Key tax considerations for trading through a subsidiary

Recently we have seen a lot of our charity clients ask for tax advice around their expansion plans.

This article, whilst not an exhaustive list of issues to consider, looks as some of the key tax matters to consider when looking to commence trade through a subsidiary company.

Making the decision to trade through a subsidiary

There are a number of reasons why you might consider incorporating a trading arm, these include:

- To perform an activity outside the charity's primary purpose (which may otherwise become subject to tax if the charity carried these out and exceeded the Non-Primary Purpose limit)
- To perform an activity not in the public benefit (e.g.: it may exclude people due to price)
- Legal/contractual reasons
- Risk reduction – the limited liability status of a separate trading company may protect charitable funds in the event of an accident.

However, to incorporate a subsidiary company, the Trustees of the charity must ensure that they are happy that the subsidiary will be financially viable as soon as possible. It is therefore important that a business plan is produced which clearly shows when the subsidiary is forecast to become profitable and to assess progress against the business plan. Where the subsidiary is not forecast to be profitable within 2 years consideration should be given to the appropriateness of the planned activity. This is because in most cases it will be the charity which is funding the operations of the subsidiary. Trustees must ensure that charity funds are used appropriately, furthermore should the charity make a non-qualifying investment, a Corporation Tax charge can arise on the value of the investment.

In practice it is not common to see non-qualifying investment charges arise, and a number of factors are considered in relation to them.

However, we would stress the importance of having clear business plans in place before the subsidiary commences trade, so that the basis of the decision to incorporate a subsidiary is well documented. Furthermore, should the charity be funding the subsidiary via a loan, a proper loan agreement should be drawn up with commercial rates of interest charged (and paid over).

Corporation tax

A key driver of trading through a subsidiary is the ability to reduce Corporation Tax to nil by making "Gift Aid" donations to the parent charity within 9 months of the year end.

However, for this to work in the long term there needs to be no difference between accounting profits and taxable profits.

Examples of where differences can arise:

- Fixed assets – if the subsidiary holds fixed assets, there might be disallowable depreciation charged on assets where no tax relief is available from Capital Allowances
- Disallowed expenses – the subsidiary may incur expenditure which is disallowable e.g.: third party entertaining, legal fees which are capital in nature.

Gift Aid donations are akin to dividends, and therefore must be made out of distributable profits. In simple terms, should the taxable profits exceed the accounting profits then it would not be possible to cover the whole taxable profit with a Gift Aid payment.

However, like most things, it isn't always that simple. It may be that the subsidiary has distributable reserves brought forward, or that within 9 months of the year end additional profits have been made which enable the distribution to be made.

VAT

Trading through a subsidiary can have VAT implications, positive or negative depending upon the fact pattern. Therefore, we would always recommend taking advice specific to your circumstances to consider issues such as:

- Will the subsidiary be required to be VAT registered? If not, would it still be beneficial to register?
- Will the transactions between the charity and the subsidiary be VAT-able?
- Should the charity and the subsidiary be VAT grouped?
- Are there any implications for the VAT recovery rate within the charity?
- Could there be implications on the VAT recovered on capital items through the Capital Goods Scheme?

Employment taxes

There are a number of ways in which staff might be employed:

- Through the charity
- Directly through the subsidiary
- Joint contracts of employment with the charity and the subsidiary.

Depending upon how you structure this you may need to make recharges for staff time between the charity and the subsidiary and/or set up a separate payroll for the subsidiary company.

We would always recommend that you take legal advice around contracts of employment.

Other issues to consider

Some addition items to take into account when considering setting up a subsidiary company include:

- It will create a more complex structure with additional costs (e.g.: audit, professional fees, additional accounting software licenses etc.)
- Possible loss of rate relief for the subsidiary's activities
- Staff time will be spent administering the subsidiary
- The subsidiary must operate at an "arms-length" to the charity (i.e.: recharges should be made at a commercial rate for services provided between the two).

Conclusion

For many charities setting up a trading subsidiary company, it is the correct course of action as it enables them to achieve objectives which are not possible or are more costly/risky through the charity.

However, we strongly recommend taking the time to carefully document the reasons for incorporating a subsidiary company, and to look in detail at the wider and long-term implications.

If you would like to discuss any matter arising from this article please contact MHA on info@mha-uk.com or your usual MHA contact.

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