ancillary to the primary purpose) Sales of school uniform bearing the school's name or badge (ancillary to the primary purpose)	Sales of generic (i.e. unbadged) clothing or sports kit. Non-educational CDs or DVDs
Supporting deaf people	Hearing aids, listening devices, telephone amplifiers	Christmas cards

It may not be the goods themselves that are charitable, but the method of trading could be part of fulfilling the charity's objectives. For instance, the shop could sell items manufactured by the beneficiaries. However the trustees need to be very clear about who is benefiting from the activity.

VAT

The sales of bought in goods are standard rated for VAT unless the zero rating provisions apply for sales of food, children's clothing etc.

6.3 WEBSITE SALES

Many charities now have on-line shops so that supporters can buy goods direct. For direct tax the same principles apply to these sales as to any other sales. It is a trading activity, but the profits will be exempt if the trading occurs in the course of carrying out the primary charitable purpose.

Charities sometimes arrange for sales through other commercial websites, e.g. eBay. Sales of donated goods are not treated as trading for tax purposes, but sales of bought in goods will be trading and the charity will then need to consider if the goods are primary purpose.

Links to other sales websites

Charities sometimes provide a link direct to the sales website of a retailer where supporters may buy products. Some or all of the income from the retailer in connection with these links will be regarded as advertising income. Charities should be careful when signing up to such agreements to ensure that they are aware of the tax and VAT treatment of such income. See chapter 3 on sponsorship.

Links to shopping websites

Charities sometimes have agreements with shopping websites (which host links to a number of different retail websites) under which they host a link to the website on their own web pages and receive a very small amount when sales are made through the link. Again any income is likely to be taxable.

VAT

Sales of goods and services will be exempt or taxable depending on the nature of the supply.

Commission from websites to which the charity provides links will be standard-rated for VAT.

Care is also required in relation to the purchase by overseas customers. Like any trader charities should be aware of the VAT position for sales to customers which are outside the EU which would be zero rated for VAT. Sales to customers within the EU but outside of the UK may give rise to the need for VAT registration in other EU countries under the distance selling rules.

6.4 SELLING SOUVENIRS

Selling souvenirs such as T-shirts, mugs, fridge magnets, mouse mats and other paraphernalia will not form part of a charity's primary purpose trade. For direct tax purposes therefore the profits will be taxable, unless they fall within one of the other charitable trading exemptions, such as the small scale exemption.

Typically such items will be standard-rated for VAT.

Souvenirs sold at fundraising events will fall within the fundraising events exemption for both VAT and direct tax if it applies (see Chapter 7). HMRC have issued the following guidance about which goods can qualify for the exemption and which cannot.

EXTRACT FROM HMRC GUIDANCE ON GOODS SOLD AT FUNDRAISING EVENTS

What income is included in the exemption?

All the income for supplies of goods and services in connection with an event is exempt, for example

- all admission charges
- the sale of commemorative brochures (may be zero-rated for VAT,)
- the sale of advertising space in those brochures (may be zero-rated for VAT,)
- other items sold by the charity such as T-shirts, non-donated auctioned goods etc. Where items are normally supplied zero-rated such as children's T-shirts, then zero-rating rather than exemption can be applied, and
- sponsorship payments directly connected with a qualifying event.

What income is not included in the exemption?

Commemorative goods and souvenirs sold for a period after the qualifying fundraising event. For example

- video and audio recordings of the fundraising event sold after the event has taken place will be standard-rated
- surplus commemorative items such as adult T-shirts, mugs etc. will be standard-rated
- commemorative programmes will remain zero-rated
- children's T-shirts will remain zero-rated
- donated goods for sale may still be sold VAT free provided the normal conditions are met.

Where goods do not fall within the VAT exemption the profits will not be exempt from direct tax.

6.5 MAIL ORDER AND CATALOGUE MERCHANDISING

Direct tax

A number of charities publish mail order catalogues, particularly at Christmas when there is an opportunity to sell cards, wrapping paper and gifts to their supporters. In most circumstances this will be non-charitable trading. If the catalogues contain products that fall within the charity's primary purpose then the charity will need to produce a profit and loss account for each part of the trade. Generally, however, charities tend to put catalogue sales through a trading subsidiary.

As catalogues are sent to the charity's supporters there is an opportunity to ask for donations on the order

form. If the catalogue is operated through the trading subsidiary it must be clear to the supporters that the donations are made to the charity (not to the subsidiary). Even if a cheque or payment is made to the subsidiary it is acting as agent and should pass the donation to the charity.

VAT

There is no particular treatment for VAT – each product will bear VAT at its own rate.

6.6 CHARITY PRODUCTS

Direct tax

Selling charity products may itself be within the charity's primary charitable purpose, and the profits from this activity would then be exempt. An educational charity can sell teaching materials; a charity focusing on disabilities can sell items that help people with those disabilities.

The Charity Commission have accepted the promotion of a 'fair trade mark' as a means of relieving poverty.

This means that the sale of Fairtrade goods by a charity whose primary charitable purpose is to relieve poverty should be regarded as primary purpose trading.

In the Fairtrade example the Charity Commission were careful to establish a verifiable link between the activities of the charity and the relief of poverty.

6.7 PUBLICATIONS, DVDS ETC

Direct tax

A theatre selling DVDs of theatrical productions could probably treat these as within their primary charitable purpose. A college choir selling CDs of their performances would also probably qualify, if its aim is "to promote the appreciation of choral music". However, if the choir sold not only CDs and DVDs of its own performances but also of completely unrelated performances the charity would have to consider carefully the status of the trade against its primary charitable purpose.

Similarly a horticultural charity's objects might be "the encouragement and improvement of the science, art and practice of horticulture in all its branches". This is very wide and would probably include the sale of gardening books and DVDs.

VAT

The sales of CDs and DVDs are standard rated (unless they are donated goods).

The sale of printed matter is zero rated for VAT purposes. Typical examples of printed matter would be books, magazines, leaflets etc. It is important to note that digitised products do not qualify for zero rating so that a downloaded book or audio CD version would not be zero rated.

6.8 SUGGESTED DONATION SALES

Direct tax

Where an item is given away, but subject to a suggested donation, the charity needs to be very careful about whether the donation is actually a free-will donation or whether it is in fact consideration for the sale of the goods. A person must genuinely be able to acquire the item without payment before any payment can be regarded as a donation.

In particular, a stated "minimum donation" will be regarded as the price for the item but using terms such as "suggested donation" will be acceptable.

Genuine donations will not be regarded as income from a trade, but donations which are really payment for the items will be included in the calculation of trading profits.

VAT

There is a VAT concession in relation to lapel stickers and similar tokens which are to be given free as an acknowledgement to donors of money, have no intrinsic value and are low cost to the charity will qualify. Under the concession any donations are treated as zero-rated, so that any input tax on the cost to the charity can be reclaimed.

The trustees should also consider whether charging a set price for the items would give a better return overall.

HMRC VAT GUIDANCE ON MERCHANDISING OF LAPEL PINS ETC:

The relief is restricted to small items designed to be worn on clothing, of a kind that were traditionally attached to the lapel. Included are paper stickers, ribbons, artificial flowers (if these are used as a symbol of the charity) and metal pins and badges.

Large items for decorating buildings, vehicles, monuments etc are not eligible for relief even if these are just bigger versions of a lapel badge.

What is considered "no intrinsic value" and "low cost" for lapel attachments?

Emblems or badges given in return for any non-specified donation or a suggested donation of up to £1. In practice this would mean that the cost to the charity would be considerably less than £1 per unit.

Does the relief cover lapel attachments to be sold for a fixed price?

No, although relief will apply if a charity suggests a donation of £1. If lapel emblems or attachments are offered for a fixed price, even if this is only £1 or less, they do not qualify for relief because the emblems are not given away freely.

CASE STUDY

Green Schemes decides to run a fundraising campaign which focuses on saving the environment. A number of retailers have agreed to position collecting tins at their checkouts, and checkout staff will hand out enamelled ladybird pins to people making donations. The tins will be labelled "suggested donation £1". The checkout staff will not monitor the amounts donated but will hand out pins on request.

In this case the donations will clearly be donations and not payment for the pins. For direct tax this will mean that the donations will not be treated as receipts from a non-charitable trade.

For VAT the pins will fall within the concession, and therefore the charity can reclaim VAT on the purchase of the pins, but does not have to account for VAT on the donations.

6.9 FREQUENTLY ASKED QUESTIONS

We are a Christian charity whose purpose is “the advancement of the Christian religion”. We sell Christmas cards every year to our mailing list. Is this a primary purpose trade?

Short answer

It has been suggested that selling cards that celebrate a religious occasion could be a primary purpose activity if the charity is a religious charity. The charity trustees would have to ask themselves if the purpose really is to promote the religion, or whether it is essentially to make money. If the answer is the latter,

the trustees should not rely on the primary purpose exemption.

In more detail

Given that most Christmas cards sold by charities are not primary purpose, the charity would have to work quite hard to make the argument that these cards are sold for the purpose of promoting the religion.

If the card contained some religious text, or was designed to be used as or turned into a devotional artefact or aid to meditation after the Christmas season was over it might be easier to argue the case.

6.10 KEY FACTS

Typically merchandising will be non-charitable trading unless it falls within the charity's primary charitable purpose.

Charities selling goods which they believe fall within their objects must show a clear link between the sales and fulfilling their primary charitable purpose.

Goods sold by catalogue or over the internet follow the same rules for direct tax as any other trading activity.

For VAT purposes internet sales may not carry the same liability as goods sold directly. In particular digitised publications are standard-rated rather than zero-rated. Also, selling over the internet may lead the charity into cross-border selling, and advice should be taken here.

Charities need to be very careful about entering into agreements with commercial participators such as retailers and should take tax and legal advice before doing so.

Suggested donation sales are a complicated area and advice should be taken about the precise wording that would allow the donations to be treated as tax and VAT free. As a rule of thumb, “minimum donation” or “suggested minimum donation” should not be used, but “suggested donation” would be acceptable.

7 Events

- 7.1 Fundraising events exemption
- 7.2 What is an event?
- 7.3 Number of events per year
- 7.4 Whose event is it?
- 7.5 Direct tax effects of fundraising exemption
- 7.6 VAT effects of exemption
- 7.7 Admissions to cultural events
- 7.8 Interaction with Gift Aid
- 7.9 Concerts
- 7.10 Non qualifying fund raising events
- 7.11 Auctions
- 7.12 Sponsored walks
- 7.13 The London Marathon and other sponsored events
- 7.14 "Challenge" and similar events
- 7.15 Frequently asked questions
- 7.16 Key facts

Section 2.9 briefly discussed the fundraising events exemption. This chapter deals with it in more detail.

7.1 FUNDRAISING EVENTS EXEMPTION

Fundraising events are “events which are clearly organised and promoted to raise money for the benefit of the charity or qualifying body” (HMRC guidance). People attending or participating in the event must be aware of its primary fundraising purpose.

If an event qualifies as a fundraising event all the income from the event is exempt from VAT, and no VAT can be recovered on the costs.

This exemption applies both to direct tax and to VAT. If an event qualifies for the VAT exemption the profits will also be exempt from corporation and income tax.

More detailed guidance is available from the HMRC website via various links. The most detailed information is provided under the link “Helpsheet ‘Fundraising events – exemption for charities and other qualifying bodies”.

7.2 WHAT IS AN EVENT?

HMRC GUIDANCE ON FUNDRAISING EVENTS STATES:

An event is a one-off activity such as:

- A ball, dinner dance, disco or barn dance
- A performance - such as concert, stage production, and any other event which has a paying audience
- The showing of a film
- A fete, fair or festival
- A horticultural show
- An exhibition - such as art, history or science
- A bazaar, jumble sale, car boot sale, or a good-as-new sale
- Sporting participation (including spectators), such as a sponsored walk or swim
- A sporting performance
- A game of skill, a contest, or a quiz
- Participation in an endurance event
- A fireworks display
- A dinner, lunch or barbecue
- An auction of bought in goods (an auction of donated goods is zero-rated, and not treated as trading for direct tax purposes).

Continuous fundraising activities such as trading through a charity shop or mail order catalogue do not count as events and are therefore not covered by the exemption.

Social events which incidentally make a profit do not fall within the exemption.

Neither do events which a charity holds as part of its charitable activities. The latter would normally fall within the primary purpose trading exemption, but might not qualify for VAT exemption.

7.3 NUMBER OF EVENTS PER YEAR

The exemption is limited to 15 events of the same kind in the charity's financial year at any one location. If there are more than 15 events then the exemption is lost for all events held at that location. However, very small scale events, such as coffee mornings, do not count towards this total provided that the gross takings from all such events are no more than £1,000 per week.

Location should be considered carefully. If the event requires particular premises such as sports facilities or a theatre, each of these will be viewed as a different location. Similar kinds of events in different locations will qualify provided that the other criteria are met. So 17 discos held by a national charity in different towns would qualify for exemption but 17 discos held by a charity in the same town at the same venue in the same year would all be taxable.

HMRC's guidance is clear on this and they state "For VAT exemption to apply, you can't hold more than 15 events of the same kind in your financial year at any

one location. If you do, then none of the events qualifies for the VAT exemption, not even the first 15".

Therefore great care must be taken to avoid a situation where a charity has organised a number of events and run them on the basis that they are exempt only to find that by breaching the limit these events will not be exempt fundraising events.

The nature of the events must also be taken into account. A concert or festival that is put on over 5 nights will count as 5 events. However a tournament that takes place over two days would still count as one event.

It should also be noted that the event itself must not distort commercial competition in the locality. If it does then the exemption will not apply.

If the charity operates on a branch basis but there is only one legal entity, all the fundraising events for the branches must be included when the charity is reviewing the types of event and locations.

7.4 WHOSE EVENT IS IT?

Charities qualify for both the VAT and the direct tax exemption. Trading subsidiaries of charities qualify for the VAT exemption but do not qualify for the direct tax exemption as they get tax relief under Gift Aid.

Various non-profit making bodies and voluntary groups specified in the VAT legislation are also entitled to the VAT and the direct tax relief, so long as the profits are used for charitable purposes or transferred to a charity. However, such bodies are very tightly defined and a voluntary group should not assume that it will automatically qualify.

The exemption may be put at risk if the event is organised by a fundraising committee. HMRC will consider whether the committee is in reality a separate legal entity. If it is, then exemption will only be available if the new entity is a charity or other qualifying body in its own right.

Joint events

Charities sometimes group together to run a joint fundraising event. Such an event would qualify for the

tax and VAT exemption, but as a practical point for direct tax purposes it must be clear to both the charities and the attendees how the profits are to be split.

HMRC also state that all the charities involved must individually satisfy the 15 event limit, which may be difficult.

It is possible to have a Gift Aid declaration form that is made out to more than one charity so long as it is clear to the donor how the donations are to be split (e.g. 50:50) or the donor is given the option to allocate the gift between the charities. Where the donation is made by cheque it can be made out to one charity so long as it is clear that that charity is acting as agent for the other, but it may be more practical to open a joint bank account for the income and expenditure from the event.

Events run by third parties

Large scale events often need the assistance of commercial bodies to coordinate and administer the event. The involvement of the third party would not in

itself disqualify the event. However the tax and VAT exemptions will depend on the arrangements between the parties.

If the commercial body acts as principal in making the supplies or if a new non-charitable organisation is formed for the purposes of the event, the event would not qualify for VAT exemption.

The third party could, however, act as an agent and charge fees to the charity for the services of organising

the event. The event would then be treated as the charity's, and qualify for the exemption. The fees charged by the third party would be subject to VAT, which would not be recoverable.

The legal documentation of the agreement must be clear as to the relationships of the parties, i.e. who is the principal and who is the agent in the delivery of the event.

7.5 DIRECT TAX EFFECTS OF FUNDRAISING EXEMPTION

If an event falls within the exemption then all the trading profits associated with that event will be exempt. This includes profits from:

- Admission charges to the general public
- Entry fees for stall holders
- Sales of programmes and advertising income
- Sales of gifts and souvenirs at the event (not afterwards)
- Charity auctions (auctions of donated goods would be exempt anyway)
- Corporate sponsorship income

- Raffles (although these would be covered by the lotteries exemption).

People often make donations at events in addition to payments for admission or goods and services. These donations do not count as part of the trading profits and can be made under Gift Aid, provided that Gift Aid declaration forms are completed.

Charities running sponsored events such as sponsored walks or swims often make a small charge for people to enter, which would cover administration costs and count as trading income, but be covered by the exemption. The donations can then be Gift Aided.

7.6 VAT EFFECTS OF EXEMPTION

Whilst the fundraising event exemption means that the income is free from VAT, it must also be considered that any VAT on expenditure may not be recoverable.

For VAT purposes it may be possible to establish zero rating for certain items which might be supplied at the event such as the sale of donated goods by a charity, eligible food, eligible publications, children's clothing, charity advertising etc. In doing so the charity will be

able to recover any input tax incurred on the direct costs associated with the event and an apportioned amount of VAT on the overheads of the event.

There are reliefs for VAT on advertising costs for the fundraising events, but it should be noted that if the fund raising campaign is in any way selective i.e. not communicating with the public at large the relief may not be obtained.

7.7 ADMISSIONS TO CULTURAL EVENTS

Also see section 10.5 for Gift Aid and entry to charity premises.

There is a separate VAT exemption for cultural events. This relates to admission charges by an eligible body to a museum, gallery, art exhibition or zoo, or a theatrical, musical or choreographic performance of a cultural nature. An eligible body is a body that satisfies the following conditions:

- It is precluded from distributing and does not distribute any profit it makes
- It applies any profits made from admission charges to the continuance or improvements of the facilities made available by means of the supplies
- It is managed and administered on a voluntary basis

7.8 INTERACTION WITH GIFT AID

People often have the idea that because the organiser is a charity, payments for admission to events, or tickets for a dinner or concert, can be made under Gift Aid. This is not the case. Where a payment is made in exchange for something it is not a donation and can not be Gift Aided. Similarly charity vouchers cannot be used to pay for tickets, as Gift Aid has already been claimed in respect of these.

If a donation is made on top of the ticket price and the donation is purely voluntary, then that amount can be paid under Gift Aid.

If the donation is significantly larger than the ticket price, and the ticket price falls below the donor benefit limits (see below), then the whole payment can be Gift

by persons who have no direct or indirect financial interest in its activities.

There has been considerable case law on the subject of cultural events particularly in relation to the last condition listed.

It may be that some fundraising events would qualify for this exemption in their own right. If this is the case and if the number of events is reaching the maximum of 15 in a year then it would be worth taking advice as to how an event could be held in such a way as to not be treated as a fundraising event.

The direct tax implications of this would also need to be considered, but if putting on concerts is part of the charity's primary charitable purpose the profits would be exempt from direct tax.

Aided including the ticket price.

Gift Aid donor benefit limits

Gift Aid cannot be claimed on a payment where the donor receives a benefit in consequence of making the donation. However, very small benefits can be ignored. Gift Aid may be claimed on payments where the value of the benefit received in exchange for the donation (i.e. the value of the ticket or other item purchased) is less than the benefit limits set out in the following table.

The following benefit limits apply to donations made on or after 6 April 2007.

AMOUNT OF DONATION	MAXIMUM VALUE OF BENEFITS
£0 -100	25% of the donations
£101-1,000	£25
£1001+	5% of the donation up to a maximum of £500 per year

Where there is no ticket price or readily ascertainable market value, the value of attending an event is treated

as the cost of putting on the event, divided by the number of attendees.

7.9 CONCERTS

Clearly a concert can fall within the definition of a fundraising event. If it does the ticket prices and any sponsorship and other receipts from the concert itself would be VAT exempt, and profits from these would not be subject to direct tax.

However, merchandise sold afterwards, and particularly recordings of the event would not fall within the exemption. They would therefore be subject to VAT and the profits would be subject to direct tax if selling the recordings is not within the charity's primary charitable purpose.

A concert held by an orchestral charity would not normally be a fundraising event, but part of its primary charitable purpose. However, such a charity could hold a specific concert as a fundraising event, so long as it was clear to supporters that the concert was being held to raise funds, and it fulfilled the other criteria for fundraising events.

A concert or event may be held on-line. HMRC have said "We regard a charity's entire website as a location for events held over the Internet." In practice it would be likely that the concert would be held in one or more physical locations and broadcast over the internet, in which case the charity's website would be regarded as a single location in addition to the physical locations. Advice should be taken before such events take place in order to ensure the most favourable tax treatment.

As discussed previously it may be that a concert would qualify for the VAT exemption for cultural events in its own right.

Interaction with Gift Aid

The admission price itself cannot be Gift-Aided, as it is a payment for admission, but any donations on top of the ticket price can be Gift Aided, so long as they are voluntary donations. Here are some examples.

Table showing examples of Gift Aid and ticket prices

TICKET PRICE FOR A CONCERT	AMOUNT ACTUALLY PAID FOR A TICKET	AMOUNT THAT CAN BE GIFT AIDED
£25	£25	None
£25	£100 (it is clear that any amount over £25 is entirely voluntary)	£75
£25	£1,000	£1,000 (because the benefit limit for a donation of £1,000 is £25)
Admission is stated to be by minimum donation of £25	£25	None – the minimum donation is treated as the admission price
Admission is stated to be by minimum donation of £25	£50	None – the payment is not purely voluntary and it is therefore treated as a payment for admission.

7.10 NON QUALIFYING FUND RAISING EVENTS

Where a fundraising event does not qualify for exemption, the charity or qualifying body may set a minimum charge which will be standard rated and invite voluntary donations from those attending. The additional contribution will be outside the scope of VAT if all the following conditions are met:

- It is clearly stated on all publicity material, including tickets, that anyone paying only the minimum charge will be admitted without further payment
- The extra payment should not give rise to any particular benefit

7.11 AUCTIONS

An auction can itself be an exempt fundraising event. However, even if the auction itself does not fall within the fundraising events exemption (e.g. because the 15 event limit has been exceeded), it is quite likely that the goods and services auctioned are donated, so the activity would be treated as the sale of donated goods, exempt for direct tax purposes and zero-rated for VAT.

However, for VAT purposes, the charity cannot limit access to selected individuals – the sale must be open to the general public. Access should only be limited for health and safety grounds. The charity can advertise the auction as it sees fit and may choose to limit advertisements to those areas where they feel they are likely to attract potential buyers.

On-line auctions

An on-line auction could be a fundraising event. A charity's own web-site would be treated as a single location for this purpose. If such an event were held over a day or a couple of days then it would potentially fall within the exemption.

However, where a charity regularly auctions items on a commercial web-site such as eBay this is likely to fall outside the exemption. In this case the sale of donated goods would still be tax-exempt, but the sale of bought-in goods would be taxable.

Gift Aid

When people buy goods or services at charity auctions they will often pay more than if they were

- The amount of the further contributions is ultimately left to the ticket purchaser to decide, even if the organiser indicates a suitable level of donation
- The entrance fee should not be less than the usual entrance fee at a normal commercial event of the same type
- The minimum sum upon which the organisers will be accounting for VAT will not be less than the total costs incurred in arranging the event.

buying the same items on the high street, so that there is an intention to make a gift to the charity. HMRC has agreed that Gift Aid is possible in these circumstances, but under strictly defined conditions:

- The goods or services must be commercially available
- It must be possible to establish a high street price
- The purchaser must be aware of the high street price when he bids for the item
- Only the excess paid over the high street price is a donation*

*subject to the Gift Aid benefit rules (see section 7.2 above)

The charity must therefore not only be aware of the high street price but must advertise it to the bidders before the bidding starts. This could be done by the auctioneer or the price could be printed on the bid-sheets.

Often items are donated for charity auctions because they have a celebrity value or are not generally available. Since a high street price cannot be established for these, Gift Aid cannot be claimed. The following table illustrates some examples where Gift Aid can and cannot be claimed:

Table showing use of Gift Aid with auctions

ITEM AUCTIONED	HIGH STREET PRICE	GIFT AID AVAILABLE?
A balloon trip for four people, that can be purchased on the open market	£100 per person	Yes, on the excess over £400. If the purchaser paid more than £8,000 the high street price would be less than the Gift Aid benefit limit (5% of the payment - see above), so Gift Aid could be claimed on the whole amount.
A trip on a private yacht owned by one of the charity's supporters	The yacht is not available for hire, so there is no high street price	No
A week's trip on a private yacht that is hired out when not in use by the owner	£1,000 per day or £5,000 per week	Yes, on the excess over £5,000
A promise by a supporter to provide a service e.g.: <ul style="list-style-type: none"> • Bake a cake • Clean a car • Cook a meal where the supporter does not provide these services commercially	Not generally available	No
A promise by a supporter to provide baby-sitting for an evening.	The sitter normally charges £10 per hour for this	Not unless the hours promised are fixed, as the price for the service would not be known at the time of the auction.
A football signed by all the members of the Arsenal football team	The football itself might have been bought for £20 without the signatures, but with the signatures a high street price cannot be established	No

It should be noted that sporting memorabilia such as signed football shirts might be available for purchase from specialist shops or on-line auction sites, but

HMRC would resist the idea that there would be a single value that could be used to establish a high street price in these cases.

7.12 SPONSORED WALKS

A sponsored walk may not involve any trading activity at all. If the walkers do not pay to participate the charity does not need to consider whether the fundraising events exemption applies. The sponsored walk is simply a method of soliciting donations from the general public, and these can be paid under Gift Aid.

Quite often the charity will charge a small entry fee to cover its administration costs, such as insurance, and the cost of a T-shirt for each participant. In this case running the event would be regarded as a trading activity, although it could fall within the fundraising

event exemption. The entry fee cannot be paid under Gift Aid. It would, however, generally be regarded as covering all the benefits to a participant in the walk so that the charity would not need to consider the Gift Aid benefit rules for other donations. The sponsors would therefore be able to get Gift Aid on their payments and only the entry fee would be regarded as trading income.

Gift Aid receipts are not subject to VAT, but any participation fee would be VATable unless the event fell within the fundraising events exemption.

7.13 THE LONDON MARATHON AND OTHER SPONSORED EVENTS

Although the London Marathon is a major fundraising event for many charities, it is not in fact run by a charity and is therefore ineligible for the fundraising events exemption. Does this matter?

Direct tax

For direct tax purposes it makes very little difference. The participants apply for places in a ballot, and the successful ones then raise sponsorship which can be donated to their preferred charity under Gift Aid. Under a separate scheme known as "the golden bond scheme", charities can buy guaranteed places and offer them to runners who miss out on a place in return for a commitment to raise a four-figure sum, known as a "pledge". These donations can similarly be made under Gift Aid.

VAT

For VAT, however, the position is very different. As the Marathon (in common with other commercially run events) does not fall within the fundraising events exemption, the sale of the places is regarded as a VATable supply.

However, where a charity allows individuals to take part in the event regardless of the amount they raise and the individuals do not receive any benefits in return, the monies raised are regarded as donations and are therefore outside the scope of VAT.

Many charities will vary conditions and incentives in relation to the places they have paid for, e.g.

(a) *Entry and registration fees*

Any amount described as an entry fee or registration fee that participants have to pay to gain entry to the event will be taxable at the standard rate.

(b) *Minimum sponsorship*

Some charities insist that the participants raise a minimum amount of sponsorship before they can take part in the event. If there is such a condition and it is, in practice, enforced i.e. participation is denied to those who do not raise the minimum amount, this is effectively an entry fee and is taxable at the standard rate. In these circumstances any payment in excess of the minimum sponsorship is regarded as a donation and is outside the scope of VAT.

(c) *Pledges or commitments to raise specified amounts*

If a charity asks individuals to 'pledge' or 'commit' to raise a certain amount of sponsorship, but do not insist on any payment before allowing the individual to take part in the event, the total amounts raised can be treated as donations and are outside the scope of VAT.

A charity may encourage individuals to pass on sponsorship monies as they receive them and before the event takes place. Providing they do not insist on receiving a certain amount before allowing the individual to take part, such amounts are donations and outside the scope of VAT.

Benefits and incentives other than those listed above may be provided. For example, some charities will provide free travel and/or accommodation or other benefits such as gifts of watches or bikes to participants. Where a charity provides such benefits

or incentives, the amount raised by the participant is a consideration for the benefit or incentive and is therefore VATable. However if the items are treated as prizes for fundraising efforts they are not treated as benefits.

Where a participant raises sponsorship on behalf of a nominated charity but does not participate as one of the charity's paid entries, for instance because there is free entry to the event or if the participant has personally paid the entry fee directly to the organiser of the event, all monies raised will normally be regarded as donations and be outside the scope of VAT.

However if there are any arrangements or agreed conditions etc between the charity and the participant

they may have VAT implications and should be considered in this context on an individual basis.

The conditions imposed by the charity or the benefits and incentives the charity offers participants may have an impact on the amount of VAT the charity can recover on related expenses. Where a charity has purchased a place in a commercial event, and makes an onward taxable supply of that place by insisting on a payment from the participant, such as a registration fee or minimum amount of sponsorship, then the charity can reclaim in full the input tax it has incurred on purchasing the place. HMRC expect the charity to make it clear to the participant that the minimum payment is for entry to the event.

7.14 "CHALLENGE" AND SIMILAR EVENTS

Challenge events are increasing in popularity as ways of fundraising for charity. Typically an individual will sign up to participate in a strenuous event, such as cycling from London to Paris, walking along the Great Wall of China, or climbing Mount Kilimanjaro.

The charity will pay for the participant's food, travel and accommodation costs. However, the participant is required to pay a deposit or registration fee and then raise a certain amount by way of sponsorship which will more than cover the costs of the trip.

Where challenge events include more than two nights' accommodation, or fall within the Tour Operators' Margin scheme, they are not covered by the fundraising events exemption.

Direct tax

Running the event is a trading activity but it is usually possible to claim Gift Aid on some or all of the sponsorship payments.

Example showing how much can be paid under Gift Aid

A charity is advertising a two week trek in the mountains of Peru. The deposit is £400 and participants are asked to raise a minimum sponsorship of £3,200 on top of this. The costs of the trek are £1,800, which the charity pays a commercial organisation to arrange.

This does not qualify as a fundraising event as more than two nights' accommodation is provided. From the charity's point of view, for direct tax purposes, this could therefore be regarded as a non-charitable trading activity.

However, £3,200 is in fact raised by donations from third parties who get no benefit themselves from the

donations. HMRC have therefore said that they will not regard running challenge events in this way as trading. In addition the sponsors will get Gift Aid on their donations, with the exception of donations from the participants themselves and "connected persons" (generally their close relatives).

The reason for this is that the participant's costs are paid by the charity, and therefore they get a benefit from their payment, and the benefit is more than the benefits allowed under the Gift Aid benefit rules. The rules extend to benefits received by "connected persons" of the giver, so donations by such persons are also excluded from Gift Aid, even though the donors get no benefit for themselves from the payment.

The full definition of a connected person is:

- the wife or husband
- a relative (brother, sister, ancestor (e.g. mother) or lineal descendant (e.g. grandson))
- the wife or husband of a relative
- a company under the control of the donor, or under control of connected persons.

Many charities fail to note on the sponsorship form that certain persons are ineligible for Gift Aid, and/or have no mechanism for identifying such persons. This leaves them open to over-claiming income tax, and to the risk of interest and penalties after a Gift Aid audit.

If the participant pays for the whole cost of the event, i.e. in the example above the full £1,800, then all the donors can get Gift Aid on their donations whether they are connected persons or not. This is because the participant derives no personal benefit from their donations.

VAT

VAT on challenge events is complicated with charities often getting involved in complex Tour Operator Margin Scheme calculations.

This usually happens when the event includes bought-in accommodation or a package of both travel and

accommodation and the charity is acting as principal or undisclosed agent. The operation of the scheme is being reviewed and is not covered in detail in this book. Details can be obtained from the HMRC website. In summary, VAT will be due on the margin between what it has cost the charity to provide a place on the event (excluding overheads) and what the charity insists on receiving as payment before allowing the participant to take part. For events/packages that take place within the EU, the margin will be taxable at the standard rate. For events/packages which take place outside the EU the margin will be taxable at the zero rate.

Agent or principal

In many cases charities were holding themselves out as principals on these supplies when in fact it was usually the travel specialist who was putting the package together.

HMRC became aware of this and issued new guidance in 2004 to help ease the charities' burden. This information is contained in Public Notice 701/1: Charities.

The VAT position is discussed below in a case study. This VAT treatment is the same regardless of whether the supply is made by the charity or the trading subsidiary.

CASE STUDY

Green Schemes decides to get its supporters to participate in a challenge event which involves trekking through the Amazon. It links up with Trekkers, a travel agency specialising in charity events.

Both Green Schemes and Trekkers have agreed that Green Schemes will act as Trekkers's agent and collect the payments from the participants. Green Schemes clearly discloses the name of Trekkers as the principal in the event's "terms and conditions" and on the documentation issued. Green Schemes is not taking any significant commercial risk in relation to the event i.e. Green Schemes does not have any financial liability should something go wrong as the trip is being arranged and managed by Trekkers.

Green Schemes is not putting the package together nor selling it as a principal. All of this work is being done by Trekkers. This means that for Green Schemes there is no requirement to undertake the Tour Operators Margin Scheme calculations for any of the income received on these events.

The arrangements are:

£200 is the registration fee is paid by the participant directly to Trekkers.

£1,800 is the fundraising target to guarantee a place in addition to the registration fee. This is paid to Green Schemes.

£1,200 is the trip cost charged by Trekkers for a place. This is included in the fundraising target, collected by Green Schemes and paid over to Trekkers.

The participant finally pays over £4,000 in total to Green Schemes (including the fundraising target but not the registration fee).

There are a number of different VATable supplies here, and the VAT treatment of each of them is as follows:

The registration fee is paid direct to Trekkers and it is the responsibility of Trekkers to account for the VAT on this.

The minimum amount the participant must pay to take part in the event is the fundraising target of which Green Schemes passes £1,200 to Trekkers. The VAT treatment of the trip cost is the responsibility of Trekkers and it will be Trekkers as the principal that will account for VAT on the £1,200 under the Tour Operators Margin Scheme.

The £600 that Green Schemes retains which is part of the "fund raising target" amount (i.e. £1,800-£1,200) is deemed by HMRC to be a 'taxable commission' payment and subject to VAT.

This is treated as a taxable commission because it is seen as the consideration retained by Green Schemes for acting as Trekkers's agent and promoting Trekkers and the services that it offers. Green Schemes will be required to issue a VAT-only invoice to Trekkers for this money even though it is retaining these funds. The VAT charged by Green Schemes will be recoverable in full by Trekkers. There will be no taxable supplies created between the individual participants and the charity under the terms of this proposed agreement.

The money raised by the participant in excess of the 'registration fee' and 'fund raising target' (£4,000-£1,800 = £2,200) will be retained by the charity and will, provided none of it relates to the commission from Trekkers to Green Schemes, be outside the scope of VAT as donation income.

In summary the VAT treatment is:

£200 Registration fee – Trekkers's responsibility to account for VAT.

£1,200 Paid to Trekkers via Green Schemes – Trekkers's responsibility to account for VAT.

£600 The remainder of the fundraising target retained by Green Schemes. This is the commission Green Schemes are retaining for promoting Trekkers. Green Schemes to issue a VAT-only invoice to Trekkers for VAT on £600, which Trekkers can reclaim.

£2,200 The additional money raised by participant retained by Green Schemes. This is outside the scope of VAT as donation income.

7.15 FREQUENTLY ASKED QUESTIONS

We held a dinner recently to celebrate the charity's ten year anniversary, and it made a profit from selling tickets and other income. Can we treat this as a fundraising event?

Short answer

It depends whether the event was clearly described and marketed as a fundraising event. How was it

advertised and what was on the tickets? If it wasn't promoted as a fundraising event then the exemption would not apply. The profits will be taxable, and VAT may also have to be accounted for on the tickets.

In more detail

Consider carefully what income should be included in the profit calculation. The charity can take out any

donations that it received in connection with the dinner, and may be able to make Gift Aid claim for income tax on them. Does the remaining turnover take the charity over the *de minimis* limit? If not then there will be no tax to pay.

If it does, then the trustees need to think about the costs, particularly the indirect and overhead costs, which may be less obvious. Are there any notional costs that can be deducted?

The VAT position may be harder to manage. If the charity is not already registered, the event could take it over the registration threshold. If VAT has to be accounted for on the tickets, the charity will be able to get a refund of input tax on the costs, and it could help recover some more of the charity's residual VAT.

An individual has taken a table at a charity event and is paying for nine of his friends to attend. They are not related to him and are not "connected persons" in any other way. Can the payment to the charity be made under Gift Aid?

Short answer

No. The person's generosity is not actually directed to the charity but to his friends. The payment to the charity is a payment for the tickets. This is a commercial transaction and cannot be Gift Aided.

In more detail:

Charities are often asked by supporters if payments for events can be made under Gift Aid, or by CAF voucher. Where a transaction involves purchasing goods or services from a charity this is not a donation and cannot be Gift-Aided. The exception is payments for admission to view charity property, which is not treated as a benefit for Gift Aid.

It may be possible to structure the event so that a split donation and ticket price arrangement can be made.

We are holding a gala dinner which is by invitation only. Due to the rules of the building where it is held it cannot be advertised as a fundraising event and there are no ticket prices, although a suggested minimum donation is stated on the invitation letter. Can the donations be Gift Aided?

Short answer

In this case the wording is borderline, and HMRC would look at all circumstances surrounding the event. In a tribunal case it was held that 'the word "minimum" indicates a certain level of compulsion', therefore such wording is not recommended.

In more detail

This illustrates why it is crucial to consider the precise wording of documentation. The facts of the case are of course paramount, but where these are not clear or subject to interpretation it can be the wording of the documentation that determines the tax treatment.

HMRC have said that they are willing to comment on individual Gift Aid cases, and therefore in cases of doubt such as here the best solution may be to contact them before making a claim.

We want to organise a fundraising dinner but rather than have a set ticket price we want to ask for donations. Will we be able to claim Gift Aid on these?

Short answer:

This may be possible provided that people can genuinely attend without making any payment, but trustees need to be very careful about the wording when advertising these arrangements.

In more detail:

Wording such as "admission by donation" would imply that a payment is required and in fact that the donations are not true gifts. However wording such as "admission free – donations welcome" or "there will be a collection after the event" should be acceptable.

HMRC suggest that the trustees should charge no less than an amount that is expected to recoup the costs of the event. The trustees certainly need to be aware of the risk that not enough donations may be received to cover the cost of the event. However, where the charity knows who will be attending and how reliable their generosity is this may well be an effective way of raising funds.

The key factor is that the payment must really be a donation.

Our charity has always carried out its fundraising events through its trading subsidiary. Do we need to change this?

Short answer

The fundraising events exemption has only been in existence in its current form since April 2000. Historically, therefore, many charities have carried out fundraising events through a trading subsidiary, and continue to do so although this is no longer necessary for tax purposes.

In more detail:

The charity trustees should review the position, but they may have good reasons for keeping the events in the subsidiary. Administratively they may prefer a separation between the charity's charitable activities and its fundraising activities. There may be doubt over

whether an activity in practice qualifies for the exemption, or there may be commercial or physical risks associated with the event that the trustees would prefer to keep separate. The important thing is that they should have documented the reasons for this decision.

If challenge events are run through a trading subsidiary this presents some tax and accounting problems. As discussed earlier, most of the receipts are donations which need to be made to the charity in order for Gift Aid to be claimed. This leaves the subsidiary with a loss-making activity, which HMRC do not regard as trading. The subsidiary would not be able to claim relief for the losses against its other profits, which would reduce the profits available to Gift Aid to the charity. In the parent charity these costs would be regarded as charitable fundraising expenditure, incurred in order to raise the associated donations.

7.16 KEY FACTS

In order to qualify for the fundraising events relief the event must satisfy the following conditions:

- the public must be aware that the purpose of the event is to raise funds for charity; and
- there must be no more than 15 events of the same type in the same location per year, unless the takings are less than £1,000 per week; and
- there must be no distortion of competition with other local traders; and
- the event must not involve more than two nights' accommodation.

The following events will not fall within the fundraising events exemption:

- Social events which incidentally make a profit
- Events which a charity holds as part of its charitable activities (e.g. a theatre production by a charitable theatre group)
- Challenge events or "treks" which fall within the

Tour Operator's Margin Scheme, i.e. which involve a package of travel and accommodation, or which include more than two nights' accommodation

- Events which are not advertised as fundraising events.

Payments for admission to a dinner, concert or other fundraising event cannot be Gift Aided. Additional free-will gifts on top of the admission price can be made under Gift Aid.

With sponsored and challenge events there are usually many components of the income received by the charity. Usually each component has a different tax treatment.

At charity auctions Gift Aid may be claimed by successful bidders on the excess over the high street price provided this is notified to bidders in advance. Gift Aid is not available on items with "celebrity-enhanced" values.

8 Providing Services

- 8.1 Contracts or grants
- 8.2 Collaborations, Partnerships and Consortia
- 8.3 Education and vocational training
- 8.4 Consultancy
- 8.5 Research
- 8.6 Room hire
- 8.7 Frequently asked questions
- 8.8 Key facts

This chapter considers the many service-providing activities that are carried out by charities

8.1 CONTRACTS OR GRANTS

Direct tax

Many aspects of charity funding are moving from grants to contracts. The contract culture with its concept of an exchange transaction and service level agreements could lead to the charity carrying on a trade. For example, a charity running a care home in return for payment is in fact trading. The absence of a profit motive is not conclusive to establish that it is not trading.

In most cases it is more than likely that charities which contract out their services will be fulfilling their primary purpose. In the example cited above if the charitable objective was to provide care for sick, elderly or disabled people then the activity would be a primary purpose trade.

It can be hard to decide whether a source of income is actually a grant or a contract. For direct tax there is

little distinction between a tax-free grant and a primary purpose trade. A grant is akin to a donation and is not taxable income as long as it is applied for charitable purposes.

VAT

For VAT the difference between a grant and a contract is crucial. Grant income is usually non-business and outside the scope of VAT. Providing services under a contract is, however, a business supply.

A contract for services will usually be VATable unless the services being provided fall within the VAT exemptions, e.g. the provision of welfare services. The exemptions are listed later in this section.

The position for VAT and direct tax can be summarised as follows:

Table summarising tax and VAT treatment of grant and contracts

	GRANT	CONTRACT
Direct tax	Not subject to direct tax	Trading, but probably primary purpose so exempt
VAT	Not subject to VAT	VATable

Grant or contract?

Unfortunately it is not always easy to distinguish between a grant and a contract. The common sense view would be that a grant is a donation and a contract is a payment for services. However, as always with tax, there are complications.

HMRC VAT GUIDANCE ON GRANTS AND CONTRACTS

Charities often receive funding to support their charitable activities. If funding is freely given, with nothing supplied in return, then no VAT is due as the funding is not consideration for any supply and therefore is outside the scope of VAT.

However, some funding may be given in return for goods or services supplied by the charity. Such funding is consideration for a supply and VAT may be due on the income if the goods and/or services supplied by the charity in return are taxable at either the standard or reduced rate.

Often funding is given subject to the provisions of a contract or agreement, the terms of which may be indicative of the nature of the funding.

However, it is important to note that many such contracts or agreements are drawn up purely to ensure that the funds are used for the intended purpose. It is important not to confuse 'good housekeeping' with supplies of goods or services. Attaching conditions or safeguards to the payment of grants to ensure that the money is spent correctly does not turn it into consideration for a supply. Please remember that a contract or agreement can be oral as well as written.

Additionally, certain 'benefits' to the funder, for example copies of reports, may arise as a result of necessary safeguards to ensure the money is spent correctly and that the end product is put to proper use. Usually where these are incidental to the primary purpose of the project and are minimal in relation to the amount of funding, the funding is not seen as consideration for a supply.

This matter has been the subject of recent VAT case law and some guidance has emerged, which can be summarised as follows:

In a grant situation the following characteristics are typical:

- The charity will approach the funder
- The charity will define how the monies will be spent
- The funder will have discretion whether to give money
- The funding agreement will cover the 'change of mind' situation and a grant because may be terminated
- There will be a relationship of trust and the agreement will cover the consequences of breach of trust
- There may be terms and restrictions relating to

accounting for the grant (commonly referred to as "good housekeeping")

- The funder will not be purchasing a benefit.

In a business contract the relationship will be defined differently and the questions to apply are:

- Is the income received consideration for a supply?
- Does the funder receive anything in return?
- If not the funder, does a third party benefit?
- Is the charity under certain obligations to the funder?
- Are there conditions attached to the provision of the money beyond normal "house-keeping"?

If the answer to any of the above questions is "Yes" then the funding may be consideration for a supply of services.

HMRC'S GUIDANCE CITES A CASE THAT EXPLAINS SOME OF THE NUANCES

A Citizens Advice Bureau (CAB) provided free legal and other advice. It received grant funding from, amongst others, the local authority. The local authority, as a condition of grant funding, required a service level agreement to be entered into by the CAB, detailing opening times, levels of service etc. On this basis the CAB viewed the funding, and linked agreement, to be consideration for a taxable supply of services to the local authority.

On appeal to the VAT tribunal it was found that there was nothing in the service level agreement to support the CAB's view. In the Tribunal's view, although strings were attached to the grant given by the local authority, that in itself did not create a supply. This was because the local authority did not derive any direct benefit from the advice given. Its only benefit was the indirect knowledge that it had helped fund a service that might be of benefit to its citizens. The strings attached to the grant funding were simply good housekeeping measures by the local authority. The only supplies made were to the local citizens and, as these were mainly free of charge, there was no supply for VAT purposes.

The only exception is where legal advice is given by a CAB to a citizen who qualifies for legal aid. In such cases the legal advice given is subject to VAT. This is because the CAB has received specific payment, from a third party, for specific advice given to a citizen.

What is the VAT liability?

The next issue is how does one determine the liability? Even if the arrangement is clearly a contact for the supply of services under a grant certain types of supplies will not be VATable. The nature of the services and who they are provided by will determine the VAT treatment, The VAT legislation provides for exemption in the following main areas;

VATA 1994 Schedule 9: Exemptions

- Group 6 – Education
- Group 7 – Health and Welfare
- Group 10 – Sport
- Group 13 – Cultural Services.

If the contract falls outside the above exemptions then VAT will be chargeable on the supply at the rate relevant to the actual service provided.

It is important to recognise that the definitions for what falls under the various groups are specific and care should be taken to establish whether the different

criteria are met. For example welfare services and related goods, supplied consistently below cost by charities to distressed people for the relief of their distress, are not business supplies (see Section 1.6)

There are also special rules for education and vocational training (see Section 8.3)

Many of the exemptions are only available to eligible bodies such as charities and as explained in Section 4.2 the VAT position may be different and sometimes more advantageous if a trading subsidiary is used.

It is also important to check what the contract says about VAT. If the contract is silent on VAT then it may well be that any VAT due is deemed to be included in the contract amount. **This matter should be addressed at an early stage in drawing up the agreement.**

If the contract is with a local authority they are probably able to reclaim the VAT charged. Other funders may not be able to recover the VAT. This may influence how a charity structures the agreement.

8.2 COLLABORATIONS, PARTNERSHIPS AND CONSORTIA

Direct tax

Increasingly charities are deciding to work together to achieve their charitable objectives. The direct tax implications of these arrangements depend mainly on the structure of the vehicle chosen.

Simple joint venture or collaboration

This is simply a method of accounting for joint projects. The income and costs are allocated to a single cost centre and are then divided up between the charities in an agreed proportion. There are no particular direct tax issues, unless the activity is non-charitable in some way, in which case it might need to be carried out through a trading subsidiary.

Partnership

A partnership has a separate legal existence, although for tax purposes the results are treated as belonging to each of the partners in their respective shares. Therefore if a partnership is carrying out charitable activities, the charity's share is treated as carried on by the charity.

If the activities are non-charitable the partnership member is likely to need to be a trading subsidiary of the charity, rather than the charity itself. The charity needs to be very clear on which entity is actually the partner and make sure that agreements are drawn up in the name of the correct body.

Joint venture company

Some charities choose to carry out joint venture activities through a subsidiary jointly owned by the participants. If all the shareholders or members are charities, then the company can take advantage of the 9 months' exemption for Gift Aid payments, but

otherwise Gift Aid payments will only be allowed in the tax accounting period in which they are made.

Where a joint venture company is only partly owned by a charity there is a more difficult issue with Gift Aid, which is that it can be treated as a distribution in respect of shares, i.e. as a dividend, which is not a tax-effective payment.

Limited Liability Partnership (LLP)

An LLP is a corporate body with limited liability, but which is treated as a partnership for tax purposes. It is therefore not taxed as a separate body, but its results are included proportionately in those of its members.

An LLP is particularly useful if a charity is entering into a joint venture with a non-charity. If the joint venture is carried out by an LLP, the charity can participate in the LLP through a wholly owned trading subsidiary, and benefit from the nine month extension to Gift Aid.

VAT position

The main issue for charities involved in working arrangements with other parties is to look at whether a new legal entity has been established for the purposes of VAT registration.

Where there is a new legal entity it is also important to look to see what the position is in relation to the liability of services supplied. In Section 8.3 below there is discussion on the change of liability for services which are delivered by a body with eligible body or charitable status.

A further consideration will be the status of the new entity in the purchase of goods and services and whether the VAT reliefs that were available to the charity continue to apply.

8.3 EDUCATION AND VOCATIONAL TRAINING

Also see Chapter 9 on training and conferences.

Direct tax

An educational charity such as a school, college or university is providing education in exchange for fees. This is a trading activity and is subject to direct tax, but will be exempt if it is within the charity's primary charitable purpose and for the public benefit (see Section 2.11).

Before the Charities Act 2006 the provision of education itself was a charitable purpose. Since the enactment of the Charities Act, in order to be charitable the education has also to be provided for the public benefit.

"Open" courses

Open courses are courses where access is not

restricted, although they may be subject to entrance criteria, such as age, qualifications and residence. Attendance is not confined to a narrow class of persons, such as employees of a particular company. Courses that a school, college or university provides for its normal student body will be regarded as open courses.

Open courses will usually be regarded as falling within an educational charity's primary charitable purposes, although the Charity Commission's guidance on fee charging should be taken into account.

Closed courses

HMRC's view is that the public benefit criterion is not met by universities or other bodies for direct tax purposes when they offer "closed courses". HMRC has issued the following guidance for universities:

HMRC GUIDANCE FOR UNIVERSITIES ON CLOSED COURSES

A closed course is broadly one where:

- The attendees are drawn from a narrow range of the public, or
- The criteria for selection for the course exclude the wider general public, or
- The benefit is not to a sufficiently wide sector of the public

A typical example would be where a university provides a course or training specifically for a single business.

HMRC considers that courses which are "closed" typically have a different purpose to a university's main educational activities. In determining the tax treatment of a closed course... the main point to consider is whether the activity passes the charitable purpose requirement. Closed courses are clearly within the charitable purpose heading of the advancement of education, but the question is whether they also provide a private benefit.

Notwithstanding the above there are clearly cases where a charity may make courses generally available but also run some courses which are focused on a narrower sector (e.g. a particular industry) and that in itself should not mean that the activity is taxable.

Example 1:

A charity whose objects are to provide first aid training might accomplish this by running a variety of different courses, both open and closed, on its own or as part of a first aid programme for different

organisations. The wide range of courses means that there is no restriction in access, and everyone who wishes to learn first aid can find a course to suit them. Teaching first aid must by definition be for the public benefit, and the fact that some of the courses are tailored to the needs of particular companies does not stop them being for the public benefit.

Example 2:

A university's Faculty of Business and Management provides closed management courses for a financial

company. Arguably it is not doing this for the public benefit. The benefit of the enhanced management skills of the trainees would be for the paying company

alone. The aim of the company would be to gain or improve a competitive advantage, and not for the general public benefit.

VAT position

The provision of educational and training courses as defined for VAT purposes is exempt from VAT when supplied by an eligible educational body. An eligible body is:

- A school
- A university, further education body etc
- A public body
- A body which is precluded from distributing and does not distribute any profits it makes, and which applies any profits made from a supply of education to the continuance or improvement of such supplies
- A provider of English as a Foreign Language course.

Therefore in the fourth bullet point above it can be seen that provided an educational charity (other than a school, university etc.) ring-fences the surpluses arising from educational activities it may provide education exempt from VAT.

It is worth considering whether this is necessarily the best position for the charity as, if the supply is taxable, there is improved input VAT recovery. For example if the recipient of the education can recover VAT it may be better not to ring-fence the surplus and to pay any profits into the general funds of the charity thereby invalidating the exemption. Alternatively the charity may choose to provide the education through the means of a non-eligible trading subsidiary. If it is provided to bodies that can recover the VAT, the subsidiary will be able to charge VAT on top of the fees, and recover VAT on all expenses. Care needs to be taken with this approach.

There has been a recent review of what constitutes an eligible body for education services. Following the review, HMRC have concluded that, in many cases where a university trading company provides education, they are acting as a 'college, institution, school or hall of a university.' As a consequence it is an 'eligible body' for the purposes of Group 6 Schedule 9 VATA 1994. This means that any education or training provided by the subsidiary

trading company is an exempt supply of education. The trading company has to meet certain requirements to qualify. Further information is available in VAT Information Sheet 03/10 issued in March 2010.

The supplies of goods or services which are closely related to an educational supply are also exempt if provided to pupils, students or trainees by the eligible body making the principal supply.

Vocational training

The provision of vocational training and associated goods and services by any body is exempt from VAT provided that the consideration is payable out of a charge to funds provided under the Employment and Training Act. Up until March 2010 this applied to funds that are ultimately provided by the Learning and Skills Council (LSC). After this date the LSC's functions are taken over by local education authorities and the new Skills Funding Agency.

Vocational training means:

Training, retraining or the provision of work experience for:

- Any trade profession or employment
- Any voluntary work connected with:
 - Education, health, safety, or welfare or
 - The carrying out of charitable activities.

The place of supply of education should be considered. Education is supplied in the place where it is physically performed. A supply that is outside the UK is outside the scope of UK VAT.

However the rules will change in 2011. Educational supplies will take place in the customer's country when they are in business and in the UK when the recipient is a private individual or not a business. Further information on this matter will be released by HMRC.

The provision of an educational conference is treated similarly to the general provision of education above.

8.4 CONSULTANCY

Direct tax

A charity providing consultancy is likely to do so under a contract, and this would be a trade for direct tax purposes.

HMRC have explained that consultancy services are usually carried out with a profit motive and will often not meet the primary purpose criterion. However, in a

number of cases this statement is too broad, and the consultancy services may be clearly furthering the charity's objectives. Simply because they also make a profit does not mean that the income is taxable as the primary purpose trading exemption should apply.

Consultancy covers a wide range of activities from training to advice. HMRC's guidelines describe consultancy provided by universities as follows:

HMRC GUIDANCE FOR UNIVERSITIES ON CONSULTANCY

For the purposes of these guidelines "consultancy" includes the provision of advisory services by students, researchers, administration or academic staff; technical analysis; sample testing; data processing services; and general "services rendered" agreements provided by a university and not work carried out in the name of individual academics as private consultants.

Consultancy and Services Rendered activities will have some of the following features:

- The application of existing knowledge rather than the creation of new knowledge
- Focused on the customer's specific business or products
- In line with similar services provided by the private sector
- Financial structure that recovers in excess of the salary and direct costs and a reasonable proportion of overheads
- Client confidentiality is a key factor.

Consultancy and the provision of similar services for consideration is more likely to be a non-primary purpose trade activity than a primary purpose activity by the nature of the contracts entered into and the common features noted above.

Provision of consultancy to a business on improving its products, or management consultancy provided on improving its processes would fall within the above guidance and not be regarded as for the public benefit.

It should be noted, however, that if the consultancy is carried out by the students it may in any case meet the "beneficiary trading" rules (see Section 2.7).

In the case of universities HMRC have explained that where it can be demonstrated that the main purpose of the charity in carrying out the consultancy is to obtain access to results for academic research or teaching purposes it may be possible to treat it as a primary purpose trade. They give the somewhat atypical example of university archaeology departments which:

"undertake contracts with property developers to meet the legal requirement for archaeological surveys on construction sites. This would appear to be a commercial arrangement with a commercial entity. However, where the university enters into the arrangements to carry out research on artefacts and collect data to which it would not otherwise have access, its purpose in entering into the consultancy contract may be to carry out research."

VAT position

Consultancy services are generally subject to VAT at the standard rate.

Charities will also need to consider the place of supply of any international consultancy services.

8.5 RESEARCH

Charities such as universities or research institutes often carry out research on a paid basis.

Direct tax

If the payment is a grant which merely requires the research to be completed, and if the carrying out of research is part of the organisation's charitable objectives, there should be no direct tax consequences.

However, if the person paying for the research acquires rights to the results it could be argued that the research is not for the public benefit, and thus not for charitable purposes. The charity could be deemed to be carrying on a non-primary purpose trade.

This is not likely to be the case where the funding organisation is itself a charity or a government body but could apply (say) with a pharmaceutical company funding medical research through a charity.

When considering this aspect HMRC and the Charity Commission will review whether the research is made available in the public domain. The Charity Commission guidelines suggest that the appropriate academic timeframe for dissemination of the research would normally be within six months of the research being completed. They will also consider whether the research is impartial and does not simply advance the views of or provide an advantage for the sponsoring organisation.

HMRC's published guidance for Higher Education Institutions incorporates guidance from the Charity Commission on research and within that guidance they have explained that to be charitable, research carried out or funded by a charity must both fall within its objects and powers and be carried out for the public benefit.

HMRC GUIDANCE TO UNIVERSITIES ON CHARITABLE RESEARCH

Research will ordinarily qualify as charitable if:

- (a) The subject matter of the proposed research is a useful subject of study; and
 - (b) It is contemplated that knowledge acquired as a result of the research will be disseminated to others;
- and
- (c) The research is for the benefit of the public, or a sufficiently important section of the public.

The Charity Commission guidance set out in their publication "Research by Higher Education Institutions" explains the public benefit requirements. Extracts from this guidance are reproduced below.

"Research must be undertaken with the intention that the useful knowledge acquired from the research will be disseminated to the public and others able to utilise or benefit from it and so advance charitable purposes.

Public benefit may arise from research in a variety of ways. In many cases, the dissemination of the useful

knowledge gained will constitute adequate public benefit. In other cases, particularly, but not exclusively, where the charity's objects are directed towards the provision of charitable relief for beneficiaries, public benefit may arise from the practical development and application of a research outcome. This might be achieved with or without collaboration with a commercial partner. Research undertaken not as charitable activity may still, nonetheless, be undertaken by a charity".

Example

A research institute carries out research on wheat genetics to improve crop yields. The research is funded by a major agricultural producer which patents the results and uses them to develop a new strain of wheat which it markets commercially. As the benefit is to the agricultural company, which also holds the IPR, the research institute is carrying out non-charitable research and any profits will be taxable.

Example

A university's medical faculty is funded by the NHS to carry out research into influenza and to test new anti-influenza drugs. The results will eventually feed into the NHS's anti-flu strategy. It is likely that the results will be published, but even if they are not, the NHS will use them for the public benefit, so the research by the university will be primary purpose and any profits arising would be tax-free.

VAT position

Grants provided by central government to fund research are outside the scope of VAT. This would include grants from one of the research funding councils.

The provision of research by an "eligible body" to another eligible body is exempt from VAT. For this purpose an eligible body includes a university or research institute, but also UK Government departments, NHS bodies and most UK charities.

Some EU funded research projects are zero-rated.

Research commissioned by a commercial body is a

business activity. In this case the liability depends on the status of the recipient and where the research takes place, but if the funder is based in the UK the supply will usually be standard rated.

Where projects are jointly funded by the government and by third parties such as commercial funders (e.g. with matched funding), the commercial part of the funding may fall within the scope of VAT.

Research as such is not defined, but it is viewed by HMRC as 'original investigation undertaken in order to gain knowledge and understanding'. It is the intention at the beginning of a project that determines whether a supply qualifies as research. If the intention is to advance knowledge and understanding, the supply is one of research. Merely confirming existing knowledge and understanding is not research.

The following are examples of work which are not accepted as research by HMRC, and which would therefore be subject to VAT:

- Consultancy and business efficiency advice
- Collecting and recording statistics without further interpretation
- Market research and opinion polling
- Writing computer programs
- Routine testing and analysis of materials, components and processes.

However if the above are included as part of a larger research project they may well qualify.

Goods used for medical or veterinary research are zero-rated.

8.6 ROOM HIRE

Direct tax

Where charities are not using their facilities all the time they often hire out their rooms to other organisations or individuals. Where no additional services are provided, and the charity essentially hands over the key, this is treated as income from property which is exempt from direct tax.

Many charities provide room hire on a very small scale, but charities with function space or lecture rooms can turn this into a large and quasi-commercial operation. The term “quasi-commercial” is used because the charity is seeking to maximise the use of the assets that it owns, not to run a trade of hiring out rooms. Typically a charity is simply seeking to offset its expenses.

Where a charity provides services such as catering, bed and breakfast and services other than just the bare letting of rooms then it is likely that a trade is being carried on, which would usually be non-charitable. Where a charity provides space and catering for weddings, or runs a private sports club in a sports centre, these would be regarded as non-charitable trading.

HMRC have re-emphasised that the use of student residential accommodation and other university and school owned premises by non-students and the associated income generation activities such as the provision of bars, external catering, and conferences, also to non-students, may be a non-primary purpose trading activity. Providing accommodation, catering, and other facilities to conferences run by the university where the focus is on education and research topics

and the sharing of knowledge or best practice in teaching or research, should be accepted as being part of a primary purpose trade.

The provision of accommodation and similar services to third parties for the purpose of generating income by utilisation of surplus capacity would normally be non-primary purpose trading and subject to tax.

See also rental income and lettings in Section 10.2.

VAT position

Basic room hire falls under the VAT exemption for the supply of land. Where the charity has exercised an option to tax on the property the supply will be standard rated unless the supply is to another charity which is to use the facility for its non business activities (in which case the option to tax is “disapplied”).

Where catering is provided with the room hire the supply may become VATable. For example the provision of room hire with a full meal (such as a wedding reception) would be regarded as the provision of catering and subject to the standard rate of VAT. However if just tea and coffee are supplied the provision of room hire would remain exempt (subject to the option to tax).

Where facilities are provided with the room hire (e.g. overhead projector etc) the supply would remain exempt if the charge is all-inclusive. However where personnel are supplied (say to operate the projector etc) the supply would be viewed as a supply of services and subject to VAT unless there are separate charges for the room hire and the services provided.

8.7 FREQUENTLY ASKED QUESTIONS

Our college runs Teaching English as a Foreign Language (TEFL) courses over the summer when the students are away. We hire the teachers and do all the organising. Is this a primary purpose trade?

Short answer

Running TEFL courses would count as the provision of education, but since the Charities Act 2006 the trustees have to consider whether the courses are providing public benefit.

In more detail

The trustees need to ask themselves:

- What criteria do we use to select beneficiaries? Is anyone excluded from being a beneficiary? If so, who is excluded and why?
- Is there any provision for reduced fees for poorer students?
- Who are our competitors – are they other charities or are they commercial bodies? Are our terms commercial or charitable?
- Are we doing this because we are fulfilling our educational objectives, or are we doing this to make money?

If the trustees believe that running TEFL courses is part of their educational objectives then this should be documented, and the reasons why. The answer may not be clear cut, in which case it may be safest to run the activity through a trading subsidiary, but the VAT implications should be considered. TEFL is exempt from VAT no matter what the status of the teaching body.

We regularly provide meeting and conference space to other bodies, including other charities. This includes coffee and sandwiches at breaks and lunchtime. Should we do this through a trading subsidiary?

Short answer

Providing conference facilities is a non-charitable trade. To avoid risks, if the income does not fall within the small scale exemption, use of a trading subsidiary is recommended.

In more detail

It may be possible to argue that providing conference space for other charities with the same objects could be a charitable trade. However, the trustees should also consider what it is charging the charities. Is it at the same rate as other bodies or are there special rates for charities? Reduced rates for other charities would be evidence that the organisation is trying to support their objectives rather than just turn a profit. HMRC has commented that a university providing facilities to third party education providers e.g. The Open University or other charitable purpose organisations would be primary purpose.

It may be easier to put the whole operation through a trading subsidiary, rather than try to draw fine distinctions between different types of user.

The room hire should be exempt from VAT provided that there is no option to tax in place. It should be noted that any option to tax made by the charity will be applied to any charge for the use of the building to the trading subsidiary. The trading subsidiary will need to consider whether it needs to make its own option to

tax taking into account its ability to recover any VAT on the charge from the charity.

We are a school and we let out our facilities in the summer to privately operated summer schools. We provide catering and bed-making, laundry and cleaning services. Our auditors have advised us to put this activity through a trading subsidiary, but this means that we will have to charge VAT. Is there a solution?

Short answer:

The supply of serviced accommodation in the above way would be treated as a supply of facilities in a hotel and would be standard rated. The law provides for this as the provision in a hotel, inn, boarding house or similar establishment of:

- Sleeping accommodation
- Accommodation in rooms which are provided in conjunction with the above e.g. bathrooms etc and
- Accommodation for the purpose of a supply of catering.

Where there is an element of room hire for general

purpose the supply can be exempt if this can be separated from the other charges.

In more detail:

If the summer schools were run by other charitable educational bodies then it could be arguable that this is a primary purpose trade. However, given that the summer schools are run by commercial companies this argument is unlikely to succeed.

A partial solution would be to separate out the charge for rent and the charge for services. The contract for renting the premises could be with the charity, and this would be exempt from direct tax. It would also be exempt from VAT provided that there was not an option to tax in place. The contract for catering and all the other non-landlord services would be with the subsidiary, and this would be both VAT-able and subject to tax but the profits can be Gift-Aided. This reduces the amount of VAT that would have to be charged if the whole operation went through the trading subsidiary. The charity would need to charge the cost of providing the services to the subsidiary, and the VAT position would need to be reviewed.

8.8 KEY FACTS

The difference between a grant and a contract is not usually important for direct tax but is crucial for VAT purposes. A very broad summary would be that a grant is essentially a donation and a contract is a commercial agreement for the provision of services, but in practice where the charity's activities are highly specified it can be difficult to tell the difference.

Joint ventures should be structured carefully in order to minimise tax liabilities. Professional advice should be sought in this area.

Since the 2006 Charities Act it is not enough for educational charities simply to be providing teaching services. The teaching must be for the public benefit, and this requires the possibility of access to the general public. Charities that restrict access due to high fees or that run closed courses are not regarded as providing education for the public benefit.

Consultancy activities need to be carefully reviewed. They may be for the public benefit, or they may be to benefit a single company. If the latter, they would not fall within the primary purpose exemption.

Research will be regarded as being for the public benefit if the research is useful and the results are published soon after carrying out the research.

The hire of rooms is treated as rental income and exempt from direct tax, but if additional services are provided over and above those that a landlord would normally provide this could be a non-charitable trading activity and the profits could be taxable.

The VAT treatment is exempt but with the option to tax. There are more details on this in Section 10.2.

Where there is a supply of staff or of significant catering the room hire will be taxable, unless there is a separate charge for the services, in which case the room hire alone should be exempt from VAT.

9

Training and Conferences

- 9.1 Conferences
- 9.2 Sponsorship of conferences or training
- 9.3 Exhibition stands
- 9.4 Frequently asked questions
- 9.5 Key facts

9.1 CONFERENCES

Charities often run conferences for their members, supporters and other interested people.

Example 1

A charity whose objects are to support blind people and prevent blindness runs an annual conference for health professionals in the field. The programme includes the presentation of scientific papers, and opportunities to network with fellow professionals.

The following sources of income arise:

- Admission fees from attendees
- Sponsorship of the conference by one or more medical companies
- Exhibition stand income from commercial companies selling products that help with blindness
- Ticket income from an evening dinner
- Advertising in the conference brochure.

Direct tax

The issue here is whether it is possible to treat such a conference as a single event, which would be regarded as a primary purpose trade, or whether the conference income needs to be split into its constituent parts which are then treated separately. Before Finance Act 2006 the view would have been that the conference was a single primary purpose activity and the trading income from advertising and the exhibition were part of that activity. However, Finance Act 2006 specifically says that where an activity is part primary purpose and part not, each part has to be treated separately for tax purposes (see Section 2.6).

This leads to a difficulty in cases such as advertising and sponsorship where each source of income is relatively easy to identify, but the costs relate to the whole activity and cannot be separately identified. For instance, the conference sponsorship would not be available if there were not a significant number of people attending the conference. As regards the advertising, the brochure is likely to be given to the attendees as part of a conference pack, so there will be no direct income from this source.

Admission fees, ticket income and advertising

The conference is not a fundraising event. The charity may be budgeting to make a profit, or to fund any excess of expenditure as part of its charitable activities. If the different aspects need to be divided between charitable and non-charitable trading, then holding the conference itself and providing a venue for scientific papers is a primary purpose activity. The admission fees and probably the evening dinner will be primary purpose, given that the object of the dinner is to allow attendees to network. If the advertising in the course brochure does no more than offset the costs, arguably the income should be treated as part of the conference activity. If not, there is a difficulty as to how to allocate the costs of the brochure, which are effectively part of the costs of the conference.

Sponsorship and exhibition stand income are discussed in sections 9.2 and 9.3 below.

VAT

An educational conference organised by a charity that is an “eligible body” is a VAT exempt supply. An eligible body for these purposes is a school, college or university, an English as a Foreign Language provider or a charity that uses any surpluses generated from educational courses for the continuance or improvement of such supplies. The exemption includes any accommodation catering and travel provided to delegates.

Income from conferences organised by businesses that are not eligible bodies, such as trading subsidiaries that are companies limited by shares, is subject to VAT at the standard rate. If a standard rated conference includes accommodation and/or travel for delegates it will fall within the VAT Tour Operators Margin Scheme (TOMS).

For VAT purposes it is also possible for a charity to treat a conference as an exempt fundraising event, providing the usual conditions are met in that the conference is organised primarily to raise funds for the charity and it is promoted as a charitable fundraising event (see Chapter 7).

9.2 SPONSORSHIP OF CONFERENCES OR TRAINING

Direct tax

The tax treatment here is not definite, and may depend on the amount of income from these sources, compared to the costs.

However, it is likely to follow the treatment of sponsorship set out in Chapter 7 Events, in accordance with HMRC guidance. If the overall function of the conference is to carry out the charity's primary charitable purpose, then the sponsorship will be

treated as part of a primary purpose trade and the profits will not be taxable.

Nevertheless advice should be taken with regard to the charity's own circumstances.

VAT

Sponsorship in this situation will be subject to VAT as there is a clear benefit to the sponsor. A full discussion can be found in chapter 3.

9.3 EXHIBITION STANDS

Typically at a conference there will be an area for commercial companies to set up stands. This is clearly advertising, although in some circumstances the advertising could be primary purpose. For example, if the charity's primary purpose is to support people who are blind then advertising products and services to help blind people would be likely to be a charitable activity.

However, there are likely to be a number of marginal cases, and stands which are very indirectly related to the charity's objects. Therefore it is likely to be preferable to run the exhibition through a trading subsidiary.

CASE STUDY

Green Schemes decides to run a high profile conference on the theme of "Climate Change – what can we do?" It invites a number of scientists and authors to give presentations and take part in panels, and asks the Minister for the Environment to make a key-note speech.

The costs are expected to be £100,000, and the charity will need to find external funding for most of this. It manages to persuade an international banking group to sponsor the conference for £30,000. The bank's branding will be on all the conference materials, and on banners at the event. The bank will also receive free exhibition space. There will be a conference dinner, sponsored for £10,000 by a manufacturer of solar panels, who will also receive free exhibition space.

Budgeted income:

Bank sponsorship	£30,000
Dinner sponsorship	£10,000
Exhibitors	£20,000
Admissions	£10,000
Total income	£70,000

Clearly on these figures the conference will make a loss overall. As running the conference will be part of the charity's primary purpose the loss of £30,000 will be regarded as charitable expenditure, and the charity would not need to use a trading subsidiary.

The exhibition should however be considered separately. It should at least make a profit on the basis of marginal costs, and therefore it may need to be put through the trading subsidiary.

VAT position

The supply of an exhibition stand space by the charity to an exhibitor for advertising purposes is a supply of services. However it would not qualify for the zero rating relief as a supply of advertising.

A charge made to the exhibitor to put up a stand in a designated area at a conference is a supply of land and would be exempt from VAT unless the charity has opted to tax the conference area.

9.4 FREQUENTLY ASKED QUESTIONS

We are a charity that does not supply education ourselves, but we provide assistance to our members which are educational bodies. We run an annual conference with an exhibition for suppliers of services to educational bodies (e.g. publishers, computer companies, facilities providers etc). Can the exhibition be regarded as a primary purpose trade?

Short answer

This isn't a simple question, and partly depends on the trustees' intentions. Is the purpose of the exhibition to support the members or is it to make money for the charity? It may be simplest to put it through a trading subsidiary.

9.5 KEY FACTS

When charities run conferences these are usually to carry out their charitable objects, and would therefore be primary purpose trading.

Sponsorship income is likely to be treated as part of a single conference trade.

Since FA 2006 it is possible that exhibition income may have to be separated out and treated as a separate trade.

For VAT purposes each form of income associated with the conference will have a different tax treatment.

10 Other Areas

- 10.1 Overseas operations
- 10.2 Rental income/lettings
- 10.3 Sports facilities
- 10.4 Property sales
- 10.5 Gift Aid and admission to premises
- 10.6 Frequently asked questions
- 10.7 Key facts

10.1 OVERSEAS OPERATIONS

Direct tax

Many charities trade overseas and the trustees must also consider local laws in addition to the UK laws and regulations.

UK tax exemptions for charities will apply for UK tax purposes even if the trade is carried out overseas.

However, local tax law in the overseas regime will not automatically allow the same concessions and exemptions as apply in the UK. In many overseas regimes the concept of charity is not recognised as it is in the UK. Simply setting up an operation overseas can lead to the creation of a permanent establishment which is a taxable entity for overseas tax purposes.

The trustees have to make a decision on whether to operate through an overseas branch, or a separate legal entity such as a trading subsidiary.

In some cases it may be better to trade through the UK operation but even if this does not create a taxable presence overseas there could be withholding taxes. These taxes usually apply if there is an activity that involves the payment of royalties, interest or dividends, although some tax authorities apply withholding tax to intellectual property rights and consultancy activities and other trading income. Withholding tax can often be mitigated or avoided altogether through the

application of relevant double tax treaties. Often the local tax authorities need to give approval for the treaty relief to be given in advance of any payments.

Withholding tax needs to be carefully considered when charities are negotiating contracts with overseas entities, and the contract should be clear on which party bears any liability.

In some cases it may be possible to use one overseas establishment in a favorable tax regime to cover operations in different countries.

It is important for charities to take advice on the relevant local laws when considering operating overseas.

VAT position

The VAT situation for overseas supplies has been examined under the various types of supplies in other sections.

A further point to note that that export of charity goods to a charity's overseas operations is zero rated for VAT purposes. Also where the operation is by way of business it may be possible to recover VAT incurred in overseas countries that are part of the EU but more detailed advice should be sought on this matter.

10.2 RENTAL INCOME/LETTINGS

Direct tax

Charities are exempt from direct tax on rental income provided that it is applied to charitable purposes. The exemption covers rental income, ground rents, amounts received as payments for right of access, way leases etc.

The charity tax exemption does not, however, apply to

trading activities that charities carry out **on** or **in** their property and this distinction is crucial where charities are providing services that would not normally be provided by a landlord, such as catering, cleaning, bed-making, and the supply of staff.

HMRC's guidance explains:

HMRC GUIDANCE ON RENTAL INCOME

All rental income from land or buildings, received by a charity, is exempt from tax provided the profits arising are applied for charitable purposes.

However, if services are provided along with the use of the land or buildings (for example, provision of a caretaker, food or laundry) these services in themselves might amount to trading. Letting activity will itself constitute a trade where the owner remains in occupation of the property and provides services over and above those usually provided by a landlord. Essentially the distinction lies between the hotelier (who is carrying on a trade) and the provider of furnished accommodation (who is not). An important difference is that in a hotel etc. the occupier of the room does not acquire any legal interest in the property. Each case must be considered on its own facts.

This is discussed further under "room hire" (see Section 8.6)

VAT

The VAT rules of letting are even more complex than the direct tax rules. In essence the charity may opt to tax, that is, it may charge VAT on its rental income. In making this decision the charity will need to consider a number of factors.

It should be remembered that the letting of domestic property and "relevant residential property" is always exempt from VAT. The letting of holiday accommodation is standard rated for VAT.

The option to tax is applicable to the letting of commercial property. However the option may be

disapplied if the letting is turned to residential use or if it is let to a charity for non-business purposes other than as an office (i.e. for a relevant charitable use).

Where a charity has a single operational centre which includes office facilities HMRC may allow the option to be disapplied despite the existence of the office. HMRC will allow up to 5% indiscriminate non business use and this will be set in the legislation from July 2010. The disapplication of the option to tax can lead to input tax recovery problems for the landlord, in particular, if the building was constructed in the past 10 years.

10.3 SPORTS FACILITIES

Some charities have sports facilities which they may want to make available for commercial or public use in order to generate income from the assets.

Direct tax

For direct tax the same rules apply as for property income generally. If the income is pure rental income then it will be exempt from direct tax.

However, if there are services associated with the sports facilities such as the services of staff (coaches, lifeguards), the provision of catering or even setting up and dismantling equipment, then the income may be regarded as trading income.

Running a sports club with a membership scheme would normally be a trading activity.

VAT position

The hire of sports facilities is generally standard-rated for VAT.

However, a let is exempt from VAT where:

- It is made to the same person for a continuous period of at least 24 hours and the person letting has exclusive control of the facilities;
- or
- It is part of a series of at least 10 sessions; and
 - The lessee is a school, club, association or an organisation representing affiliated clubs or constituent associations e.g. a local league and there is exclusive use of the facilities during the sessions;
 - Each session is for the same sport or activity and is the same place but the sessions may be of different duration;
 - The interval between each session is at least 1 day but no more than 14 days (even if the facility is closed for any reason);
 - The series is paid for as a whole, supported by written evidence which stipulates that payment is to be made in full whether or not the right to use the facility for any specific session is actually exercised. Refunds can be made for unforeseen circumstances where the facility is unavailable.

The supply of sporting services to an individual, or, where a membership scheme is operated, to a member is exempt from VAT when supplied by an "eligible body".

Sporting services are services that are closely linked with and essential to sport or physical education, e.g. coaching, refereeing, use of changing rooms and equipment, etc. but not general administration.

To qualify as an eligible body an organisation must;

- be non profit making or have in its constitution restrictions on the distributions of profits, and
- not be subject to "commercial influence" (see below).
- It must also use all profits or surpluses from its playing activities to maintain or improve the related facilities or for the purposes of a non profit making body (i.e. the charity).

Commercial influence exists where a salary calculated by reference to profits or gross income is paid to anyone who is an officer or a shadow officer of the club, or

certain other persons connected with or who interact with them. Further details are specified in the legislation.

If a membership scheme exists the exemption applies where the services are to individuals taking part in the activity who are members of the scheme and whose membership is for at least three months.

The exemption does not apply to any catering or transport that may be supplied with the sports facilities.

Further details are available in HMRC Reference: Notice 701/45 (April 2002)

10.4 PROPERTY SALES

Direct tax

Property sales will not fall within the exemption for rental income. The tax treatment of property sales will generally fall within one of the following categories, where the property is owned by the charity:

- Disposal of property that has been held for a while, either as an investment or for use in the charity's charitable activities, and where the sale is executed without any further development activity. This is a capital gain and will be exempt from direct tax provided the gain is applied to charitable purpose
- Disposal of property which was acquired under a legacy. The exempt capital gains treatment would apply even if it was sold immediately after acquisition, provided that no further development took place
- The sale of a property (whether or not following further development) which has been bought for the purpose of realising a profit on the sale. This will be a trading activity and as the charity's primary charitable purpose is unlikely to include dealing in property (with certain narrow exceptions in the case of charitable housing associations), any profits will be taxable
- Transactions that do not fall fully within the trading category above, but which involve an element of

property development. E.g. where a charity has held a property for some years as an investment, and decides to undertake some building work before sale in order to realise a better return. These transactions can fall within Section 776 ICTA 1988 (see below).

When undertaking property development the trustees would need to review their investment powers and consider whether investing in development activity would be speculative and correct for the charity to undertake.

Charity trustees are required to obtain the best terms when disposing of charity property. This can often have tax ramifications. For example, it may be the best commercial decision to obtain planning consent before disposing of a property and, taking this one step further, the charity may plan to develop the property itself or receive a proportion of the developer's profits (an overage agreement). Neither of these would necessarily amount to trading, but could fall within Section 776.

Sales connected to the development of land – Section 776

Section 776 ICTA 1988 was enacted to prevent the avoidance of tax by persons concerned with land or the development of land. The wording is therefore deliberately wide:

SECTION 776 ICTA 1988

This section applies wherever –

(a) land, or any property deriving its value from land, is acquired with the sole or main object of realising a gain from disposing of the land; or

(b) land is held as trading stock; or

(c) land is developed with the sole or main object of realising a gain from disposing of the land when developed;

and any gain of a capital nature is obtained from the disposal of the land –

(i) by the person acquiring, holding or developing the land, or by any connected person, or

(ii) where any arrangement or scheme is effected as respects the land which enables a gain to be realised by any indirect method, or by any series of transactions, by any person who is a party to, or concerned in, the arrangement or scheme;

and this subsection applies whether any such person obtains the gain for himself or for any other person.

Example

A charity has a property valued for sale at £1 million. It has been used as a charity building for many years and is being sold because the charity is moving offices. When it is put on the market a developer offers £800,000 plus 10% of the profits from the development. This is known as an overage contract. In the event the charity receives a further £400,000 on top of the £800,000.

The overage contract will fall under Section 776. However, providing the original valuation is correct

and can be justified, the charity will only be taxed on £200,000 or the excess over the original £1 million valuation. £1 million is treated as the capital value of the property, and £200,000 as the amount arising from development.

HMRC have clarified that simply applying for and obtaining planning permission will not trigger Section 776.

HMRC GUIDANCE ON DEVELOPMENT

Whether the land has been developed is a question of fact.

'Development' for this purpose is not defined, but is interpreted to mean any physical adaptation or preparation for a new use.

The obtaining of planning permission does not constitute physical development.

One possible way to avoid a Section 776 charge may be to use a separate trading subsidiary. However, under charity law the charity cannot gratuitously give away assets or rights to its trading subsidiaries and transactions will need to be on an arm's length basis. Moreover transactions involving disposals of land and buildings to a trading subsidiary are fraught with tax and accounting complications, and need to be considered very carefully.

VAT position

The sale of a commercial building that is under three years old is subject to VAT. After the three years the sale is exempt from VAT but with the option to tax (see section 1.8). Charities may consider opting to tax buildings prior to sale in order to recover VAT on professional fees or on preparation of the property for sale. This decision will very much depend on the ability of a potential buyer to recover the VAT charged. Where the property is to be purchased for the conversion to a residential purpose the option may be

disapplied – it is recommended that further advice is taken in these circumstances.

The sale of a residential building is generally exempt from VAT. Where the sale or grant of a lease over 21 years is the first grant of a major interest the sale by the developer is zero rated for VAT.

The first grant of a major interest in a building constructed for relevant charitable purposes is also zero rated for VAT. Relevant charitable purpose means a building that is intended for use as a village hall or for use by a charity for non-business purposes.

The sale of bare land is exempt from VAT with the option to tax. The option to tax is generally not applied where the sale is to a housing association subject to special provisions contained in public notice 742A. The option is disapplied if the sale is to an individual for the purpose of creation of a dwelling. It is recommended that further advice should be taken in these circumstances.

10.5 GIFT AID AND ADMISSION TO PREMISES

Also see Sections 7.7 and 7.8 on cultural events.

Many charities charge a fee to visitors to their premises – for example, an entrance fee to visitors to a museum or zoo. There have been a number of changes to the rules that govern whether this payment can qualify as a Gift Aid payment. Generally, admission charges do not qualify for Gift Aid but if a charity allows visitors an equivalent right of free admission in return for a donation, Gift Aid may apply.

The rules that were enacted in the Finance Act 2005 have broadened the scope of which charities qualify for the exemption so that all charities where the public pays an admission charge to view qualifying property can benefit from the exemption. This means that Gift Aid can be used (in certain circumstances) if the right of admission is a right granted by the charity for the purpose of viewing property preserved, maintained, kept or created by a charity in pursuance of its charitable purposes. Property includes, in particular:

- buildings;
- grounds or other land;
- plants;
- animals;
- works of art (but not performances);
- artefacts; and
- property of a scientific nature.

The rules limit the application of the popular Gift Aid on entry type schemes. The new rules will apply where the following conditions are met:

- The visitor makes a donation that is at least 10% more than the admission charge for the equivalent right of admission.

Or

- The donation secures admission to the property for a twelve-month period, for example through a season ticket or a membership scheme. Access should in general be unlimited whenever the property is open to the public during that 12 month period but

charities may exclude from the right of admission up to 5 days in each 12 month period when the property is otherwise open to the public and still qualify.

The VAT position generally is unaffected and only the additional 10% on top of the admission fee is treated as a donation for VAT purposes.

Family Tickets

If a charity has a membership scheme that meets the conditions discussed above, and a family ticket admits the donor and members of their family, the donor who purchases the family ticket may complete a Gift Aid declaration for the payment of the family ticket.

HMRC have accepted that the charity does not have to ensure that those attending are a “family” and have stated that the definition of “family” is a matter for the charity to decide in accordance with its admissions policy. It is likely that the charity will decide to set limits on the number of adults and/or children who can be admitted by a family ticket. In addition, it is not necessary for all individuals included in the family ticket to enter together. Note that the family ticket scheme does not extend to general group tickets.

Voluntary donations

Many arts galleries and museums are now open to the public free of charge. They often seek voluntary donations from visitors and for the avoidance of doubt it should be clarified that as long as the donations meet the rules the donations will qualify as Gift Aid payments.

10.6 FREQUENTLY ASKED QUESTIONS

**We are setting up trading activities overseas.
Will we get the same tax exemptions overseas?**

Short answer

Not necessarily.

In more detail

Local tax law will in the overseas regime not automatically allow the same concessions and exemptions as apply in the UK. Charities have found that they face local tax liabilities because the exemptions do not work in the same way as they do in the UK. In many overseas regimes the concept of charity as it is in UK is not recognised and simply setting up an operation overseas can lead to the creation of a permanent establishment for tax purposes.

We are disposing of a property which has been owned by the charity as an investment for some years, and we understand that we will get a better price if we (successfully) apply for general planning permission. Will Section 776 apply?

Short answer:

Simply applying for and obtaining planning permission will not trigger a tax liability.

In more detail

However, if the charity then goes on to carry out any physical development work after obtaining planning permission then the profits from this could be taxable under S776. Typically a development will have a number of different stages and it is important for the charity to identify the tax treatment of each different stage.

In addition, if a charity shares in development profit then this will trigger a tax liability.

10.7 KEY FACTS

Trading overseas can lead to tax even if the trade would not be taxable in the UK. The local laws need to be considered. In certain cases withholding tax may be applicable.

Property rental is exempt from direct tax unless it involves the provision of non-landlord services.

Property sales will generally be exempt from direct tax unless they involve either buying or selling land with a view to a profit, or property development. Advice should be taken.

Property sales can be a very complex area both for direct tax and for VAT and charities need to take advice when planning property transactions.

11 Cost Allocation, Transfer Pricing and Loss Making Trades

- 11.1 Basic principles of cost allocation
- 11.2 Loss-making trades
- 11.3 Transfer pricing
- 11.4 Frequently asked questions
- 11.5 Key facts

11.1 BASIC PRINCIPLES OF COST ALLOCATION

Many charities and their trading subsidiaries operate from the same premises and may use joint facilities such as staff, communication services, the computer system etc. In fact many trading subsidiaries do not have any staff or facilities of their own.

In most cases the charity's facilities are used by the trading subsidiary and following the arm's length principle under charity law the charity should levy a fair and reasonable charge.

Direct tax

In the past this area of cost allocation between charities and their subsidiaries was not given much importance. The thinking was that it all came out in the wash and if more costs were allocated to the subsidiary the Gift Aid payment back would be smaller and vice versa. This approach is risky.

Following the Finance Act 2006 and the changes to the trading exemptions found in Section 505 ICTA 1988 HMRC have published new guidance. This explains that trading receipts should be allocated between trades that are taxable and non-taxable on a reasonable basis.

In correspondence with the authors HMRC have explained:

"S505B ICTA 1988 requires that a reasonable apportionment of expenses is made between the primary purpose and non-primary purpose deemed trades created by that section. HMRC does not normally accept a marginal costing basis for the apportionment and looks for an apportionment of all direct and indirect costs. In the higher education sector, for example, the 'full economic costing' which is being introduced may often give the right answer.

"Cost-sharing with a subsidiary does not normally give rise to problems so long as, on the facts, that is what it is. Again, we would expect all direct and indirect costs to be apportioned on a reasonable basis. If a marginal costing approach is adopted then the charity is incurring indirect costs on behalf of the subsidiary. Those costs may well be non-charitable expenditure.

"It is necessary to be clear about whether the charity is dividing costs or providing a service. Many charities find simple division of costs offers the advantage of simplicity."

Therefore the allocation of costs should include both direct and indirect costs, including overheads.

It is important to ensure that the management charges are a fair calculation and only amount to a reimbursement since any profit element could perhaps be regarded as a trading receipt which would not normally fall within the trading exemptions.

Alternatively, HMRC may seek to disallow any excessive amounts in the subsidiary company's tax computations as not being wholly and exclusively expended for trading purposes.

HMRC clarify that the profits of taxable non-primary purpose trading, including capital allowances if applicable, should be calculated in the same way as for any other trader. They emphasise that *"This may involve apportioning what was originally charitable primary purpose expenditure to a non-primary purpose or deemed non-primary purpose trade. Any such apportionment will only apply for tax purposes."*

HMRC have issued the following guidance for allocating costs to trading activities:

EXTRACT FROM HMRC DETAILED GUIDANCE NOTES:

For a non-primary purpose deemed or part-beneficiary trade, S505 (1B) ICTA 1988 now requires that there be a 'reasonable apportionment of expenses and receipts'. This will involve taking into account direct expenditure and a reasonable proportion of indirect expenditure such as overheads, whether or not these were originally incurred for charitable purposes.

For example, if a non-primary purpose trading activity is the charity's only trading activity, is carried on in the charity's premises and takes 30% of the floor area, it might be proper to allocate to the non primary purpose trade 30% of the costs of the premises such as:

- heat and light
- rent
- building repairs and maintenance

Apart from the use of premises, other indirect overheads that may be partly attributable to the trade are:

- employee salaries
- computer costs
- telephone charges
- postage costs
- accountancy and legal fees
- general administration.

The proper basis of apportionment of indirect costs will depend on the facts. In the case of the use of premises, the apportionment might be based on:

- the size of floor space allocated to the trade
- where student accommodation is let to tourists out of term, the number of days in the year when the premises are allocated to the trade, and actively marketed
- in the case of employee salaries, the amount of employee time devoted to the trade compared to total employee time.

HMRC have indicated a preference for a detailed allocation of costs, but the size and nature of the trading activity have to be taken into account. If the activity is relatively small scale when compared to the rest of the charity's activities, an allocation based on turnover might be appropriate rather than carrying out very detailed calculations of employee hours or floor space.

HMRC have issued detailed guidelines on cost allocations in relation to the catering and conferencing activities of universities and these can be obtained from the website of the British Universities' Finance Directors' Group (BUFDG). While the notes have been drafted specifically for universities they include

many statements of general principle which can be extended to other situations and in particular where other educational bodies such as schools or colleges are involved.

It should be noted that by far the majority of the costs in relation to universities' letting activities relate to the fixed costs of buildings. HMRC's view is that the costs should be allocated between periods when the buildings are **in use** by students (generally in term time) and when they are **available** for external (non-charitable) letting (out of term). If the buildings are available for letting but **not in practice fully let** out of term, the costs for these periods would fall under the heading of non-charitable trading. This means that

there is a high likelihood of the non-charitable trading activity making a loss (see Section 11.2). This approach seems unreasonable, given that the fixed costs would be incurred in any case and if no non-charitable trading took place, all these costs would be regarded as charitable.

The BUFDG guidelines are not mandatory and it is open for charities to use another reasonable basis for cost allocation, although this may have to be justified to HMRC.

VAT

VAT should be accounted for on cross charges if the charity is registered for VAT and there is no group VAT registration. In fact this can usually work to the

organisation's advantage.

Many charities are not registered or are partially exempt for VAT, and consequently they cannot reclaim all their input VAT. It is not always fully appreciated that the unrecoverable element may decrease proportionally as VATable supplies increase.

Depending on its VAT recovery methodology it is often beneficial for a charity to try and increase its VATable outputs especially when the supply is to a 'person' who can recover the VAT charged. Therefore, by accounting for management charges with VAT the charity may indirectly increase the amount of input VAT it can recover. Of course, the trading subsidiary should be able to recover all the input VAT.

11.2 LOSS-MAKING TRADES

If a charity is operating a loss-making trade this can have serious effects for direct tax purposes.

If a **charitable** (i.e. primary purpose) trade makes losses there is no direct tax problem, as these are regarded as charitable expenditure. However, the tax treatment of **non-charitable** trading losses is more problematical.

The catch here is that HMRC regard losses on non-charitable trading as **non-charitable expenditure**, which means that if they are left in the charity the charity's tax exemptions are at risk. However, if the trade is transferred to a subsidiary and that subsidiary makes losses, funding those losses is a non-qualifying investment and hence also non-charitable expenditure.

Why would a charity have a loss making trade?

There are a number of possible answers to this:

- The losses are start-up losses. It is common for a new business to make losses in its early years, even

if it is ultimately expected to be profitable.

- The business is profitable but there are unforeseen circumstances that mean a loss is earned in one year
- The trade makes a contribution to the charity's fixed costs. When these costs are allocated against income from the trade on a full-cost basis as advised by HMRC, it makes an overall loss. However, it is still worth the charity carrying on the trade as it contributes net income.

So for example, an educational charity may use its premises for running training courses which fall within its primary purpose. Spare capacity may be used by the charity for non primary purpose activities or the charity may allow other organisations to run courses on its premises. A full cost recovery calculation as required by HMRC (see Section 11.1) may mean that in fact the non primary purpose trade is loss making.

Example 1

A charity runs conferencing activities on its premises. The results for the first year of trading are as follows:

Turnover		£100,000
Direct costs		
Staff costs (i.e. staff employed just for the conferencing activity)	30,000	
Catering	5,000	
Advertising	5,000	
Postage, printing and stationery	3,000	
Indirect costs		
Staff cost (apportioned administrative time)	15,000	
Telephone	3,000	
Light, heat and power	10,000	
Depreciation	30,000	
Allocated costs of shared departments	30,000	
Total expenses		£131,000
Profit/ (loss)		£ (31,000)

In this case, when the depreciation is adjusted for and replaced by capital allowances there may be a taxable profit. However, it can be seen that it is the indirect allocated costs that take this activity into a loss-making position.

There is a detailed explanation provided by HMRC in its guidance to the British Universities Finance Directors Group (BUFDG), as noted above. The following paragraphs attempt to paraphrase relevant aspects. However if a charity is in this situation it should refer to the full guidance.

In their guidance for universities HMRC have explained that if the result of the deemed non-primary purpose trade calculated is a loss (after adjustment for tax), then tax law treats this loss as non-charitable expenditure. Where a charity incurs non-charitable expenditure, it has the following impact:

- Charitable tax exemptions otherwise available against the primary purpose income are restricted;
- The restriction is applied such that for every pound of non-charitable expenditure, one pound of tax exempted income is excluded from tax exemption;
- The restriction removes exemption from this charitable income such that it becomes chargeable to tax in the university. This is referred to as “deemed income” and is chargeable to tax.

Tax relief for losses on non-charitable trading

HMRC have gone on to explain that in certain circumstances a loss on non-primary purpose trading may be offset against the deemed income it creates, under Section 393A (3) (9b) of ICTA 1988. Utilising the loss against deemed income should reduce the chargeable deemed income and taxation liability to nil. However, this only applies in the following circumstances:

Either:

- The deemed non-primary purpose trade is by itself carried out **on a commercial basis with a view to the realisation of a gain**. If the non-primary purpose trade loss does not pass this test it is seen to be an “uncommercial” loss and under tax legislation cannot be offset against other income of the same period.

Or:

- The non-primary purpose trade is not by itself carried out with a view to a gain (or profit), but that trade forms a part of a “Larger Undertaking”; and the whole undertaking is carried on with a view to gain.

Regrettably, there is no real definition of a larger undertaking and for the purpose of this test HMRC have explained that the phrase “Larger Undertaking” is interpreted, for tax purposes, as “normally the whole of the charity’s **trading** activities”, though each case depends on its own facts.

This unfortunate situation has led to the situation where some charity trustees have decided that it is not worth trying to generate further income from non-primary purpose activity. This is not a happy state of affairs and it is hoped that ongoing discussions with the regulators will lead to a satisfactory resolution and a simplification of the rules.

It is crucial when considering using a trading subsidiary that the trustees should prepare detailed projections to determine whether the relevant activity is likely to make a profit.

11.3 TRANSFER PRICING

Under HMRC transfer pricing rules any intra-group transactions must be at an arm's length rate for direct tax purposes.

These rules do not apply to transactions between a

charity and its trading subsidiaries, if the size of the group as a whole (including the parent charity) is below the following limits:

Table showing limits for transfer pricing rules

	MAXIMUM NUMBER OF STAFF (FULL TIME EQUIVALENTS)	AND LESS THAN ONE OF THE FOLLOWING LIMITS:	
		ANNUAL TURNOVER, OR	BALANCE SHEET TOTAL
Small Enterprise	50	€10 million	€10 million
Medium - sized Enterprise	250	€ 50 million	€ 43 million

Small enterprises or groups do not have to apply transfer pricing rules. Medium-sized enterprises are only obliged to apply them if HMRC issue a direction after enquiry into a tax return.

Under transfer pricing rules, intra-group transactions

are treated as being at market value for tax purposes.

However, even large charities are not obliged to apply transfer pricing rules if they are not acting as "enterprises". Enterprise is defined as "the carrying on of any business". HMRC guidance states:

HMRC GUIDANCE ON TRANSFER PRICING:

If a charity enters into a cost sharing arrangement with a connected person, and the costs being shared are incidental to the charity's primary charitable purpose, this is unlikely to represent an enterprise being carried on by the charity.

An example of the above is the case where a charity allows a connected company to use property owned by the charity. If the property is held principally for the purpose of the charity's charitable activities, this is likely to represent no more than a means of offsetting costs, and so would not be an enterprise.

However, arrangements conducted in a commercial way, for the purpose of generating income may well represent an enterprise. As noted above, any form of trade represents an enterprise, but the term also encompasses activity that falls short of a trade if it is undertaken with a view to financial gain.

In the first two paragraphs above, therefore, HMRC would not expect an arm's length rate to apply to the transactions between the charity and its trading subsidiary. In the third it would.

11.4 FREQUENTLY ASKED QUESTIONS

We are an educational charity with large freehold premises that include conference and seminar rooms. We provide conferencing facilities through our trading subsidiary. How much should we recharge to the subsidiary?

Short answer

You should recharge any direct costs of the conferencing activity, if these are not incurred directly by the subsidiary. You should also recharge indirect costs.

In more detail

Under charity law you should charge a market rent to the subsidiary for the use of the premises. This is likely to be a daily rate for the time actually used. If no other services are provided as part of the rental contract then the rent should be exempt in the charity's hands. This means that the agreement for use of the premises should be kept separate from any other agreement for management services.

You should recharge staff costs on a time basis. These

will include the costs of staff working generally on the conferences but also costs of receptionists and porters who will have some peripheral involvement.

There should be a charge for overheads including utilities. This might be on a proportion of time and floor area. You should also recharge costs of shared services such as Finance, HR and IT and general administration.

If the subsidiary is not VAT-grouped with the charity then VAT will also need to be charged on relevant supplies, and in particular supplies of staff and catering.

The charity should also remember to charge for any intangible assets that the subsidiary uses such as its database and name and logo. The agreement for these should be structured so that a tax charge does not arise in the charity's hands.

If the charity is a large enterprise, and educational charities often have too many staff to count as small or medium-sized, it will need to consider how to satisfy the requirements of the transfer pricing legislation

11.5 KEY FACTS

Charities and trading subsidiaries often share premises, facilities and staff. A share of the charity's relevant direct and indirect costs must therefore be allocated to the trading subsidiary.

A similar principle works when a charity carries on non-charitable trading activities, where costs must be allocated to the non-charitable trade in order to determine whether there are any taxable profits.

For direct tax purposes HMRC generally accept that a recharge of the costs alone is acceptable, as any mark-up would itself probably be taxable in the charity's hands.

When a charity and its subsidiaries fall outside the definition of a small or medium-sized enterprise transfer pricing rules may apply meaning that an arm's length rate should be charged rather than simply the costs. This may lead to a tax liability in the charity's hands.

The tax legislation requires a reasonable apportionment to be made of any shared costs. HMRC do not accept that this can be on a marginal cost basis (i.e. ignoring fixed costs that the charity would have incurred in any case). They insist on a full cost apportionment.

Where fixed costs are fully apportioned to a non-charitable trade this may mean that the trade is making a loss for tax purposes. Such losses can be treated as a non-charitable use of the charity's funds, which can cause a tax liability to arise in the charity. Advice should be taken in these circumstances.

12 Social Enterprise

- 12.1 What is social enterprise?
- 12.2 Tax effects of social enterprise
- 12.3 Signposts for companies and Community Interest Companies
- 12.4 Alternative structures
- 12.5 VAT position
- 12.6 Frequently asked questions
- 12.7 Key facts

12.1 WHAT IS SOCIAL ENTERPRISE?

Social enterprise is a popular term for trading activities that in some way benefit the community. Many charities are carrying on social enterprises by carrying

out their normal charitable activities. For instance running a local community centre could be a social enterprise.

12.2 TAX EFFECTS OF SOCIAL ENTERPRISE

Carrying on a “social enterprise” does not confer any tax benefits on an organisation. A charity will be exempt from tax on trading as a social enterprise if this falls within its primary charitable purpose.

Example

A charity which supports adults with learning difficulties runs a café where the beneficiaries are employed. The aim is to demonstrate that the beneficiaries can hold jobs as members of society, as well as earning money both for the beneficiaries and for the charity.

This is clearly a social enterprise, but it is also trading as part of the charity’s primary charitable purpose (and also beneficiary trading). The profits will be exempt from direct tax.

If a non-charity is carrying on a social enterprise activity it will be liable to corporation or income tax on its trading profits, and also any interest or other income that it receives, and it will also be subject to tax on its capital gains. It is likely to receive interest gross and will have to account for tax in its tax return.

12.3 SIGNPOSTS FOR COMPANIES AND COMMUNITY INTEREST COMPANIES

A new vehicle for a social enterprise is a Community Interest Company or CIC. The key features of a CIC are noted in Chapter 4. The main distinction between a CIC and a normal company (limited by either by shares or by guarantee) is the restriction on distributions and the asset lock.

In practice whether or not to use a charity or another vehicle such as a CIC will depend on the circumstances.

Example

Robert and Charles met at drama school and want to set up a community theatre group, putting on plays written by new dramatists and engaging actors in accordance with a stated policy of diversity, including actors who are mentally and/or physically handicapped. The objects of such a body could be charitable, but Robert and Charles need to ask themselves some hard questions before going down the charity route:

- *What are they going to live on? If they are to receive a salary from the company they cannot be trustees*

- *Would they be comfortable handing over control to a body of trustees? Would they expect to have ultimate control over the charity’s direction?*
- *If they want to make donations to the company, even if they are not trustees they need to be careful not to take any benefits out of it – in particular salary and expenses payments would need to be considered very carefully*
- *If the company makes profits what do they intend to do with them? Will they be retained in the company to fund future productions or will they want to take a profit share?*
- *Will they need grant funding to survive? It is generally easier for a charity to access this, although a CIC might have some sources of funding.*

The answers to these questions may mean that although a charity is a possibility in theory, in practice a CIC or company limited by shares may allow Robert and Charles more flexibility.

12.4 ALTERNATIVE STRUCTURES

It may be possible to have the benefits of both charitable and non-charitable status by having a charity and a non-charitable body in parallel. Typically the non-charitable body would be a trading subsidiary owned by the charity, but this may not be practicable.

Example 1

A campaigning organisation has two main activities. One would be regarded as political and non-charitable and the other is a welfare activity which is charitable. Each activity is operated by a company limited by guarantee, but only the second one is a charity. The welfare arm is funded by donations from the campaigning arm and by its supporters. Depending on the voting arrangements the charity may be able to treat the campaigning arm as a trading subsidiary under its control.

However, there are often practical difficulties with such an arrangement. Often the charitable arm will have most of the income, and the campaigning arm most of the expenditure. But the charity cannot fund the non-charity as it does not have charitable objectives.

Moreover, if the organisation's raison d'être is essentially the campaigning, it does not make structural sense for the welfare arm to be the parent company.

Example 2

Robert and Charles (see example above) could set up a production company to provide their services to the charity. They would also be able to provide their services commercially to other non-charitable bodies if they wished. They would have the flexibility to make Gift Aid payments to the charity, and also to pay themselves salaries and dividends if they wished.

In this scenario it would still be preferable for them not to be trustees of the charity. The terms of the contracts between the charity and the production company would also need to be considered very carefully. It should be demonstrable that the charity is paying no more than a market rate to the production company and that using this company is the best way of achieving the charity's objectives. The Substantial Donor rules would also have to be considered.

12.5 VAT POSITION

There is no general exemption from VAT for social enterprises that are not charities but which undertake trading activities. Enterprises operating without a profit motive are still liable to pay VAT. However, those engaged in the provision of education, health or welfare may find that some exemptions apply. The reliefs available on expenditure will only apply to those enterprises that have charitable status.

12.6 FREQUENTLY ASKED QUESTIONS

We're a small arts and disabilities charity. Our aim is to run arts activities for disabled and disadvantaged people. We want to move towards a social enterprise model and set up a trading arm. How do we do this? We are planning to earn money from:

- Running art courses for adults and young people with learning disabilities
- Running a club night for our beneficiaries at a local venue
- Producing and selling CDs and DVDS of the club night
- Helping people with disabilities to produce their own videos
- Setting up an on-line TV channel for short films produced by our beneficiaries, and charging for advertising
- Running art courses for the general public at a local arts centre.

Short answer

A trading arm doesn't need to be a separate subsidiary company. Most of the trading activities above look as though they would be primary purpose, although there may be a question over the advertising and the courses for the general public.

In more detail

Calling an activity a social enterprise doesn't mean anything in tax terms. You still have to go through each activity in turn and decide whether it is a primary purpose activity. Where there is some doubt, or where the turnover from non primary purpose activities exceeds the de minimis limit, then a trading subsidiary may be needed. It is crucial to make this decision on the basis of forecast income and expenditure.

Of course, a trading subsidiary may be needed for other reasons, for instance, to isolate the charity from the commercial risks of trading, or to give trading partners a commercial body to deal with if they tend to equate the word "charity" with "amateur".

12.7 KEY FACTS

Social enterprise is a label that has no direct tax effect. A charity carrying on a social enterprise will be exempt from direct tax on the profits if the activity is a primary purpose trade. A non charity will be taxable on any profits.

There are no specific VAT reliefs or exemptions for social enterprises, but reliefs may be available for particular activities.

If a charity uses a non charitable subsidiary to carry on a social enterprise it will need to consider which body is providing the funding for which activities. Any funds provided by the charity to the other body must support its own charitable objects.

Practical issues such as control and remuneration of trustees may mean that a social enterprise cannot be a charity even if its objects are charitable.

NOTES



The Charity Finance Directors' Group exists to support finance professionals in the voluntary sector, through the provision of information and training, conferences, web-based resources and informal networking. For more information: **WWW.CFDG.ORG.UK**