Trading issues
made simple

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Introduction

To obtain charity registration and the benefits of charitable status, an organisation must be established for charitable purposes only and all its activities must fall within its charitable objects.

Many charities will seek to achieve their charitable objects by raising donated funds and providing services to beneficiaries free of charge. If donations are Gift Aided they are within the scope of income or corporation tax but exempt. However, many charities provide a service in return for a fee and this may amount to trading, although it may be permitted trading within the charity. If charities undertake trading activities, they need to take care that they stay within the tax exemptions for charities or set up appropriate structures otherwise they may suffer tax on any profit made from the trading activities.

Additionally, charity trustees will be aware of the requirement that all activities of the charity should provide public benefit. One of the criteria is that the price charged for any services should not be excessive as the service should be available to a wide section of the public. Your charity may have an opportunity to charge higher prices and therefore cross-subsidise your activities. The profit-making activity may be safely undertaken in a charity subsidiary with the profits donated to the parent charity tax effectively.

A key benefit of charitable status is the tax relief available to charities. Charities are exempt from income tax, corporation tax and capital gains tax on most types of income applied for charitable purposes.

These tax reliefs will be forfeited if the charity is in breach of the special conditions attached to them. Charities which trade will need to consider how they should structure their activities to avoid loss of valuable tax reliefs and to minimise the cost of tax on potentially taxable activities.

Non-trading income

Charities are exempt from paying corporation tax, income tax or capital gains tax on most types of non-trading income provided the income is applied for charitable purposes. Certain sources of income are not taxable, such as:

- donations
- grants
- legacies
- donated goods and services
- donated shares

Sale of donated goods

The sale of donated goods by a charity is generally not regarded as a trade for tax purposes, but as the realisation of the value of a gift.

This is so even where the donated items are sorted, cleaned and given minor repairs. If the goods are subjected to significant refurbishment or to any process which brings them into a different condition for sale purposes than that in which they were donated, the sale proceeds may be regarded as trading income. Note that this applies in various situations such as auctions as well as charity shops.

Letting out premises

Rental income from property is exempt from tax for charities providing 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. A charity renting out some spare space in its own premises is not considered to be trading provided it does not provide substantial additional services.

Investment income

Investment income such as dividends and bank interest is considered to be income derived from the charity's assets, but not trading and so exempt from tax. Royalties may also be in this category if they are an annual payment and so pure profit

i.e. the charity does nothing active to earn them.

Cause-related marketing

A company may wish to link its name to that of a charity and may undertake to make donations to the charity. This type of commercial participation arrangement will often allow for the charity to receive a percentage of takings for a day, or £10 per holiday booked or some similar arrangement. This is still considered a payment to use the charity's name or logo and can be structured so as to be exempt from tax as long as this is not seen as a part of a trading activity. HMRC's position is that where a charity allows its logo to be used in return for payment by a business as an endorsement for one or more of the business's products or services, and the charity likewise promotes the endorsement in its own literature, the payments are likely to be trading income of the charity.

Company donations

Company donations received by charities will be non-trading income providing the charity does not provide goods or services in return for the payment. This also applies to sponsorship income as long as they are in substance donations and the company receives no more than a mere acknowledgement.

Membership

Some membership subscriptions confer no benefits other than the right to be part of a movement and are really supporter schemes. The charity may provide information about the charity's work, but no concrete benefits. The subscription therefore amounts to a donation and is not considered trading. However, where members receive substantial benefits, the activity may amount to trading.

Lotteries

Raffles and prize draws are exempt from taxation and are seen as fundraising activities when undertaken by charities.

What is trading?

Trading is the exchange of goods or services for a fee. For tax, the law does not specifically define trading, but case law has built up to create a set of indicators or 'badges' of trade. The main points to look for are:

- Repetition – where the trading is regular rather than a one-off event.
- Profit motive – generally the profit motive should be present for trading to exist, even though a profit is not always actually made.
- Mechanism for selling – the existence of a shop or catalogue or other means for the sale of the goods or services indicates the existence of a trade.
- Acquisition of items for re-sale – buying goods with the intention of reselling them rather than consuming them will indicate a trade.
- Similarity to existing trades – selling goods or services in the same or a similar way to existing traders.

HM Revenue & Customs ('HMRC') could decide that a trade is being undertaken even if only one of the above criteria is fulfilled.

Trading within the charitable objects

A charity may trade in the course of carrying out the main objects of the charity. This is known as primary purpose trading. For example:

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

If a trade is partly primary purpose and partly non-primary purpose then it is said to be a mixed trade. For example, the sale by a gallery of educational goods in a gallery shop together with commemorative goods such as mugs and tea towels.

Trading undertaken mainly by the charity's beneficiaries

The profits of a trade are exempt where the work in connection with the trade is mainly carried out by beneficiaries of the charity. This often applies where the work carried out by the beneficiaries has a therapeutic, remedial or educational value. The beneficiaries can be paid or unpaid. Examples include:

- A farm operated by students of an agricultural college.
- A restaurant operated by students as part of a catering course at a further education college.
- The sale of goods manufactured by disabled people who are beneficiaries of a disability charity.

Mainly means that at least 50% of the work connected with the trade must be undertaken by the beneficiaries. If the beneficiaries carry out less than 50% of the work then it is a mixed trade.

Ancillary trading

Trading which is ancillary to a primary purpose is also exempt. Ancillary means that the trade is undertaken in the course of carrying out a primary purpose. HMRC quote the following examples:

- 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.

However, if the trade deals in a range of goods or services only some of which are within, or ancillary to, a primary purpose or if the trade deals with some customers who cannot properly be regarded as beneficiaries of the charity, the trade is not ancillary, but mixed.

Mixed trades

Where a trade is not entirely primary purpose or ancillary to the primary purposes and is not mainly carried out by the charity's beneficiaries, then the trade is said to be mixed. The two components (within the exemption and not covered by the exemption) are deemed to be two separate trades.HMRC quote the following examples:

- A shop in an art gallery or museum which sells a range of goods, some of which are related to a primary purpose of the charity (e.g. direct reproductions of exhibits and catalogues which supports the primary purpose of education and preservation of property for the public benefit), and some of which are not (e.g. promotional pens, mugs, tea towels, stamps, etc).
- The letting of serviced accommodation for students in term-time (primary purpose), and for tourists out of term (non-primary purpose), by a school or college.
- The sale of food and drink in a theatre restaurant or bar both to members of the audience (beneficiaries of the charity) and the general public (non-beneficiaries).

The trade within the exemption is exempt, as long as its profits are used for charitable purposes. The non-primary purpose deemed trade is taxable, although the exemption for small trading (see below) can apply to this trade.

Further exemptions

Small-scale trading exemption

Non-charitable trading activities are allowed within charities up to specified limits:

- If turnover from all non-charitable trading activity is less than £8,000 in the year
- If the turnover from all non-charitable trading activity is less than 25% of the gross income, subject to an upper limit of £80,000.

This means that charities with a small trading operation selling Christmas cards or similar will be allowed to undertake the trading activity through the charity.

Profits may still be exempt if the charity can show that, at the start of the relevant accounting period, it was reasonable for it to expect that the turnover would not exceed the limit. This might be because:

- the charity expected the turnover to be lower than it turned out to be, or
- the charity expected that its total incoming resources would be higher than they turned out to be.

Qualifying fundraising events

There is a general exemption from tax and VAT for fundraising events. Charities may have up to 15 events of the same kind in the same location in one financial year. Events may be held by the charity or its trading subsidiary, but the limit of 15 would apply to them jointly. Once you have 16 events, then you have lost the exemption altogether. Events can be widely interpreted, so that it can include an event on the internet or participatory events such as golf days.

Events do have to be organised by charities or their subsidiaries with a clear fundraising purpose, which should be made known to the public. Any events which create a distortion of competition and place a commercial enterprise at a disadvantage will not be exempt fundraising events.

Small-scale events can be ignored, as long as the aggregate gross takings from events of that type in that location do not exceed £1,000 in a week. This means that jumble sales and coffee mornings are not usually included when counting up the number of events.

When you need a trading subsidiary

If the activities you are planning do not fall within the exemptions and the activities are not fulfilling the primary purpose of the charity, then the activity may be undertaken within a trading subsidiary owned by the charity. The Charity Commission advise trustees to consider the risks involved in the trading and to channel risk-bearing activities and trading to generate income through a trading subsidiary. In particular, the trustees should not put the charity's assets at risk through its trading activities.

However, a trading subsidiary will not solve all the potential problems associated with trading risk. A trading subsidiary operating at a loss may still need support from the parent charity and so the financial risk is still borne by the charity. Therefore charity trustees need to carefully consider the risks inherent in the trading activity itself and ensure that it is appropriate for the trading subsidiary to undertake the activity.

If the charity lends funds or buys share capital in the trading subsidiary, this is an investment by the charity and should be in the best interests of the charity and its beneficiaries. It therefore must be assessed in accordance with the charity's normal investment policy, security should be obtained where possible, interest charged at a commercial rate and a repayment schedule set out. If investments or loans are made that do not meet the requirements to be charitable investments then this is classified as non-charitable expenditure. As a consequence, an equivalent amount of charitable income will lose its exempt status.

The profits in the trading subsidiary can be transferred to the charity under Gift Aid and thus are not liable to tax. Similarly, it may suit the charity to channel all activity liable to VAT through a trading subsidiary. The charity may then remain unregistered for VAT.

There may also be good management reasons for operating a separate company. For example, if the charity is taking over activities from another entity and staff will be transferred, it may be more suitable to manage the activity in a separate company. There may be other reasons in connection with the management structure, managing commercial risk or a different set of objectives for the activity. Providing the charity assesses the activity as an investment, it may set up a subsidiary to handle activities for any reason.

Advantages of a separate trading subsidiary

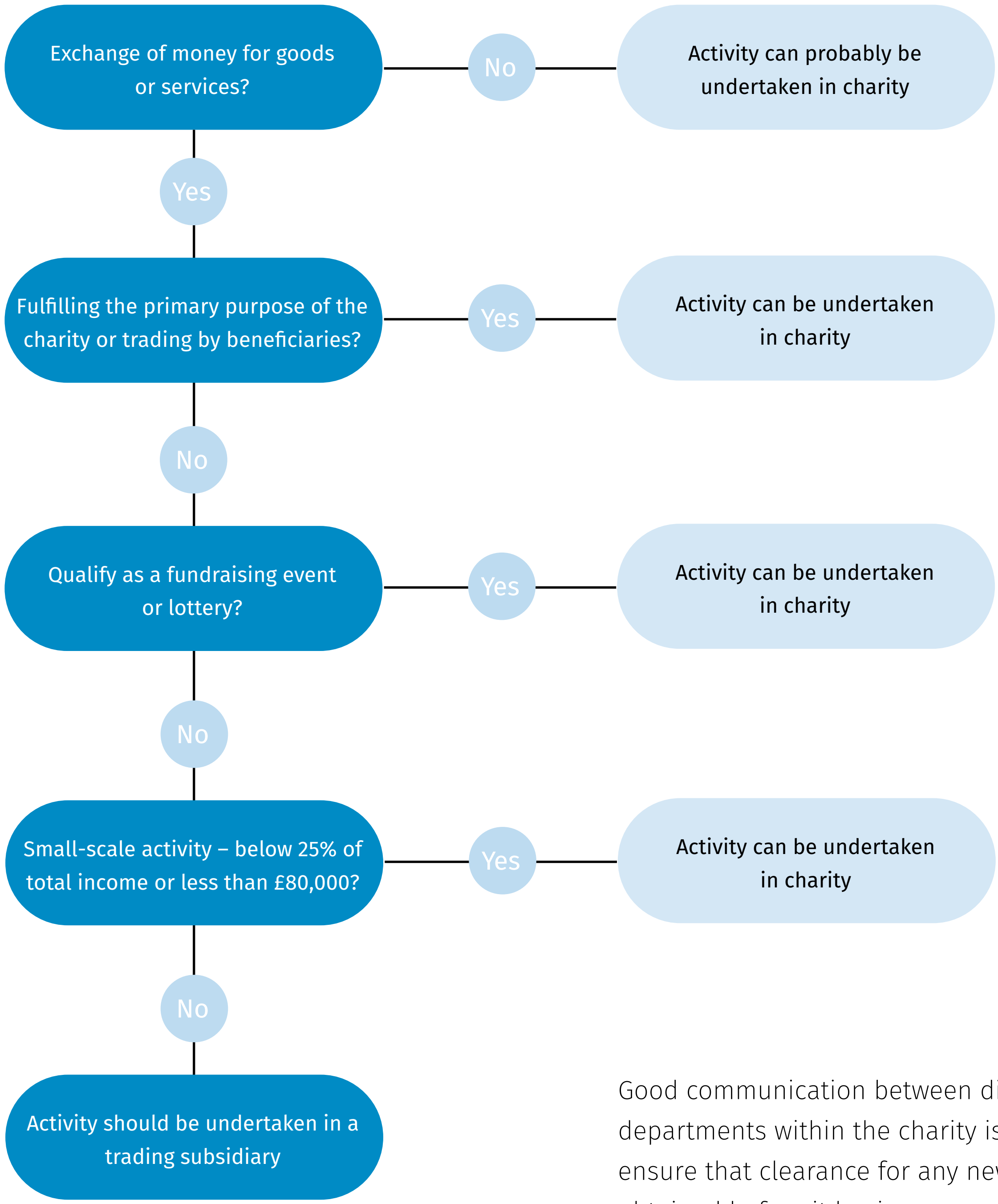
- Protects charity from tax liability
- Clarifies objectives for each part of organisation.
- Limited liability status for separate trading company may protect charitable funds in the event of a mistake.
- Allows you to undertake certain activities which a registered charity may not.
- May be convenient for VAT planning.

Disadvantages of a separate trading subsidiary

- A more complex structure with added costs e.g. incorporation, audit, professional advice.
- Knowledge of very specific tax rules needed,
- Company must operate at 'an arm's length' to the charity.
- There may have to be management charges between company and charity.
- Rates relief may be lost for activities undertaken in the subsidiary.

Conclusion

In order to plan your charity's activities properly, you need to consider how each activity would be classified from a legal and tax perspective.



Good communication between different departments within the charity is essential to ensure that clearance for any new activity is obtained before it begins.

Further information

Detailed guidance notes for charities

www.gov.uk/government/publications/charities-detailed-guidance-notes

Charities and trading

www.gov.uk/charities-and-trading

Trustees trading and tax: how charities may lawfully trade (CC35)

www.gov.uk/government/publications/trustees-trading-and-tax-how-charities-may-lawfully-trade-cc35

Charities, trading and the law

by Stephen Lloyd and Alice Faure Walker

published by Jordans ISBN 978 1 84661 106 3

Made simple guides

Made Simple guides are aimed at finance professionals and other managers working in charities. They cover technical areas such as tax and VAT treatments as well as information management areas and aim to provide practical guidance to busy managers and trustees in charities.

Made to measure

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