

Subsidiaries made simple

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Introduction

The common way for charities to deal with trading which does not fall within their objects is to channel the income and expenditure relating to those activities through a separate company. This is necessary where the trading might put the charity's assets at risk, but clearly trustees should be considering the risk profile of any activity and consider whether it is appropriate to continue with high-risk activities.

A subsidiary is a company where the majority of the shares are owned by the charity. Usually all the shares in a trading subsidiary are owned by the charity, making it a wholly-owned subsidiary. Charities are obliged to produce consolidated accounts for the group (the charity and its subsidiaries) unless the subsidiary's transactions are low in value and therefore not material in the context of the charity accounts. This is a higher requirement for consolidation under the *Statement of Recommended Practice for Charities (SORP 2005)* by comparison to commercial companies.

A charity may be able to use the opportunity of a group structure to organise activities to be tax effective. For example, it may be useful to put activities subject to VAT through a subsidiary so that only the subsidiary needs to be registered. However, you will also need to consider how the activities will be managed and ensure that you are not creating complex structures that cause confusion among staff and supporters.

1

Tax aspects

So that the subsidiary does not pay tax, it must shed its taxable profits by tax-effective transfer to the charity. This is usually achieved by gift aid.

The trading subsidiary can make the gift aid payment to the charity up to nine months after the end of its financial year. The gift aid may be included in the trading subsidiary's corporation tax computation for the financial year. This gives the trading subsidiary time to draw up accounts and calculate the taxable profit.

The trading subsidiary can make transfers at various points during the year by gift aid, and then just make a final payment after the end of the financial year to mop up the rest of the profit. This use of gift aid works in the same way as for any company and no forms or declarations are required. The amount paid to the charity is the gross amount and the charity does not claim back any tax. To be safe, the trading subsidiary should physically pay over the gift aid to the parent charity and avoid including it as part of any inter-company account settlement.

The subsidiary may act as agent in collecting donations and if it receives donations on behalf of the charity, then these should be transferred promptly to the charity. With an agreement in place, a charity's wholly owned subsidiary may organise qualifying fundraising events and sell donated goods. However, many other tax reliefs are not available to subsidiaries, for example relief from business rates and the right to zero rates of VAT on advertising and other supplies.

2

Financing aspects

Whatever the activity, there will be a need to consider how the activity will be financed. Working capital may be needed for stock and funds may be needed to finance the initial start up costs.

A charity using its own funds to invest in a trading subsidiary must follow normal rules for investments and have the express power to invest in its constitution. If the charity does not have investment powers then it should amend its constitution and notify the amendment to the Charity Commission before starting a subsidiary.

The trustees must give careful consideration to the decision to invest and the most appropriate way to fund the working capital. One option is to seek a commercial loan from a bank or similar lender. Commercial lenders will be reluctant to lend to a company that is really just a 'shell'. With few assets, the security for a commercial lender will be scant so it is likely that the lender would seek guarantees from the charity. This presents difficulties for charities because trustees would probably be in breach of trust if a guarantee was called upon and the charity's assets were lost to satisfy the liabilities of the trading company.

The most common route for funding the working capital of the trading company is for the charity to lend the money to the company. This should be properly assessed, just as if the loan were to an external body. The trustees should receive appropriate documents, such as a business plan, to satisfy themselves that the trading is viable. The trustees' decision should be taken at a trustees' meeting and minuted. There should be a loan agreement and commercial rates of interest should be charged. The interest should be actually paid over regularly; it is not sufficient for an entry simply to be made

in the accounting records. There should be a charge over the trading company's assets, including stock, debtors and cash balances (it is usual to take a fixed and floating charge). This has to be registered at Companies House and means that the charity has the power to appoint a receiver and has first call on the assets of the company should it become insolvent.

The charity can buy more than the minimum of shares in the trading company. This would then provide the company with some or all of the capital needed to start up. The decision to buy share capital would have to be made as any other investment decision. The disadvantage with investment by shares is that the charity will have few ways of ever recouping its investment. The shareholders are the last to be paid out in the event of a winding up and the share capital cannot easily be repaid if the company continues trading. It is possible for the company to buy its own shares back, and the charity may be able to sell the company to a commercial purchaser at some point. However, share capital more or less permanently ties up the charity's money, whereas there is the possibility that a loan might be repaid. In situations where the trading is likely to continue for some time or where it is better for the trading company to have a 'clean break' from the parent charity, then an appropriate mix of share capital and loans may be the best option.

A trading company can retain profits to build up its reserves to cover its own working capital requirements, however tax has to be paid on profits before they are retained.

Tax rules on investments

Charities only retain tax relief if their income is spent on their charitable purposes and 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, and some other pooled investment funds. Charitable investments also include other investments that HMRC accept are for the benefit of the charity; charitable loans are similarly defined. HMRC guidance on acceptability states that loans should bear a commercial rate of interest and have suitable security and repayment terms. In practice the most common area of difficulty for investments and loans relates to the financing of subsidiaries.

The following key points should be met when a charity makes a loan to a trading company:

- Assess the loan request as if it were from an external body
- Document the decision
- Ensure that a business plan is drawn up
- Execute a loan agreement
- The trading company should pay a commercial rate of interest to the charity
- The interest must be physically paid over to the charity in accordance with the loan agreement
- The charity should have a charge over trading company's assets

The consequence of a non-charitable investment is that an equivalent amount of charitable income or gains will lose its exempt status going back for up to five years. This can only happen to income or gains that, without the exemptions, would have been taxable. Income that is outside the scope of income and corporation tax, such as legacies, grants and donations, can never become taxable. However, the gross value of covenanted and gift aided donations is potentially taxable, rather than exempt.

3

Governance aspects

A company must have a minimum of one director, but usually there will be several. It is tempting to make all the trustees of the charity the directors of the trading company. However, this is unwise and the Charity Commission advises against it. If the two boards are exactly the same, then there could be a conflict of interest. The charity trustees must always have regard to the interests of the beneficiaries of the charity and so must protect its assets and minimise risk. While the trading subsidiary may wish to maximise profits for the benefit of the charity, there may be occasions where a conflict could arise, such as agreeing a management charge (that is, a charge from the charity to the company for the services of the charity such as staff time).

Many charities like to have some representation on the board of directors of the trading company, to ensure that they do exercise control in practice as well as in theory. This may be one or two employees of the charity and one or two trustees. Preferably they should be people with business experience. It may also be appropriate to have one or two senior employees of the trading company on the board of directors, as one might in a commercial setting. It is worth remembering that the board of directors of a trading company does not have to be large. It is not the same as the board of trustees of a charity, where you may be trying to represent various different interests.

The charity trustees will need to review the progress of the subsidiary, ensuring that the strategic objectives of the company are not in conflict with its own and that the return is satisfactory.

4

Practical aspects

Before you set up a trading subsidiary, check these points:

- Do we need a trading company? You may want to refer to Trading Issues Made Simple to check the rules on charities trading.
- Does our governing document (e.g. the Memorandum and Articles of Association of a company or trust deed) allow us invest in the shares of a company?
- Which activities should be channelled through the trading company?
- Do those activities make a profit? What will the working capital needs of a trading company be?
- Can the charity afford to lend the funds for the working capital?
- Should some of the investment be share capital?
- What will be the charity's return on the investment and is this adequate?
- Will the company use facilities or staff time which the charity should charge for?
- How will the VAT position be affected?

Setting up the company

Usually the company will be an ordinary share company, with general trading objects and the usual clauses for a commercial undertaking. It is normal for two shares to be issued, which are usually owned by the charity, or by charity trustees who hold them on trust for the benefit of the charity.

Decide on the amount of the charity's investment, and whether this should be in the form of share capital, and allot shares accordingly.

Then:

- Appoint directors of the company.

- Make sure the accounting reference date is the same as the charity – you may need to submit a form to Companies House to change this.
- Notify HMRC when the company starts trading – you will be sent a form when a new company is registered and completing this will be sufficient.
- Inject some working capital and formalise any loans through proper loan agreements.
- Ensure there are proper agreements if there are any arrangements for use of facilities, equipment and so on.
- Set up systems to monitor profitability and liquidity.

Shared premises, facilities, staffing

If the trading company uses any facilities or staff time paid for by the charity, then a service charge or management charge must be made. The charity should charge these facilities at cost and will have to bear in mind that these charges may be subject to VAT and cause the charity to have to register for VAT if the charity's total VATable activity exceeds the VAT registration threshold. Care must be taken that the principal of operating 'at arm's length' is maintained. The charity should not make a profit on the management services either, unless they are primary purpose trading, as otherwise the profits may be taxable. The charity should issue invoices for the services it provides on a regular basis, say quarterly.

If the charity fails to charge for any use of its resources by the trading company then this is likely to be seen as a loan by the charity to the trading company. This risks breaching the tax rules on investment explained above.

Use of logos

The charity may wish to channel arrangements with corporate sponsors or income-earning ventures such as affinity arrangements

through the trading subsidiary. In order to do this, the trading company needs to be licensed to use the charity's logo.

Equipment

It is usually wiser 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. It is therefore easier for the charity to retain ownership of all significant assets (certainly property) so that it is not risking those assets.

Accounting and record-keeping

The new company is a separate legal entity and you should establish a separate nominal ledger and separate bank accounts. You will need to prepare and submit accruals accounts in the correct statutory format to Companies House within the 10 months of the end of the financial year (reducing to nine months in late 2008).

The accounts of the trading company will not require a separate audit if the whole group qualifies as small under the Companies Acts limits (consolidated group turnover less than £5.6 million or £6.5 million after 6 April 2008 and consolidated gross assets less than £2.8 million or £3.26 million after 6 April 2008), but the results of the subsidiary may be material to the group and would therefore need to be audited insofar as they affect the group's results.

Inter-company accounts

You will need to set up an inter-company account in each nominal ledger. You should post transactions and payments between the two companies into these accounts. It is essential that any posting to the inter-company account in one entity is mirrored in the inter-company account of the other. The accounts in each entity need to

be checked and reconciled on a regular basis, for example when management accounts are produced. You should be showing a debtor in the balance sheet of one (usually the charity) and a creditor in the balance sheet of the other.

You use the inter-company account for any payments made by the charity on behalf of the company, charges for services and loans to the company. The balance can build up over time and should be cleared from time to time. When the trading company makes a gift aid payment, this should be a physical payment (not just a bookkeeping entry) and so it will reduce the inter-company account. It may also be appropriate to treat the charges for services separately and the company should physically pay for these. It should then be possible to analyse any balance remaining into separate, recent advances.

Guidance for staff and volunteers

Having set up a trading company, there will need to be clear guidance for staff about which activities are channelled through the trading company and which activities are carried out through the charity. Charitable trading may go through the charity, as may many fundraising activities, such as exempt events and lotteries. It is advantageous for shops selling donated goods to be kept within the charity, as then the charity retains eligibility to mandatory business rates relief. However, shops selling a significant proportion of new goods will be conducting a mixed trade and may need to channel activities through the trading company.

Board meetings

The trading company must hold separate board meetings and prepare separate minutes of meetings.

5

VAT implications

As the trading company is a separate legal entity it must register for VAT if its taxable supplies exceed the VAT registration threshold. As explained above, any charges from the charity to the trading company for use of the charity's resources are likely to be within the scope of VAT and may cause the charity to have to register for VAT. If the management charge includes a charge for the use of premises it may be possible exempt the premises related element.

If the parent charity is a corporate body (for example a company or Industrial and Provident Society) it may be possible for the charity and trading company to form a VAT group. In a VAT group all entities in the group are treated as a single entity for VAT purposes and most transactions between group members are ignored for VAT purposes.

There are three key advantages to forming a VAT group:

- It can simplify VAT administration – there is only one VAT return to complete each quarter
- The charity and trading company do not have to charge VAT on supplies to each other
- The level of taxable activity in the trading company may help improve the charity's residual VAT recovery rate

However a potential problem is that in a VAT group each member becomes jointly and severally liable for the VAT debts of the others. If the charity is held liable for the VAT debts of the trading company this may amount to a non-qualifying loan by the charity to the trading company. If the charity and trading company intend forming a VAT group it would be wise to deal with this possibility as part of any loan agreement.

6 Conclusion

One of the benefits of channelling trading activities through a separate company is that a certain clarity of objectives may be achieved. The main objective of a trading company is fundraising for the charity and it should be trying to maximise profits and the return on capital. It is true that a certain amount of image enhancement or public profile may be achieved as well, but this should not be used to justify loss-making trading activities. A charity is more likely to prop up a loss-making activity if it is kept under the charity umbrella, whereas this becomes harder to justify once the activity is hived off into a separate trading company.

As well as considering the governance, legal and tax issues, charities should consider how the arrangements will be managed. It may be simpler to undertake all of one type of fundraising activity, such as events, through the trading subsidiary. There is no loss or additional cost to the charity, as profits may be transferred by gift aid at regular intervals to the charity.

On the other hand, there is no point in complicating the structure if this is not necessary and charities should only establish trading subsidiaries where the activities are outside the scope of the charity's objects or there are benefits from managing the risks in a separate entity.

Charities should take care to manage subsidiaries as separate entities and ensure that they comply with company and tax legislation. You do have to stay within the prescribed time limits for paying over gift aid, submit corporation tax returns each year and file annual accounts with Companies House within ten months of the financial year end.

References and further information

CC35 Trustees, trading and tax – How charities may lawfully trade

(April 2007)

Charity Commission

www.charitycommission.gov.uk

Detailed Guidance Notes for Charities

H M Revenue & Customs

www.hmrc.gov.uk

Charities Trading and the Law

Stephen Lloyd and Alice Faure Walker

Published by Jordans

ISBN 978 1 84661 106 3 (new edition June 2008)

A Practical Guide to Financial Management for Charities and Voluntary Organisations

Kate Sayer

Published by the Directory of Social Change

ISBN 1 903991 72 2 (third edition 2007)

A Practical Guide to VAT for Charities

Kate Sayer and Alastair Hardman

Published by the Directory of Social Change (new edition May 2008)

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Where the text refers to a book or other reference material, the name of the publication is highlighted *like this* and listed at the end in Reference and Further Information. The names and contact details of organisations from whom the publications and further information can be obtained are also listed.

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