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TRUSTEE HUB

Trading and Tax

It's a common misconception that charities and other not-for-profit organisations are automatically exempt from tax, given that charitiesare typically funded by donations and grants and spend those funds on charitable activities.

However, charities typically have a variety of sources of income, more so in recent years, as the third sector has faced a reduction in the availability of grant funding and as the cost of living crisis has reduced levels of public donations and legacies.

Trading and Tax

UK charities have preferential tax status (derived from the Elizabethan principle that socially beneficial activity should not be subject to tax), and current tax law provides a number of valuation exemptions to registered charities. In practice there are some taxes that charities pay in full such as National Insurance; some where there are exemptions such as VAT; and others where tax is rarely paid such as corporation tax. The primary guidance from the Charity Commission is set out in Trustees, trading and tax – how charities may safely trade (CC35), alternatively HMRC also provides valuable guidance, and most charities will need to consider both.

The Nature of Trading

Donations are not a trade, because nothing is received in return (technically, a non–exchange transaction). Grants also commonly fall into this definition.

Any exchange of goods or services for money is a trade. However, there are complexities, and the following issues all need to be considered:

- The number and frequency of transactions.
- The nature of the goods or services being sold.
- The intention of the charity in acquiring the goods to be sold.
- Whether the goods can be used and enjoyed by the charity.
- The nature and mechanics of the sales.
- The presence or absence of a profit motive.

What Trades are Lawful for Charities

The main aspect is trading that contributes directly to the provision of charitable activity, known as primary purpose trading. A related aspect is ancillary trading, where a secondary activity is provided in support of the primary activity. A third aspect is where the purpose is to raise funds for the charity and the activity does not involve significant risk. Risk is limited by the small-scale exemption.

Primary Purpose Trading

This covers the majority of charitable activities and where fees are charged for goods or a service.

Specific examples include:

- Course fees at a charitable school or college.
- Sale of goods manufactured by disabled people at a sheltered workshop.
- Residential care and accommodation at a residential care charity.
- Sale of tickets for a performance by a theatre charity.
- Entrance to a charitable museum or art gallery.

Ancillary Trading

Ancillary trading is where a service is provided that supports the primary activity, such as a café in a theatre for the audience. It must be closely aligned with the primary activity and the purpose of raising funds for the charity is not sufficient to qualify.

Non-Primary Purpose Trading

Charities can undertake non primary purpose trading, but the principle is that they are liable for corporation tax (or income tax if they are a charitable trust) unless the activities fall within specific exemptions.

If these exemptions do not apply, charities are advised to establish a trading subsidiary. This trading subsidiary would normally be limited by guarantee and if it became insolvent, the charities assets would be protected.

Charity trading subsidiaries are often set up so that all of the taxable profits are donated to the parent charity, thereby avoiding a corporation tax liability.

Small Scale Exemption

The small scale has a threshold calculated with reference to the overall income of the charity and the income from the trading activity. For small charities with an overall income of less than £32,000, the threshold is £8,000 with a sliding scale at 25% of overall income to a maximum permitted turnover from trading of £80,000.

Fundraising and Lotteries

Most fundraising events are exempt from corporation tax, but they cannot be a trade and therefore provide unfair competition with commercial companies. Therefore, charities need to consider the detailed guidance available in “Charities and Fundraising CC20” and in the OSCR publication “Benevolent Fundraising”. Lotteries are trading, but there is a specific tax exemption for charities as Lotteries are governed by the Lotteries Act 1976, and this limits the risk.

Trading Subsidiaries

Trading subsidiaries are a commercial company, normally fully owned by a charity, although it is possible to have other shareholders if that route is chosen. The company requires directors and to be administered according to company and tax law. The charity will have to demonstrate why they are investing in a trading company and how this investment is an appropriate use of charitable funds. A trading company should protect the charity's funds from risk and could bring some tax advantages. However, it will involve higher costs of administration.

Funding the Trading Subsidiary

As the owner, the charity will normally be responsible for providing the funding for the subsidiary to operate. Any loan must include properly set out terms of repayment and interest payable in writing and approved by both the trustees of the charity and the directors of the subsidiary.

Donating to the Charity From the Trading Subsidiary

Companies can make donations and treat them as expenses, herefore reducing any taxable profits. However, this is normally limited to small amounts. Trading subsidiaries will donate all unretained profits at the year end. This transaction is treated as a distribution of profit, but a gift aid declaration is still made and recognised by HMRC. A trading subsidiary cannot donate under gift aid more than the profit it has available for distribution.

Monitoring income streams and application of funds

With charities seeking increasingly diverse sources of funds, it is possible that a charity can become liable to tax without realising it. New income streams may contribute to non-primary purpose trading, leading to the small scale exemption being breached. Alternatively, fees for delivery of services may fall under the definition of a service level agreement (an exchange transaction) rather than a traditional grant.

How we can help

When a charity is not solely funded through donations, the trustees should make sure they understand their tax position.

This article is designed for information purposes only. Whilst every effort has been made to provide accurate and up to date information, it is recommended that you consult us before taking or refraining from taking action based on matters set out in this article.

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