AFVS Briefing Papers

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Charity Trading Made Simple

Contents

1. Introduction

1.1. We regularly get calls from charity trustees keen to make some money for the charity by carrying out some form of trade. Often, they want to go the whole hog from the start and set up a trading company which will make big profits which will be passed across to the charity.

1.2. When I hear this my initial advice is to think it all through carefully, make sure you have a plan that's written down and, unless it's a big venture properly thought through, start with a restricted fund in the charity accounts. When it starts to build is the time to think about a trading company. It's commonly said that 9 out of 10 businesses fail in the first year. This is an exaggeration but early years are nevertheless fraught with danger. The failure rate in the voluntary sector is high, often because of people's dreams not being sufficiently translated into reality and risk not being properly assessed. (If risk was considered, few projects would survive the planning stage; sometimes you just have to go for it; if you do, keep it simple and considered)

2. What isn't Trading?

2.1. Charities are exempt from Corporation Tax, Income Tax, and Capital Gains Tax on most kinds of non-trading income, provided the income is spent on charitable purposes. Grants, legacies, donated goods and services and donated shares aren't taxable.

2.2. Selling Donated Goods: This isn't seen as a trade for tax purposes. Goods can be cleaned and given minor repairs; if they are subjected to a significant refurbishment, sale proceeds could be regarded as primary purpose trading income.

2.3. **Letting Premises:** Rental income is exempt from tax provided the profits are used for charitable purposes. If services are provided, these services might be regarded as trading. If your charity rents out spare space it's not trading, provided it doesn't provide significant services, for example catering.

2.4. **Investment income:** Again, exempt from tax. Same applies to Royalties, where it's pure profit, with no service being provided.

2.5. **Company Donations:** Regarded as non-trading income provided the company receives nothing more than a simple acknowledgement. Anything more than this can be seen as advertising and the charity is drifting into the realm of trading, and even VAT implications. This particularly applies to sponsorship income.

2.6. **Cause related marketing;** same principles apply. Provided the charity does nothing to promote the arrangement it can receive payments made as donations.

2.7. **Membership subs:** The charity may provide information about the charity's work; provided no concrete benefits are provided the subscription is counted as a donation.

2.8. **Lotteries:** Seen as fundraising activities and not counted as trading.

3. What is Trading?

3.1. There isn't a specific definition of trading; case law has created a set of indicators which are listed below. If any of these criteria are fulfilled HMRC may decide you are trading.

3.1.1. **Repetition:** it's regular, not a one-off event.

3.1.2. **Profit motive exists** (even though a profit may not actually result)

3.1.3. **Means of selling,** i.e., there's a shop or a catalogue or a website

3.1.4. **Acquisition of items to sell,** as opposed to consuming them.

3.2. **Primary Purpose Trading:** This is trading within the charitable objects. For example, running a fee-paying school or a museum that charges an admission fee, or a residential care home that charges fees.

3.3. **Non-Primary Purpose Trading:** This is trading to raise money for the charity. A charity could set up a shop buying in new goods to sell onto the public, to raise money for the charity.

3.4. **Mixed Trading: W**here there's a mixture of primary and non-primary trading. An example I know about is a Christian bookshop that sells scout and guide uniforms as a sideline. This makes a useful addition to the profits of the shop, but the sales figures for these items have to be kept separate in the accounts from the other sales figures to make sure that HMRC rules are met (section 4 below). Another example could be a museum shop which sells mainly educational goods but also carries other goods such as mugs and tea towels. Another example is where a college lets serviced accommodation during term time, and offers the accommodation to tourists in the holidays.

3.4.1. Where mixed trading applies, the taxable profits of the non-primary trading have to be separated out with a reasonable apportionment of expenses. CT600 and CT600E returns need to be completed. You'll need the services of an accountant who understands charity accounts.

3.4.2. Where a loss is incurred you will have to apportion it between primary and non-primary. The non-primary loss will mean an equivalent loss of exempt status of charity income. It's likely that this will incur a tax liability. Again, you'll need an accountant for this.

3.5. **Trading undertaken mainly by beneficiaries:** This is usually where there is a therapeutic, educational or remedial value to the work. The trade itself does not need to be primary purpose and the beneficiaries can be paid or unpaid. Examples include a farm operated by students of an agricultural college, a restaurant operated by a catering college, or sale of goods manufactured by disabled people who are beneficiaries of a disabled charity. At least 50% of the work must be undertaken by beneficiaries; in practice, there might be some HMRC flexibility on this. Otherwise there could be a mixed trade situation.

3.6. **Ancillary Trading:** This is trading to support primary purpose trading. Here are some examples: Cafe for visitors to a museum, or a theatre, or a hospital. Take care in such a situation; if only some of this trading is ancillary, the trade could be mixed.

4. Exemptions from Primary Purpose Trading.

4.1. Where trading is on a small scale HMRC grants exemption from tax liabilities up to certain specified limits. This will often provide a small to medium charity with the ability to begin a project to test the water without having to set up a complex operation.

4.2. If income from the non-primary trading activity is below £5,000 in the year, or if it is less than 25% of the income of the charity, subject to an upper limit of £50,000. (So, a charity with an income of over £200,000 could not go over the £50,000 non-primary trading limit.)

4.3. If a charity does go over these limits HMRC will consider a 'reasonable expectation' argument, i.e, charity income lower than expected or trading income higher than expected. Of course, your case would need to be well argued and it'll only work once.

4.4. **Fundraising events:** There's a general exemption from tax and VAT for fundraising events.

4.4.1. A charity can hold up to 15 events of the same kind in the same location in a year. This limit would apply jointly to a charity and any trading subsidiary. 16 events and you lose the exemption totally for all the events.

4.4.2. Small scale events can be ignored as long as the gross takings don't exceed £1,000 in a week. This means that jumble sales and coffee mornings etc won't need to be included.

4.4.3. The events must be clearly to raise funds for the charity and can be disallowed by HMRC where they place commercial organisations at a disadvantage, so take care.

5. Trading Subsidiaries.

5.1. Once a non-primary trading activity begins to take root and begins to look like going outside the exemptions mentioned above, it's time to consider setting up a separate trading company. Often this might be a Community Interest Company, (CIC).

5.2. Risk needs to be considered and a separate company will give the parent charity a degree of protection.

5.3. In the early days in particular the trading company may need support from the charity, so there are still elements of risk to be carefully considered by the trustees. I've been involved in situations where trustees invested funds into a trading company set up to make money for the charity. The business failed and the investment had to be written off. The auditors were obliged to report this to the Charity Commission who required the trustees to make restitution out of their own pockets, under threat of legal action. (Had the trustees taken advice, this requirement may have been mitigated, but they didn't, and it wasn't)

5.4. Any investment into the trading company must be considered by the trustees in accordance with their investment policy; it must be in the best interests of the charity and its beneficiaries and professional advice must be taken. Contracts and agreements between the 2 entities for investment and support must be properly agreed and documented.

5.5. If due diligence is not undertaken the trustees can be deemed to be negligent in their duties and HMRC can classify the investment as non charitable expenditure. This means that an equivalent amount of charity income will lose its tax exempt status which may have tax implications.

5.6. Profits generated by a trading subsidiary can be transferred to the charity under gift aid rules, so avoiding tax. There are pitfalls however following a budget a few years back; your accountant will advise you on this.

5.7. Advantages of a separate trading company:

5.7.1. Protects the charity from tax liability
5.7.2. Limited liability reduces risk for parent charity
5.7.3. Permits activities which a charity may not carry out
5.7.4. Can separate up VAT to allow the charity to remain unregistered. (This is generally a good thing, for a charity not to register for VAT.)

5.8. Disadvantages:

5.8.1. More complex structure will add to costs. Often staff and volunteers are involved with both entities so clearly understood protocols and agreements must be in place. There may be an agreement for management charges, and other service agreements.
5.8.2. The trading company must be truly independent.
5.8.3. There may be a loss of rates relief.

6. Conclusion. In these days where sources of funding are getting increasingly hard to find and sustain, charities will increasingly be looking at whether they can embark on commercial activities to help secure their future. There are lots of exciting opportunities and possibilities. There are also lots of pitfalls waiting to trap the unwary. Trustees must make sure they get sound advice from people who understand charities and can help you on your journey. We are always glad to hear from charities that need our help to reach their destination safely.

References and further information

CC35 Trustees, Trading and Tax - How charities may lawfully trade
Sayer Vincent publication, 'Trading Issues Made Simple'
Lloyd and Walker - Charities Trading and the Law

Daryl Martin - April 2017
www.afvs.org.uk