Charity Trading

What is charity trading and why is it important?

Learning about charity trading is essential if you are an existing charity looking to start trading, or if you are looking to start a charitable company and are planning to trade.

It is also useful for those thinking about starting up a social enterprise and for existing social enterprises that are considering whether to apply for charitable status. Although there are limitations on trading and other management challenges, having charitable status is sometimes the right choice for social enterprises given some of the benefits involved.

So, whether you are already a charity or you are thinking about becoming one, you should be aware of the implications of charity trading.

Why would a charity want to trade?

There may be a number of reasons that charities choose to start trading:

- to increase the amount of income received so that the charity can increase the delivery of its charitable objects
- to counter the increasing competition for grants and donations
- to reduce the risk of over reliance on just one or two sources of income
- to improve the charity's long term financial sustainability

Many grant making trusts now ask grant applicants to communicate their "Exit" strategy. By this they mean that they want the charity to explain how it will survive financially after the grant applied for has been exhausted. Charities with diversified income streams are often regarded more favourably.

Undertaking trading activity is a complex issue for charities. It can have implications on the charity's charitable status and may subject it to corporation tax. This guide explains what is and isn't considered trading for tax purposes. It will then look at how to establish trading activities and some of the major issues to consider before starting.

Trading

Trading is generally accepted to mean the exchange of goods or services for a fee. Characteristics of trading activity include:

- **profit motive** – where there is an expectation of profitability even if no profit is actually made
- **repetition** – where the trading is regular rather than a one-off event
- **period of ownership** – goods are bought for resale rather than for own use
- **sales mechanism** – having a means of conducting a trade e.g. a shop, website etc

Achieving charity recognition requires all of the organisation's objects to be charitable. Since charities are not set up to make profits, trading may impact how the charity is viewed by the Charity Commission. For example, a charity that is trading for profit may be deemed to be no longer a primarily charitable organisation and/or subject to taxation. Therefore, it is important to understand what does and does not constitute trading.

What is not trading?
Certain sources of income are not considered to be trading and would therefore not be taxable. These include:

- grants
- donations

- legacies
- donated good and services
- payroll giving

Primary Purpose Trading
Primary purpose trading is when a charity conducts a trade in the course of carrying out its main charitable objects. For example, if the primary object of a charity is to provide education it can charge fees for providing an educational related service.

Such trading does not endanger the charity's charitable status and there are no limitations on how much primary purpose trading a charity can undertake. The profits from primary purpose trading must however be reinvested in the organisation for the benefit of its charitable purposes. Otherwise the profits will be subject to taxation.

Secondary Purpose Trading
Where a charity charges for services or products that are apart from its primary purpose, this is considered to be secondary purpose trading. For example, a religious charity selling non religious books would find that the profits from these activities would be secondary purpose trading and also subject to taxation.

Trading undertaken mainly by the charity's beneficiaries
Where trading is mainly carried out by beneficiaries of the charity the profits of such trading are not subject to taxation. The trade itself need not be a primary purpose trade and the beneficiaries can be paid or unpaid.

An example of this type of trading is the sale of goods made by people with a disability who are beneficiaries of that charity. This type of trading is quite often undertaken by beneficiaries because it has an educational, remedial or therapeutic value.

Other sources of income

There are a number of other transactions that many charities undertake which are not considered to be trading for tax purposes. These must take place within certain parameters and in each case the profits have to be reinvested for charitable purposes. Examples of some of these are set out below:

Sale of donated goods
This is considered to be a realisation of the value of a gift and not a profitable trade. If the goods are altered or substantially made better before sale then the trade may be considered to be profitable.

Commissioned research
Firstly, the research must be within the remit of the charity's objects. Secondly, the research must be made available to the public. In this case the payment for the research is being treated as a grant and is not considered to be a profitable trade. However, if the person paying for the research withholds it from the public, the commission is not deemed to be charitable in nature. The transaction may subsequently be considered to be profitable and therefore taxable.

Property rental
Rental income from property is not considered to be taxable. However, if services additional to the use of the property are provided, such as food or caretaking, these may be taxable.

Investment income
Bank interest and dividend income is not considered to be trading and is exempt from taxation for charities.

Corporate sponsorship
Acknowledgement of sponsorship is not considered to be trading. However, care must be taken because promotion of the sponsor on publicity and marketing material will be considered as supply of advertising services and therefore taxable. The same applies to company donations, providing the charity does not provide goods or services in return.

Membership

Where membership subscriptions offer no benefit, i.e. where the member is only being a supporter, then the income is not considered to be from trading because the fee is considered to be a donation. If there are benefits available, such as free invitations to private events, then it becomes trading income.

Lotteries
Raffles and prize draws are exempt from taxation and are seen as fundraising activities when undertaken by charities.

Other exemptions

Small-scale trading exemption
Charities can undertake secondary purpose trading, i.e. non-charitable trading activities, up to certain specified limits. Profits from trades are exempt if the annual turnover from the trading is either below:

- £5,000 or the lower of
- £50,000 and
- 25% of the charities total incoming resources

Trading subsidiaries

What do you do if your trading income is not derived from your primary purpose and exceeds the small scale exemptions?

Under these circumstances the Charity Commission advice is that the activity may be undertaken within a trading subsidiary owned by the charity.

There are a number of advantages to having a trading subsidiary. It ensures that the following risks are contained in the subsidiary rather than within the charity:

- **Financial risk** – this ensures that the charity's assets are not at risk if the trading activity is unprofitable or if there is any litigation regarding the trading activity.
- **Reputation risk** – any problems with the trading activity are not reflected onto the charity. However, this may be difficult to mask if the trading subsidiary uses a similar name to the charity or associates itself with the charity in marketing activities.
- **Opportunity maximisation** – a subsidiary has the freedom to undertake a wider range of activities, many of which a charity may not be able to do.

However, a trading subsidiary will not solve all the potential problems associated with trading risk. The parent charity may well have to financially support a trading subsidiary whilst operating at a loss, resulting in the charity still bearing the financial risk. Trustees therefore need to be sure that they have understood the risks associated with the trading activity before supporting it.

Financing the trading subsidiary

For a trading subsidiary to get started it will need to be funded by the parent charity. There are two ways of doing this:

- buying shares in the trading subsidiary, or
- making a loan

Both forms of funding are an investment by the charity. By law, any investment that the charity undertakes must be in the best interests of the charity and its beneficiaries. So the investment must be assessed in accordance with the charity's normal investment policy.

If the trading subsidiary is undertaking activities that support the parent charity's objects or support the parent charity's beneficiaries then the decision to invest is much clearer cut.

Where possible, security for the investment should be obtained. An example of security would be having the right to posses the subsidiary's fixed assets, debtors and cash in case of financial problems (known as taking a charge on the assets) so the money invested can be recovered. Similarly, interest on a loan should be charged to the subsidiary at a commercial rate and a loan repayment schedule should be agreed and documented.

Profits
Profits earned by the subsidiary can be transferred to the charity as a gift. In effect, this reduces the level of profits made by the subsidiary and therefore reduces its tax charge. The money received by the charity is treated as a donation and is therefore tax exempt.

Ownership structure
The subsidiary can be a company limited by guarantee or a company limited by shares, with whole or part of the ownership vested in the parent charity.

If the charity wants to establish the subsidiary as a Community Interest Company (CIC) then, according to the rules of the CIC Regulator, the subsidiary must be undertaking a service or trade that in itself is of community benefit.

Management
Since a trading subsidiary operates as a profit making entity, the management and governance requirements may be quite different to those needed by a charity. It would therefore not be advisable to replicate the trustee board of the parent charity into the trading subsidiary.

The trading subsidiary should have a chief executive who has commercial experience and is able to manage and grow the enterprise to maximise profit for the parent charity. Representation for the parent charity's interests can be maintained by having one or more trustees of the parent charity on the trading subsidiary's board. The board will also be able to review governance issues.

Conflicts of interest
By law, the directors of a company have to act in the best interests of the company. A trustee of a parent charity who is also on the board of a trading subsidiary may have a conflict of interest over which company should take priority. For instance, the charity will inevitably want to maximise the income it can receive from the subsidiary, whereas the subsidiary's management may wish to invest profits into the company to grow or start new projects and thereby hand over less profit than the parent charity desires.

These types of issues will need to be thought through and procedures for dealing with them agreed before launching a trading subsidiary.

Control
In order to ensure that the trading subsidiary does nothing that could cause damage to the parent charity, the latter may wish to keep a close eye on the subsidiary's activities. However, if control is too stringent the parent charity may end up smothering the entrepreneurial flexibility and rapid decision making that a trading company needs in order to succeed.

On the other hand, if the parent charity allows too much leeway the subsidiary may act in a way that is not in the best interests of the parent charity.

Getting the balance right is an important aspect of ensuring the success of the trading subsidiary and ultimately of the charity. Adequate planning and advice on the organisational structure, its management and procedures should be sought before the subsidiary begins operating.

Culture
There is always the possibility of a culture clash between the parent charity and the trading subsidiary. This is especially true if the trading subsidiary's management is drawn from outside the charitable sector. What is acceptable practice and behaviour in the commercial sector often does not sit easily in the charity sector.

Allowances for different ways of operating and behaving will need to be explained to the trustees and the staff of the charity as well as to the subsidiary's management right from the start.

An example of the potential problems is illustrated in the following case:

A long established educational research charity realised that some of its methodology could be sold as a training service across many sectors over and above education. Following advice it set up a trading arm with a dynamic managing director recruited from the commercial sector. The subsidiary operated from the same premises as the charity, having desk space in the general administration office. The subsidiary's employees were provided with mobile phones, cars and entertainment budgets to enable them to sell the training service.

However, the behaviour and "flashiness" of the sales personnel greatly upset the employees of the charity. At the same time, the sales staff employed by the subsidiary were disrespectful of the charity staff, calling them "nerdy" and staid. This conflict in culture was just about manageable until the year end when it all came to a head. The managing director of the subsidiary was entitled to a bonus based on sales targets achieved. This took his pay well over that of the chief executive of the charity. Even though the chief executive of the charity had herself negotiated this in the recruitment contract the reality of the situation upset her so much that she did everything she could to damage the trading subsidiary.

The trustees of the parent charity had to resolve matters by moving the trading subsidiary staff into separate premises and replacing the charity's chief executive with a trustee on the board of the subsidiary. The resentment between the two organisations was never eradicated.

Other pitfalls
Charities are allowed business rate exemption from local authorities. This can be jeopardised by having a profit making subsidiary operating from the same premises.

There will also be additional costs associated with having a subsidiary trading company. Examples are statutory filing fees, audit fees, legal fees etc.

Care has to be taken that the trading activities do not come to dominate the charity; this can lead to the charity straying from its charitable objects and may result in the loss of charitable status.

Summary

Trading activities can benefit a charity by increasing and diversifying income streams. Trading through a subsidiary may also allow the charity to exploit opportunities that it cannot undertake itself.

However, there are disadvantages stemming from the management, control and cultural clashes between the two different activities - charitable and profit making.

Good planning before the launch of any trading activity will assist in overcoming these potential pitfalls and will help to ensure success.

If managed well, the use of a trading subsidiary will assist in reducing financial, operational and reputation risk to the parent charity.

Further information

Read CC35 Trustees, trading and tax – how charities may lawfully trade, on the Charity Commission website:
www.charitycommission.gov.uk

Read detailed guidance notes for charities on the HM Revenue and Customs website:
www.hmrc.gov.uk