

Direct Taxation in Charities

Charity + Caring

As charities look for ever more innovative ways to generate funds it's important that fundraisers, as well as finance staff, have an appreciation of what constitutes trade in a charity.

Contrary to popular belief, Charities are not automatically outside the scope of taxation on any surpluses/profits and gains they generate. We rely on a series of specific exemptions which may be taken by registered charities, which means that charities usually have no profits or gains which fall subject to corporation tax.

Key exemptions

The following are the exemptions that most charities use to mitigate any liability to income or capital gains tax:

- ▶ Income not in exchange for goods and services i.e. gifts, donations, grants, sponsorship and legacies.
- ▶ Sale of donated goods is considered to be the realisation of a gift and not trading. Sorting, cleaning and minor repairs to the goods does not stop this income from being exempt. Where the extent of work is such that it could be considered a refurbishment it may be regarded as trading income but may be captured by another exemption e.g. primary purpose or beneficiary trading.
- ▶ Fundraising events – any event which meets the conditions for the VAT exemption for “qualifying fundraising events” are also exempt that event from direct tax (see below).
- ▶ Membership subscriptions, which are akin to supporter schemes, are treated as donations. Members may receive information regarding the charity e.g. newsletters but no tangible benefits.
- ▶ Ancillary trading (see below).
- ▶ Primary purpose trading that directly furthers your charity's aims e.g. a care home charging residents for accommodation/care, a college selling students text books.
- ▶ Beneficiary trading exemption – where the work is carried out mainly (at least 50%) by the charity's beneficiaries. In reality this would usually be a primary purpose activity. However the exemption does allow for the activity not being primary purpose in nature e.g. catering students operating a college restaurant or an agricultural college operating a farm shop staffed by students. Where beneficiaries carry out less than 50% of the work the trade would be considered to be a mixed trade.
- ▶ Income from property including rents, room hire and lettings. If services are provided alongside the hire of a room e.g. food, room set up, these services themselves might constitute trade.
- ▶ Income from investments including bank interest and dividend receipts.
- ▶ Profits generated by lotteries which have been operated in accordance with underlying gaming regulation. In reality such lotteries are often operated by third parties with surplus funds remitted to the charity. Such arrangements still hold for this exemption.
- ▶ Profits from selling the rights to Intellectual Property such as a brand name or logo.
- ▶ Capital gains.

For any of these exemptions to be applied the profit generated must be applied by the charity to achieve the objects of the charity. If profits are not applied for the purposes of the charitable objects, they will become subject to taxation.



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Fundraising – qualifying fundraising events

Any fundraising activity which meets the conditions for the VAT exemption for “qualifying fundraising events” as set out in VAT notice 701/1 is also exempt from direct tax as long as the profit is applied for a charitable purpose.

To be classed as a qualifying fundraising event ALL of the following conditions should be met:

- ▶ The event should be organised by a charity or a charitable subsidiary (events may be run jointly by charities)
- ▶ The purpose of the event is to raise money for the charity and it must be promoted as such
- ▶ There is a limit of 15 events of the same type in the same location in any year, if this is breached none of the events are exempt. The 15 event limit doesn't apply to fundraising events where the gross takings from all similar events are no more than £1,000 per week
- ▶ Any event which falls within the Tour Operator's Margin Scheme, such as a package of travel and accommodation, or which includes more than 2 nights accommodation doesn't qualify for the fundraising exemption

For the purpose for VAT if the income would normally qualify for zero rating this zero rating may be taken in preference to the exemption. This will allow the recovery of direct input tax for certain costs attributable to events e.g. the sale of donated goods, eligible printed matter, the supply of advertising time or space to a charity.

Ancillary trading

Ancillary trading contributes indirectly to the successful furtherance of the purposes of the charity. This is treated as part of ‘primary purpose trading’ for both charity law and tax purposes.

The level of turnover may have a bearing on the question as to whether the trading really is ancillary, but there is no specific level of annual turnover beyond which a trade is not considered ancillary. Trading cannot be considered ancillary simply because its purpose is to raise funds for the charity, even if they are to be used for fulfilment of the charities objects.

HMRC give the following examples of ancillary trading activities in their guidance:

- ▶ Sale of goods or services to students by a school or college e.g. sale of text books.
- ▶ Provision of a paid crèche for the children of students of a school or college.
- ▶ The sale of food and drink in a café to visitors of a museum or gallery.
- ▶ The sale of food and drink in a bar or restaurant to the audience of a museum.
- ▶ The sale of items such as toiletries, confectionary and flowers to patients and their visitors in a hospital.



Mixed trades

Some trades may consist of activities which directly contribute to the charities aims i.e. primary purpose, and some which do not. This is considered a mixed trading activity for tax purposes. HMRC give a number of examples of this, it is best highlighted by the theatre bar which sells drinks to audiences (ancillary) and also to members of the general public who are not beneficiaries of the charity.

The primary purpose element of the trading activities, provided the profits are applied to the objects of the charity, will be exempt from tax. The other activities are taxable, but may be covered by the small-scale trading exemption detailed below.



What is charity trading?

Trading is the exchange of goods and or services for a fee. There is no legislative definition of trade but case law has built up a set of indicators or “badges” of trade.

The main badges which HMRC will look for in making any assessment are as follows:

- ▶ the number and frequency of transactions
- ▶ the nature of the goods or services being sold
- ▶ the intention of the charity in acquiring the goods which are to be sold
- ▶ whether the goods are capable of being used and enjoyed by the charity selling them
- ▶ the nature and mechanics of the sales
- ▶ the presence or absence of a profit motive

The above is not an exhaustive list of considerations and HMRC may conclude that a trade exists even if only one of the above badges is identified.

Small-scale trading exemption

Any profits not covered by a specific exemption may also be exempt as long as the level of such trade doesn't exceed the small-scale trading exemption. To qualify for this exemption, income from all non charitable trading must either be no more than £5,000, or no more than 25% of total income for the year subject to an overall upper limit of £50,000.

Examples:

Charity A has total income of £15k so the maximum amount of non charitable trading income it could receive for the small-scale trading exemption to apply will be £5,000 as this exceeds 25% of income which would be £3,750.

Charity B has total income of £100,000 so the maximum amount of non charitable trading income it could receive for the small-scale trading exemption to apply will be £25k i.e. the lower of 25% of total income and £50k.

Charity C has total income of £5m so the maximum amount of non-charitable trading income it could receive for the small-scale trading exemption to apply will be £50k, which is the lower of 25% of income and £50k.



Using a trading subsidiary

If the level of non charitable trading in a charity exceeds the small-scale trading limit all profit from the non charitable trade falls subject to direct taxation, not just the excess over the small-scale trading limit. The only exception to this is if that charity did not have an expectation that the limit was going to be breached at the start of that period.

Charities often set up subsidiary undertakings to operate its non exempt trading activities.

These activities tend to most commonly include:

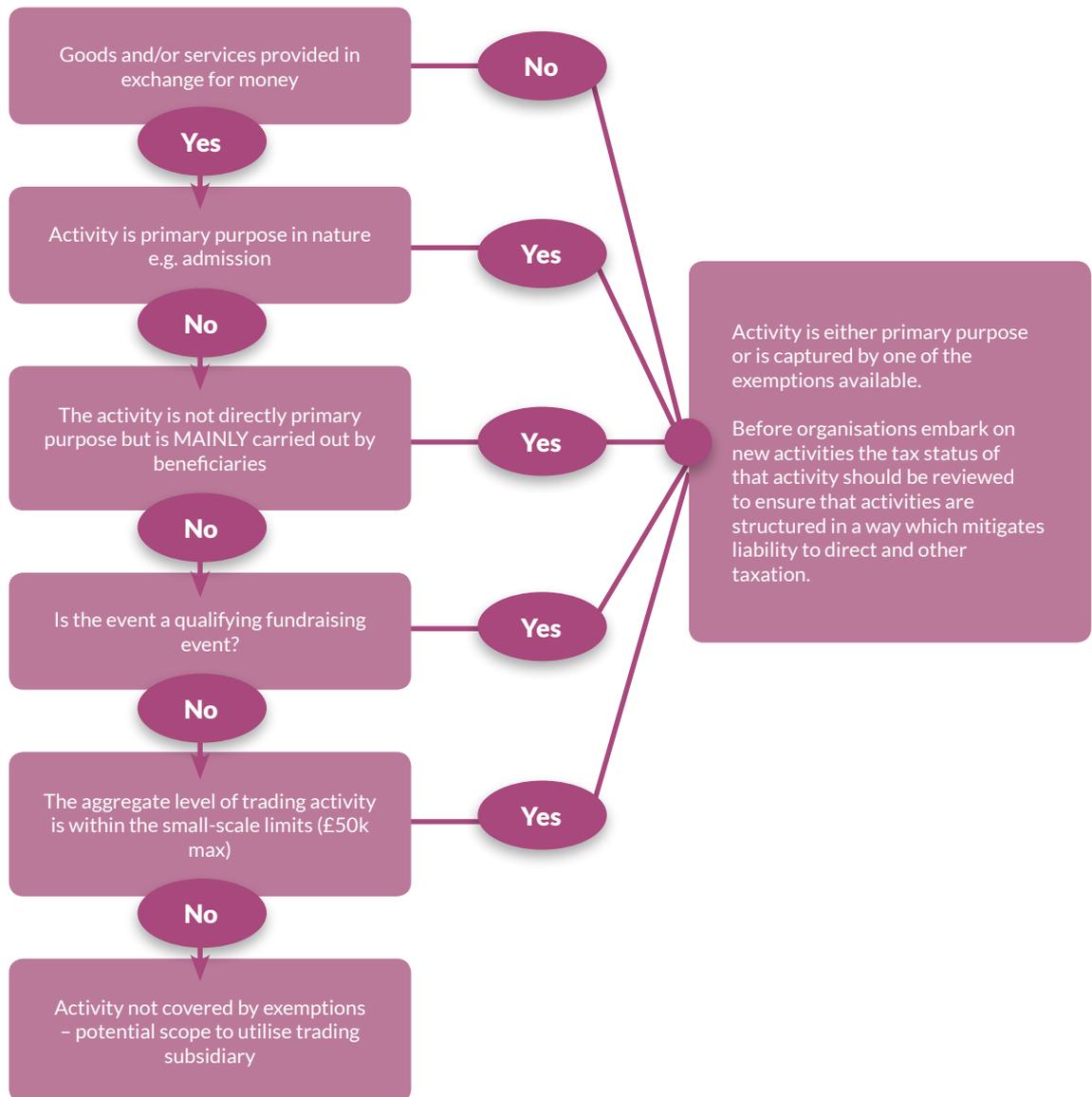
- ▶ Sale of new goods e.g. fancy goods, Christmas cards etc.
- ▶ Commission from the sale of donated goods under the Retail Gift Aid scheme in the charity.
- ▶ Venue hire and catering commissions.



The trading subsidiary remains liable for corporation tax on its trading profits. However it can use corporate Gift-Aid to donate its taxable profits up to its parent charity therefore avoiding any corporation tax liability. If the subsidiary is wholly owned by the charity it has 9 months to physically pay over the balance and still be able to claim a tax deduction.

Practically the Trustees/Directors of each entity do need to manage this arrangement carefully. While the payment is considered to be a deduction for taxation it is considered to be a distribution under company law. Accordingly at the balance sheet date a legal or constructive obligation to make a distribution must exist for it to be recognised in the Financial Statements. If no obligation exists at the balance sheet date the distribution would not be recognised in the financial statements and the tax deduction would be deferred into the following accounting period. Many subsidiaries are set up with a deed of covenant which provides the ongoing legal obligation to distribute up trading profits.

Charity Trading Decision Tree



Further information

If you would like further information, or for how our Charities team may be able to help you, please contact us at hello@garbutt-elliott.co.uk

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