'TRADING – A SURVIVOR'S GUIDE'

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Trading - A survivor's guide

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PART 1 THE DREADED TRADING

An increasing number of charities are faced the need to finance their work from earned income and as expenditure outpaces income there is a constant need to look for innovative means of income generation. On the voluntary fundraising side charities are trying to increase their slice of the compassion 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. Hence charity shops, commercial sponsorship, affinity card schemes and other sources of charity income generation that arise from earning income. Contrary to popular misconception many charities do have earned income streams arising from fees and sales of products and services. Indeed, earned income is a significant proportion of the income of the UK charity sector. Charities are providing products and services for a fee on a regular basis and these arrangements often leads to the dreaded 'trading' with its consequent charity law and tax implications. As charities widen the range of their income generation efforts, the incidence of trading increases and income generation activities come under close scrutiny to establish what is behind the transaction.

Surprisingly, a number of charities continue be unaware of the ramifications in the extreme, trading activities can threaten the charitable status of a charity since the generation of income per se, albeit for charitable purposes, is in itself not a charitable objective. Apart from the threat of endangering the charitable status there are also the taxation and practical "business" issues to consider.

The aim of charity trading is usually to generate income and profit and it is important to avoid having to pay tax on that profit. Charities are not automatically exempt from tax. The trading exemptions are restrictive and often difficult to fall within.

What is trading?

What then is trading? My dictionary refers to, *"the practice of some occupation, business, or profession habitually carried on especially when practised as a means to a livelihood e.g. shop keeping, commerce, buying and selling".* However our everyday understanding is considerably widened by Section 832 of the Taxes Act 1988 which states that a trade includes, *"every trade, manufacture, adventure or concern in the nature of trade"*. It does not cease to amaze me how unhelpful this circular definition which originates almost 200 years ago is. Consequently, the courts have on several occasions had to scrutinise activities to decide whether they fall within the definition of trade.

A Royal Commission reported in 1955 and identified six main badges of trade:

(i) the subject matter;
(ii) period of ownership;
(iii) frequency of transactions;
(iv) supplementary work;
(v) cause of sale; and
(vi) motive.

Some of the income generation activities of charities are easily recognisable as traditional charity trading - the purchase and sale of goods, Christmas cards and such. In addition, more and more charities are being enmeshed in the trading net for activities that they had thought were part of their normal fundraising effort. For example, commercial sponsorships, affinity card schemes, lotteries, conference income, etc.

What is allowed - Statutory Exemptions

Section 505 of the Income and Corporation Taxes Act 1988 (ICTA 88) gives exemption for trading profits which are used solely for charitable purposes providing:

- the trade is exercised in the course of the actual carrying out of a primary purpose of the charity; *or*
- the work in connection with the trade is mainly carried out by the beneficiaries of the charity.

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The Charity Commissioners' guidelines also recognise these categories of trading as acceptable and a charity in so doing will not normally endanger its charitable status. Nevertheless, it must be appreciated that when considering primary purpose trading a distinction must be made between activities which are directed to the achievement of the objectives and activities, which although they help the charity, cannot be described as carrying out or carrying out part of its charitable purposes.

For example, a church that may have charitable status with the objective of advancing religion would find that the sale of religious books qualifies as part of its primary purpose although the sale of other books would not. This is despite the fact that the profits from both types of sales are used exclusively for its charitable objects.

The sale by a charity, for the handicapped, of goods produced in a workshop staffed by the beneficiaries would qualify under the second alternative. As could the sale by an international aid charity of goods produced by its beneficiaries in developing countries.

Of course a prerequisite for a charity when it is considering trading is that it should have the constitutional powers to do so. Having such a power, even when it refers to non primary purpose trading, does not preclude an organisation from having charitable status.

The question to be asked is whether the trading is on such a scale that it might dominate the organisation's original purpose. If the organisation's powers allowed trading to such an extent, it would be questionable whether the organisation could be said to be established for exclusively charitable purposes.

On the other hand incidental and insignificant trading is usually permissible by law and although any profits that do not fall within the statutory tax exemptions would be taxable there are further avenues open to the trustees. Strictly, if a charity carried out non-exempt trading activities at the same time , they could lose the exemption altogether. Within limits, HMRC used to treat the primary-purpose activity as a separate, exempt trade, but case law has said that both activities have to be treated as a single trade.

The 2006 Finance Act now specifically requires the trade to be split into two, with the primary-purpose one exempt and the non primary purpose trade being taxable. The same applies to the parallel exemption where the trade is mainly carried on by beneficiaries of the charity. Following changes to the trading exemptions found in Section 505 ICTA '88 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 their guidance HMRC have explained that it is necessary to divide the charity's trade into a number of different statutory forms, which, for chargeable periods beginning on or after 22 March 2006, include 'deemed trades'. They explain the position as follows:

All trading exercised in the course of carrying out a primary purpose of the charity (e.g. a theatre charity selling programmes, a charitable school charging pupils, or a residential care charity charging residents) is referred to as 'primary purpose trading'. S505 (1)(e)(i) ICTA 1988. The profits of such trades are not taxable if they are applied for charitable purposes.

Where a charity's trade is carried out partly in the course of carrying out a primary purpose of the charity, and partly for non-primary purposes, Section 505 (1B) ICTA 1988 deems each part as a separate trade for tax purposes. The primary purpose deemed trade is not taxable. S505 (1B)(a) ICTA 1988 but the non primary purpose trade is taxable.

The exemption from tax can also extend to other trading, which is not overtly primary purpose in nature but which is ancillary to the carrying out of a 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.

Charities also carry out trading which is not part of the primary purpose of the charity but which is typically undertaken to raise funds to be applied for charitable purposes (e.g. sales of promotional items or commercial sponsorships). Where a charity's trade is carried out partly in the course of carrying out a primary purpose of the charity, and partly for non-primary purposes, Section 505 (1B) ICTA 1988 deems each part as a separate trade for tax purposes. The charity's non-primary purpose deemed trade is not exempt from tax, unless the work is carried out mainly or partly by beneficiaries (see below) - or the small trading exemption applies (see below)

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Beneficiary Trading encompasses trades which are non primary purpose but carried out mainly by beneficiaries (e.g. the manufacture and sale of items by residents). Where the work in connection with a charity's trade is carried out partly by beneficiaries, the part not carried out by beneficiaries is deemed to be a separate trade, which, assuming it is non-primary purpose, will be taxable unless the small trading exemption applies

Small Trades

Since April 2000 there is also a new relief for small trades. 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 to its 'reasonable expectation'.

Extra statutory concession for fundraising events (ESC C4)

Also see separate guidance note on Fundraising events

In recognition of the fact that ICTA 88 Section 832's unsatisfactory definition of trading would catch a number of activities that have traditionally been associated with charity fundraising, (bazaars, jumble sales, etc) the Inland Revenue published an Extra Statutory Concession, (ESC C4) This concession was similar yet different to the VAT exemption for fundraising events and therefore caused unnecessary complications and as a result of the Charity Tax Review the two have been harmonised and ESC C4 now states:

"Certain events arranged by voluntary organisations or charities for the purpose of raising funds for charity may fall within the definition of 'trade' in Section 832 ICTA 1988, with the result that any profits will be liable to income tax or corporation tax.Tax will not be charged on such profits provided:
a. the event is of a kind which falls within the exemption from VAT under Group 12 of Schedule 9 to the VAT Act 1994 and
b.the profits are transferred to charities or otherwise applied for charitable purposes."

There are however certain caveats. All the conditions of the concession must be met This area is complicated and has been covered in a separate guidance note on Fundraising events.

Ancillary Income and Part Exempt Trades

HMRC have also extended the exemption from tax to other trades, which in themselves are not primary purpose but which are ancillary to the carrying out of a primary purpose. They have cited the example of "the sale of food and drink in a cafeteria to visitors to exhibits by an art Trust or museum". Such trades will qualify as primary purpose trades.

The Inland Revenue have also recognised that in some cases a primary purpose trading activity may include an element of some non-exempt trading.

HMRC will establish whether the non-exempt activity can be assessed as a separate trade. In the example of the shop, if there was a separate shop selling the souvenirs it would probably be assessed as a separate trade.

In the past the Reveneu adopted a rule of thumb and if the trade was seen to be part of a single trade and the turnover of the non-exempt part amounts to less than ten per cent of the total trade the Revenue will usually permit it to be disregarded as *de minimis* so long as it is not large (defined as £50,000). If it is not treated as *de minimis* the Revenue exeplained that they may seek to tax the whole trade. This guidance has now been superseded and HMRC explain

"The exemption from tax can also extend to other trading, which is not overtly primary purpose in nature but which is ancillary to the carrying out of a 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. Any impression that it is a separate category is incorrect.
"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."*

Sale of Donated Goods

When one thinks of charity trading it is the traditional charity shop selling donated goods that come to mind. Neither the Charity Commissioners nor HMRC treat the sale of donated goods as trading. The sale of donated goods is treated by them as the mere conversion of donated gifts into cash. As a result donated goods can be sold by a charity without fear of endangering charitable or tax status.

HMRC has 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.

The VAT rules take an even more favourable view and offer the best possible VAT situation. The sale of donated goods is zero rated. This applies to charities as well as 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.

Corporate sponsorship

Also see separate guidance note on corporate partnerships and donations

Many charities are now targeting the marketing budget of corporate donors, instead of seeking pure charitable donations. What starts as a means of profitable fundraising can have fairly disastrous tax implications if the arrangements are not properly structured and planned.

Typical examples are commercial sponsorship and joint ventures. In these cases it is important to see whether the charity, in return for the sponsorship, is offering free publicity. There is no problem with the mere acknowledgement of a donation. On the other hand if the 'gratitude' offers free publicity for the corporate organisation (eg. by prominent use of their logo or strap line) then it is quite likely that it will be construed that the charity is supplying an advertising service. This is within the realms of the dreaded 'trading' and the making of 'taxable supplies', with implications both in terms of corporation tax and
VAT.

It is vital when looking a transaction of this sort to establish the exact substance of the transaction and see whether it is a true donation or commercial transaction, with the charity supplying advertising and publicity services. In essence, if the payments are made in exchange for something, such as advertising of the sponsor, the payment is often no longer treated as a pure donation. For example, a charity may publicise and acknowledge the sponsor in publications, posters, etc. In such cases if this is simply a mere acknowledgement then the payment can be treated as a donation.

The key element is that the charity must remain passive – if the sponsor publicices the fact that they have made a generous donation and derives benefit from that the donation will still be treated as a donation

When looking at a transaction of this sort HMRC will examine the substance of the transaction and may conclude that the charity may be selling advertising services. HMRC looks carefully at this and have stated that, references to a sponsor which amount to advertisements will cause the payments to be treated as trading income. HMRC 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 the sponsor's corporate colours,, or
a description of the sponsor's products or services.

Similarly, if a charity provides the sponsor with goods or services in exchange for the payment it may be deemed to be trading with attendant tax consequences. Some of the examples provided by HMRC may seem to be fairly innocuous they include the use of the charity's mailing lists, logo, exclusive right to sell goods and services on a charity's premises etc.

This may not be altogether simple and clear. A corporate sponsor might make a very large payment and indeed receive some form of advertising benefit. Even though it may be argued that the benefit is not commensurate with the payment made, case law now provides that it is not possible to apportion the payment between the elements relating to the advertising service provided and a pure donation for VAT purposes. Unless there is a specific price for the benefit (which will bear VAT) and the balance of the payment being totally discretionary (a gift, which will not bear VAT), VAT could be due on the whole payment.

Allowing use of the Charity's logo

Payments for the use of the charity's logo can lead to the taxation of intellectual property. The marketing by charities of their name and logo to commercial organisation who then use these to endorse the commercial organisations own products is likely to constitute a trading activity leading to taxable income.

There is also tax exemptions for income which meet the criteria of an "annual payment" and this will apply where a commercial organisation make annual payments solely for the use of a charity's logo. Such arrangements need to be structured carefully to ensure they meet the definition of an annual payment. The organisation making the annual payment has to deduct tax at the basic rate from the payment and the charity can reclaim the tax . The payment must be :

- applied solely for charitable purposes
- made under a legal obligation
- recurring (each year)
- treated as a pure donation in the hands of the charity

Commissioned Research

Some charities often carry out research on a paid basis. If the payment is in the nature of a grant which merely requires the research to be completed, and if the carrying out of research is part of their charitable objective, there should be no problem. However, if the person paying for the research acquires rights to the results it could be construed that the research is not for the benefit of the public and thus not for charitable purposes and the charity could be deemed to be trading.

When considering this aspect the Inland Revenue and the Charity Commission will review whether the research is made available in the public domain and whether it is impartial and does not simply advance the views of the sponsoring organisation.

Contracting

The contract culture with its ethos of something for something could lead to the charity being seen to

carry out a trade. For example, a charity providing housing 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 housing then it would be within the realms of primary purpose trading.

On the other hand universities and schools whose primary purpose is education are seen to be trading if they hire residential facilities to tourists in the holidays, because holiday lets are unrelated to the provision of education.

There are also of course VAT considerations. There are exemptions for welfare services carried out on a not for profit basis and charities should ensure that they are aware of the rules.

Property Letting

For income or corporation tax purposes, income derived from property is taxable under Schedule A and/or Schedule D. Schedule A includes rental income, ground rents, amounts received as payments for right of access, etc.: see ICTA 1988, s15(1).

Where there is a furnished letting, the income derived from it would fall under Schedule D, Case VI (see ICTA 1988, s.18(3)) if the letting is of a regular nature, e.g., the letting of a hall with seating accommodation or lettings by charitable schools. ICTA 1988, s.505(1)(a) specifically exempts charity property income assessable under Schedule A or Schedule D, so far as it is applied to charitable purposes.

Where accommodation is let and not only is it furnished but services are provided as well, e.g., if a university lets its bedrooms and provides laundry services and meals, the income becomes trading income (as in, e.g., a hotel trade) and is liable to tax unless it falls within Schedule A.

HMRC's guidance explains

"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".

The VAT rules of letting are more complex – in essence the charity may opt to tax, that is it may charge VAT on its rental income. The correct answer for the charity will require consideration of a number of factors and is not within the scope of this guidance note.

Property sales

Generally gains arising from the sale of property would call within the exemption found in Section 256 of the Taxable and Chargeable Gains Act but there is a need to be aware of another pitfall.

Charity trustees are required to obtain the best terms when disposing of charity property.. This can often have tax ramifications and may cause tax problems. 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. After considering the investment powers of the trustees and whether investing in development activity would be speculative and correct for the charity to undertake, there is a further question of whether the development profits would be taxable as trading.

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S776 ICTA 88 was enacted to prevent the avoidance of tax by persons concerned with land or the development of land. The section will apply when land is acquired or developed with the intention of realising a capital gain from the disposal. In these circumstances the profits or gains are chargeable to tax under Case VI of Schedule D and would not usually fall within the primary purpose trading exemptions exemption of s505 of ICTA 88.

The law is far reaching and explains that "where, whether by a premature sale or otherwise, a person directly or indirectly transmits the opportunity of making a gain to another person, that other person's gain is obtained for him by the first-mentioned person".

Care must be taken with such transactions to ensure that the University is not in breach of its investment powers or exposed to tax. Often the safest route is to use a separate trading subsidiary. However, the University can not gratuitously give away assets or rights to its trading subsidiaries and transactions will need to be on an arms length basis.

Lotteries

Charities do not have to pay tax on profits from lotteries run to raise funds for their charitable purposes if the lotteries are promoted and conducted under a licence issued under section 98 of the Gambling Act 2005 or Article 133 or 135 of the Betting, Gaming, Lotteries and Amusements (Northern Ireland) Order 1985. There is the overall requirement that the lottery profits are applied solely to the purposes of the charity.

In some cases a subsidiary company,may be registered as “the Society” under the legislation. In such cases , the lottery profits will belong to the company and not to the charity for tax purposes. The exemption will not apply and the company will need to pass the profits to the charity as discussed further in this guidance note/

The Finance Act 2006 made changes to primary ;legislation but maintains the existing exemption from tax for charities for the profits from charitable lotteries run in accordance with lottery regulations.

Earlier the exemptions were given by section 505(1)(f) ICTA 1988) by reference to the Lotteries and Amusements Act 1976. The relevant sections of the 1976 Act have been replaced by sections of the Gambling Act 2005. The 2005 Act also brings in a new regulatory framework for lotteries. The Finance Act 2006 ensures that only lotteries which are lawful under the 2005 Act receive tax relief, but does not extend or restrict the existing relief. These amendments were brought into force to coincide with the introduction of the new licencing regime under the 2005 Act, on 1 September 2007.

Changes to tax law in the Income Tax Act 2007 (ITA 2007) separate charitable trusts from charitable companies, so that section 505(1)(f) ICTA 1988 will only apply to charitable companies. The legislation also amends the law to ensure that charitable trusts continue to receive the relief.

For VAT purposes a lottery is the distribution of prizes by chance where the persons taking part in the operation, or a substantial number of them, make a payment or consideration in return for obtaining their chance of a prize. The right to take part in a lottery is exempt under VATAct 1994, Sched. 9, Group 4, Item 2. The value of the exempt supply is the gross proceeds from ticket sales less only the amount of cash prizes given or the cost, including VAT, of goods given as prizes. However, where an element of merit or skill is introduced the event is not a lottery but a competition and VAT rules for sports competitions will apply.

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PART 2 TRADING SUBSIDIARIES

Trading subsidiaries - The answer?

As we have seen, charities are now increasingly exposed to the implications of trading. Some of the areas of exposure are new but the issues have been around and discussed for a long time. In their 1980 report the Charity Commissioners stated that drawing the line between the charity which is merely raising funds and furthering its activities by trading and what is in substance a trading institution wearing a charitable mantle is not easy. They went on to say that where a charity wishes to benefit substantially from permanent trading for the purpose of fundraising it should do so through a separate non charitable trading company so that its charitable status is not endangered.

Essentially, trading through a separate trading company has a number of benefits. It is encouraged under charity law, it is possible to arrange matters so that all the profit is transferred to the parent charity in a tax efficient manner and if properly structured the trading subsidiary will be a separate entity with limited liability. However, great care must be taken to ensure that all the detail is fully considered so that none of the potential benefits are lost.

Setting up and financing the trading company

It is usual for a trading company to be owned by the charity.

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

- borrowing from a commercial source
- borrowing from the charity
- issue of share capital

The charity's trustees must consider two questions when considering investment in subsidiary companies. These are:

- does the charity have the wide investment powers to make such an investment; *and*
- is a trading venture of this sort too speculative and risky for the charity?

Trustees must generally only invest in investments authorised by the Trustee Investments Act 1961 or by their own trust instrument. So the first of the above conditions would require scrutiny of the constitution, and if necessary the widening of the investment powers given to the Trustees.

The second question is more subjective - trustees should not make hazardous or speculative investments. The general rule that a trustee should act as an ordinary prudent man of business was expanded in Learoyd v Whiteley (1883) when Lord Watson said:

> *"Businessmen of ordinary prudence may, and frequently do, select investments which are more or less of a speculative nature: but it is the duty of a trustee to confine himself to the class of investment which are permitted by the Trust and likewise to avoid all investments of that class which are attendant with hazard."*

Therefore, it is important that there is adequate evidence that the trustees have carefully considered their investment. There should be business plans and forecasts to show the expected return on the investment. Additionally, it is important that the trustees show that they regularly reconsider the appropriateness of their investment in the trading subsidiary. In my opinion the trustees should, at least each year, formally minute that they have reviewed the trading operation and considered whether it is appropriate to continue to invest in it.

In their guidance on Trading the Charity Commisison have explained that:

- *the trustees must reasonably consider that it is in the charity's interests to make the investment, after making a fair comparison of this form of investment with other forms of investment which might be selected;*

- *this fair comparison must involve an objective assessment of the trading subsidiary 's business prospects;*
- *the trustees must be satisfied as to the financial viability of the trading subsidiary, based on its business plan, cash flow forecasts, profit projections, risk analysis and other available information; and*
- *the trustees must ordinarily take appropriate advice on the investment, and the financial viability of the trading subsidiary. What is 'appropriate' will depend on the circumstances: the cost of taking the advice is a relevant factor, and the cost should be commensurate to the size of the proposed investment.* "

Furthermore, in 1986 various provisions were introduced which are now enshrined in Section 506 of the Taxes Act 1988. These provisions broadly state that the charity could lose tax exemption already obtained if it incurs expenditure which is non qualifying. Qualifying expenditure includes the list of qualifying investments and qualifying loans contained in part 1 and part 2 of schedule 20 to the Taxes Act. Unfortunately, that list does not include investment in or loans to subsidiary companies. There is, however, a provision that a charity can make a claim to the Inland Revenue to treat such loans or investments as qualifying but it should be clear that they are made for the benefit of the charity and not for avoidance of tax.

Regrettably, the law does not provide any prior approval procedures and normally the claim can only be made after the charity has completed the investment or loan. Both the Revenue and the Commissioners expect the transactions with the trading subsidiary to be on an arms-length basis. That is to say the investment stands up to commercial scrutiny. This will be tested in the case of a loan by the rate of interest payable, the terms of repayment and security. Any transactions between the parent and subsidiary should be at arms length and no extended credit should be provided. In the case of share capital the trustees should be able to demonstrate that the investment is not speculative by considering the profitability of the trading subsidiary.

There should also be proper procedures to enable the charity to transfer assets for use and exploitation by the trading company. In addition, the subsidiary's constitution should allow it to transfer profit to the charity.

Prior to establishing a trading subsidiary it is important to ascertain exactly what "trade" is to be carried out. There are many examples where trading subsidiaries have been established without considering whether it was necessary. Therefore, consider the rules - is it primary purpose trading?

It is also important to consider the question of financing and vital to remember that there needs to be a proper infrastructure to monitor and control the trading operation.

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PART 3 PROFIT SHEDDING

Profit Shedding

In order to avoid a tax charge the trading company must use a tax effective method of transferring its profits from itself to the parent charity. There have been three time honoured methods for doing this:

- Variable Deed of Covenant;
- Gift Aid; *and*
- Dividends.

Most of us are familiar with these methods but they merit some discussion.

Deeds of Covenant

Some charities continue to make payments under Deed of Covenant but the rules are now similar to the Gift Aid rules. A payment under a deed of covenant is a charge on income. In essence, this means that if a company makes a profit and properly covenants all of its profit to a charity there will be no tax charge.

Where the company is wholly owned by the charity, for the payments after 1 April 1997, the payment can be made be made up to nine months after the end of the accounting period. This saves the 'gives, pay and repay' charade which had been necessary.

Gift Aid

The Gift Aid regime is much simpler than that for a deed of covenant in that the deed must be properly drawn up and properly executed so that it is legally binding. With Gift Aid, once the money has been given the actual procedure for reclaiming the tax can be completed subsequently. However, the rules are precise and no refund can be permitted.

The gross amount of the payment is allowed as a deduction against the company's profits for corporation tax purposes for the accounting period in which the payment is made. The option to make the payment up to nine months after the end of the accounting period is available to trading subsidiaries that are wholly owned by charities.

Dividends

The subsidiary can of course elect to pay its profits to the charity using dividends. This method should only be used if the subsidiary has not used the covenant or gift aid route and it has to pay tax on its taxable profits.

From 6 April 1999 Advance Corporation Tax was abolished but there are transitional provisions for charities and the tax credit recoverable is being reduced over 6 years to zero by 6 April 2004. This means that the charity will not be able to recover all the tax on the dividends and the loss to the group will increase over the 6 year period.

There is also anti avoidance legislation which imposes a tax liability when dividends are paid out of pre-acquisition profits. However, this does not apply in most cases since charities do not often buy subsidiaries that have pre-acquisition profits.

Choice of Method

In my opinion either the covenant / gift aid route is the most suitable although it does require that the covenant is properly set up and executed - an over paid covenant can be repaid. With gift aid there is no mechanism for repayment and the subsidiary will suffer.

Some charities wrongly believe that to show the viability of the investment in the subsidiary there should be a dividend stream. Consequently they have been using the dividend route even when it leads to a loss of tax. The viability of the investment is measured by the return to the charity and the method of transferring profits is not really relevant. Apart from the tax rate issue already discussed the dividend, if it is paid before the year end, suffers from the same problems of estimating the

profits. If it is paid after the year end then there will be cash flow disadvantages since the advance corporation tax in respect of the dividend cannot be used to offset the mainstream corporation tax liability until the following year's tax liabilities have been agreed.

Does the Gift Aid have to be paid?

I sometimes see cases where a charity and its subsidiary operate intercompany accounts in the accounting records with each making payments on behalf of the other (eg one invoice may cover both the charity and the trading company)

This often leads to the position that the Gift Aid payment from the trading subsidiary has not been paid by an exchange of cheques or transfers between bank accounts but is discharged through the intercompany account. This is not seen to be the favoured option as the Gift Aid rules refer to a payment of a sum of money and I have seen HMRC be concerned about this in the past.

However, they appear to be more open to discussion on this and in correspondence with us they have stated.

"*Following a very recent Solicitors' Opinion on a similar matter we have reconsidered our view on what constitutes a "payment of a sum of money" in certain circumstances.*

We now take the view that, where a wholly owned trading company makes payments on behalf of its parent charity (for example, one invoice may cover both the charity and the trading company) and an intercompany account is in operation, the trading company can make Gift Aid payments by discharge through the intercompany account. That is, we regard the discharge of the debt owed to the trading company as a "payment of a sum of money" at the time the discharge is made – if the discharge is within the 9 month period then the Gift Aid payment can be carried back to an earlier accounting period.

The above view has not been tested and, to avoid doubt, the best course of action remains for the trading company to physically make a payment from its own bank account to the charity".

Deducting the tax

Prior to 1 April 2000 companies had to deduct basic rate tax from the covenanted or Gift Aid amount paying over the net amount to the charity. There is no longer a need to do this and the gross amount is paid to the charity.

Comparison of Taxable and Accounting Profits

Since the trading company pays up the taxable profit there may be a complication where the taxable profit differs from the accounting profit. This is likely to occur for a number of reasons. Most commonly, where the subsidiary has fixed assets, the depreciation charged in arriving at the accounts profit is different from the capital allowances given in calculating the taxable profit. Also, timing differences resulting from considerations such as when interest is paid can affect the taxable profit. Similarly, there may be other items of expenditure in the trading subsidiary such as entertaining that may be disallowed for tax purposes.

As a consequence the taxable profit may be larger than the accounts profit and since the aim is to transfer the taxable profit this would result in a negative profit and loss account. In this case the subsidiary will not have any distributable reserves and this may cause problems. The definition of a "distribution" in Section 263 of the Companies Act 1985 is extremely wide and is defined to include "Every description of distribution of a company's assets to its members in cash or otherwise". The exceptions that are listed would not really apply in typical cases.

This issue does need to be carefully addressed in each situation to establish a satisfactory solution The Charity Commission's guidance explains . "*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 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."

Additionally, a charity can allocate a notional charge for goods and services supplied at undervalue. This could include volunteer time and reduced rates for professional fees.

A question of interest

The Charity Commission and HMRC consider that loans from charities to their trading subsidiaries should be on commercial terms and that charities should charge interest to these trading subsidiaries.

The "War on Want" enquiry highlights this issue. The enquiry found that advances to finance the trading company were not at arms length and said that if they were not repaid with interest they represented an application of charitable funds for non charitable purposes. They went on to recommend that if repayment was not possible, consideration should be given for an action under Section 28(7) of the Charities Act 1960 for recovery from the members of the Council of Management.

Capital gains and Gift Aid

The exemption from capital gains tax which is given by virtue of Section 256 of the Capital Gains Tax Act 1992 (if the gain is used for charitable purposes) is available only to the charity and not the subsidiary. Of course the trading subsidiary may dispose of its own property or other assets and make capital gains. The subsidiary can deduct Gift Aid payments from total profits, which includes chargeable gains as well as all other income.

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PART 4 OPERATING AT 'ARMS LENGTH'

Liabilities and losses of the trading subsidiary

Not all trading companies are profitable. In fact, there have been incidents of late where trading subsidiaries have gone bust whilst owing considerable amounts of money. The Charity Commissioners addressed this matter in their 1988 report which referred to the liquidation's of Search 88 & Co Limited owing £700,000 and Sports Aid Limited owing £2-£3 million. In both these cases the charity trustees and promoters followed sound and recommended advice in order to protect the assets of the Charities.

In one of these cases the creditors thought that they were dealing with the charity rather than an arms length limited liability company. It is vital that it is made clear to those involved as to whether the transactions are with the charity or its subsidiary.

Failed subsidiaries often leave the charity's trustees in a dilemma. In order to avoid the adverse publicity which may arise and because of a perceived moral obligation to the creditors, they may wish to settle the liabilities of the trading subsidiary. Such a course of action would normally be outside the trustees' powers.

Whilst talking about subsidiaries failing it is worth mentioning that it is possible that directors of a trading subsidiary could be guilty of wrongful trading under Section 214 of the Insolvency Act. When a subsidiary is making losses there is perhaps a tendency to expect better times. Directors should act with extreme caution and when there appears to be no reasonable prospect of avoiding liquidation there is a need to take immediate steps to minimise the loss to creditors.

A director is expected to conform to an objective standard of ability and should be aware of the current position of the company. A director may be personally liable if the company is allowed to continue trading when it is effectively insolvent. Similarly, the charity's trustees may be personally liable if they continue to prop up a failing subsidiary by lending it charitable funds.

HMRC will also look at a loss making trading subsidiary to consider whether the charity by funding it is incurring non charitable expenditure that could jeopardise its tax exemptions. Previously they took the view that they would exclude notional charges and indirect cost allocations when considering this. Similarly in the pats they disregarded the element of the loss that is created by the allocation of fixed costs if it can be shown that the charity would have incurred that expenditure in any case. However this view appears to have changed – see the section on management charges and cost allocations.

It is important to recognise that if the trading subsidiary is carrying out activities that further the primary purpose of the charity then losses made by it even if they are subsidised by loans grants etc from the charity will not be non charitable expenditure. In essence, the charity would have to be able to show that it could have incurred the expenditure that created the loss.

Management charges and cost allocations

Many charities and their trading subsidiaries operate from the same premises and may use joint facilities such as staff, communication services, computer system etc.

In most cases the charity's facilities are used by the trading subsidiary and following the arms length principle the charity should levy a fair and reasonable charge. VAT should be accounted for on these charges if the charity is registered for VAT and there is no group Vat election. In fact this can usually work to the organisation's advantage.

Many charities are not registered or are partially exempt for VAT, 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 their 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.

The allocation of costs should include both direct and indirect 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.

Following the Finance Act 2006 and the changes to the trading exemptions found in Section 505 ICTA '88 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.

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 has placed much more importance on cost allocation and they state, "*For most charities the challenge will be to maintain adequate accounting systems to properly identify the separate primary purpose and non-primary purpose deemed trades, to allocate and where necessary apportion costs to each. Charities are strongly recommended to do this. The approach may vary. For example, there could be a 'high level' approach of identifying the trading activity of a particular department, division or building, etc. as primary or non-primary purpose. Alternatively, there might be a 'middle level' approach of, for example, identifying particular contracts or projects, or the work of individuals as primary or non-primary purpose. At the most detailed level, charities might identify each individual piece of work done, flag it primary purpose or non-primary purpose in the accounting system, and allocate costs accordingly*

"HMRC's view is that a high or medium level approach may be justified on the facts – a department or a project may be identifiable as wholly primary purpose or wholly non-primary purpose. However, this approach would be inappropriate for mixed primary/ non-primary purpose activity. In HMRC's view, a 'low level' approach to accounting for primary and non-primary purpose activity will be more appropriate. This will give the greatest accuracy and take the least risks with charity law, which places a responsibility on trustees to identify non-primary purpose trading carried on by the charity for which they bear responsibility."

HMRC has gone into much detail about cost allocation and stress that for a non-primary purpose deemed or part-beneficiary trade, the new legislation now requires that there be a 'reasonable apportionment of expenses and receipts'. They explain that in their view 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.

They have provided the following guidance to illustrate what they would expect:

"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."*

In correspondence with us HMRC have explained:

"S505B (ICTA '88 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. Your example of the computer system is not clear but it seems possible the charity is providing a service. In that case, it is possible that (if the charity is a large enterprise and otherwise within the criteria of INTM 432090) UK-UK transfer pricing may apply. A mark-up may be appropriate, or possibly a charge-rate referenced to conditions obtaining in the open market."

In the past this area of cost allocation between charities and their subsidiaries were 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.

Conflicts of Interest

It is often the case that one or more of the charity's trustees or employees act as directors of the trading company. There are differing views about this. On the one hand there is an argument that this is a good way of ensuring that there is operational control over the subsidiary. Conversely, it is felt that charity trustees duty to the charity may be in conflict with their duty as directors of the trading subsidiary.

Similarly, some charities use joint employment contracts for their staff who are then employed by both the charity and the trading subsidiaries. In my opinion, there should not be total commonality between the trustees/staff of the charity and the directors/staff of the subsidiary. Whilst some commonality may be advantageous it is imperative that there are procedures in place to ensure that there is no detrimental conflict of interest.

Many subsidiaries have on their board independent directors who have the requisite skill and experience to add value to the subsidiaries business.

Joint VAT Registrations

The issue is that it is sometimes expedient, in the interest of the charity, to have a joint VAT registration with its trading subsidiary. This arrangement can often mitigate the VAT burden for the charity and its subsidiary by allowing enhanced recovery of input VAT and dispensing with a need to charge VAT on inter company transactions.

However, the taking of such joint registration also means that all parties to the joint registration are liable for any VAT liabilities of each other.

There is a view that this is similar to the charity giving a guarantee on behalf of the trading subsidiary which may result in the charity having to meet the VAT liability of the subsidiary. To my mind, joint registration could perhaps be seen as not giving of a gratuitous guarantee where there is a definite financial benefit to the charity to undertake such a joint registration.

In my opinion, if the trustees have taken sound professional advice that it would be in the financial interests of the group to enter into joint VAT registration then the probability of the trading subsidiary failing and the charity having to meet any VAT liability would be justified.

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PART 5 ACCOUNTING FOR TRADING SUBSIDARIES

Accounting for Trading Subsidiaries

The SORP describes a subsidiary undertaking in relation to a charity as being 'any entity in which the charity or its trustees hold or control the majority of the voting rights or have the right to appoint or remove a majority of its board of directors or trustees'. The SORP definition also refers to the wider definition contained in the Companies Act 1985 Section 258 and 259.

This section addresses principally the issues concerning trading subsidiaries of charities established under the Companies Act to carry out 'non charitable' or 'trading' activities of the charity. Such companies are typically established in order to minimise any direct tax or VAT costs which may arise if those activities were accounted for in the charity. Charities have historically accounted for their trading subsidiaries in a variety of ways.

Financial Reporting Standard 2 (FRS2)

FRS2 came into force for accounting periods ending on or after 23 December 1992 and applies to all entities required to prepare financial statements that give a true and fair view, to the extent that the requirements of the FRS are permitted by any statutory framework under which the entity reports. The effect of FRS2 therefore was to introduce a single set of requirements relating to the preparation of consolidated accounts that apply to charities regardless of their constitution.

FRS2 requires exclusion from consolidation in the following circumstances:

- Where there are severe long term restrictions which hinder substantially the exercise of the parent undertakings rights over the subsidiaries undertakings, assets or management; or
- The Group's interest in the subsidiary undertaking is held exclusively with a view to subsequent resale and the subsidiary undertaking has not previously been consolidated; or
- The subsidiary undertaking's activities are so different from those of other undertakings to be included in the consolidation that their inclusion would be incompatible with the obligation to give a true and fair view.

Whereas the Companies Act permits exclusion in cases I and II above, the FRS requires exclusion in such circumstances because the same conditions that justify exclusion also make consolidation inappropriate.

It is worth considering the rationale and principles that underlie the concept of group accounts. FRS 2 defines consolidation as "*the process of adjusting and combining financial information from the individual financial statements of a parent undertaking and its subsidiary undertakings to prepare consolidated financial statements that present financial information for the group as a single economic entity."* The FRS goes on to explain the purpose of consolidated financial statements, *"For a variety of legal, tax and other reasons undertakings generally choose to conduct their activities not through a single legal entity but through several undertakings under the ultimate control of the parent undertaking of that group. For this reason the financial statements of a parent undertaking by itself do not present a full picture of its economic activities or financial position. Consolidated financial statements are required in order to reflect the extended business unit that conducts activities under the control of the parent undertaking."*

Clearly the aim of consolidated accounts is to present the activities of the group as "a single economic unit". Therefore it seems appropriate to present the results on the basis of the activity rather than the entity which carries them out. In practice charities may set up subsidiaries to campaign, perform research, fund raise etc. Due to the views of the Inland Revenue and HMC&E a number of fund-raising activities that traditionally were carried out by the charity itself and reported in its own accounts are now channelled through a trading subsidiary. These include innovative fund-raising schemes that may involve corporate sponsorship where it could be held that the charity

is trading. Similarly, the agreements reached with the tax authorities on charity affinity cards will mean that an element of the income is deemed to be trading and will have to be channelled through a trading subsidiary.

Different Activities

What does FRS 2 really mean by 'activities that are so different'? FRS 2 makes specific reference to not for profit undertakings, stating that the contrast between a 'profit' and a 'not for profit' undertaking is not sufficient of itself to justify non consolidation.

Many charities hold the view that trading is fundamentally different to charitable activity and that trading activity has no place in a charity's accounts. However in recent years the distinction between the type of activities that are accounted for in the trading subsidiary and those that are accounted for in the charity has become somewhat blurred. Many charities channel fund-raising activities through the trading subsidiary such as innovative schemes which may involve corporate sponsorship and could be held to be trading. Similarly, the agreements reached with the tax authorities on charity affinity cards mean that an element of the income arising is deemed to be trading and is therefore channelled through the trading subsidiary whilst the remainder is channelled through the charity itself. The sale of donated goods in a charity shop is not considered by the Charity Commission or the Inland Revenue to constitute trading and is generally accounted for in the charity whereas the sale of bought in goods, such as Christmas cards in the same shop are accounted for through the trading subsidiary.

Clearly, under the circumstances described above, it would be anomalous that only a percentage of a similar activity is reported in the charity's accounts.

For example, if a charity receives two corporate donations and one donor has asked for its logo to be used in the acknowledgement then the charity would rightly conclude that this donation should go through the trading subsidiary for tax reasons. Clearly it is anomalous that one donation is shown as a donation with the other netted off in the trading income line. Therefore the Charities SORP 2000 advocate a treatment that achieves parity of presentation and disclosure on items that are only artificially segregated due to the tax treatment or other management reasons

SORP 2005

Some charities were concerned that the consolidation of subsidiaries may adversely affect the ubiquitous cost ratios since the cost of generating income in most merchandising operations is higher than that of raising voluntary or statutory income by the charity. They preferred therefore to relegate the subsidiaries' costs to the notes. This is not acceptable and Paragraphs 293 et seq of SORP 2005 explain the method of consolidation that should be used:

393 The normal rules will apply regarding the method of consolidation, which should be carried out on a lineby-line basis as set out in FRS 2.
394 All items of incoming resources and resources expended should be shown gross after the removal of intra-group transactions. Clearly it is desirable that similar items are treated in the same way. For instance, incoming resources from activities to generate funds in the charity should be combined with similar activities in the subsidiary, and charitable activities within the charity should be combined with similar activities in the subsidiary. Similarly, costs of generating funds and/or governance costs in the subsidiary should be aggregated with those of the charity.
395 Each charity should choose appropriate category headings within the permissible format of the Statement of Financial Activities and suitable amalgamations of activities. The headings used should reflect the underlying activities of the group. If it is not possible to exactly match items between the subsidiary undertaking and the parent charity, segmental information should be provided so that the results of the parent charity and each subsidiary undertaking are transparent."

The effect of consolidation is usually not likely to be very material on the balance sheet but can alter the picture shown on the Income and Expenditure account. There is a fear that important information about the trading subsidiary such as its profitability can be concealed in a consolidated profit and loss account. For example, the fact that a charity may be propping up a loss making subsidiary will not be apparent from a consolidated income and expenditure account. The 2005 SORP recognises this and requires that where a separate charity only SOFA is not included in the financial statements sufficient information should be provided:

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PART 6 CHARITY SHOPS

Many charities operate charity shops, some of these sell only donated goods, some of them sell only bought in goods and some sell a mix of both. Donated goods can be collected house to house and also donated directly at the shops.

Shops owned by subsidiaries

In some cases the shops are operated through the subsidiary and whilst this structure will work. I think there are problems associated with it and it is cumbersome. I usually advise 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. It might be useful to briefly consider the different types of goods charities sell.

When a charity sells new goods it is trading and unless this trading qualifies for the statutory trading exemptions found in S.505 of ICTA 1988 the profits will be taxable. To qualify the trading should be part of the charity's primary purpose or a trade carried out by the charity's beneficiaries. Additionally, significant non-charitable trading can jeopardise charity status. The circumstances that qualify are limited, for example, if the primary purpose was to relieve poverty then the sale of bought goods at a reduced price to an approved class of beneficiary might qualify or a charity set up to advance religion could sell religious books.

Even here there are special rules and the Charity Commissioners have decided that community shops per se are not charitable. In their 1991 Report they discussed the case of the Community Shop, Leeds, a charity established to relieve poverty by the provision of clothing and other goods at low cost to people in need. The constitution did not preclude the sale of bought in goods and it was not possible to control who bought goods in the shop. The Commissioners considered there was a risk of non-charitable trading and the charity was advised to set up a trading subsidiary to shelter taxable profits which would then be transferred to the charity in a tax effective way.

This has lead to some advisors suggesting that charity shops should be operated through a trading subsidiary. However, as explained earlier, neither the Charity Commissioners nor the Inland Revenue treat the sale of donated goods as trading. This endorses my view that donated goods should be sold through the charity and not the trading company.

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

Previously, this zero rating was only given if the sale was made by a charity and consequently to benefit from the zero rating many charities channelled the income from the sale of donated goods through the charity whilst bought in goods were rightly channelled through a trading subsidiary.

This changed on 1 April 1991 and VAT zero rating on the supply of donated goods now also applies to a 'taxable person' who has covenanted by deed to give all the 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 company so long as the company concerned covenants the profit of that supply to the charity. Following this change some charities decided that they would channel both the donated goods and bought in goods through the non-charitable trading subsidiary. This leads to certain problems.

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. Fore example when goods are collected "house to house" charities must comply with the House to House Collections Act 1939. (This is an area that many charities often neglect believing that the rules governing house to house collections only apply to collections of cash and not collections of goods).

House to house collection licences are granted in the name of the charity that 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. The question is how are these donated goods 'transferred' to the trading subsidiary to sell. There are, of course, complicated agency agreements that might allow this but then the profits of the sales must appear in the charity's books and not in the trading subsidiary's.

The principle being that charity should not gratuitously give goods donated to it to the subsidiary. I have heard the argument that the gift of the goods is given in exchange for the trading subsidiary covenanting or gift aiding back the profits. This is a dangerous argument, as it would invalidate the tax effectiveness of a deed of covenant payment. I have also heard the argument that the goods are being donated directly to the subsidiary but this causes other problems.

The Rates Issue

Section 43 of the Local Government Finance Act 1988 gives mandatory relief from non-domestic rates to charities where the rate payer is a charity or trustees for the charity and the property is wholly or mainly used for charitable purposes. This means that your present treatment could fall foul of a proper interpretation of this relief.

The rate payer being a trading company is not a charity and the property being used to generate income for 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 in my opinion strictly allow it to obtain this relief. I have seen this point being taken by local authorities that are then denying rates relief.

The VAT issue

As explained, the law allows zero rating for goods sold by a trading company so long as they covenant all the profits of that supply to the charity. Interestingly, despite the specific reference to covenants in the legislation, in practice H M Customs & Excise appear to accept that if a charity subsidiary transfers its profits by gift aid or dividend this will suffice. However, I have seen them 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 covenants the £90,000 to the charity it will not be covenanting 'all the profits' of the supply of donated goods. I must confess that I have not seen this point taken but having discussed it with HMC&E they do recognise the point and say that they would not expect all the profits of the supply 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 capital gains tax conferred by S.256 of the Taxation of Chargeable Gains Act 1992 is available only to charities and not trading subsidiaries. Consequently, if there is a covenant in place it should be properly worded to allow the inclusion of capital gains.

The solutions

Clearly there are a number of problems associated with the structure of using the non-charitable trading subsidiary to sell all the goods. Consequently where the charity primarily sells donated goods I have always advocated that the shops should 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.

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 and 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.

With regard to rates relief Section 64(10) of the Local Government Finance Act 1988 states that a property will pass the wholly or mainly used for charitable purposes test if it "is wholly or mainly used for the sale of goods donated to a charity and the proceeds of sale of the goods (after any deduction of expenses) are applied for the purpose of a charity".

When a shop sells both donated and bought in goods I believe it qualifies so long as more than half the goods are goods donated to a charity for resale. I have seen some rating authorities take the view that "mainly" requires a much larger percentage but they have changed their mind when faced with the words of Lord Morton of Henryton. In Facet Properties Ltd v/s Buckingham City Council he acknowledged that the word 'mainly' gave rise to difficulties but suggested that it probably did mean "more than half". Clearly, the ratepayer must be a charity selling goods donated to the charity.

I usually recommend a 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 that is appropriately charged. 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 or Deed of Covenant. This is the way that most of the large charity shop chains operate.

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PART 7 CONCLUSIONS

Papers of this length can merely highlight some issues. There are several others such as consumer protection legislation, accounting, staffing, financial management, evaluation, rates relief etc. that must be considered.

Admittedly, the whole process does seem unnecessarily long winded and it appears that the charities do have to go through hoops and loops to ensure that income generation by trading is possible. But, the laws exist and ignorance is not bliss. Those charities that get it wrong could find themselves in very awkward and costly situations. It is perhaps useful to quote from the 1988 report of the Charity Commissioners:

> *"Trustees have a duty to consider the tax effectiveness of the arrangements between them and any associated trading company, and they may be personally liable to account for taxation liabilities which are unnecessarily incurred directly or indirectly as a result of the inefficient administration of the charity. It makes no difference that the liabilities may arise not from the disqualification of the investment made by the charity, but from the disallowance to the associated trading company of corporation tax relief. The associated trading companies are not charities and are not directly subject to our jurisdiction, but we are of course concerned as to the manner in which charity trustees exercise the administrative rights which the ownership of the shares in those companies gives them."*

In essence, when entering into activities that may appear to be trading it is important to consider:

- What is the activity - is there any exchange of goods or services or is there any benefit to a third party?
- What are the charity law, direct tax and VAT implications?
- Does the charity's constitution allow it to carry out the activity?
- Should the transactions go through a trading subsidiary?
- Is the trading subsidiary properly set up and treated on an arms length basis?
- Is the profit being properly passed over?
- Is the profit commensurate with the financial investment and effort?

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