CHARITY COMMISSION
FOR ENGLAND AND WALES

GUIDANCE

Trustees, trading and tax: how charities may lawfully trade

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Contents

1. Introduction

1.1 This guidance

This guidance explains when and how charities may engage in trading. It is mainly about trading for the purpose of raising funds, rather than trading to carry out the charity's objects. It also explains when a separate trading company should be established to carry on such activity. Information about fundraising by means other than trading can be found in the Charity Commission's guidance **Charities and fundraising (CC20)**.

The present guidance also contains some basic information on the application of income and corporation tax on trading profits, as this is a significant factor in determining the sort of organisational structures which should be adopted by charities to carry on a trade for fundraising purposes.

Detailed information on the taxation of trading profits earned by charities can be obtained from **www.hmrc.gov.uk**, the website of HM Revenue & Customs ('HMRC') - see the trading and business activities guidance within the detailed guidance notes for charities section which deals with charities. The Commission refers to that information throughout this guidance.

1.2 'Must' and 'should': what the Commission means

In this guidance:

- 'must' means something is a legal or regulatory requirement or duty that trustees must comply with
- 'should' means something is good practice that the Commission expects trustees to follow and apply to their charity

Following the good practice specified in this guidance will help you to run your charity effectively, avoid difficulties and comply with your legal duties. Charities vary in terms of their size and activities. Consider and decide how best to apply this good practice to your charity's circumstances. The Commission expects you to be able to explain and justify your approach, particularly if you decide not to follow good practice in this guidance.

In some cases you will be unable to comply with your legal duties if you don't follow the good practice. For example:

Your legal duty	It's vital that you
Act in your charity's best interest	Deal with conflicts of interest
Manage your charity's resources responsibly	Implement appropriate financial controls Manage risks
Act with reasonable care and skill	Take appropriate advice when you need to, for example when buying or selling land, or investing (in some cases this is a legal requirement)

Trustees who act in breach of their legal duties can be held responsible for consequences that flow from such a breach and for any loss the charity incurs as a result. When the Commission looks into cases of potential breach of trust or duty or other misconduct or mismanagement, it may take account of evidence that trustees have exposed the charity, its assets or its beneficiaries to harm or undue risk by not following good practice.

1.3 Previous guidance

This guidance replaces the previous guidance Charities and Trading (CC35), published in July 2001. As well as being written in a clearer style, this guidance provides more practical advice on charities investing in and using trading subsidiaries, and reflects developments in the law and the Commission's experience of advising on the issues.

1.4 Using this guidance

This guidance has 2 main parts. The first is section 3, which deals with the position of charities which are themselves directly engaged in trading activities, or are considering doing so. This is followed by section 4, which is about charities which have set up a trading subsidiary, or which may need to do so.

Each part is divided into a number of sections, each beginning with a question, to which a summary answer is given, followed by a more detailed explanation.

1.5 Terms and definitions

The following terms are used throughout this document, and should be interpreted as having the specific meanings given.

(The) 1988 act: the Income and Corporation Taxes Act 1988.

Ancillary trading: trading ancillary to a charity's primary purpose, legally part of the charity's 'primary purpose trading'.

Chargeable period: a tax year for income tax purposes, and an accounting period for corporation tax purposes. The trustees of a charitable trust are (subject to the charity exemptions) liable to income tax. Corporate charities and charitable unincorporated associations are (subject to the exemptions) liable to corporation tax.

Charitable expenditure: this is defined in section 506 of the 1988 act. In effect, expenditure made for exclusively charitable purposes.

(The) Commission: the Charity Commission.

(The) Gambling Commission: the Gambling Commission was set up under the Gambling Act 2005. It has taken over the role previously played by the Gaming Board for Great Britain in regulating casinos, bingo, gaming machines and lotteries.

Gift Aid: this scheme provides tax relief for companies and individuals making gifts to charities. Where a gift has been made by an individual who pays UK tax, the charity can claim repayment of the tax (and if liable to higher rate tax, the donor gets additional tax relief). Where a gift is made by a company, the amount of the gift reduces the company's taxable income.

Governing document: any document which sets out the charity's purposes and, usually, how it is to be administered. It may be a Royal Charter, trust deed, constitution, memorandum and articles of association, will, conveyance or Commission scheme.

HMRC: Her Majesty's Revenue and Customs.

Incoming resources from miscellaneous activities: non-trading income of a charity which is taxable, and is not covered by any of the charity tax exemptions, or is not covered by any of the tax exemptions apart from the small-scale exemption.

Incorporated charity: a charity which is set up as a company, an Industrial and Provident Society, or as another type of incorporated body.

Non-primary purpose trading: trading which is not primary purpose trading. In practice this will mean that the trading is carried on with the main or sole aim of raising funds for a charity.

Non-charitable expenditure: expenditure by a charity which is not charitable expenditure within the meaning of section 506 of the 1988 act, ie it is not expenditure for exclusively charitable purposes. The making of investments (including loans, whether they are investments or not) is not ordinarily 'expenditure'. But, in some circumstances, section 506 treats the making of loans/investments as non-charitable expenditure. Also, payments to a body situated outside the United Kingdom may automatically be treated as non-charitable expenditure, if the charity making the payment has not taken such steps as are reasonable in the circumstances to ensure that the payment will be applied for charitable purposes.

Parent charity: the charity or charities which own(s) a trading subsidiary.

Primary purpose trading: trading that is carried on by a charity in the course of carrying out a primary purpose of the charity. For present purposes, it includes trading in which the work in connection with the trading is mainly carried out by beneficiaries of the charity. This type of trading will normally, in any case, be carried on in the course of carrying out a primary purpose of the charity, but, whether this is so or not, the treatment of the 2 types of trading is similar.

(The) small-scale exemption: the provision in section 46 Finance Act 2000 which exempts from income and corporation tax charity trading profits, and some other income of charities, which would otherwise be liable to tax, provided that the trading turnover, together with the other relevant income, does not exceed a specified threshold.

Trustees: trustees means charity trustees. Charity trustees are the people who are responsible for the general control and management of the administration of the charity. In the charity's governing document they may be called trustees, managing trustees, committee members, governors, or directors, or they may be referred to by some other title.

Trading subsidiary: any non-charitable trading company owned by a charity or charities to carry on a trade on behalf of the charity (or charities). Throughout this guidance it is assumed that any such company is established in one of the UK countries - England, Wales, Scotland or Northern Ireland. In this guidance 'trading subsidiary' includes a company which is wholly owned by more than one charity, even if it is not technically a 'subsidiary' of any of the charities which own it.

Unincorporated charity: a charity which does not have any form of legal incorporation. The trustees themselves represent the charity.

VAT Group: a group of organisations (generally comprising parent and subsidiary companies) which is treated as a single entity for VAT purposes.

2. Summary

Under the law of England and Wales, charities may engage in some types of trading.

Compared to ordinary commercial companies, charities enjoy considerable advantages in the tax treatment they receive in relation to trading and trading profits. For example, in terms of VAT, certain sales and purchases are exempt or zero-rated. In terms of direct tax, there are a number of benefits - for example:

- a charity's trading profits are, in certain circumstances, exempt from tax; this includes profits from primary purpose trading, and profits made from lotteries and from certain types of fund raising event - exemption is subject to conditions relating to the application of the profits received by the charity
- income received by a charity from the sale of goods that have been donated to it is not generally regarded as trading profits, and is not taxable

However this preferential treatment comes at a cost. While charities may trade more or less freely in pursuit of their charitable objectives, there are restrictions on engaging in trades the objective of which is to generate funds for the charity. In particular, charities may not engage in such commercially-oriented trades where a significant risk to their assets would be involved.

Where trading (other than trading in pursuit of its charitable objects) involves significant risk to a charity's assets, it must be undertaken by a trading subsidiary. But even where it is not essential for the trading to be undertaken by a trading subsidiary, the use of trading subsidiaries may produce benefits, for example in reducing tax liabilities. In particular, trading subsidiaries may make donations to their parent charity as 'Gift Aid', so reducing or eliminating the profits of the subsidiary which are liable to tax.

But the use of trading subsidiaries where it is not essential to do so is not always beneficial, since it may involve additional management and other costs. And there may be fiscal drawbacks to balance against the advantages to be obtained, although direct financial considerations may not be the only ones which are relevant. Trading operations may benefit from using a trading subsidiary due to the organisational and financial clarity conferred by distinguishing a trading operation from the charity's main work.

Trustees of charities with one or more trading subsidiaries need to be aware of their responsibilities. In particular they need to remember, in all decisions made in regard to a trading subsidiary, that the interests of the charity are paramount. The interests of a trading subsidiary, its directors, creditors or employees, must all be secondary to those of the charity.

This is because the purpose of using a trading subsidiary is to benefit the charity in some way, for example to protect the charity's assets from the risks of trading, or to increase the level of financial return to the charity by saving tax. If the charity's assets are employed or put at risk for the benefit of the subsidiary, or its directors, creditors or employees then that purpose is frustrated. In such cases, the trustees of the charity may be personally liable for any loss of, or decline in value of, the charity's assets.

This guidance sets out the main principles and considerations which apply to trading by charities themselves, and to trading through trading subsidiaries. However, due to the complexity of the law in this area, and the potential scale of adverse consequences if mistakes are made, charities and the trustees of charities engaging in substantial trading operations should also take independent advice from appropriately qualified professional persons.

Further information

See section 3 for more information on trading by charities.

See section 4 for more information on trading subsidiaries.

3. Trading by charities

3.1 What is trading?

The short answer

There is, unfortunately, no short answer. The sale of goods (including property) or services is an essential feature of any trade. However, there are cases in which charities may sell goods or services, without the activity being regarded as a 'trade', and without the income so arising being treated as trading profits. This distinction matters, for example, because trading profits may be taxable (see 3.4).

In more detail

Whether the sale of goods and services by a charity is 'trading' depends on a number of factors, including:

- 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

But the fact that the sale of goods, services and property furthers the objects of the charity, or that the trading profits are to be used for the furtherance of those objects, does not prevent an activity from being regarded as 'trading'.

The following activities are not generally regarded as 'trading', and the income derived from them is not regarded as trading profits:

- the sale or letting of goods donated to a charity for the purpose of sale or letting (see 3.3)
- the sale of investments
- the sale of assets which the charity uses, or has used, for its charitable purposes
- the letting of land and buildings where no services are provided to the user

Where a charity is trading, the trading profits are, in principle, subject to corporation tax (or income tax in the case of charitable trusts), other than as specifically exempted. See 3.4 for further information.

Further information

Please refer to the HMRC website guidance Trading and business activities for more information on trading by charities.

When a charity lets property, the trustees will normally need to obtain the advice of a qualified surveyor regarding a proper rent for the property: see the Commission guidance **Sales, leases, transfers or mortgages: what charities need to know about disposing of charity land (CC28)**. If services are provided to the user, such letting may amount to a property business, which would be 'trading'.

3.2 What kind of trading may charities carry on?

The short answer

Charities may carry on trading activities which contribute directly to the furtherance of their charitable objects, or (where the purpose is to raise funds for the charity) which do not involve significant risk.

In more detail

Charity law allows charities to trade provided that the trading falls into one of the following categories:

- 'primary purpose trading' (see 3.6)
- 'ancillary trading' (see 3.7)
- 'non-primary purpose trading' that does not involve significant risk to the resources of the charity (see 3.8)

Note that the third category of trading listed, 'non-primary purpose trading' that does not involve significant risk to the resources of the charity, is normally understood to include both:

- the conduct of lotteries, subject to conditions (see 3.11)
- trading within the terms of the 'small scale exemption' (see 3.12)

But it may also include other types of trading: it depends on the circumstances.

Further information

For further information on the sale of alcohol from charity premises, please see: **Alcohol at charity meetings and events.**

3.3 Is the sale or hiring out of donated goods 'trading'?

The short answer

No. The sale, or letting on hire, by a charity of goods donated to it with the intention that they should be sold (or let) is not normally 'trading'. The income so derived is not considered as trading profits and is not liable to corporation tax (or income tax in the case of charitable trusts). Such sales are zero-rated for VAT purposes.

In more detail

The selling or letting of donated goods is not considered as 'trading'. It 'is' a business activity for VAT purposes, and such sale or letting is within the scope of VAT. However, the sales are zero-rated if the goods are sold or let through charity shops, or through charity auctions or similar events, to the general public, disabled people, or people receiving certain specified benefits, or are exported. The sale or letting of donated goods by a trading subsidiary may also be zero-rated (see section 4, in particular 4.13).

If goods donated to a charity with a view to sale are substantially altered or improved prior to sale, for example by turning donated raw materials into finished, saleable goods, then the profits from such sales may be treated as trading profits, and the VAT treatment may be affected. However, sorting and cleaning items, or giving them minor repairs, does not make the profits obtained from their sale trading profits.

See also 3.10.

3.4 Do charities have to pay tax on trading profits?

The short answer (legal requirement)

Yes. Trading profits, and some charity income from other sources, are liable to corporation tax (or income tax in the case of charitable trusts) unless specifically exempted.

In more detail

Charity trading profits are exempt from corporation tax (or income tax in the case of charitable trusts) where the trading is:

- 'primary purpose trading' (see 3.6)
- 'ancillary trading' (see 3.7)
- within the terms of the 'small scale exemption' (see 3.12)
- a lottery (see 3.11)
- connected with certain fund-raising events (see 3.13)

In all these cases the exemption is subject to the condition that the profits are applied solely to the purposes of the charity.

Also note that the sale or hiring out of goods donated for that purpose is not normally 'trading' and that income from this activity is not liable to income or corporation tax (see 3.3).

Most types of charity income - other than trading profits - are either not liable to income or corporation tax at all, or qualify for generally applicable exemptions, so long as the income is only applied for charitable purposes. But certain types of non-trading income (technically described as 'incoming resources from miscellaneous activities') are taxable. In some cases the 'small scale exemption' may be available, in others there is no exemption at all. Examples of such 'incoming resources from miscellaneous activities' include:

- income from the underwriting of shares (except where this is done on a regular basis, when this is likely to be treated as trading)
- gains arising on the sale of land, which are treated for tax purposes as income rather than capital, because the land was acquired specifically with a view to obtaining a gain on disposal, or because the consideration for the sale is structured wholly or partly by reference to the profits of the subsequent development of the land by the purchaser

It may be beneficial to a charity for it to carry on in a trading subsidiary such forms of business as are expected to produce incoming resources of this nature, since the subsidiary's liability to corporation tax may be reduced or eliminated as indicated in 4.4.

However this guidance is primarily about charities and trading, not about how charities can reduce their tax liabilities. Professional advice should be taken before a charity hives off non-trading activities of this nature to a trading subsidiary.

Further information

More information about the tax liabilities of charities can be obtained from the HMRC website.

3.5 Do charities have to charge VAT on sales?

The short answer (legal requirement)

Yes. Charities which are registered for VAT must charge VAT on standard/reduced rated sales in the same way as other organisations, but there are some specific provisions for zero-rating or exemptions, which apply to charities, or to some charities, but not to other organisations, or not to all other organisations.

In more detail

The sale of goods by charities is subject to VAT on the same basis as would apply to commercial organisations, unless specific provisions for zero-rating or exemption apply. There are a number of such provisions applying to some charities, to charities generally, or to a class of supplier which includes some charities or charities generally. The following are examples of the special treatments:

- the sale or hiring out of goods donated to charities for that purpose is zero-rated for VAT (see 3.3)
- the sale of goods or services at certain charity fund raising events is exempt from VAT (see 3.13)

Further information

More information about the tax liabilities of charities can be obtained from the HMRC website. The area of VAT is a notoriously complex one, and any charity making sales should seek the advice of a taxation specialist.

3.6 What is 'primary purpose trading'?

The short answer

'Primary purpose trading' is trading which contributes directly to one or more of the objects of a charity as set out in its governing document. For present purposes, it includes trading in which the work in connection with the trading is mainly carried out by beneficiaries of the charity, as that will normally be primary purpose trading. Whether it is so or not, both the charity law and the tax treatment are similar.

In more detail

Typical examples of primary purpose trading include the:

- provision of educational services by a charitable school or college in return for course fees
- sale of goods manufactured by disabled people who are beneficiaries of a charity for the disabled
- holding of an art exhibition by a charitable art gallery or museum in return for admission fees
- provision of residential accommodation by a residential care charity in return for payment
- sale of tickets for a theatrical production staged by a theatre charity
- sale of certain educational goods by a charitable art gallery or museum

The profits from primary purpose trading are exempt from corporation tax (or income tax in the case of charitable trusts). This exemption from tax is only available if the profits are applied solely to the purposes of the charity. However the sales which have given rise to those profits will be regarded as a business activity for the purposes of determining liability to VAT.

Further information

HMRC Charities will advise trustees whether, in their opinion, a particular activity is within the definition of primary purpose trading. In case of any doubt or difficulty trustees may need to consult their own professional advisers as well.

3.7 What is 'ancillary trading'?

The short answer

'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.

In more detail

An example of ancillary trading is the sale of food and drink in a restaurant or bar by a theatre charity to members of an audience. The level of annual turnover in trading which is said to be ancillary may have a bearing on the question whether the trading really is ancillary, but there is no specific level of annual turnover beyond which trading will definitely not be regarded as ancillary. Trading is not regarded as ancillary to the carrying out of a primary purpose of the charity simply because its purpose is to raise funds for the charity.

Further information

More detail can be found in the HMRC website guidance Trading and business activities within the 'Charities' section.

3.8 What is 'non-primary purpose trading', and when may charities engage in it?

The short answer

'Non-primary purpose trading' is trading intended to raise funds for the charity, as distinct from trading which in itself furthers the charity's objects. Charities may engage in such trading only where no significant risk is involved.

In greater detail

Charity law permits charities to carry on non-primary purpose trading in order to raise funds, provided that the trading involves no significant risk to the assets of the charity.

The 'significant risk' to be avoided here is that the turnover is insufficient to meet the costs of carrying on the trade, and the difference has to be financed out of the assets of the charity.

Whilst this is not invariably the case, the trade creditors would normally have a right of recourse to any of the assets of the charity, whether those assets had any connection with the trading or not. The consequent depletion of the charity's assets could have the effect of preventing the charity from being able to continue serving the community as effectively as it might otherwise have done, or at all. Those who provided the charity's assets are likely to have expected that those assets would be used to further the charity's purposes, or invested prudently, and would not be put at risk in trading activities the object of which was simply to raise further funds.

Whether or not the risk of non-primary purpose trading is 'significant' depends on a number of factors, including:

- the size of the charity
- the nature of the business
- the expected outgoings
- turnover projections
- the sensitivity of business profitability to the ups and downs of the market

Inevitably, the assessment of the significance of the risk will involve an element of judgment on the part of trustees and their advisers. In general, however, a lottery, or trading which qualifies for the 'small-scale exemption' (see 3.12) may be considered not to involve significant risk.

There is no general exemption from corporation tax (or income tax in the case of charitable trusts) on the profits of non-primary purpose trading carried on by a charity, even where the profits are all applied for the charity's purposes. However, some exemptions do apply, ie the lotteries exemption (see 3.11), the 'small-scale exemption' (see 3.12), and the fundraising exemption (see 3.13).

If charities wish to carry on non-primary purpose trading involving significant risk, they must do so through a trading subsidiary, as set out in section 4. This applies whether or not the trading profits would, if the trading were to be carried on by the charity itself, be tax exempt.

3.9 What if trading comprises both 'primary purpose' and 'non-primary purpose' elements? (legal requirement)

An example of this sort of trading is a shop which is run by a charity providing a public art gallery, and which may sell a range of goods, some connected with furthering the charity's primary purpose (eg books relating to the exhibition, copies of the charity's paintings), and some not so connected (eg promotional pens, mugs and tea towels).

Although in general terms a charity will actually only have one trade, for tax purposes this type of mixed primary and non primary purpose trading activity must be treated as 2 separate trades, and the rules applying to primary purpose and non-primary purpose trading apply separately to each. There must be a reasonable apportionment of expenses and receipts between the notionally separate trades.

This treatment applies for accounting periods commencing on or after 22 March 2006. Previously this type of trading was treated as wholly primary purpose or wholly non-primary purpose, depending on the size of the non-primary purpose element. The trustees of charities carrying on this type of trading will need to consider whether any re-structuring is desirable.

3.10 What if donated goods are sold together with other goods?

The short answer (legal requirement)

The sale of goods which have been donated to a charity, is not trading. Where donated goods are sold together with other goods the sale of which 'is' trading, the income from the sale of donated goods has to be separated from the trading profits.

In more detail

The sale or letting of donated goods is not regarded as trading (see 3.3). Income from the sale or letting of donated goods must be separately identifiable in the charity's records from trading profits. The connected trading must be considered separately, whether as 'primary purpose trading' (see 3.6 and 3.7), or as 'non-primary purpose trading' (see 3.8).

This situation might arise in a charity shop run by a charity whose aim is to enhance the skills of disabled people. The shop might sell, for example:

- books, CDs and videos donated for sale - not trading
- wooden toys made by disabled people - 'primary purpose trading'
- bought-in soft toys - 'non-primary purpose trading' whose only purpose is to raise funds

In this case, the only trading being conducted is that in wooden toys and soft toys. The trade is separated into its primary purpose and non-primary purpose elements, as indicated in 3.9.

Further information

If trustees are concerned about the tax implications of a business of this nature, professional advice should be taken, or HMRC Charities contacted for information. Trustees may also find it helpful to refer to the trading guidance on the HMRC website.

3.11 Does running a lottery count as 'trading'?

The short answer (legal requirement)

Yes. Conducting a lottery is trading. However, subject to conditions, charities are allowed to hold lotteries and the profits from such lotteries are exempt from tax.

In more detail

The promotion and conduct of a lottery in accordance with either section 3 or section 5 of the Lotteries and Amusements Act 1976 is not regarded as contravening the charity law restrictions on carrying on non-primary purpose trading, since any risk to the charity's assets from carrying on this sort of trading is negligible.

The profits from a lottery which is promoted and conducted by a charity are exempt from corporation tax (or income tax in the case of charitable trusts), provided that:

- the lottery is promoted and conducted in accordance with either section 3 or section 5
- the profits from the lottery are applied only for the purposes of the charity

A section 3 lottery, also known as a 'small lottery' must abide by these conditions:

- it must be genuinely incidental to what are called in the 1976 act 'exempt entertainments', including fêtes, bazaars, sales of work, etc
- the total value of the prizes must not exceed £250
- the proceeds of the lottery must be devoted to purposes other than private gain
- no cash prizes may be given
- the sale and issue of tickets and the announcement of results must be carried out during the entertainment and on the premises where it is held

A section 5 lottery, also known as a 'society's lottery', is more tightly regulated, and the general public can be invited to participate. Such a lottery can only be conducted by a body registered with the Gambling Commission, or with a local authority, depending on the size of the lottery business. Charities and trading subsidiaries can seek registration.

If a trading subsidiary, rather than the charity itself, is registered as the 'society' under section 5 of the 1976 act, it will promote and conduct the lottery, and there is no special tax treatment for any profits of the trade.

The provisions of the 1976 act which are referred to have been replaced by the Gambling Act 2005 with corresponding provisions. The latter provisions are not yet in force.

3.12 What is the small-scale exemption?

The short answer

The small-scale exemption is an exemption from corporation tax (or income tax in the case of charitable trusts) on the profits from small-scale non-primary purpose trading and the income from some other business activities carried on by charities. It applies only where all the relevant profits or income are applied for the charity's purposes. It does not apply where the trading profits or other income are exempt from tax on some other basis.

In more detail

The small-scale exemption applies to profits from non-primary purpose trading, plus certain other income falling into the category of 'incoming resources from miscellaneous activities'. In order to qualify for the small scale exemption within a given chargeable period, either:

- the annual turnover of the relevant non primary purpose trading of the charity, plus the 'incoming resources from miscellaneous activities' potentially qualifying for exemption, must not exceed the 'relevant threshold' during the chargeable period
- if it 'does' exceed the 'relevant threshold', the charity must have had a reasonable expectation at the start of the chargeable period that it would not do so

The turnover of trading, the profit from which is subject to specific tax exemptions, such as trading connected with fundraising events (see 3.13), should not be counted when determining what the 'relevant threshold' is. Nor should 'incoming resources from miscellaneous activities' which do not potentially qualify for the small-scale exemption.

The following table indicates how the relevant threshold is calculated. It assumes that the charity has no applicable 'incoming resources from miscellaneous activities' in the chargeable period which would qualify for the exemption.

Total of all incoming resources in a particular chargeable period of the charity	Maximum permitted annual turnover of the relevant trading in that chargeable period
Under £20,000	£5,000
£20,000 to £200,000	25% of charity's total incoming resources
Over £200,000	£50,000

There is no statutory definition of the term 'all incoming resources'. However HMRC Charities consider that it means the total receipts of the charity for the chargeable period from all sources - grants, donations, investment income, trading receipts, etc - calculated in accordance with normal charity accounting rules.

If the turnover of the relevant trading (taken with the relevant 'income from miscellaneous activities') exceeds the maximum level (as indicated in the right-hand column in the table) the small-scale exemption does not apply unless the charity had a reasonable expectation at the start of the chargeable period that it would not exceed that level.

The carrying on by a charity of trading the turnover of which is within the scope of the small-scale exemption is unlikely to contravene the charity law restrictions on carrying on non-primary purpose trading (see 3.8). The low maximum permitted level of trading turnover means that any risk to the charity's resources from the trading is likely to be small.

Therefore, unless prohibited by its governing document, any charity can carry on small-scale, non-primary purpose trading, and be exempt from corporation tax (or income tax in the case of charitable trusts) on the profits, provided that the profits are applied for the purposes of the charity.

Further information

More details of the exemption can be found in the HMRC website guidance Trading and business activities within the 'Charities' section. If trustees have any difficulties with the application of the exemption they should contact HMRC Charities.

3.13 What tax privileges apply to charity fundraising events?

The short answer

The supply of goods or services at or in connection with a wide range of fundraising events is exempt from VAT, and the trading profits are exempt from corporation tax (or income tax in the case of charitable trusts), subject to strict conditions.

In more detail

Certain tax exemptions apply to sales/income at or in connection with events that fall within the terms of Group 12 of Schedule 9 to the VAT Act 1994. The Commission refers to these events as 'qualifying events'. They are subject to the following conditions:

- the event must have a charitable purpose
- the event must be organised by a charity, or a trading subsidiary (see section 4) or another qualifying body, for the charity's own benefit
- trading is not being undertaken through a series of events (multiple events - such as, say, a regular weekly dinner dance)
- accommodation for the event is not provided for more than 2 nights duration
- 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 (including its trading subsidiary) or qualifying body

(Note that if a charity does hold more than 15 events of the same kind at the same location during its financial year, none of the events will qualify for exemption.)

There are no restrictions as regards the nature of the event. The following list, which sets out examples of events which can be held for fundraising purposes, and where the profits from occasional trading may be exempt from corporation tax (or income tax in the case of charitable trusts), and where sales may be exempt from VAT, is not exhaustive:

- dances, for example balls, dinner dances, discos or barn dances
- live performances, for example concerts, theatrical productions, ballets, gymnastic performances, puppet shows and similar events with a paying audience
- film, video or DVD showings
- fetes, fairs and festivals
- horticultural shows
- exhibitions, for example of objects of artistic, historical, cultural, educational, religious, scientific, mechanical, sporting, ecological or environmental interest

- bazaars, jumble sales, car boot sales and good-as-new sales
- games of skill, knowledge or ability, including contests and quizzes
- firework displays
- meals, such as dinners, lunches, teas and barbecues
- auctions of donated goods; (Note that donated goods are zero-rated for VAT, as opposed to exempt, and that this enables VAT to be recovered on costs associated with the sale; donated goods sold at an event can still qualify for zero rating, as opposed to exemption.)
- auctions of bought in-goods (which may attract VAT)

The following tax exemptions apply to such qualifying events:

- goods or services sold by a charity or a trading subsidiary in the course of a trade at, or in connection with, a qualifying event are exempt from VAT
- the profits from such sales by a charity (but not by a trading subsidiary) are exempt from corporation tax (or income tax in the case of charitable trusts) provided that they are applied for charitable purposes only

This exemption has no turnover limits. It therefore has the potential to provide relief from tax for profits from substantial trading. In some cases such substantial trading might involve significant risk to the assets of the charity which carries on the trading. This would be in violation of the principle that 'non-primary purpose trading' must not involve significant risk, as set out in 3.8.

In such cases where significant risk attaches to a charity fundraising event, the event must be conducted by a trading subsidiary, and not by the charity itself. This is regardless of the fact that, had the event been conducted by the charity itself, the profits from it would have been exempt from tax. Sales made by a trading subsidiary at qualifying fundraising events may also be exempt from VAT, but the trading subsidiary enjoys no special corporation tax treatment (see 4.3).

Further information

See the Commission's guidance **Charities and fundraising (CC20)**, and the HMRC website guidance from paragraph 36 of the Trading and business activities on line guidance.

3.14 What happens if a charity loses money from non-primary purpose trading?

The short answer

If a charity incurs losses in non-primary purpose trading which it has carried on, the charity's tax exemptions on other income may be at risk, and the trustees may be liable for breach of trust.

In more detail

If a charity incurs a loss from its non-primary purpose trading, the loss in connection with the trading will be regarded as 'non-charitable expenditure', within the meaning of section 506(1) of the 1988 act. This could result in a restriction of the charity's tax exemptions on other income and/or gains.

The Commission's view is that incurring such a loss would only amount to a breach of trust if the loss had been incurred irresponsibly. There would, in the Commission's view, be no breach of trust, if:

- there was a rational expectation that the trading would be successful
- it was reasonable for the charity to have carried on the trading itself, rather than use a trading subsidiary
- the expenditure which gave rise to the loss was within the powers available to the trustees

However, tax exemption is at risk whether the loss has been incurred irresponsibly or not. Trustees, when deciding whether or not trading should be carried on by a trading subsidiary, should consider the fact that, if the trading is carried on by the charity itself, a trading loss could give rise to a restriction of the charity's tax exemptions. In some, but not all, cases, the restriction of these exemptions may be offset by the availability of loss relief. Paragraphs 52 to 55 of the HMRC Charities trading and business activities on-line guidance gives full details.

Further information

See section 4 for more information on trading subsidiaries.

4. Charities with trading subsidiaries

4.1 What is a 'trading subsidiary', and when must a trading subsidiary be used?

The short answer (legal requirements)

A 'trading subsidiary' is a company, owned and controlled by one or more charities, set up in order to trade. The purpose of a trading subsidiary is usually to generate income for its parent charity. Trading subsidiaries must be used for non-primary purpose trades involving significant risk.

In more detail

A trading subsidiary must be used in any case where there would be a significant risk to the assets of the charity, if it were to carry on non-primary purpose trading itself (see 3.8). The trading subsidiary must be set up in such a way as to protect the parent charity and its assets from the risks involved in the trading. The need to protect the charity's assets from any significant risk involved in non-primary purpose trading is paramount. The fact that the trading profits would have been exempt from tax if the trading had been carried on by the charity itself does not necessarily mean that it is appropriate for the charity to carry on the trading.

The profits from a trade which is carried on by a trading subsidiary do not qualify for charity tax exemption. They are liable to corporation tax in the usual way. But payments made by the trading subsidiary to the charity or charities which own it can reduce the level of profits which are taxable in the trading subsidiary. And tax exemption is available to the recipient charity in respect of the income which it receives from the trading subsidiary.

This explains why it may be beneficial for a charity to use a trading subsidiary even where there is no legal barrier to the charity carrying on the trading itself. Where the profits from trading carried on by a charity would be liable to corporation tax (or income tax in the case of charitable trusts), the use of a trading subsidiary to carry on the trading may enable the liability to tax in respect of the trading profits to be, in effect, reduced or eliminated.

The provision by a charity of advertising and other promotional services in return for business sponsorship is an example of trading which is unlikely to present significant risk to the assets of the charity, since the outgoings which a charity faces in the course of such trading are likely to be minimal. So there may be no charity law imperative to hive off this type of trading to a trading subsidiary but there may be a tax benefit from so doing, if the profits would not qualify for any charity exemption. This is because the charity would be liable to tax on the trading profits, if it were to carry on the trade itself, whereas if the trading were to be conducted by a trading subsidiary, the profits of the trading subsidiary could be transferred to the charity as a Gift Aid donation, and thus restrict or eliminate any tax liability.

If primary purpose trading is conducted through a trading subsidiary, much of the guidance in this section does not apply: the funding of the trading subsidiary would be a charitable application of funds, rather than an investment of funds for profit.

A trading subsidiary should become financially viable as soon as possible. It is therefore important to have a business plan in place that clearly identifies the point at which trading is expected to be profitable and to assess progress against the business plan. Where financial viability is not anticipated within 2 years of operation, careful consideration should be given to the appropriateness of undertaking the planned trading activity.

4.2 What are the benefits of using a trading subsidiary?

The short answer

The main benefits of using a trading subsidiary are to protect the parent charity's assets from the risks of trading; to create a separate administrative unit; and to reduce tax liabilities. However in those cases where the use of a trading subsidiary is not essential, trustees need to bear in mind that there may be drawbacks to the use of a trading subsidiary, and those drawbacks do, of course, have to be balanced against the benefits.

In more detail

A trading subsidiary must be used in any case where there would be a significant risk to the assets of the charity, if it were to carry on a trading activity itself. However trustees may use a trading subsidiary for other reasons, for example:

- to protect the charity's assets from the risks of trading, even where the risks are not significant
- to protect the charity's assets from the risks of trading, even where the trading is primary purpose or ancillary
- to create a separate administrative unit for accounting and/or management purposes in order, for example, to facilitate the undertaking of contracts for public service delivery whilst protecting the assets of the charity
- to reduce or eliminate the tax liabilities arising from trading activities

However, for a charity to pass its trading activities to a trading subsidiary can have disadvantages.
For example:

- where the use of a trading subsidiary is primarily tax-driven, the tax benefits may be insufficient to justify the additional costs associated with establishing and operating a trading subsidiary
- the use of a trading subsidiary may have disadvantages in that some benefits which charities enjoy may not be available, eg charity rate relief (see 4.14) and exemption from stamp duty land tax (see 4.21)

Further information

See also the Commission's guidance **Charities and public service delivery: an introduction and overview (CC37)**.

4.3 Do trading subsidiaries pay tax like other companies?

The short answer (legal requirement)

Yes. There are few legal distinctions between trading subsidiaries of charities and other companies. However it is possible for a trading subsidiary to pay some or all of its trading profits to its parent charity, so excluding those profits from the calculation of the trading company's liability to corporation tax purposes, and thus reducing the level of that liability.

In more detail

A trading subsidiary is liable to corporation tax on its profits, in the same way as any other company. But the trading subsidiary can make payments to its parent charity as Gift Aid, and this may reduce or eliminate the subsidiary's corporation tax liability. See 4.4.

Trading is a business activity, and a trading subsidiary (or indeed a charity) which carries on a trade must be registered for VAT if the taxable turnover exceeds the statutory limit. Some of the parent charity's VAT privileges may be enjoyed by trading subsidiaries (see 4.13).

Further information

General advice on the use of trading subsidiaries can be found in the HMRC website guidance Trading and business activities within the 'Charities' section.

Information on the VAT threshold can be found in the current edition of VAT Notice 700/1. The VAT notices 701/1 (Charities) and 701/5 (Clubs and Associations) give further information. These are also available from in the 'Charities' section of the HMRC website.

4.4 How can a trading subsidiary pay funds to its parent charity?

The short answer

Funds may be paid in the form of a share dividend, interest on, and repayments of, loan capital, or as Gift Aid. There are considerable tax benefits in making the payments in a way which has the effect of reducing the level of corporation tax liability in the trading subsidiary.

In more detail

Gift Aid is a common means for a trading subsidiary to pay funds to its parent charity. This is because:

- Gift Aid payments reduce the trading subsidiary's taxable income by the amount of the payment; it is often possible, therefore, by making such payments, to eliminate the trading subsidiary's entire potential corporation tax liability (but see 4.5)
- Gift Aid payments to the parent charity from a trading subsidiary are exempt from corporation tax (or income tax in the case of charitable trusts) if they are applied for charitable purposes only

A trading subsidiary can make Gift Aid payments to its parent charity at any time from the start of the relevant accounting period until 9 months from the end of that period. Deferring payments may assist cash flow in the trading subsidiary.

The timing of the Gift Aid payments is primarily a matter for the directors of the trading subsidiary. Trustees of the parent charity would not be expected to intervene unless they had reason to believe that the directors of the subsidiary were not giving proper consideration to the interests of the charity when taking the relevant decisions.

Funds are now rarely, if ever, paid to the parent charity by way of share dividend. Dividends, like Gift Aid payments, are exempt from tax in the hands of the parent charity, but they do not reduce the trading subsidiary's taxable profits. So, this method of paying funds to the parent charity would leave a liability to corporation tax in the trading subsidiary.

Where a parent charity provides loan capital to a trading subsidiary, the trading subsidiary must, of course, make interest payments and repayments of principal in accordance with the terms of the loan agreement with the charity. For more information see 4.10 and 4.11. The costs of servicing a loan may be effectively offset when calculating what the taxable income of the trading subsidiary actually is, either directly as expenses of the trade, or through capital allowances.

4.5 Can trustees expect their charity's wholly-owned trading subsidiary to always Gift Aid all the profits shown in the profit and loss account to its parent charity?

Note: this section was revised on 24/02/2016. It is based on an updated legal view and replaces section 4.5 which was withdrawn on 31/10/2014.

No. Company law makes it unlawful for any company to make distributions in excess of distributable profits. If the accounting profit is higher than the value calculated for distributable profits, only the lower figure can be paid across under Gift Aid.

A consequence of this is that when the taxable profits of the trading subsidiary are greater than its distributable profits, the trading subsidiary may have a tax liability. HMRC's **guidance on charities and trading** contains advice on the tax treatment of this issue.

Parent charities with wholly-owned trading subsidiaries must bring their operations into compliance with this revised position for any accounting period starting on after 1 April 2015. Where wholly-owned trading subsidiaries have previously paid a higher figure of accounting profit under gift aid, they may need to take advice from a suitably qualified professional adviser on how to proceed.

The Institute for Chartered Accountants in England and Wales (ICAEW) has issued a 'technical release' **Guidance on donations by a company to its parent charity [TECH 16/14BL]** which provides a more detailed explanation. It is based on legal advice provided to them.

ICAEW's technical release also provides guidance on potential ways of addressing likely accounting issues that may arise when rectifying the position. This includes an option to write off all or part of a loan made to a wholly-owned trading subsidiary in connection with this situation. If trustees are considering this option, they would need to be able to show that:

1. The decision is genuinely in the charity's interests, using the principles in **It's your decision**.
2. The only purpose of the write-off is to rectify a technical problem resulting from the need to align the arrangements with this clarified company law position.
3. The relationship with the trading subsidiary is itself a legitimate and justifiable arrangement that is clearly operating in the charity's interests.
4. There has not been a previous history of the writing-off of loans advanced by the charity to its trading subsidiary due to the subsidiary's non-performance in repaying loans.
5. The trading subsidiary is otherwise financially viable and a going concern.

If the conditions listed are fulfilled then trustees do not need to seek any waiver or prior agreement from the Commission. If these conditions are not all fulfilled then the Commission will not issue any waiver or approval except under the most exceptional circumstances and only after the trustees have taken professional advice and made a case outlining all relevant facts including a reasoned justification for their request.

4.6 How should trading subsidiaries be funded?

The short answer (legal requirement)

Trading subsidiaries are usually funded by their parent charities, although outside finance may also be obtained. The finance may be provided as share capital and/or loan capital. Trading subsidiaries may also retain profits, subject to tax considerations.

In more detail

When a trading subsidiary is formed, its parent charity can freely make a nominal subscription of share capital in the trading subsidiary in order to comply with the requirements of company law concerning the formation of companies. However the trading subsidiary will usually require more than a nominal amount of capital in order to operate effectively.

Most companies fund their business through a mixture of share capital, loan capital, and retention of profits. However the tax system encourages a trading subsidiary to transfer its profits to its parent charity as Gift Aid. Consequently a trading subsidiary has an incentive not to meet its funding needs out of retained profits (see 4.7).

A trading subsidiary's need for funding will therefore, in most cases, be met mainly out of share capital and/or loan capital. This capital is normally, though not always, provided by the parent charity.

This provision has to be justifiable as an investment of the charity's assets (see 4.8). Parent charities must not provide support to trading subsidiaries, on terms which involve a greater or lesser element of gift
For example:

- a parent charity must not make donations to the trading subsidiary, in cash or in kind, whether by purchasing stock for the subsidiary, and donating that stock to the trading subsidiary, or otherwise;
- a parent charity must not settle the debts of a trading subsidiary
- a charity must, if allowing the use of its staff, buildings or equipment by a trading subsidiary, make fair charges for those uses (see 4.21 and 4.22)

4.7 Can a trading subsidiary fund itself by the retention of profits?

The short answer

Yes, this is possible. However retained trading profits will be liable for corporation tax.

In more detail

As noted in 4.4, if all the trading subsidiary's distributable profits are paid to the parent charity as Gift Aid, the trading subsidiary 's liability to corporation tax is reduced or eliminated. However, the trading subsidiary's needs for finance then have to be met entirely out of capital.

Some parent charities prefer to accept the corporation tax consequences of the trading subsidiary retaining distributable profits. Indeed such retention may be required, where funding by way of loan has been obtained from commercial banks or other third parties, in order to service the loan. This approach:

- enables the trading subsidiary to fund itself by a combination of capital and retained profits in a way which is closer to ordinary commercial practice

- may also make it easier for the parent charity to justify investments in the trading subsidiary, especially where significant equity finance is required to fund ongoing trading activities; however, such retention of profits by a trading subsidiary can also prejudice VAT reliefs which would otherwise be available (see 4.13)

Further information

Professional advice should be taken in any case where trustees have doubts about the level of Gift Aid payment to the parent charity which is, overall, most beneficial to the charity.

4.8 What are the legal obligations of trustees investing charity funds in a trading subsidiary?

The short answer (legal requirement)

The parent charity's trustees must be able to justify financial support for a trading subsidiary as an appropriate investment of the charity's resources. In all cases the interests of the charity must be paramount. Any investment should be consistent with the charity's overall investment policy.

In more detail

The same considerations apply to an investment by a parent charity in a trading subsidiary, as to any other investment of a charity's resources. Trustees must, whenever investing a charity's resources:

- be certain that the investment is within the charity's investment powers
- exercise such care and skill in the investment process as is reasonable in the circumstances
- have regard to the suitability to the charity of investments of the same kind as the particular investment which it is proposed to make
- have regard to the suitability of the particular investment in question, as an investment of the kind which it seems appropriate to make
- have regard to the need for diversification of investments, as appropriate to the circumstances of the charity
- ordinarily obtain and consider advice about the investment from a person reasonably believed by the trustees to be qualified to give it by his or her ability in and practical experience of financial and other matters; the advice needs to have regard to the suitability and diversification points previously mentioned

In the context of a proposed investment in a trading subsidiary which is used to carry on a non-primary purpose trade, this means that:

- the trustees must reasonably consider that it is in the charity's interests to make the investment, after making a fair comparison of this form of investment with other forms of investment which might be selected
- this fair comparison must involve an objective assessment of the trading subsidiary's business prospects
- the trustees must be satisfied as to the financial viability of the trading subsidiary, based on its business plan, cash flow forecasts, profit projections, risk analysis and other available information

- the trustees must ordinarily take appropriate advice on the investment, and the financial viability of the trading subsidiary; what is 'appropriate' will depend on the circumstances - the cost of taking the advice is a relevant factor, and the cost should be commensurate to the size of the proposed investment

Trustees should also:

- pay attention to the length of time over which funds may be tied up in an investment in a trading subsidiary, since funds needed in the short to medium term may not be easily realised when invested in this way
- consider, and take suitable advice on, the possibility of obtaining independent funding as an alternative to funding by the charity; see 4.9

Precisely how the investment in the trading subsidiary is structured is a decision for which the parent charity's trustees (with professional advice) are responsible, having regard to the trustee investment duties summarised. Trustees must also consider periodically whether or not an existing investment should be retained or disposed of. When reviewing investments, duties similar to those outlined apply.

Trustees must also take into account section 506(4) of, and schedule 20 to, the 1988 act. These provisions can create a tax effect where loans to, or equity investments in, trading subsidiaries are inappropriate. This subject is summarised in 4.12.

Further information

More information about trustees' investment duties can be obtained from the detailed guidance on **Charities and investments**.

4.9 Can a charity seek outside investment in a trading subsidiary?

The short answer

Yes. It is good practice for trustees of a parent charity to consider the desirability of obtaining investment from others in its trading subsidiary. This would spread the risks of the trade, and it may contribute positively to the charity's liquidity. However it may be difficult to attract such investment at reasonable cost.

In more detail

Sharing the risk of trading failure with an independent financier may be a sensible option for a parent charity, provided that the cost is not excessive. An additional advantage of involving an independent financier is that such a person will provide an independent assessment of the economic viability of the trading subsidiary's operation.

Careful thought needs to be given to the nature and terms of any outside investment. In order to minimise its corporation tax liabilities, the trading subsidiary will normally pay all its taxable profits to its parent charity as a Gift Aid donation (see 4.3). This would leave no remaining funds to distribute to shareholders as dividends.

Share capital investment in a charity's trading subsidiary will usually, therefore, be unattractive to outside financiers motivated by profit. However a share capital investment in a trading subsidiary could be marketed to supporters of the parent charity, who might not be looking for a commercial return.

In most cases, outside investment in a charity's trading subsidiary will be in the form of loan capital, since interest payments on loans and repayments of the principal will take place before any Gift Aid payments to the parent charity. Loan finance may be available from banks, and from other private lenders, including supporters of the charity.

Trustees should pay close attention to the terms on which loan capital is acquired since interest payments could significantly reduce the level of trading profit in the subsidiary. Even if the subsidiary's trading operation is profitable before loan charges, it may not be so after them. Charities should consider the possibility of obtaining loan capital from their supporters, who may be prepared to provide finance on preferential terms.

When entering into a joint venture of this nature, it is important that the investment is in the charity's interests. As an aspect of considering the appropriateness of the joint venture, the trustees should consider whether any due diligence checks should be made regarding the financial status of the other partner(s), and should be satisfied that they share with their joint venture partner(s) similar views regarding the scale of investment required, the level of trading risk accepted, the mechanism for setting the direction of the trading activity and for reconciling for any disagreements between the partners.

When entering into a joint venture, whilst all parties will anticipate a successful outcome, it is also important to consider the 'exit strategy', should insuperable difficulties arise.

It is considered that one of the main underlying causes of joint venture failures is an irreconcilable difference in the understanding of the partners about the direction the joint venture is taking. Consequently it is recommended that all partners should consider and agree the objectives of the joint venture, should ensure that all of the necessary documentation is completed, and that a business plan has been agreed. Trustees are recommended to take further professional advice, where appropriate.

Trustees contemplating a joint venture of this nature need to bear in mind the following 2 tax points:

(1) Unless the joint-venture company is wholly-owned by one or more charities, any payments made to a charity as Gift Aid must actually be made during the financial year in which the payments are to offset the company's taxable profits. The facility to make Gift Aid payments up to 9 months after the end of the relevant financial year (see 4.4) is only available to companies which are wholly-owned by one or more charities.

(2) Where the commercial partner receives a distribution of profit from the company, HMRC may challenge the use of Gift Aid to make a corresponding payment to the charitable partner.

4.10 What considerations apply to a charity's investment of share capital in a trading subsidiary?

The short answer

In the event of business failure, shareholders are less likely to recoup their investment than investors of loan capital. However an investment of share capital by the parent charity will give confidence in the trading subsidiary to suppliers and others with whom it does business.

In more detail

A shareholder in a trading subsidiary is not, as such, a creditor of the company. Share capital can normally only be repaid in the event of the company's dissolution, and then shareholders will only get a distribution in respect of their share capital if all the company's creditors have been repaid in full. As a shareholder, the parent charity has no absolute right to receive dividends or gifts from its trading subsidiary.

Normally, the attraction of a share capital (as compared with loan capital) investment is that it gives (or increases) a right to participate in the profits of the company in the form of dividends as and when declared. This justifies the greater investor risk when compared with loan capital. But that attraction clearly does not exist if the trading subsidiary is already wholly owned by the parent charity.

However, there are valid reasons why a parent charity might choose to capitalise a trading subsidiary by means of share capital rather than loan capital. For example:

- the subscription by a parent charity of substantial share capital in its trading subsidiary can give confidence to suppliers, customers, creditors, prospective creditors and others with whom the trading subsidiary has a business relationship
- where a trading subsidiary would be exposed to the risk or actuality of insolvency if it were to be capitalised by loan, trustees will have little choice but to invest share capital (subject to the considerations set out in 4.8)

The fact that share capital subscribed by the parent charity in a trading subsidiary might not be repaid in full, or even in part, on the dissolution of the subsidiary, is only one factor which the charity's investment adviser should consider when deciding whether to recommend the trustees of the parent charity to subscribe for share capital. The adviser would have to consider the overall economic return to the charity, balancing Gift Aid payments and any anticipated distributions against the risk of capital loss.

4.11 What considerations apply to a charity's investment of loan capital in a trading subsidiary?

The short answer (legal requirement)

As a provider of loan capital to its trading subsidiary, a parent charity has a contractual right to repayment of the principal. This gives the parent charity greater assurance of repayment, but can also give rise to the company's insolvency if it is unable to service its loans.

In more detail

A lender has a contractual right to the payment of interest on the loan, and to repayment of the principal at the end of the loan's term. The provision of loan capital therefore gives the investing charity greater security than the provision of share capital, which offers no such guarantees.

However the amount of any loan capital held by a company is taken into account when determining its solvency. A company must not trade whilst insolvent. Trustees should not, therefore, invest loan capital in a trading subsidiary, if it is reasonably foreseeable that the subsidiary may not be able to service the loan or repay it when the term expires. In such cases trustees should:

- consider whether it is in the charity's interest to maintain the company at all, or whether it is best to dissolve it or to sell it as a going concern (based on the principles set out in 4.8) (see also 4.16)
- provide the investment as share capital (see 4.10), if it is indeed in the charity's interest to provide additional finance

The provision of loan capital can inadvertently create insolvency in a trading subsidiary even where it is trading profitably. This is because, in order to eliminate corporation tax liability, a trading subsidiary will often pay to its parent charity as Gift Aid all its distributable profits which would otherwise be liable to corporation tax (see 4.4). As a result the trading subsidiary may retain insufficient resources for it to repay loans made by the charity as and when due. That would render the trading subsidiary insolvent, in that it would be incapable of paying its debts.

If a charity makes a loan to a trading subsidiary, trustees must decide on the terms as regards the interest rate and repayment of principal. They must also decide how the loan is to be secured. These decisions are part of the duties of trustees as set out in 4.8.

Trustees might wish to provide a trading subsidiary with an interest-free loan, or a loan which is secured only by the contractual undertaking of the subsidiary, and not by a charge over assets of the subsidiary. However HMRC Charities takes a critical view of loans which are not made on proper commercial terms (see 4.12). In particular:

- it is unlikely that interest-free loans to a trading subsidiary could be justified as an investment, unless the amount of the loan was small
- whilst the creation of a charge over property of the trading subsidiary to secure a loan involves expense, it is unlikely that a loan secured only by the contractual undertaking of the trading subsidiary could be justified as an investment, unless the amount of the loan is small, or the value of the security which is available in the subsidiary is limited

4.12 What other tax implications need to be considered when investing in a trading subsidiary?

The short answer

It is important to ensure that any investment by a parent charity in a trading subsidiary is not treated as 'non-charitable expenditure', as defined in section 506 of the 1988 act. If it is so treated, then tax liabilities may arise.

In more detail

Any investment in a trading subsidiary, whether in the form of share capital or loan capital, will be treated as 'non-charitable expenditure' within the meaning of section 506 of the 1988 act if is not a qualifying investment or loan as defined in Schedule 20 to that act. If treated as non-charitable expenditure, some of the charity's tax exemptions may be restricted.

To avoid treatment as non-charitable expenditure, the trustees must be able to satisfy HMRC Charities that the investment in the trading subsidiary was made purely for the benefit of the parent charity, and not for the avoidance of tax, by the charity or anyone else.

An investment would not be considered to be 'for the benefit of the parent charity', if, for example, the investment was speculative, or driven by a desire to keep the trading subsidiary going, regardless of the prospects of economic return to the parent charity.

A loan which purports to be an investment may also be regarded by HMRC Charities as 'non-charitable expenditure' if:

- the loan agreement does not include proper provision for repayment
- the loan is unsecured where the company has assets on which the loan might have been secured
- the loan agreement provides for a rate of return that does not reflect the level of risk
- it was envisaged from the outset that the loan agreement would not be worked out, eg the loan would be written off by the parent charity

It is important for trustees to keep a record of the deliberations which precede any decision to make an investment in a trading subsidiary, and to be able to demonstrate to HMRC Charities that the investment duties described briefly have been properly discharged in relation to the making of that investment.

The 'substantial donor' provisions which were enacted in the Finance Act 2006 can also have the effect of treating a charity's investment in a business as non charitable expenditure, where that business has made substantial donations to the charity. However, a trading subsidiary cannot be a 'substantial donor' in relation to its own parent charity, regardless of the size of the payments which it makes, or has made, to the parent charity.

Further information

Please refer to HMRC website guidance Trading and business activities.

4.13 Does a trading subsidiary enjoy the VAT and corporation tax privileges accorded to its parent charity?

The short answer

A trading subsidiary enjoys some, but not all, of the VAT privileges of its parent charity, provided that certain conditions are met. There are no corresponding privileges as regards corporation tax.

In more detail

Provided that the trading subsidiary passes the trading profits derived from the relevant sales to the charity under a written agreement or other legal obligation, the following privileges of the parent charity also apply to a trading subsidiary:

- the zero-rate of VAT on the sale or letting of donated goods (see 3.3)
- the VAT exemption on sale of goods and services by a trading subsidiary in connection with fundraising events (see 3.13)

No corresponding corporation tax exemptions apply. However the trading subsidiary may reduce its corporation tax liability by making payments to the parent charity as Gift Aid (see 4.1 to 4).

4.14 Do trading subsidiaries qualify for rate relief?

The short answer

Trading subsidiaries have no absolute right to rate relief in respect of the properties which they occupy. However the rating authority may grant rate relief at its discretion.

In more detail

Non-domestic premises occupied and used by a charity are entitled to 80% mandatory rate relief, known as 'charity rate relief'. The remaining 20% may be waived at the discretion of the rating authority. In order to qualify for this relief, a property must be:

- occupied by a charity, or the trustees of a charity
- used wholly or mainly for charitable purposes

In this context, the term 'charitable purposes' normally excludes fundraising activities, but includes the sale of donated goods.

This mandatory relief is not available in the case of premises occupied by a trading subsidiary. However rating authorities have discretion to grant rate relief to some bodies which are not charities.

Premises occupied partly by a charity and used for charitable purposes, and partly by a trading subsidiary, qualify for the mandatory charity rate relief only in respect of the part occupied by the charity.

Charity rate relief may be available if a charity is in occupation of premises even though the premises are used partly for fundraising, provided that they are used 'mainly' for 'charitable purposes'. Even if the fundraising trade is being carried on by a trading subsidiary, the charity may be able to argue that it is occupying the whole of the premises, and using them 'mainly' for charitable purposes.

For example, where donated goods are being sold at the same shop as bought-in goods, the charity may sell the donated goods itself (bearing in mind that this is not 'trading' (see 3.3) and may sell the bought-in goods as agent for a trading subsidiary (see 3.10). The charity may then be able to claim charity rate relief in respect of the shop by satisfying the authority that the shop is occupied by the charity 'mainly' for the purpose of selling the donated goods.

There is no statutory definition of 'mainly'. However it is often argued that, if in a particular period the value of the sales of the donated goods exceeds the value of the sales of the bought-in goods, the premises are used 'mainly' for the sale of the donated goods, and thus for charitable purposes. In such cases the trustees should contact the appropriate rating authority, and if necessary their own legal advisers, for further advice.

4.15 Can charity trustees and employees also work for a trading subsidiary?

The short answer

It is normal for some of the trustees and/or employees of a parent charity also to be directors of a trading subsidiary. However the usual restrictions on paying charity trustees for any work they do for the charity apply also to any work they do for the trading subsidiary.

In more detail

In order to ensure that the trading subsidiary is managed in the interests of the parent charity, and to monitor its performance, some of the trustees and/or employees of the charity often become directors of the trading subsidiary. However, they must bear in mind that the charity and the trading subsidiary are different entities. Anyone involved with the administration of both has 2 distinct responsibilities, and it can at times be difficult to balance conflicting pressures.

A charity trustee cannot be paid for his or her services as a director or employee of the charity's trading subsidiary unless either:

- the governing document of the charity specifically provides for this
- there is some other specific authority, such as an order from the Commission

The establishment of a trading subsidiary, where the directors of that subsidiary are the same people as the trustees of the parent charity, cannot be used as a means of paying the charity's trustees 'by the back door'.

As a matter of good governance, there should be both:

- at least one person who is a trustee, but not a director or employee of the trading subsidiary
- at least one person who is a director of the trading subsidiary, but not a trustee or employee of the charity

These people are described as 'unconflicted' as they have no conflict of interest in their roles. These unconflicted trustees and directors should advise their colleagues as to the proper course of action where the duties of those with dual responsibilities are in conflict. This reduces the risk of any transaction between the parent charity and the trading subsidiary being challenged or questioned.

If trustees have delegated responsibility for monitoring the operation of the trading subsidiary to a committee made up entirely of people who are directors or employees of the subsidiary, they should ensure that systems are in place for ensuring that advice is obtained from an unconflicted trustee wherever appropriate.

4.16 What should trustees do if the trading subsidiary is in financial difficulty?

The short answer (legal requirement)

Trustees must always put the interests of the parent charity first. This will sometimes mean liquidating, or selling, a failing trading subsidiary. If trustees keep a failing trading subsidiary going at the charity's expense, they may be personally liable for consequential losses to the charity.

In more detail

If the trading subsidiary has been running at a loss for a significant time, without any special short-term factors in play, trustees must consider the trading subsidiary's viability. Trustees must minimise any losses to the charity, regardless of any sense of moral obligation the trustees may feel towards the trading subsidiary, its directors and employees.

If the trustees sink further funds into supporting an ailing trading subsidiary at a time when it was reasonably clear that the failure of the subsidiary was likely, this could constitute a breach of trust on their part, putting them at personal risk to make good any losses to the charity. Trustees facing these circumstances should take advice from their professional advisers.

If a trading subsidiary defaults on a loan agreement with the charity, the trustees must consider enforcing the charity's rights under the agreement. In deciding on their precise course of action, trustees must exercise their commercial judgement, based on appropriate professional advice. Their decision needs to be based on the best interests of the charity which owns the trading subsidiary.

Trustees have similar responsibilities where the charity has invested share capital in the trading subsidiary, even though share capital is not liable to repayment. The ultimate response for the parent charity - in its role as shareholder - to the trading subsidiary's trading failure is either to procure the subsidiary's termination or to sell the business as a going concern to a third party.

Trustees might fear that allowing a trading subsidiary to go into insolvent liquidation would adversely affect the charity's reputation. This might seem to justify making a further investment, and/or retaining existing investments in the subsidiary, to prevent or reduce losses to the subsidiary's creditors.

However the main point of carrying on a trade through the trading subsidiary is to protect the charity's assets from the risks of the trade (see 4.1). To use those assets to protect the subsidiary's creditors is the very outcome which charity law restrictions on trading by a charity itself are designed to prevent. If trustees act to keep the trading subsidiary in business, regardless of the interests of the charity, they may be personally liable for any consequential loss in the value of the charity's investment in the trading subsidiary.

4.17 What duties do charity trustees have in regard to trading subsidiaries?

The short answer (legal requirement)

Trustees must routinely monitor the performance of all trading subsidiaries, and of the parent charity's investments in them, with a view to ensuring the good and proper use of the charity's assets. They must be prepared to assert the rights of the parent charity as shareholder.

In more detail

Trustees must review regularly the relationship between the parent charity and the trading subsidiary. The purpose of establishing a trading subsidiary is normally to raise funds for the charity, and its effectiveness in doing this should be monitored. Investment review must not await a specific trigger, such as the discovery that a trading subsidiary is in financial difficulty.

The parent charity's trustees must also exercise the charity's rights as shareholder in the trading subsidiary so as to promote the charity's interests. The directors of the trading subsidiary are responsible for its management, but other major decisions are for the trustees, as representatives of the parent charity. For example, trustees are responsible for:

- the appointment/removal of the directors of the trading subsidiary
- the directors' terms of service, including any remuneration
- the continuation, or dissolution, of the trading subsidiary

4.18 Can a trading subsidiary be owned by more than one charity?

The short answer

Yes. This type of organisational structure used to be discouraged by a prohibition on the making of Gift Aid payments by a trading subsidiary with more than one charitable owner to those owners. But this prohibition no longer exists.

In more detail

A trading subsidiary may be wholly owned by one charity, or it may be owned jointly by a number of charities. Clearly, in the second case, the participating charities need to agree on the division of the trading profits of the subsidiary.

The comments about joint ventures which are made in the last 2 paragraphs of 4.9 apply equally to joint ventures with other charities.

4.19 Can a charity guarantee the liabilities of a trading subsidiary?

The short answer

Such guarantees, if given, will often be unenforceable against the charity and may expose trustees to personal liability.

In more detail

A parent charity or its trustees may be invited to guarantee liabilities of a trading subsidiary. For example, the trading subsidiary's bank may be reluctant to provide overdraft facilities to the trading subsidiary unless the parent charity (or its trustees) guarantees the trading subsidiary 's obligation to repay.

If such a guarantee is given by trustees of a parent charity, and liability under the guarantee is enforced by a creditor of the trading subsidiary, trustees are unlikely to be entitled to an indemnity from the charity, and will have to settle the liability personally, where:

- the liability arises out of a failure of a trade carried on by a trading subsidiary
- the parent charity could not itself properly have carried on that trade

The effect of allowing the guarantee to be enforced at the expense of the charity would simply be to frustrate the purpose of the charity law restriction on the carrying on of the trade by the charity itself.

If such a guarantee is given by an incorporated parent charity, it may not be valid at all. The validity of such a guarantee will depend on:

- the provisions of the charity's constitution
- the provisions of section 42 of the Companies Act 2006

If liability under the guarantee 'is' enforceable, and is enforced by the creditors of the trading subsidiary, the trustees may be personally liable to make good the corporate charity's liability under the guarantee, where:

- the liability arises out of a failure of a trade carried on by a trading subsidiary
- the parent charity could not itself properly have carried on that trade

In addition, payments made by a parent charity under a guarantee of the liabilities of a trading subsidiary may be considered to be non-charitable expenditure, creating a potential adverse tax effect for the charity.

The registration of a 'VAT group' comprising a charity and its trading subsidiary or subsidiaries means that each entity within the group guarantees the settlement of the VAT liabilities of the other entities within the group. There is no objection in principle to the registration of a charity as part of a VAT group. But before doing so, trustees need to satisfy themselves that the overall benefits of group registration outweigh the risk of loss to the charity's assets, if those assets have to be used to settle a VAT liability of a trading subsidiary.

In general, trustees must aim to ensure that all arrangements are demonstrably on commercial terms and for the benefit of the charity, and do not give rise to the difficulties previously mentioned.

Further information

Guaranteeing the liabilities of trading subsidiaries can be a complex area, and trustees should seek professional advice before reaching decisions.

4.20 Can a parent charity and its trading subsidiary consolidate their bank accounts?

The short answer (legal requirement)

Yes, there is no objection in principle to the consolidation of bank accounts in order to obtain better terms of business from the bank. However the financial structures of the parent charity and the trading subsidiary must be kept separate.

In more detail

The bank accounts of a charity and its trading subsidiary or subsidiaries may be consolidated so long as:

- a proper record is kept of the state of the balances on the individual accounts which have been consolidated
- the benefits and burdens of the consolidated account are fairly apportioned between the parent charity and the trading subsidiary or subsidiaries, having regard to the state of the individual accounts
- the consolidation does not result in the charity incurring non-charitable expenditure, creating in turn a potential tax effect, or otherwise suffering a tax disadvantage

Further information

Pooling arrangements can be a complex area, and professional advice is recommended, with the aim of ensuring that all arrangements are demonstrably on commercial terms and for the benefit of the charity.

4.21 Can a trading subsidiary use its parent charity's land and buildings?

The short answer (legal requirement)

Yes. However such use must be on a proper contractual basis and on proper commercial terms.

In more detail

Any use of the parent charity's land and buildings by a trading subsidiary should be covered by a formal lease or licence of the property concerned from the charity to the subsidiary. The trading subsidiary must pay a rent or fee which is comparable to that which would be payable for letting the property on the open market.

The granting of a lease will, and the granting of a licence may, constitute a disposition of the charity's land. Any such disposition will need to be authorised by the Commission because the trading subsidiary is a 'connected person' in relation to the charity. If a charity purchases land for use by a trading subsidiary, this must be justifiable as an investment of the charity's resources in terms of the commercial return received.

Charities enjoy an exemption from stamp duty land tax on their purchases of land (which includes buildings). However the relief does not apply to purchases by trading subsidiaries. The exemption will be lost if the purchase of the land and buildings cannot be justified as an investment of the charity's resources; or is made in order to avoid tax by the trading subsidiary.

Further information

See the Commission's guidance **Sales, leases, transfers or mortgages: what trustees need to know about disposing of charity land (CC28)**.

4.22 Can a charity invest indirectly in a trading subsidiary?

The short answer (legal requirement)

Yes. Indirect investment such as allowing the use of staff time and office equipment is an important means of support to a trading subsidiary. However the charity must charge the subsidiary, at fair value, for such services and use of facilities.

In more detail

Indirect investment in a trading subsidiary can be as important to the trading subsidiary's viability as capital formally provided by the charity. Allowing the trading subsidiary the use of the charity's land and buildings has already been mentioned (see 4.21). Indirect investment may also take the form of the parent charity allowing the trading subsidiary to use the charity's staff and equipment.

However the indirect investment must not involve any element of subsidy of the trading subsidiary, as that would prevent the objective evaluation of the subsidiary's performance as an investment. Arrangements which involve a subsidy by the charity to the trading subsidiary can also have an adverse tax effect as, in general, such subsidies are unlikely to be 'charitable expenditure' under the 1988 act.

The parent charity should therefore charge for any services and facilities which it provides to the trading subsidiary. Accordingly:

- where staff employed by the charity do some work for the trading subsidiary, or where the trading subsidiary uses facilities owned by the charity, appropriate charges must be made by the charity
- such charges must be paid within a reasonable period of time; unpaid charges can become a significant form of long-term financing, and amount to a form of subsidy of the trading subsidiary by the charity
- such charges should not normally go beyond the reimbursement of the charity's costs; if they do, they will be considered to be a receipt of trading carried on by the charity, the profits of which may not qualify for exemption from tax

Cost-sharing arrangements could be subject to challenge by HMRC Charities, if the costs are not calculated in an acceptable way or shared appropriately.

Such arrangements should be used only where staff and facilities are shared between the parent charity and the trading subsidiary. Where staff are employed exclusively on the trading subsidiary's business, the trading subsidiary should employ the staff. Where equipment is used exclusively by the trading subsidiary, the trading subsidiary should own the equipment.

Sharing arrangements between the parent charity and the trading subsidiary need to be carefully considered, with a view to ensuring that they do not damage the charity's ability to carry out its objects. Trustees wishing to enter into such arrangements should seek advice from their own professional advisers and contact the Commission at an early stage.

Some very large charity groups may also need to consider the implications of transfer pricing legislation. Where applicable, this requires 'arms-length' pricing of transactions within the charity group for tax purposes, regardless of the terms of the actual agreement between the parent charity and the trading subsidiary. The substitution of an arms length price for the actual price (for tax purposes) may increase the receipts of a trade, increasing the profits of the trade, and so give rise to a tax liability. It should be noted that HMRC Charities do not normally expect charities to commission expensive transfer pricing reports, but that charities should be in a position to demonstrate that arrangements are on commercial (arm's length) terms.

Further information

HMRC guidance on transfer pricing legislation is to be found in manuals published on their website - INTM 432090. Professional advice should be taken if this guidance causes concern. HMRC Charities will also answer specific queries about legislation and practice, but cannot advise on tax-related planning.

4.23 How may trading subsidiaries be named?

The short answer

The names of trading subsidiaries ought to be distinct from those of their parent charities to avoid confusion of identity. Company law also contains other restrictions on the choice of names.

In more detail

The key principle when naming a trading subsidiary is that the separate identities of the parent charity and the trading subsidiary are made clear to all concerned. The names of the parent charity and the trading subsidiary ought therefore to be different to prevent any confusion between the 2 organisations.

However the parent charity's name can be included in the name of the trading subsidiary, so long as this does not give the false impression to those dealing with the subsidiary that they are dealing with the charity itself. For example it would be acceptable to name a trading subsidiary as '[charity name] Sales Company Ltd'.

Company law restricts the use of the words 'charity' and 'charitable' in the name of any company - the approval of the registrar of companies is required to such use. These words should normally be avoided in the name of a trading subsidiary except where they form part of the name of the charity itself, and that name is being integrated into the name of the trading subsidiary.

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