

# insight

keeping you informed

## Taxation of Charities

It is a common misconception that profits made by a charity are automatically exempt from tax. This factsheet looks at the exemptions available to charities and ways that they can structure their activities to minimise exposure to tax.

### Basic features

To obtain tax exemption for their profits, it is essential for charities to determine if their activities fall within available exemptions. Non-charitable expenditure can result in a loss of exemption. Where exemption is not available, use of trading subsidiaries should be considered.

### Exempt income sources

Income received from donations, grants, renting out land or property, investment income and receipts from capital disposals are generally exempt from tax provided that the income is applied for charitable purposes.

### Trading income

The definition of 'trading' can be subjective, and there are a number of 'badges of trade' which have been established over time. A charity may not consider itself to be trading, but its activities, even if one off in nature, may be caught by the rules.

The profits arising from trading undertaken by charities may be taxable unless they fall within certain exemptions as detailed below. For these exemptions to apply, the profits arising must be used for charitable purposes.

### The primary purpose trading exemption

Profits from trading that can be classed as primary purpose trading are exempt from tax. Primary purpose trading can be described as trading which is undertaken to fulfil the charities objects, for example, the provision of residential accommodation by a residential care charity in return for payment.

This exemption is extended to other trading which is ancillary to the carrying out of the primary purpose, for example the sale of confectionery, toiletries and flowers to patients and their visitors by a hospital.

### Trading activities undertaken by beneficiaries

Where trading profits arise from activities undertaken by the beneficiaries of the charity, eg the sale of goods made by disabled people for a charity benefiting the disabled, the profits will be exempt from tax.

### Lotteries

Income received by charities from lotteries is also classed as trading income, but subject to conditions, it is exempt from tax. The lottery must be conducted in accordance with relevant law. Be careful – no such exemption exists if lotteries are undertaken by trading subsidiaries.

### Fundraising events

Profits arising from fundraising events are normally exempt from tax, but the event must fulfil set criteria.

### Small trading exemption

For trading activities that do not fall into one of the above categories, a small trading exemption applies. The level of the exemption is set in relation to the income of the charity, as shown in the following table:

Total incoming resources of the period including trading income (annual equivalent)	Maximum permitted turnover of the relevant trading in that period which qualifies for the exemption (annual equivalent)
Under £20,000	£5,000
£20,000 to £200,000	25% of total incoming resources
Over £200,000	£50,000

Where a charity's trade has primary purpose, and non-primary purpose elements, each part is classed as a separate trade for tax purposes. The primary purpose element is exempt from tax as detailed above. The charity's non-primary purpose trade is not exempt from tax, unless the work is carried out mainly or partly by beneficiaries, or the small trading exemption applies. If the income from the non-primary purpose trade exceeds the small trading exemption, all of the profits from this activity are taxable. To arrive at the taxable profit figure therefore, it will be necessary to identify expenditure directly relating to that activity, and apply a reasonable apportionment of other expenses.

### Use of trading subsidiaries

Where trading falls outside of these exemptions, a trading subsidiary may be a useful vehicle in which to undertake these activities. We set out below the procedures which should be followed in order to minimise the tax payable by trading companies.

### Use of gift aid

Companies owned by charities are liable to pay tax on their profits just like any other company. Like other companies, they can get tax relief on donations made to UK charities under gift aid, subject to certain restrictions. The receipt of the gift aid donation by the charity will not be regarded as trading income, and so it will be exempted from tax providing that it is applied for charitable purposes. The amount paid to the charity is the gross amount and the charity does not claim back any tax, as it would from an individual donor. It is advisable to physically make the gift aid payment and avoid using inter-company accounts. No forms or declarations are required for this sort of payment.

### Wholly owned trading subsidiary

Where the company is wholly owned by the charity, a transfer of its profits, being the donation to the parent charity, can be made during, or up to nine months after the end of the financial year. This gives the trading subsidiary time to prepare its accounts and calculate its taxable profit before making payment.

#### Example

Year ended December 2008. Taxable profits before deduction for donation are £100,000.

Donation of £60,000 paid 15 June 2008. Donation of £40,000 payable by 30 September 2009.

Taxable profits after deducting the donation are £nil.

### Trading subsidiary not wholly owned

If the company is not wholly owned, it can only deduct the gift aid payment from profits in the year in which it is paid.

#### Example

Year ended December 2008. Taxable profits before deduction for donation are £100,000.

Donation of £60,000 paid 15 June 2008.

Taxable profits after deducting the donation are therefore £40,000.

In this case, it is therefore important to prepare accurate budgets so that the taxable profit can be estimated before the year end.

To summarise, this means that where a trading subsidiary transfers all of its taxable profits to the parent charity within the timescales mentioned above, no corporation tax will be payable. The amount to be transferred may be limited by available reserves. Also, there is likely to be a difference between accounts profits and taxable profits.

### Non charitable expenditure

Where a charity spends money that is not incurred for the reasons of the charity's objects, an equivalent amount of the charity's income will be taxed.

### Does the charity need to complete a tax return?

A tax return should be completed for any year in which the charity has taxable income or non charitable expenditure and it is the charity's responsibility to identify that fact. In all other cases, a tax return is only required when the charity receives a notice to deliver a return from HMRC. These are normally issued on a periodic basis.

### What next?

This summary is intended to be a brief guide only of the taxation of charities. There are important issues to consider when undertaking any of the above activities and advice should be sought regarding the tax consequences and most tax efficient structure. This factsheet is not intended to cover the complex VAT issues that affect charities which are covered in a separate Insight.

#### For further information

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