
Private client law

Briefing

MACFARLANES

Charities and trading - a complicated business

For a charity, a trade may be a valuable source of income - but charity law and the tax rules conspire to make trading by charities a difficult area, with numerous pitfalls for the unwary. Often, as will be seen, trading activities must be transferred to a non-charitable trading subsidiary ("hived down") rather than being carried on by the charity itself. However, setting up a trading subsidiary is not entirely straightforward.

This note looks at whether a trade is being conducted, when it may be necessary to hive trading activities down, and how this should be done.

Is there a trade?

There is a substantial body of case law on this subject. Almost any form of commercial enterprise will qualify as a trade, provided that it is pursued for a financial objective and with a certain degree of regularity. The holding of events for fund-raising purposes, such as bazaars, dances and dinners, may be regarded as a trade, as may the holding of lotteries. The provision of a service, such as education or childcare, is likely to constitute a trade if fees are charged.

Similarly, the sale of goods in a shop or at a stall generally constitutes a trade. However, the sale of donated goods is

usually an exception. Unless the donated goods have been subjected to significant refurbishment before sale, the sale of such goods is regarded as a means of realizing the value of gifts made by the donors, and not as a trade.

If a trade is being carried on, the next question is whether its nature is such as to permit the carrying on of the trade by the charity, or whether it is necessary, as a matter of charity law or because of tax considerations, to hive the trade down to a trading subsidiary.

Is it a "primary purpose trade"?

The first step in answering the above question is to determine whether the trade qualifies as a "primary purpose trade". This is where the trade is a means of performing one or more of the charity's main objects (as stated in its governing document). Common examples are the provision of educational services by an independent school or the provision of residential care accommodation by a care charity in return for payment. In principle, there is no difficulty with primary purpose trading. A primary purpose trade can, and generally should, be carried on by the charity itself rather than being hived down.

The main exception to the general rule that a primary purpose trade should be carried on by the charity is where the nature of the trade creates a risk of a

claim by a third party. For example, in the case of a charity selling goods in a shop, a member of the public might have an accident on the premises and sue for personal injury; a purchaser from the charity might bring proceedings in respect of a defective product; and, if the shop is run from leased premises, there might be an unforeseen liability to the landlord, for dilapidation of those premises. Where there is potential for liability to third parties, the use of a trading subsidiary can provide valuable protection for the assets of the charity. Insurance can of course be purchased against certain risks of this nature, but there may be significant gaps in the cover which can be obtained, and the use of a trading subsidiary will provide an extra layer of protection. The charity trustees and their advisors will need to consider whether this advantage outweighs the disadvantages of hiving the trade down - not least the extra bureaucracy involved in this, as discussed below.

If a primary purpose trade is carried on by the charity, any profits are exempt from income or corporation tax, provided that they are applied solely for the objects of the charity.¹ This exemption from tax must be formally claimed from HMRC, but the charity trustees have about 6 years to submit this claim from the date on which the profits arose.

¹ S.505(1)(e)(i) ICTA 1988

Non-primary purpose trades

A non-primary purpose trade, on the other hand, will often need to be hived down. Under charity law, charities may not, as a general rule, incur significant expenditure in non-primary purpose trading, because a charity's funds can only be applied for its objects and the expenses incidental to the performance of those objects. Moreover, the profits of a non-primary purpose trade will, generally speaking, be subject to income or corporation tax, notwithstanding that these profits are being made by a charity. The solution to this problem, once the trade has been hived down, is for the trading subsidiary to gift its net profits to the charity, thereby wiping out the tax liability. This is discussed in more detail below.

There are four exceptions to the general rule that a non-primary purpose trade must be transferred to a trading subsidiary. Hiving down may be unnecessary in the following cases:

- **Ancillary trading:** This is where the trade is not, in itself, a means of performing the charity's objects, but is carried on in the course of performing those objects, and as an adjunct to the performance of those objects. An example would be the sale of food or drink to visitors to a museum operated by a charity. This is treated in the same way as primary purpose trading for charity law and tax purposes, and can usually be carried on by a charity rather than being hived down.
- **Beneficiary worker trading:** This is where the trade is wholly or mainly carried on by beneficiaries of the charity. An example would be a shop staffed by people with learning difficulties, and owned by a charity set up to help such people. Beneficiary worker trading will normally be treated in the same way as ancillary trading for charity law purposes, and such activities will not, therefore, usually need to be hived down. There is a specific exemption from tax for a trade which, while not carried on in the performance of the charity's objects, is wholly or mainly conducted by the beneficiaries of the charity.² Again, a formal claim must be submitted for the exemption.
- **Small-scale fund-raising events:** Events held for the purpose of fund-raising, where there is a charge for admission or participation, are capable of constituting a trade if they are held with any frequency or regularity. The funds raised by such events will then be regarded as the profits of a trade. Such profits will, as a general rule, be subject to income or corporation tax. However, there is an exemption from tax³ on profits from fund-raising events, such as dances, dinners, concerts, shows, sporting events, auctions and bazaars, where no more than 15 such events occur in the charity's financial year in any one location. If there are events involving a charity of any one kind which are held at the same location and the gross takings from all such events are no more than £1,000 per week, then the 15 event limit does not apply.⁴ This is a useful exemption, but it should be used with caution. As a general principle, significant expenditure cannot be incurred for a trade which is not a primary purpose or ancillary trade. Moreover, a charity will not necessarily have power under its governing document to carry on such activities. It will, therefore, often be necessary to hive down activities of this kind.
- **Other small-scale trading:** There is a further exemption from tax on the profits of a trade carried on by a charity if the charity's gross income in the chargeable period (from all sources) does not exceed the lesser of £50,000 and 25% of the charity's incoming resources (meaning income plus other funding), subject to a minimum of £5,000; or if, at the beginning of the chargeable period, it was reasonably expected that the charity's gross income would not exceed this amount.⁵ There is an additional requirement that all such income must be applied solely for the purposes of the charity.⁶ As with the exemption for primary purpose trading,

² S.505(1)(e)(ii) ICTA 1988
³ See Revenue guidance note IR2001

⁴ See Charity Commission guidance note CC35
⁵ ESC C4
⁶ S.46 FA 2000

this exemption must be formally claimed from the Revenue, but the charity trustees have about 6 years to do this. The Charity Commission guidance indicates that, where the turnover of a trade falls within this limit, the trade can be carried on by the charity, provided that the charity has power to trade under its governing document. However, as noted above, charity trustees should be wary of incurring any significant expenditure on a non-primary purpose and non-ancillary trading activity, as this may constitute a breach of trust

There is a special rule regarding mixed trades. A mixed trade is one which combines elements of primary purpose and non-primary purpose trading. For example, a museum charity might run a shop selling books on the subject of the objects on display, which would fall within its object of educating the public, but also other items which are not of an educational nature, such as souvenirs. HMRC regard the primary and non-primary purpose parts of the trade to be two separate trades. The primary purpose trade is not taxable while the non-primary purpose trade is considered to be chargeable to tax.⁷ HMRC's guidance recommends setting up accounting systems that distinguishes between the two types of trade. There should be a reasonable

apportionment of expenses and receipts between the separate trades.⁸

It should also be noted that, even if a trading activity falls within one of the above categories, so that there is scope for it to be carried on at charity level, there may nevertheless be factors which require it to be hived down, or which make this desirable. In particular, the carrying on of the trading activity at charity level may expose the charity's assets to commercial risks, or the risk of public liability, which would be reduced if the activity were transferred to a trading subsidiary. If the charity suffered financial loss because of such factors, the omission by the charity trustees to hive the trading activity down might constitute a breach of trust, for which they would be personally liable.

Establishing a trading subsidiary

Where a trade cannot be carried on by a charity, either because this would be a breach of charity law or because the profits of that trade would not be exempt from income or corporation tax, it will need to be hived down to a wholly-owned non-charitable trading subsidiary. A conventional private company limited by shares is still the best vehicle in most cases; the new community interest company form is generally thought to be unnecessarily bureaucratic and restrictive for this purpose.

The governing document of the charity should be checked to ensure that it has power to establish such a company. If there is no express power to do so under the governing document, there may (in the case of a trust or an unincorporated association) be an implied power by virtue of the Trustee Act 2000.⁹

The subsidiary will then need to be funded. This is usually the most problematic aspect of hiving down a trading activity.

There are, usually, three possible sources of funding for a trading subsidiary. A bank is one obvious possibility. However, being a start-up, the company is unlikely to have any real assets, and a bank will therefore want a guarantee by, and security over the assets of, the charity. This is unlikely to be in the best interests of the charity and, if the trading subsidiary failed and the bank exercised its security over the charity's assets, the charity trustees would be at risk of a breach of trust action by the Charity Commission.

A trading subsidiary could, in theory, be funded by supporters of the charity. However, trustees should note that the "sweetener" of income/corporation tax relief under the gift aid scheme will not be available. Methods of funding which could be considered are by way of share capital or by loans or by some combination of the two. The Charity Commission has historically cautioned

⁷ See s.3 and s.7 Trustee Act 2000

⁸ Under s.660A ICTA 1988

⁹ S.506 and paragraph 9, Schedule 20 to ICTA 1988

charities against allowing supporters to make equity investments in trading companies otherwise held by charities. Whilst this scepticism has not entirely disappeared, the Commission has relaxed its position somewhat. The Commission suggests that share capital investments by supporters of the charity, who are not interested in a commercial return could be considered. However, it makes the obvious point that there will be little if any scope for the payment of dividends, as a trading subsidiary will normally pay all of its taxable profits to its parent charity under the gift aid scheme. Prospective shareholders in the company (other than the charity) will therefore need to treat the investment as a charitable gift, without tax relief and with little prospect of a return unless, in due course, the company is sold to a commercial purchaser.

The charity will need a majority equity stake so that it can control the composition of the board and (indirectly) ensure that gift aid payments are made when profits are realized. Furthermore, there is a disadvantage in relation to the timing of gift aid payments if the subsidiary is not wholly owned by the charity.

If supporters are to make loans to the company, these loans should ideally bear interest at a commercial rate, to avoid a theoretical risk that the supporters could

be taxed on the profits of the company¹⁰ (although it is doubtful whether HMRC will take this point in practice). Advice should be taken before any such loans are written off by the supporters, as this could in theory give rise to inheritance tax for them.

In most cases, the trading subsidiary will need to be funded by the charity. Such funding may be provided by way of loan or by way of share capital. While it is more usual to provide funding by way of loan, the Charity Commission suggests that an investment of share capital by a parent charity in its subsidiary is an expression of confidence by the parent which will be of benefit when dealing with suppliers and other contracting parties. The Commission stresses that in the event of the subsidiary's bankruptcy, a shareholder will rank behind all other creditors when and if the subsidiary's creditors are repaid. In the past the Charity Commission did not encourage providing funding by way of share capital and it is only recently that it has entertained such a possibility in its guidance to charities.

If funding is to be provided by way of loan, it should be on commercial terms with full security (normally a fixed charge over any land owned by the subsidiary, coupled with a floating charge); have proper terms for repayment and not be written off by the

¹⁰ S.4 Trustee Act 2000

charity. There are two, connected reasons for this:

- **Charity law:** In general, a charity's funds can only be applied for non-charitable purposes if this is to produce an investment return. The funding of the trading subsidiary must therefore be regarded as an investment, and one which by its very nature carries a certain amount of risk. The inherent risk borne by the charity can only be justified if the terms of the investment, including the interest rate and the security, are broadly the same as those which would be imposed by a commercial lender, to maximize the return and minimise the chances of the money becoming irrecoverable. Otherwise, if the company gets into financial difficulties, the charity trustees may face a claim by the Charity Commission that the making of the loan constituted a breach of trust.
- **The tax legislation:** A loan by a charity to a non-charitable entity may result in a loss of income/corporation tax relief by the charity, unless HMRC are satisfied that the loan was made for the benefit of the charity and not for the avoidance of tax.¹¹ Although HMRC will consider the circumstances of the loan as a whole, it will not usually be regarded as being in the charity's interests to make a loan which is not on broadly the same terms as would be imposed by a bank. HMRC will not give formal

¹¹ S.5 Trustee Act 2000

clearance of a proposed loan although, in our experience, they are usually willing to consider the facts and provide an informal indication of whether, in their view, the conditions referred to above are satisfied.

In view of the above, the charity trustees need to bear in mind the following:

- **Due diligence:** It is advisable for a formal business plan and financial forecasts to be drawn up by or on behalf of the proposed directors of the trading subsidiary, and for these to be presented to the charity trustees for evaluation of the case for investment. The charity trustees should consider these documents in detail and their deliberations should be carefully recorded in the minutes.
- **Portfolio theory:** If, as discussed above, the funding of the subsidiary is to be regarded as an investment by the charity, it follows that the charity trustees should be considering such factors as investment diversification and the balancing of risk. If the charity is a trust or unincorporated association, the Trustee Act 2000 will apply. Where trustees are proposing to make an investment, the Act requires them to consider the suitability to the trust of investments of the same kind as the proposed investment (in this case, loans to unquoted companies), the suitability to the trust of the particular proposed investment (in this case, the loan to

the trading subsidiary), and the need for diversification of the trust investments (in each case, insofar as is appropriate to the circumstances of the trust).¹² There is an argument that the charity should not be making an investment in a trading subsidiary (necessarily a high risk investment) unless it forms a relatively small part of a balanced investment portfolio in which risk is properly managed (effectively requiring a significant body of other investments which are comparatively low risk in nature). However, relatively few charities have investment portfolios of sufficient scale to allow them to comply with this principle, and the Charity Commission does not seem to apply it very rigorously in practice. The Act does not apply to corporate charities, but the view of the Commission is that the directors of charitable companies should, as a matter of good practice, consider these points as if the legislation did apply.

- **Proper advice:** If the charity is a trust or unincorporated association, the charity trustees will also need to consider the rules in the Trustee Act 2000 concerning advice on proposed investments. The Act imposes a requirement on trustees to obtain and consider “proper advice” when they are proposing to exercise their powers of investment, unless they reasonably conclude that in the circumstances

such advice is unnecessary or inappropriate. “Proper advice” is defined as the advice of a person who is reasonably believed by the trustees to be qualified to give such advice, by virtue of his or her ability in and practical experience in financial and other matters relating to the proposed investment.¹³ It will often be necessary to engage a professional business consultant for this purpose. However, if one of the trustees has suitable abilities and experience, and is willing to advise (bearing in mind the potential for liability for negligence), the other trustees may treat his or her advice as “proper advice” for the purposes of the Act. Again, the Act does not strictly apply to corporate charities, but it may be advisable for the directors of charitable companies to take similar steps.

- **Amount of the investment:** This must be sufficient to cover the subsidiary’s cash requirements until these requirements can be satisfied out of trading income. Clearly, the amount needed will need to be carefully estimated, taking a realistic view of how long it will take the subsidiary to achieve financial independence. Funding the subsidiary properly at the outset should minimize the risk that the charity will be called upon to inject further funds into a struggling

¹² S.339 ICTA 1988

¹³ S.339(7AA) ICTA 1988

subsidiary, which can be difficult to justify.

- **Interest:** As mentioned above, any loan to the subsidiary should, in principle, bear the same rate of interest as if the money were being provided by a bank. Arguably, this should be the same rate as if a bank were making the loan without security over the charity's assets - which is likely to be high. The loan agreement should provide for interest to be paid at regular intervals, rather than being "rolled up", and the charity trustees should not allow interest to be rolled up in practice. The failure to call for the payment of interest to which the charity is entitled may constitute a breach of trust.
- **Repayment:** If a loan is made, the loan agreement should provide for repayment of all of the principal within a fixed period. The Charity Commission's recommendation is that the trading subsidiary should aim to be financially viable within the first five years of operation, and arguably full repayment should normally be required within this five year period.

The charity trustees should also note the following points:

- **Transferring the business to the trading subsidiary:** If assets of the charity are used in the business which is being hived down, the subsidiary will need to be given ownership of, or at least the right to use, those assets.

For example, it may be necessary for premises and equipment to be sold, let, or licensed to the subsidiary. Employees may need to be transferred to the subsidiary, or alternatively the subsidiary may need to be charged, on an ongoing basis, for services provided by employees of the charity in the furtherance of the business carried on by the subsidiary. In addition, if there is significant goodwill attaching to the business, this too will need to be sold to the subsidiary. In entering into these transactions the charity trustees will need to bear in mind that they have a duty to maximize the value of the charity's assets, which will entail obtaining a market value for all assets or services sold or provided to the subsidiary.

- **Management separation:** The Charity Commission recommends that there be at least one person on the board of the trading subsidiary who is not a charity trustee, and at least one charity trustee who is not on the board of the trading subsidiary, to reduce the risk of roles becoming confused. Where the individuals involved are accustomed to acting in multiple capacities, it is not necessarily a problem if the charity trustees and the company directors are the same people (and the governing documents of both entities deal appropriately with the issue). However, the trustees should think about putting a conflict of interests policy in place.

- **Remuneration:** A charity trustee who is also a director or employee of the trading subsidiary cannot receive remuneration from the company unless he or she is permitted to receive remuneration under the charity's governing document, or this has been expressly authorized by the Charity Commission. Alternatively, the statutory procedure set out in Charities Act 1993 may be used.
- **Rates relief:** A charity in occupation of non-domestic premises is entitled to 80% relief on the rates payable in respect of those premises, provided that such occupation is wholly or mainly for charitable purposes (and, where the 80% relief applies, the balance of 20% will often be waived by the relevant local authority). Charitable purposes, in this context, will include the carrying on of a primary purpose trade; they will also include the sale of donated goods (as noted above, this is not regarded as a trade). This relief will be lost if the person carrying on the trade at those premises ceases to be the charity and becomes its trading subsidiary. However, it may, on occasion, be possible to avoid the loss of rates relief by arranging matters such that the subsidiary occupies the premises as a mere licensee of the charity. If the purposes of such occupation are wholly or mainly charitable, in the sense outlined above, the test for rates relief will be passed, notwithstanding that the charity is

occupying the premises as agent rather than on its own behalf.

— **VAT registration of the trading subsidiary:**

It should be possible to apply for a joint VAT registration of the charity and the subsidiary (or to include the subsidiary in the charity's existing VAT registration). This will usually be preferable to a separate VAT registration for the subsidiary, as the charity may be making supplies to the subsidiary (or vice versa) and if both entities are within the same VAT registration there is no need to worry about VAT on such supplies.

— **Name of trading subsidiary:**

a trading subsidiary should have a name that sufficiently distinguishes it from the parent in order to avoid confusion of identity. Company law requirements regarding names must also be followed, in particular the restrictions upon the use of the words 'charity', 'trust' and 'charitable' which require approval of the Registrar of Companies before they may be used. In practice, names containing these words cannot be used for trading subsidiaries, although it is perfectly acceptable (and conventional) for a trading subsidiary to have a name which suggests a link with the owning charity.

Administering the new structure

Clearly, more administration is involved in running a charity and a trading subsidiary than in running a charity alone. The

directors of the subsidiary need to comply with the Companies Act 1985 regime, including the preparation of annual accounts, auditing of these, and submission of the audited accounts and annual reports to Companies House (subject to the exemptions for smaller companies). Board meetings need to be held at appropriate times, and, where charity trustees are on the board, care needs to be taken to keep the management of the two entities separate.

The directors of the trading subsidiary also need to make sure that, where possible, profits which would otherwise give rise to a corporation tax liability for the subsidiary are given to the charity, under the corporate gift aid scheme.¹⁴ This is known as "profit-shedding". A gift of a sum of money by a company to a charity will, provided that certain conditions are satisfied, reduce the company's taxable profits by the amount given. To qualify under the corporate gift aid scheme, the gift must not be repayable in any circumstances or be part of an arrangement involving the acquisition of property by the charity, and the company must not receive a significant benefit in consequence of the making of the gift.

It is worth noting that a wholly-owned trading subsidiary does not need to shed its profits in the accounting period in which those profits have arisen. A company which is wholly-owned by a charity can

elect to have a gift aid payment which was made up to 9 months after the end of a given accounting period backdated, for tax purposes, to that accounting period.¹⁵ This greatly facilitates accurate profit-shedding, as there is plenty of time to have accounts of the subsidiary prepared and audited, so that the directors have a precise idea of the profits realized in the relevant accounting period, before the deadline for the gift aid payment. The election must be made within the period of 2 years from the end of the accounting period in which the payment was actually made.

It is also worth noting that interest payments by the subsidiary to the charity are deductible in determining the subsidiary's profits, for tax purposes, in a given accounting period. Repayments of principal due to the charity are not tax-deductible, however, and the requirement to make such repayments may prevent the subsidiary from eliminating its corporation tax liability under the corporate gift aid scheme.

It is sometimes suggested that a charity having down a trading activity to a wholly-owned subsidiary should enter into an agreement with the subsidiary, under which the subsidiary agrees to give its surplus profits to the charity at regular intervals under the corporate gift aid scheme. This is unnecessary, as the charity will, as the sole shareholder, have ultimate control of the subsidiary. Moreover, considerable care

¹⁴ See *Noved Investment Company v Revenue and Customs* [2006] UK SpC 00521

¹⁵ S.339 (7AA) ICTA 1988.

should be taken with agreements and arrangements between charities and trading subsidiaries under which the charity is positively entitled to “gifts” by the subsidiary. Previously, if such an entitlement was considered to be in respect of or attributable to the charity’s shareholding in the subsidiary, the corporate gift aid scheme might not have applied (defeating one of the main purposes of the arrangement!).¹⁶ By virtue of a provision in the Finance Act 2006, this is no longer a risk unless the “gifts” take the form of dividends, or the subsidiary is not wholly-owned by the charity.

As indicated above, the charity trustees need to treat the investment which has been made in the subsidiary as if this was an investment in an unrelated business - that is, dispassionately (as far as they can) and with a view to maximizing the return for the charity. The activities and financial results of the subsidiary must be kept under close review. If the subsidiary has been funded by way of a loan, interest should be charged as stipulated in the loan agreement, and, assuming that the loan agreement provides for periodic repayments of

principal, these should likewise be demanded from the subsidiary on the due dates. Above all, a request for additional funding from the charity should be resisted unless there is a very clear business case (from the perspective of the charity) for adding to the investment, and this is in keeping with the charity’s investment portfolio.

VAT

It should be noted that a charity which is engaged in a trade will generally be required to charge VAT on supplies of goods or services made by it. The sale, hire or export of donated goods by a charity or its trading subsidiary is zero-rated for VAT¹⁷ as is the sale of bought-in goods at fund-raising events. However, the sale of bought-in-goods is otherwise at the standard rate for VAT. There is an exemption from VAT for small-scale fund-raising events, the conditions of which are exactly the same as for the income / corporation tax exemption for such events. There is also an exemption for admission to cultural events, for example museums, galleries, art exhibitions and musical performances.¹⁸

Conclusion

Engaging in a trading activity - either at the level of the charity or through a trading subsidiary - can be a complicated business. A great deal of thought will need to be put into such a project, and most charity trustees will need professional advice. However, the advantages to a charity of having a successful business, which can provide it with a reliable source of funding and a degree of financial autonomy, are clear.

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This note is intended to provide general information about some recent and anticipated developments which may be of interest. It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

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¹⁶ See *Noved Investment Company v Revenue and Customs* [2006] UK SpC 00521.

¹⁷ This is Group 15, Sch 8 of VATA 1994

¹⁸ Schedule 9, Group 13 VATA 1994