Charities and trading: the rules explained

Charity and tax law impose restrictions on charity trading activity.

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Sung-Hyui Park and **Rebecca Bruce** outline the broad principles and explain how charities can structure their trading activities

Can charities trade?

Charities can trade provided the trading is directly in furtherance of the charity's objects. This is known as 'primary purpose trading'.

Primary purpose trading may include selling places on educational courses for an education charity, or entry fees to heritage buildings for a preservation charity. It also includes trading where the work in connection with the trade is carried out by the charity's beneficiaries, such as a relief of poverty charity selling goods made by its beneficiaries overseas.

Charities may also carry out so-called ancillary trading, which is trading that is in some way complementary to a charity's primary purpose trading activity. This could include a college selling text-books to benefit the students, or a theatre selling drinks to members of the audience (although sale to the general public, as opposed to the audience, would not be ancillary trading).

Profits on primary purpose and ancillary trading are exempt from tax, provided they are used for the charity's purposes.

Trading that is solely to raise money for the charity, and does not directly further the charity's purposes, is known as non-primary purpose (or non-charitable) trading. The sale of Christmas cards or charity t-shirts or pure fundraising events are common examples. The Charity Commission's view is that as a matter of charity law, a charity may carry out non-primary purpose trading provided it does not present significant risk to the assets of the charity. But the charity should check its constitution to see whether there are any limits on its power to carry out non-primary purpose trading.

Non-primary purpose trading can have tax implications. The basic rule is that where a charity carries out non-primary purpose trade the profits are taxable, unless an exemption applies. The most common exemption is the so-called 'small-scale exemption'. Under this exemption, charities are permitted to derive up to 25% of their annual turnover from non-primary-purpose trading, subject to a maximum limit of £50,000 per year (increasing to £80,000 in April 2019) without incurring a tax charge. Note that these limits apply to turnover, not to profits. For charities with an annual turnover under £20,000, the limit is £5,000 per year – due to increase to an annual turnover of £32,000 with a limit of £8,000 from April 2019. If a charity goes beyond these limits, all of the profits from the non-primary purpose trade will be subject to tax.

These are the broad principles: there are more detailed rules to consider. For example, the Charity Commission and HMRC do not consider the sale of donated goods in a charity shop to count as trading.

Use of a trading subsidiary

In light of the restrictions that apply to non-primary purpose trading, many charities choose to set up a separate non-charitable subsidiary company to conduct their trading activity.

The advantages of a trading subsidiary

Ring-fencing of risk
As a matter of charity law, charities may not directly carry out non-primary purpose trading that poses a risk to the charity's assets: using a trading subsidiary resolves this issue. Ring-fencing risk in this way may also be appropriate for any primary purpose trading activity carrying greater risk. If the trading subsidiary makes a loss, the charity will not generally be liable for the losses (provided it has not entered into any contractual arrangements to guarantee the trading subsidiary for losses or liabilities).

Tax
The trading subsidiary is liable to corporation tax on its profits. However, it can reduce or eliminate its tax liability by paying its distributable profits to the parent charity under Gift Aid. The payment must be made within nine months of the end of the relevant accounting year.

Clear roles and responsibilities
There may be administrative advantages to setting up a trading subsidiary as each entity can focus on its

core activity: the charity on its public benefit activities, and the subsidiary on carrying out trade.

The potential drawbacks

Costs and ongoing administration
There are costs associated with establishing a trading subsidiary, and the ongoing administration that comes with managing two separate entities. For example, the trading subsidiary will have to file separate accounts and make other filings with Companies House. The trading subsidiary will need its own board of directors and separate board meetings.

The public need to be aware of the distinction between the two organisations, such as in relevant correspondence, and the charity and its subsidiary may need to set up separate websites, or at least webpages. If the two entities share employees, and/or other resources they will need to give some thought to the terms of these arrangements.

Impact on rate relief
The charity will need to consider the implications for any entitlement to rate relief if the charity's trading subsidiary shares the same location as the charity itself. This entitlement may be lost if the property is no longer used wholly or mainly (ie more than 50%) for charitable purposes.

VAT
Complex VAT issues can be involved in setting up a trading subsidiary. The charity should seek professional advice.

Establishing and managing the relationship between a charity and its trading subsidiary

We would usually expect:

- the trading subsidiary to be a company limited by shares, with the parent charity as its sole shareholder;
- the parent charity to fund the trading subsidiary by loan (on arms-length terms), share purchase or grant (the latter is only possible where the trading subsidiary carries out primary purpose activity);
- the trading subsidiary carries out the trading activity; and
- the trading subsidiary's distributable profits are paid to the parent charity under Gift Aid, as mentioned above (and a deed of covenant put in place to document this arrangement).

Trustees must be able to justify the investment of charitable funds into the trading subsidiary, as with any other type of charitable investment. The charity must have the constitutional power to invest. The investment must be a so-called 'qualifying investment' from HMRC's perspective – otherwise it may be 'non-charitable expenditure', with potential tax implications. The trustees should consider whether the investment is reasonable, suitable and financially viable in the circumstances.

A resource-sharing agreement should be put in place to cover, for example, the use of the charity's intellectual and other property by the trading subsidiary, such as the charity's name and logo, data and premises. If the trading subsidiary is carrying out non-primary purpose trading activity, the relationship between the charity and trading subsidiary must be at arm's length. The charity should not allow the trading subsidiary to use its resources without proper remuneration or reimbursement. Nor should it overcharge for, say, the use of its name and logo.

Find out more
This article summarises the broad principles of charity trading. We are happy to advise you on the specific issues you should consider in your charity's circumstances.

Charity Commission guidance CC35 Trustees, Trading and Tax **https://www.gov.uk/government/publications/trustees-trading-and-tax-how-charities-may-lawfully-trade-cc35**

HMRC detailed guidance notes on trading and business activities by charities **https://www.gov.uk/government/publications/charities-detailed-guidance-notes/annex-iv-trading-and-business-activities-basic-principles**