

Hospice shops – accounting and tax issues

A short guide for shops selling
donated and other goods



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Acknowledgements

Help the Hospices is grateful to the partners and staff at Sayer Vincent for making this publication available.

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Published by Help the Hospices in April 2010

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1. Introduction

Charity shops are an important source of income for hospices and are an excellent way to draw on the goodwill and support of local people. Most charities depend on volunteers to operate their shops and local supporters to donate goods for resale.

Now, many charity shops are asking their supporters to help them increase the value of their gifts by using Gift Aid. This makes the administration associated with operating charity shops a little more complicated, but plenty of hospices are already using Gift Aid as well as the normal sales of goods.

This guide explains in detail how the scheme works so that finance teams in every hospice can use it with confidence. It provides illustrations of appropriate accounting treatments, as well as background information on other tax and VAT issues and the legal framework affecting different types of shop activities.

2. Legal and tax framework

Hospices are set up as charities to provide services to their beneficiaries – this is their primary purpose. Hospices may charge health authorities or primary care trusts fees for services they provide to them, but this is within the scope of their objects and quite acceptable within the legal framework for charities. It is important to check the charity's objects to see whether they extend to activities such as providing training and the geographical area it can cover.

Charities may also undertake various forms of fundraising. However, some fundraising activities are more commercial in nature and may not be permitted in the charity. Charities may only undertake limited non-charitable trading activities.

A charity must be established for charitable purposes only and all income must be applied to its charitable purposes. If a charity sets up a trading activity, this may involve expenditure on premises, fittings and stock, which would be considered non-charitable even though the charity is hoping to make a profit. As a result, many charities with a substantial trading operation put this through a trading subsidiary.

Income tax or corporation tax for charities

There are several tax exemptions for charities. These apply to income, corporation and capital gains tax, but VAT is treated differently.

Non-taxable income – donations and grants

Certain sources of income are not subject to income tax or corporation tax. These include:

- donations that are not 'Gift Aided'
- government grants
- legacies
- payroll giving
- donated goods and services: the sale of donated goods by a charity is generally not regarded as a trade for tax purposes but as the realisation of the value of a gift.

Charity tax exemptions

Other sources of income are in principle subject to tax but are exempt when applied to charitable purposes. These include:

- income from charitable trading – trading undertaken to fulfil the charity's objects
- income from trading mainly undertaken by a charity's beneficiaries
- royalties and other income from intellectual property
- gains from disposals of charity assets
- rental income from charity property
- investment income such as dividends and bank interest
- income from lotteries, raffles and prize draws
- income from small scale fundraising events (the event must meet the conditions for VAT exemption)
- Gift Aided donations
- grants and donations from other charities.

Ancillary trading

The exemptions for primary purpose trading and trading mainly carried out by a charity's beneficiaries extend to ancillary trading activities. For example:

- the sale in a charity shop of bought-in goods that are related to the primary purposes of the charity, eg literature providing advice and support for people with cancer
- the sale of confectionery, toiletries and flowers to patients and their visitors in a hospice
- sales from a hospice café to patients and their visitors.

However, ancillary trading does not extend to:

- sales from a charity shop of bought-in goods that are unrelated to the charity's objects, eg sales of greeting cards and jewellery
- the sale of confectionery, toiletries and flowers to the general public
- sales from a hospice café to members of the general public.

Such sales are non-charitable trading. Where there is a mix of ancillary trading and non-charitable trading, the two must be distinguished.

Small trades exemption

Non-charitable trading activities are allowed in charities up to specified limits:

- if turnover from that activity is less than £5,000 in the year, or
- if the turnover from the trade is less than 25% of the gross income of the charity, or less than £50,000, whichever is the lower.

This means that charities with a small operation selling Christmas cards or similar activities will be allowed to undertake the trading activity through the charity.

Profits may still be exempt if the charity can show that, at the start of the relevant accounting period, it was reasonable for it to expect that the turnover would not exceed the limit. This might be because:

- the charity expected the turnover to be lower than it turned out to be
- the charity expected that its total incoming resources would be higher than they turned out to be.

HM Revenue & Customs (HMRC) will consider any evidence the charity may have to satisfy the reasonable expectation test. The charity will need to provide evidence to demonstrate the levels of turnover and incoming resources that were expected, eg minutes of meetings at which such matters were discussed, copies of cash flow forecasts, business plans and previous years' accounts.

Business rates relief

Charities are entitled to mandatory rates relief of 80% of the rates payable, which has to be claimed from the local authority. It is only available where the ratepayer is a charity and the property is mainly used for charitable purposes. The sale of donated goods and charitable bought-in goods is considered a charitable purpose, but the sale of non-charitable bought-in goods is not. If a charity is running a shop, then it is entitled to claim the mandatory rates relief as long as the charitable sales exceed the non-charitable sales. It is best to agree with the local authority how the two are compared. Options include turnover and floor area.

Local authorities can provide discretionary rates relief of up to 100%. This will depend to a certain extent on the local policy on granting discretionary rates relief. This can also be available to cover the remaining 20% payable by a charity.

Investing in trading activities

A charity using its own funds to invest in a trading activity must have the express power in its constitution to do so and must follow normal rules for investments. The trustees must give careful consideration to the decision to invest and the most appropriate way to fund the working capital. This should be properly assessed and the trustees should receive appropriate documents, such as a business plan, to satisfy themselves that the trading is viable.

Charities only retain tax relief if they spend their income on their charitable purposes; tax exemptions are not available for non-charitable expenditure. Non-charitable expenditure includes:

- investments or loans that do not meet the requirements to be charitable investments or loans
- losses on non-charitable trading or other non-charitable activities, and losses on trades where any profit would not be exempt
- expenditure that is not for charitable purposes.

Charitable investments include:

- listed shares
- unit trusts
- commercial bank deposits
- land
- some other pooled investment funds.

3. Traditional charity shop operations

Sale of donated goods

The sale of donated goods by a charity is generally not regarded as a trade for tax purposes but as the realisation of the value of a gift. This is so even where the donated items are sorted, cleaned and given minor repairs. If the goods are subjected to significant refurbishment or to any process that brings them into a different condition for sale purposes than that in which they were donated, the sale proceeds may be regarded as trading income.

Selling bought-in goods

As well as donated goods, a charity shop may sell bought-in goods, including items such as greeting cards and jewellery. There is a distinction between:

- bought-in goods that are sold to further the charity's objects, eg literature that is relevant to and useful for the charity's beneficiaries – these are referred to as charitable bought-in goods, and
- bought-in goods that are sold purely to raise funds, eg greeting cards and jewellery – these are referred to as non-charitable bought-in goods.

The former is charitable trading, the latter is non-charitable trading. The former can be carried out in the charity regardless of the level of turnover. The latter can only be carried out in the charity if the turnover from all non-charitable trading remains below the small trades limit, otherwise it may have to be transferred to a trading subsidiary.

The distinction can be difficult. HMRC may be prepared to go through a list of goods sold and agree which are charitable and which are not.

VAT status of charity shops

The sale of donated goods is zero-rated for VAT purposes. The goods may be new or secondhand but must be donated for the purpose of a sale or hire and should be available for purchase or hire by the general public. By concession, HMRC also allows zero-rating of the sale of donated goods that are in a poor condition and unwanted donated goods such as electrical items to scrap merchants and similar. This means that VAT does not have to be charged when selling the goods but that VAT on costs incurred in operating the shops can be recovered.

The sale of bought-in goods will usually be standard-rated for VAT, although:

- books and magazines, children's clothing and footwear, and some food items are zero-rated
- supplies of welfare advice by a charity are reduced-rate, eg posters and DVDs, but not dual purpose items such as t-shirts displaying messages.

The current threshold for VAT registration is £70,000 of taxable supplies in a year, which includes standard-rated, reduced-rate and zero-rated supplies. Charities have to register for VAT if they exceed the threshold. Once registered for VAT, a charity may be able to recover a limited amount of the VAT it incurs on overheads. However, this proportion will relate to the scale of shop activities.

If a charity has mainly zero-rated supplies, it can request an exemption from registration if its input VAT normally exceeds its output VAT. Though this will usually be disadvantageous financially, it can be useful in helping avoid the administrative burden of VAT.

Accounting treatment

The gross income from charity shops should be shown in the statement of financial activities in the charity's financial statements under the heading 'Activities for generating funds'. It is common to show the income under a subheading specifically for charity shop income. This should be repeated for expenditure, with the costs of running the shops shown under the subheading 'Costs of generating funds'.

For a charity's own bookkeeping, it is important to use separate codes to identify the shops' income and expenditure. If the entire shops operation is run in the charity, to help make sure it stays within the small trades limit it is also important to distinguish between income from:

- sales of donated goods and charitable bought-in goods, and
- sales of non-charitable bought-in goods.

Charities need to consider whether to apportion some of their management time and overheads to their shop operations as well as the shops' direct costs, such as rent, gas, electricity, insurance and maintenance.

If a charity has registered for VAT, then the basic bookkeeping will provide the data for the VAT return. Output VAT will only be due on the sales of standard-rated and reduced-rate bought-in goods. However, the full amount of the takings (including zero-rated donated goods and zero-rated bought-in goods) should be shown in 'Box 6' on the VAT return, as zero-rated supplies count towards the value of taxable supplies.

Charities are entitled to recover all the VAT on purchases relating directly to their shop operations, so VAT on shop costs needs to be flagged in some way. In computerised accounting systems this is usually achieved by assigning specific VAT codes to such expenditure. The system then totals the amount of VAT assigned to each VAT code.

To make the VAT accounting simpler, some charities use a separate nominal ledger for their shop operations and treat them as a department for accounting purposes. This can be more convenient for the VAT bookkeeping and analysing transactions to suit the shop operations. However, it is the whole charity that is registered for VAT, so it is important to take care not to miss other activities where VAT should apply, eg the sale of refreshments, cards and confectionery from a hospice shop or café. An appropriate proportion of VAT should also be recovered on general overheads.

Illustration – St Jude’s Hospice

St Jude’s Hospice runs four charity shops selling donated goods (takings approximately £150,000 per year) and a small amount of bought-in goods, such as the charity’s greeting cards. The annual level of sales of bought-in goods is about £20,000 in the shops and about £35,000 overall. Since this is below the small trades exemption, it has decided to run the whole charity shop operation within the charity. This enables it to claim mandatory rates relief of 80% on all the shop premises.

The hospice has to register for VAT as the takings from the sale of donated goods count towards the registration threshold despite being zero-rated. Consequently, it has to charge VAT on the sale of bought-in goods – both in the shops and through other channels.

St Jude’s is thinking about setting up a subsidiary company to handle the sales and purchasing of bought-in goods, which it wants to expand. In practice, the hospice could act as the subsidiary’s agent in selling the bought-in goods. This would enable the takings to be kept together and even banked as one amount, but the till system or other manual method would have to keep a record of the different types of sales.

If the takings are all banked together in the hospice, then the nominal ledger entry to reflect the banking would need to split the income between:

- sale of donated goods
- inter-company account – for the value of sales of bought-in goods
- output VAT.

The trading subsidiary would then mirror the entry by making a journal entry to debit the inter-company account with the hospice and credit an account for income – sales of bought-in goods. The trading subsidiary should buy the goods on its own account so that these costs are directly attributable to the sales and correctly allocated at the time of purchase.

The charity should make sure it charges the trading subsidiary for all costs it incurs in providing the agency services. This will be standard-rated for VAT purposes.

The trading subsidiary will only be able to recover the VAT on the purchases if output VAT is charged on the sales and it is registered for VAT.

4. Gift Aid on donated goods

A number of charities have introduced a new way of selling donated goods in order to benefit from Gift Aid. The rules for Gift Aid do not allow 'gifts in kind' to be given under Gift Aid – only cash donations qualify. Therefore, donors have to be invited to donate the cash raised from the sale of their donated goods to make the donation eligible for Gift Aid. This means that the way the sale of donated goods is organised has to change:

- Charities are now selling the goods as agent for the donor.
- For VAT reasons, the Gift Aid scheme should be restricted to personal goods brought in by individuals; business goods should be excluded (see 'Changes to VAT treatment' section on page 13).
- When the donor brings in goods, the shop staff should explain the Gift Aid scheme, and ask the donor if they qualify for Gift Aid and if they wish to participate. To avoid problems, it may be advisable to have a written agency agreement that the donor signs, though there is no obligation for them to do so.
- The donor should complete a Gift Aid declaration. This should be an open Gift Aid declaration – the donor agrees to Gift Aid all future donations (and, if appropriate, all past donations).
- Charities can charge the donor a commission for selling the goods – this would be non-charitable trading income and subject to VAT at standard rate.
- All donors should be given a unique reference number, which should be used to log all the goods they donate to identify them as the donor. Donors could be given an ID card and asked to bring it with them every time they donate goods. This would remove the need to get repeat agency agreements and Gift Aid declarations.
- When the goods have been sold, the donor should be informed of the sale proceeds on their goods and invited to donate the proceeds to the charity. This can be phrased so that the donor does not have to do anything if they are happy to donate, though they should be given at least 21 days to reply. The donor must be paid the proceeds less the commission (and any VAT due on the commission) if they ask for it.
- Providing the donor does not ask for the sale proceeds, the charity can then claim Gift Aid on the amount of the proceeds less the commission.

As a result, charities can increase the value of the funds raised by approximately 28%, as this is currently the value of Gift Aid on a donation. Obviously, not every donor will sign up to this, so this percentage increase in income will not be achieved across all shop takings.

Illustration – Gift Aid on donated goods

St Jude's Hospice decided to introduce Gift Aid to shops gradually, piloting the scheme in one shop first. The shop's annual takings from the sale of donated goods are approximately £50,000. The hospice estimates that by the end of the first year 20% of the takings will be under the Gift Aid scheme. The additional income from Gift Aid on those sales is calculated below:

CALCULATION OF GIFT AID ON SALES	£
Total takings from sale of donated goods in one year	50,000.00
20% move to Gift Aid scheme	10,000.00
Commission at 5%	500.00
VAT on commission	87.50
Total commission to deduct	587.50
Eligible for Gift Aid (exclude commission + VAT)	9,412.50
Gift aid at 28%	2,635.50

How Gift Aid works

A donation is assumed to be paid net of basic rate income tax. Charities can reclaim this tax from HMRC provided the donor has paid an equivalent amount of UK tax (income tax and/or capital gains tax).

Since 6 April 2008, the basic rate of income tax is 20%. A charity receiving a £100 donation under Gift Aid can gross up the donation by dividing by 80 and multiplying by 100 (because the net amount is the equivalent of 80% of the gross amount).

$$£100 \times \frac{100}{80} = £125$$

The tax to reclaim is the extra £25, which is the same as 20% of £125.

Before 6 April 2008, the basic rate of income tax was 22% so the calculation was:

$$£100 \times \frac{100}{78} = £128.21 \quad £128.21 \times 22\% = £28.21$$

Therefore, the reduction in the income tax rate from 22% to 20% has reduced charities' income. The government announced a transitional measure to top up all Gift Aid claims on donations made between 6 April 2008 and 5 April 2011. This top-up is called 'Gift Aid transitional relief' and effectively means that charities can continue to claim at a basic rate of 22%. For a £100 donation, the value of the transitional relief is the difference of £3.21. Charities do not need to make a separate claim and the relief is automatically added to Gift Aid claims.

So until April 2011, charities will continue to receive 28p for every £1 donated.

Gift Aid declarations

For Gift Aid to work, the donor must declare that they want Gift Aid to apply to their donation. Usually, charities will provide the Gift Aid declaration on a form that also explains how the scheme works. The following must be on the form and correctly completed by the donor:

- name and number of the charity
- statement that the donor has to have paid sufficient income tax or capital gains tax to cover the Gift Aid and that they should provide notification if they are no longer a taxpayer
- name of the donor – surname and initials is sufficient
- home address of the donor including the postcode – it must not be a business address
- statement that the donor wishes Gift Aid to apply to all future donations (and optionally all past donations) – the donor can tick a box next to this statement
- date of signing the declaration.

Declarations do not have to be signed, but it can be useful to ask people to sign to make sure that the procedure is followed correctly in shops.

As charities need to be able to link the receipt of income to the correct declaration, many now use a unique reference number for each donor to reference each transaction.

All declarations should be stored safely as they will be required for inspection in the event of a Gift Aid audit by HMRC.

Changes to VAT treatment

Introducing the Gift Aid scheme changes the nature of retail activity for VAT. It is no longer the sale of donated goods and no longer qualifies for zero-rating. In law, the donor is selling their goods to the purchaser, with the charity acting as the donor's agent in offering the goods for sale, finding a purchaser and managing the sale.

VAT status of the sale

If the donor is a VAT registered business and recovered VAT on the donated goods, then the sale of those goods will be a taxable supply by the donor. This means, unless the goods are inherently zero-rated (eg books and children's clothing), VAT should be added to the sale price and the donor must pay this VAT to HMRC.

Also, if the donor is a company, then the charity cannot reclaim Gift Aid on the company's donations.

To avoid these complications, it will usually be advisable to limit the scheme to personal goods donated by private individuals. As no VAT has been recovered on the purchase of the goods by the individual, and as donations from individuals are eligible for Gift Aid claims, no VAT is due on their sale and the whole proceeds (net of any commission) can be Gift Aided.

Effect on VAT recovery

Where a shop just sells donated goods (zero-rated) and possibly bought-in goods (zero-rated or standard-rated), then all activity in the shop is taxable and the shop can recover all the VAT it incurs.

If the shop starts selling goods as agent for a donor and provides this service for free, this is a non-business activity. The shop will have a mix of taxable and non-business activities, and VAT recovery on shop costs will be restricted.

To avoid this, the charity should charge the donor a commission on the sale. This commission would be VAT standard-rated and make the activity of

selling goods as agent a taxable business activity, therefore protecting the shop's VAT recovery. Commercial traders usually charge at least 5%, but a charity could charge less.

The rate of commission needs to be enough to justify the claim that it is a commercial activity and allow the recovery of input VAT on shop overheads. To avoid complications, the commission should be set at a rate that aims to make sure the agency sales activity, over the medium to long term, generates a slight profit after allowing for direct costs and apportioned overheads.

For charities that have significant shop operations, the volume of income from the sale of donated goods is also a significant driver for the overall recovery of VAT. The standard method for calculating the recovery of VAT on overheads uses the proportion of taxable income to total income as the basis for recovery. So if taxable income is reduced, this has a direct impact on the percentage of VAT recovered on overheads. This is illustrated in the example on page 14.

For charities using income-based business/non-business and partial exemption methods, one way of avoiding this reduction in VAT recovery is to argue that income-based methods are no longer fair and reasonable, and that for agency sales, the total proceeds from the sales (net proceeds plus commission less VAT) should be used in place of the commission in the method calculations. This is because an agency sale clearly incurs at least the same amount of effort and VAT-bearing overhead as a donated sale of an identical item. However, an income-based apportionment would apportion much less VAT-bearing overheads to the agency sale than to the donated sale. For partial exemption purposes, this would be a departure from the standard partial exemption method, requiring prior written approval from HMRC.

Illustration of VAT changes

St Aidan's Hospice runs a chain of 20 charity shops generating takings of approximately £1.6 million a year. The majority of this (£1.5 million) is from the sale of donated goods. The hospice's other income is approximately £5 million, from grants, donations and other fundraising.

Currently, the hospice recovers all the VAT it incurs in running the shops and its overall recovery rate on general overheads is:

$$\frac{£1.6m}{£1.6m + £5m} = 24\%$$

If the hospice moves 50% of donated goods sales over to Gift Aid, the changes will be:

CHANGES IF 50% MOVE TO GIFT AID	£	VAT
Total takings from all shops in one year	1,600,000	
Sales of bought-in goods	100,000	17,500
Takings from donated goods	1,500,000	
50% move to Gift Aid scheme	750,000	
Commission at 5%	37,500	6,563
Eligible for Gift Aid (exclude commission + VAT)	705,938	
Gift Aid at 28%	197,663	
Sale of donated goods	750,000	

This means that the taxable supplies change from the total takings of £1.6 million to:

TAXABLE SUPPLIES	£
Sales of bought-in goods	100,000
Commission	37,500
Sale of donated goods	750,000
Total taxable supplies	887,500

Charging a commission should make sure that the VAT on shop overheads continues to be recovered; however, the overall recovery rate on general overheads is changed to:

$$\frac{£887,500}{£1.6m + £5m} = 13\%$$

Changes for income or corporation tax and business rates relief

Acting as an agent in selling goods is a non-charitable trading activity. If the proportion of Gift Aid agency sales is low, then it may still be possible to undertake all the shop operations within the charity. The agency commission will count towards the small trades limit.

The switch to agency sales may affect business rate relief. This is only available if the shop is mainly used for charitable purposes. Sales of donated goods are charitable purposes but agency sales are not. So switching sales to agency sales will decrease charitable activity and at the same time increase non-charitable activity. If the level of charitable activity drops below 50%, mandatory business rate relief for the shop operations will be lost, though some local authorities may still be prepared to grant discretionary relief.

Therefore, charities may need to consider how their shop operations are structured and use a trading subsidiary to handle the non-charitable activities.

Other aspects

It may not be cost-effective to notify a donor every time any of their goods are sold. A more practical solution may be to set up individual donor accounts, log sales proceeds to these accounts but only routinely notify a donor when their account balance has gone above a specified amount. There could then be a periodic sweep-up notification capturing all accounts where the balance is below the specified amount. For example, if donors whose balances are above the specified amount are notified monthly, then there could then be a quarterly or six-monthly sweep-up notification of lower balances to clear out the donor accounts.

As goods must remain the property of the donor until sold, charities do not have the right to dispose of goods they consider unfit for sale without the donor's consent. This consent should be built into the agency agreement.

Selling goods as agent of a donor is likely to have many other legal consequences besides tax. It is recommended that charities take legal advice before the scheme starts to help make sure they are aware of all the consequences and that any donor agency agreement is properly drawn up.

5. Using a trading subsidiary

Charities that have a significant number of sales from non-charitable bought-in goods, such as Christmas cards, or a significant level of agency sales may need to consider transferring such activities to a trading subsidiary. There are two ways to organise this:

1. operate all shop operations through the trading subsidiary
2. channel only the non-charitable trading activities through the trading subsidiary.

Shops operated through a trading subsidiary

Charities can put their entire shop operations through a trading subsidiary. For this to work for donated goods, donors must donate their goods to the trading subsidiary, not the charity. This is because, in charity law, the charity cannot give its assets to the trading subsidiary free of charge. However, if the charity charges the trading subsidiary for the goods this would then be the sale of purchased goods by the trading subsidiary and not the sale of donated goods, meaning they are not eligible for VAT zero-rating.

The sale of goods donated to a 100% owned trading subsidiary of a charity is zero-rated for VAT purposes, provided the subsidiary has agreed to give any profits from the sales of the goods to the parent charity. This should be recorded in a formal written agreement.

Each entity has to be operated separately and will only have to register for VAT if it goes over the registration threshold. The subsidiary should normally be registered for VAT to enable VAT recovery on shop costs, but the charity may be able to avoid registering. The charity could sell some goods and services up to the VAT threshold of £70,000 and the small trades threshold of £50,000.

Where shops sell goods as agent of a Gift Aid donor, the sale of the goods is recorded as a separate category in the takings, but the entire takings can be banked together. The takings from sales on behalf of donors should be allocated to a separate clearing account in the trading subsidiary nominal ledger. After the donor has been notified and the 21-day notice period has elapsed, then the takings become donations to the charity. At this stage, they should be moved from the clearing account by making a cash transfer to the charity, or they should be moved to the inter-company account and a cash transfer made later. Exactly how a charity does this will depend on how it makes Gift Aid claims. Note that Gift Aid is only available to charities, not their trading subsidiaries, so the donations have to arrive in the charity bank account to provide the audit trail for an audit visit.

Any commission the charity charges would be deducted from the takings and recorded as income on which VAT is payable at standard-rate. The VAT should be taken out of the gross takings so that the net amount to be treated as a donation for Gift Aid is after deduction of the commission and the VAT on the commission.

Illustration – using a trading subsidiary to operate shops

St Aidan's Hospice decides to move all its shop operations into a trading subsidiary. It has succeeded in moving 50% of donors over to the Gift Aid scheme.

Its shops' total yearly takings are £1.6 million, of which £100,000 is from the sale of bought-in goods. It is charging commission at 5% so will have income of £37,500 in commission (being 5% on £750,000).

Overall, the position in the trading subsidiary will be:

POSITION IN TRADING SUBSIDIARY	£
Sales of bought-in goods	100,000
Commission	37,500
Sales of donated goods	750,000
Total income	887,500

Another £750,000 of the takings relates to sales on behalf of Gift Aid donors. The commission and the VAT on the commission is deducted from this amount and the balance (£705,937.50) is posted to the clearing account with the trading subsidiary's nominal ledger. This is then cleared down monthly as the notice period expires for donors who have been notified. The net amount is entered on the hospice's donor database so that it automatically generates the Gift Aid claim at the end of each quarter.

These donations are recorded separately in the hospice's nominal ledger so that when the management accounts are drawn up it is clear that these were donations generated from shop operations.

Shared premises, facilities, staffing

A service charge or management charge must be made if the trading subsidiary uses any facilities or staff time paid for by the charity. The charity should charge these facilities at cost – these charges may be subject to VAT and cause the charity to have to register for VAT if its total VATable activity exceeds the VAT registration threshold. The charity should issue invoices for the services it provides on a regular basis, eg quarterly.

Equipment

It is usually best for the charity to own the major fixed assets and then lease these to the trading subsidiary, otherwise the charity would have to lend the money to the trading subsidiary to buy the assets and then take a fixed charge over the assets. Therefore, it is easier for the charity to retain ownership of all significant assets (certainly property) so that it is not risking those assets.

It is also easier from a corporation tax perspective

as without depreciation, the taxable profit and the accounting profit will probably be the same result. It allows the trading subsidiary to maximise the transfer of profits to the charity as a donation under company Gift Aid and make sure that no corporation tax is payable in the trading subsidiary.

Business rates relief

Mandatory rates relief is not available if the charity's trading subsidiary is the ratepayer. However, the charity may be able to obtain discretionary rate relief.

Accounting for the trading subsidiary

In year-end financial statements, the trading subsidiary's results will be consolidated with the charity's results to produce group accounts. Shops' income should be included in the statement of financial activities under 'Activities for generating funds' with the costs appearing in the corresponding 'Costs of generating funds' section.

The trading subsidiary will have transferred the donations for Gift Aid to the charity during the year, so this income no longer appears in the trading subsidiary's accounts. So that the fundraising cost ratios are not distorted, many charities add the Gift Aid donations (including the Gift Aid) to the shops income in the year-end financial statements. This can be shown as a separate line, but there is no prescriptive guidance on this matter. The financial statements need to show a true and fair view, so the description of income and expenditure should be accurate and the notes to the financial statements will have to provide further detail on the trading subsidiary results.

Use the trading subsidiary only for non-charitable trading activities

Only the agency sales and sales of non-charitable bought-in goods need to be moved to the trading subsidiary; the sales of donated goods and charitable bought-in goods can remain in the charity. Keeping these in the charity may help protect business rate relief by reducing the level of shop activity attributable to the trading subsidiary and at the same time help avoid breaching the small trades limit in the charity.

The charity must act as agent for the trading subsidiary in selling these goods. The non-charitable bought-in goods must be purchased by the trading subsidiary and donors' contracts for agency sales must be with the trading subsidiary.

Shared premises, facilities, staffing

As with transferring all shop operations to the trading subsidiary, the charity must make sure it charges the subsidiary at cost for the use of its facilities and resources.

Accounting implications

It is important to record the takings correctly in the nominal ledger using the inter-company account (see the St Jude's Hospice illustration on page 8). However, one of the main complications with this type of subsidiary arrangement is

making sure the shops' tills can distinguish between the different types of sale so the takings can be recorded correctly.

If the takings are all banked together in the hospice, then the nominal ledger entry to reflect the banking would need to split the takings between:

- sales of donated goods
- net sales of charitable bought-in goods
- VAT control – output VAT on sales of charitable bought-in goods
- inter-company account – sales of non-charitable bought-in goods (including output VAT on such sales)
- inter-company account – Gift Aid agency sales (including the subsidiary's commission and output VAT on the commission).

The trading subsidiary would then mirror the entry by making a journal entry to debit the inter-company account with the charity and credit:

- income – sales of non-charitable bought-in goods
- VAT control – output VAT on sales of non-charitable bought-in goods
- income – commission on Gift Aid agency sales
- VAT control – output VAT on commission on Gift Aid agency sales
- donors' control accounts – net proceeds on Gift Aid agency sales.

If the donor does not claim the proceeds after the 21-day notice period, their proceeds will be transferred to the charity via the inter-company account. If the donor does claim the proceeds, their account will be cleared to the bank.

The trading subsidiary will only be able to recover the VAT on the purchases if output VAT is charged on the sales and it is registered for VAT.

The charity may have to register for VAT if the sale of donated goods at zero-rate VAT takes it over the registration threshold.

Group VAT registration

In either arrangement, there is a chance that the charity will have to register for VAT as well as the trading subsidiary.

If the charity is a charitable company, it is possible for it and the trading subsidiary to form a VAT group so that they are treated as a single entity for VAT purposes. This means there would be no VAT on transactions between the two. There are three main advantages to forming a VAT group:

1. It can simplify VAT administration – there is only one VAT return to complete each quarter.
2. Neither party has to charge VAT on supplies to each other.
3. The level of taxable activity in the trading subsidiary may help improve the charity's recovery rate on general overheads.

6. Conclusions

From a tax and accounting perspective, operating a shop that just sells donated goods is relatively straightforward. As the sale of donated goods by a charity is zero-rated, there are significant advantages to registering for VAT, though this may create complications for other activities in the charity. There are no adverse consequences for income or corporation tax and business rates relief.

Introducing the sale of bought-in goods creates some complications. For the purposes of the small trades exemption, it may be necessary to distinguish between charitable bought-in goods and non-charitable bought-in goods. Business rates relief may be affected, and for VAT purposes, charities will have to establish which bought-in goods are standard-rated, reduced-rate and zero-rated. However, VAT recovery on shop costs is not adversely affected.

As sales of non-charitable bought-in goods grow, it may be necessary to set up a trading subsidiary to handle these sales. There are two options when working with a trading subsidiary: transfer all shop operations to the subsidiary or just the non-charitable sales. Both options have their complications and knock-on effects for VAT and business rates.

Gift Aiding donated goods is an attractive option, offering the potential to increase income from the sale of donated goods by up to 28%. However, a commission must be charged to protect a shop's VAT recovery. This commission is VAT standard-rated and non-charitable trading for the charity. Therefore, this activity may need to be carried out by a trading subsidiary. Selling goods as agent may also affect business rates relief as shop activity is being transferred from charitable to non-charitable.

So while the income gain from Gift Aid is attractive, there are hidden costs and complications that must be carefully examined before implementing the scheme.

7. Further reading

Charity Commission. *CC35 - Trustees, trading and tax - How charities may lawfully trade (version April 2007)*. www.charitycommission.gov.uk (accessed 19 April 2010)

H M Revenue & Customs. *Charities: detailed guidance notes*.
www.hmrc.gov.uk/charities/guidance-notes/intro.htm (accessed 19 April 2010)

Sayer Vincent. Made simple guides for charities on various accounting and taxation topics including:

- Gift Aid made simple
- Trading issues made simple
- Subsidiaries made simple

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