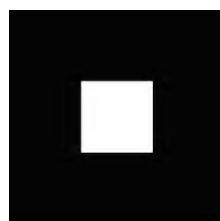


CHARITY TRADING SUBSIDIARIES

CHARIOT HOUSE LIMITED
CHARTERED ACCOUNTANTS
&
REGISTERED AUDITORS

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CHARITY TRADING SUBSIDIARIES

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CHARITY TRADING SUBSIDIARIES

Do You Need a Subsidiary?

1 Reasons to set up a trading subsidiary - there are three main reasons why a charity would set up a trading subsidiary:

- (1) To avoid or benefit from *indirect tax* (VAT) issues.
- (2) To avoid *significant risk* to the charity.
- (3) To avoid *direct tax* (corporation tax or income tax) liabilities.

2 Indirect tax - in terms of *indirect tax*, setting up a trading subsidiary may help with issues of the VAT registration threshold and VAT recovery levels where partial exemption applies. This is a complex area and each charity would need to take advice on its own particular situation.

3 Significant risk - there are circumstances when although there would be no tax issues, a charity should still set up a trading subsidiary to avoid *significant risk* residing with the charity. Examples of such situations are uncertain primary purpose (see below) trading activities, or lease or other contractual commitments (though third parties may still seek guarantees from the charity itself).

4 Shops - charities often decide to run their shops through a trading subsidiary for a combination of indirect tax and risk reasons.

5 Direct tax - when it comes to *direct tax* issues, there are a number of exemptions allowing trading to occur tax-free in the charity itself:

- (1) Primary purpose trading – trading that contributes directly to one or more of the objects of a charity as set out in its governing document.
- (2) Ancillary trading – trading that contributes indirectly to the successful furtherance of the purposes of the charity (eg theatre bar at performances).
- (3) Beneficiary performed trading – trading mainly carried out by beneficiaries of the charity.

(4) Small-scale fundraising – to qualify, the following conditions must be met:

- The event must have a charitable purpose.
- The event must be organised by a charity, charity trading subsidiary, or other qualifying body, for the charity's own benefit.
- Trading is not being undertaken through a series of events.
- Accommodation for the event is not provided for more than 2 nights.
- There may be no more than 15 events of the same kind in a charity's financial year at any one location by a charity, its trading subsidiary or qualifying body.

(5) Small-scale trading – profits are exempt whatever the trading source if they fall within the following limits:

- Do not exceed £5,000 (proposed £8,000 wef April 2019).
- Are limited to £50,000 if total income exceeds £200,000 (proposed £80,000 if income exceeds £320,000 wef April 2019).
- Are limited to 25% of total income, if total income is between £20,000 and £200,000 (proposed £32,000 and £320,000 wef April 2019).

6 Non-trading activities - certain specific activities are not regarded as trading:

- 1 The sale or letting of goods donated to a charity for the purpose of sale or letting.
- 2 The sale of investments.
- 3 The sale of assets which the charity uses, or has used, for its charitable purposes.
- 4 The letting of land and buildings where no services are provided to the user.

CHARITY TRADING SUBSIDIARIES

Structural Issues

1 Power to set up - if a charity is going to set up a trading subsidiary, it should first ensure that it has the power to do so within its governing documents.

2 Legal structure - the legal structure of the subsidiary would normally be a company limited by shares, and would be 100% owned by the charity. Other legal structures are possible, but there would generally be administrative, financial or tax costs with these alternative structures.

3 Directors - the directors of the trading company should not be exactly the same people as are the trustees of the charity. There should probably be some overlap, but there should be both:

(1) At least one person who is a trustee of the charity, but not a director or employee of the trading subsidiary.

(2) At least one person who is a director of the trading subsidiary, but not a trustee or employee of the charity.

4 Separate records - separate financial records should be kept by the subsidiary, and it is generally better and easier to have a separate bank account, though the Charity Commission does not insist on this.

5 Financing - care needs to be taken with the financing of the subsidiary. Share capital is generally kept low, so financing mainly happens through loans from the charity. In this regard:

(1) A commercial rate of interest should be paid.

(2) Security should be taken wherever possible.

(3) Repayment terms should be agreed.

In respect of any loans and in setting up and investing in the subsidiary, the charity should be satisfied that there is a business plan indicating the investment is justifiable.

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Operational Issues

1 Records – the trading subsidiary should keep its own financial records reflecting the full transactions of the company.

2 Staff – quite often charity staff will also spend time working for the subsidiary. Such costs should be borne by the subsidiary and to avoid VAT issues joint contracts of employment should be in place for these staff.

3 Facilities and overheads – the subsidiary should bear its share of such costs. Any recharge from the charity should be at cost, and not made at a profit. Management charges are standard rate for VAT purpose, so care (and advice) needs to be taken with this.

4 Rates relief – trading subsidiaries have no absolute right to rates relief in respect of properties they occupy. However, the rating authority may grant rate relief at its discretion.

5 Losses – particular attention is required by the charity trustees if the subsidiary is making a loss. While it is sometimes the case that losses may arise when the trading subsidiary starts activities, the Charity Commission expect that the company should be operating profitably within two years.

Trustees run the risk of personal liability if they allow a loss-making subsidiary to continue in operation when there is no reasonable prospect of the company being able to make a sustainable longer-term profit.

6 Monitoring – in the light of point 5, it is therefore vital that the trustees regularly monitor the performance of the subsidiary.

7 Profits – all being well, however, the subsidiary will be making profits. In order to avoid paying corporation tax on these profits the following should be remembered:

(1) Taxable profits should (subject to point (5) below) be fully paid up as a Gift Aid payment to the charity within 9 months (see point (2) below) of the subsidiary's year end.

(2) If the trading subsidiary's accounting period is longer than 12 months (either the first period after incorporation or if the year-end is changed), the deadline for paying up profits will be earlier than the 9 month deadline. Advice should be taken from the charity's accountants as to the actual deadlines.

(3) It is acceptable for some of the profits to be paid up during the year, but it is safer to wait until the actual taxable profit is known before paying up the full profits.

(4) Profits must actually be paid up; book entries are not sufficient.

(5) The maximum permitted Gift Aid payment is the subsidiary's accounting profit (assuming that there was not a brought forward deficit on reserves) and not the subsidiary's taxable profit. This has the potential for leaving some profit subject to corporation tax in the subsidiary, but the risk of this can be minimised by taking care over the treatment within the group of:

- Fixed assets
- Leasehold improvements
- Permanently disallowable expenditure

(6) Generally, in the accounts of both the trading subsidiary and the charity itself, the donation is recognised in the year of payment ie it is not treated as a creditor in the subsidiary and a debtor in the holding charity.

If, exceptionally, there is a legal obligation (by deed of covenant) for the subsidiary to pay up its profits to the charity, then a debtor and creditor respectively should be included in the accounts of each entity.

This recent change does not affect the corporation tax treatment in the trading subsidiary, whereby tax relief is still granted as long as the subsidiary does pay up the donation to the charity within 9 months of the subsidiary's year end.

CHARITY TRADING SUBSIDIARIES

Sources of Information

The Charity Commission guidance on trading subsidiaries is found within CC35 - Trustees, trading and tax: How charities may lawfully trade.

This was last updated in February 2016.

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/508202/CC35.pdf

HMRC guidance is given in summary at:

<https://www.gov.uk/guidance/charities-and-trading#overview>

And in more detail at:

<https://www.gov.uk/government/publications/charities-detailed-guidance-notes/annex-iv-trading-and-business-activities-basic-principles>

Sayer Vincent have produced a useful guide ‘Subsidiaries made simple’:

<http://www.sayervincent.co.uk/wp-content/uploads/2015/07/SubsidiariesMadeSimple-SayerVincent-July2015.pdf>