



Charity shops

made simple



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Introduction

Shops are an important source of income for many charities and are an excellent way to draw on the goodwill and support of local people. Many 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 charities 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 charity 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 of different types of shop activities.

Legal and tax framework

All UK charities must be established for charitable purposes only, those charitable purposes being defined in charity legislation. These purposes are the charity's *objects or primary purposes*. A charity's constitution will normally set out the powers the charity possesses. The powers describe what the charity may and may not do to further its primary purposes. For example, a charity may have the power: "To trade in the course of carrying out the objects and to carry on any other trade provided such other trade is not a substantial permanent trade".

Charities can enter into contracts for the provision of goods or services if doing so furthers the charity's objects. Trading in the course of carrying out the charity's primary purposes is referred to as *primary purpose trading*. However, the charity in the example above could not carry out a substantial and permanent non-primary purpose trading activity, for example, the permanent and substantial sale of bought-in goods that are unrelated to the charity's primary purposes.

It is important to check the charity's objects and powers to see what trading activities your charity can and cannot undertake.

As explained below, a charity selling goods donated to it for sale is not normally regarded as a trade. However, the sale of bought-in goods on a permanent basis will normally be regarded as a trade. If the constitution prohibits a type of trading that the charity wishes to undertake, then it may be possible to amend the constitution or it may be necessary to set up a separate entity to carry out that trade.

Charity tax reliefs

The various charitable tax reliefs (income tax, capital gains tax, corporation tax and VAT) are only available to charitable bodies if all the following conditions are met:

- The body must be established for charitable purposes only. Charitable purposes are the England and Wales definitions in Section 2 Charities Act 2011.
- The body must be subject to the control of a relevant UK court (the High Court or Court of Session) in the exercise of its jurisdiction with respect to charities, or any other court in the exercise of a corresponding jurisdiction under the law of a relevant territory. Relevant territories are the member states of the EU, Iceland, Norway and Liechtenstein.
- The body must have complied with any requirement to be registered with a charity regulator such as the Charity Commission, OSCR or the Charity Commission for Northern Ireland and any equivalents in a relevant territory

The body's managers must be *fit and proper persons* to be managers of the organisation. Managers are defined as 'the persons having the general control and management of the administration of the organisation'. This is the same as the definition of a charity trustee used in s177 Charities Act 2011, though HMRC see the definition for tax purposes as extending to include senior staff with financial authority such as the CEO and CFO. HMRC provide non-statutory guidance on what they see as being the meanings of *managers* and *fit and proper* (available on gov.uk). This condition is treated as met if HMRC consider that the failure to meet this condition has not prejudiced the charitable

purposes of the organisation, or it is just and reasonable in all the circumstances for the condition to be treated as met.

Income tax or corporation tax for charities

In principle, corporate charities are subject to corporation tax on all of their profits and gains and charitable trusts are subject to income tax on all of their profits and capital gains tax on all of their gains. There are, however, a number of income and corporation tax exemptions for charities. In practice, these usually cover all of a charity's income, trading activities being the most common cause of difficulty.

Non-taxable income

Certain sources of income are normally regarded as being outside the scope of income tax or corporation tax. These include:

- Donations from individuals that are not 'Gift Aided' or provided under the Gift Aid Small Donations Scheme (GASDS) and not provided under Payroll Giving.
- Legacies.
- Selling donated goods: the sale of donated goods by a charity or its wholly-owned trading subsidiary is 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 income or corporation tax but are exempt when any associated profit or gain is applied to the charitable purposes. These include:

- Income from primary-purpose trading. This is trading that is exercised in the course of carrying out the charity's primary purposes.

- Income from a trade that is mainly undertaken by the charity's beneficiaries. This means that the work in connection with the trade is mainly carried out by the charity's beneficiaries.
- Income from the sale of intellectual property rights.
- Gains from disposals of charity assets.
- Rental income from charity property.
- Most forms of investment income such as dividends, deposit interest and passively received royalties.
- Income from lotteries, raffles and prize draws.
- Income from small scale fundraising events (the event must meet the conditions for VAT exemption).
- Gift Aid, GASDS and Payroll Giving donations.
- Grants and monetary donations from other charities and from companies.

Ancillary trading

The exemption for charitable trading extends 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, e.g. the sale of literature providing advice and support for people with cancer by a welfare charity.
- The sale of confectionery, toiletries and flowers to patients and their visitors in a hospice or hospital.
- Sales from a café to theatre attendees.

However, ancillary trading does not extend to:

- Sales from a charity shop of bought-in goods that are unrelated to the charity's objects, e.g. sales of greeting cards and jewellery.

- The sale of confectionery, toiletries and flowers to the general public.
- Sales from a 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 scale trades exemption

The profit of non-charitable trading activities are exempt provided all non-charitable trading activity is on a small scale. This means:

- If turnover from all non-charitable trading activities is less than £5,000 in the year, or
- If the turnover from all non-charitable trading activities is less than 25% of the total incoming resources of the charity, or less than £50,000, whichever is the lower.

Total incoming resources means the total receipts of the charity for the year from all monetary sources (grants, donations, investment income, all trading receipts, etc), calculated in accordance with normal charity accounting rules (whether the income is taxable or not). It does not include capital receipts (for example, from the sale of shares or a property).

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, e.g. minutes of meetings at which such matters were discussed, copies of cash flow forecasts, business plans and previous years' accounts.

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. 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 withdrawn for "non-charitable expenditure". Non-charitable expenditure includes:

- Investments or loans that are not "approved". Approved investments include land, listed shares, charity common investment and deposit funds, most bank deposits and investment products, and any loan or other investment made for the benefit of the charity and not for the avoidance of tax.
- Losses on non-exempt trading activities.
- Other expenditure that is not for charitable purposes only.

Business rates relief

Charities are entitled to mandatory rates relief of 80% of any business 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 may be necessary 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 on the local policy on granting discretionary rates relief. This can also be available to cover the remaining 20% payable by a charity.

Traditional charity shop operations

Sale of donated goods

The sale of donated goods by a charity, or by a charity's wholly-owned trading subsidiary, 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, e.g. literature that is relevant to and useful for the charity's beneficiaries – these are referred to as charitable bought-in goods.
- Bought-in goods that are sold purely to raise funds, e.g. 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. Assuming the charity possesses the necessary powers, charitable trading can be carried out in the charity regardless of the level of turnover. However, a charity may lack the power to carry out the non-charitable trade, and even if it possesses the necessary power, if the level of trading is sufficient for the small scale trades limit to be exceeded, then the profit of that trade will lose exemption from income tax or corporation tax.

The standard solution in such a situation is to carry out the non-charitable trade in a wholly owned subsidiary company – commonly referred to as a trading subsidiary.

VAT status of charity shops

The sale by a charity or by a *profits to charity person* of goods donated to it for sale is zero-rated. A profits to charity person is a person who has agreed to transfer to a charity the profits from supplies of the goods or a person for whom the profits are otherwise payable to a charity. So sales by a charity's trading subsidiary also qualify for zero-rating if any profit from the sales is payable to the parent charity.

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 or by two or more *specified persons* (defined as people in receipt of certain state benefits). By concession, HMRC also allows zero-rating of the sale of donated goods that are in a poor condition and unwanted donated goods 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, e.g. advice posters and DVDs, but not dual purpose items such as t-shirts displaying messages.

The current threshold for VAT registration (2018/19) is £85,000. If the total value of all taxable supplies made by a charity exceeds this value then it must register for VAT. The value of taxable supplies is the turnover (net of any VAT) from all standard-rate, reduced-rate and zero-rate sales.

Once registered for VAT, a charity can recover the VAT it incurs (*input* VAT) on making the taxable supplies and an apportionment of the amount of VAT it incurs on overheads. This proportion relates to the scale of shop and other taxable activities.

If a charity makes 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 it can be useful in helping avoid the administrative burden of VAT.

Accounting treatment

The gross income from charity-run shops should be shown in the statement of financial activities ('SoFA') in the charity's financial statements under the heading *activities for generating funds*. If the level of shop sales is significant, it is common to show the income under a subheading specific 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*. If the shops are run in a trading subsidiary, they are shown in the group SoFA.

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
- 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 the sale of donated and bought-in goods, so VAT on shop costs needs to be flagged in some way. In computerised accounting systems such as Sage this is 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, e.g. online sales or sales from a 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. This is below the charity’s small scale trades exemption limit, so 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.

Gift Aid on donated goods

Many charity shops have introduced a new way of selling donated goods in order to benefit from Gift Aid. This allows the charity to increase the value of its sales by up to 25%. This approach is commonly referred to as the Retail Gift Aid Scheme ('RGAS').

The Gift Aid rules do not allow Gift Aid to be claimed on donations of goods – only monetary donations qualify. To convert a donation of goods into a monetary donation, donors have to retain ownership of their goods until sold so the proceeds from their sale belong to the donor. The donor can then donate those proceeds to the charity under Gift Aid.

Under the Retail Gift Aid Scheme, the charity or its trading subsidiary sell the goods as agent of the owner. When the goods are sold, the owner is notified of the sales proceeds, giving them the opportunity to claim them. If the owner fails to claim within a set period, then the proceeds can be assumed donated to the charity.

How Gift Aid works

Under Gift Aid a donation is assumed to be paid net of basic rate income tax. The donor must have paid an equivalent amount of UK income tax and/or UK capital gains tax. The charity receiving the Gift Aid donation can reclaim this income tax from HMRC.

Since 6 April 2008, the basic rate of income tax has been 20%. If a charity receives a donation, the income tax on the donation is calculated as:

So with income tax at 20%, Gift Aid is worth 25% of the donation amount. If the rate of income tax changes, replace 20% with the new rate in the formula above

Gift Aid declarations

For a donation to be eligible for Gift Aid, the donor must provide the charity with a valid Gift Aid declaration. The declaration can be oral or in writing and it can cover future donations and donations made in the previous four years (accounting years for corporate charities and tax years for charitable trusts). A declaration must include all of the following:

- The donor's name – at minimum an initial and surname.
- The donor's home address – at minimum a house number or name and (for a UK address) a postcode. The charity can add the postcode from a postcode database if omitted by the donor.
- Identity of the donations that are to be Gift Aided, for example "this donation, all donations in the last four years and all future donations". If a declaration covers past or future donations it is referred to as an enduring declaration. Enduring declarations require a declaration date.
- Confirmation that the identified donations are to be Gift Aided, for example "Please Gift Aid the above gifts".
- Identity of the charity to benefit. This can be via a logo but any ambiguity should be avoided.
- An explanation that the donor must have paid sufficient tax. HMRC issue model wording for this which changes from time to time. This has now developed into a confirmation by the donor that they have and will pay sufficient tax and understand they may be held liable by HMRC if they have not paid sufficient tax.

HMRC provides several model Gift Aid

declarations, and it is advisable to follow these when creating your own declarations. See the Further Reading section below for links to the HMRC model declarations.

All written declarations should be stored safely as they will be required for inspection in the event of a Gift Aid review by HMRC. HMRC accepts that paper declarations can be scanned into a database and the paper documents disposed of. For oral declarations, charities can either keep an audio recording of the declaration or send the donor a written record of the declaration giving the donor 30 days to cancel. The charity should keep a record of letters sent though this can be in the form of a mail merge database record.

How the Retail Gift Aid Scheme works

HMRC provide detailed instructions on how to operate the Retail Gift Aid Scheme and it is advisable to follow those instructions carefully. In outline the Retail Gift Aid Scheme works as follows:

Selling agent

Charities (or their trading subsidiaries) are now selling the goods as agent of the owner. HMRC expect there to be a legally binding written agency agreement between the agent and the owner of the goods. This can be something the owner signs or it can be in the form of a leaflet or information sheet given to the owner to take away that the owner consents to verbally. HMRC recommend that shops use differently coloured labels to identify goods sold under RGAS and that shops put up a notice explaining the meanings of the different labelled colours, so that customers are aware that the shop is selling some goods as agent.

Personal goods

The Retail Gift Aid Scheme should be restricted to personal goods brought in by individuals. Business goods should be excluded.

Explain the scheme

HMRC expect shop staff to fully explain the Retail Gift Aid Scheme before individuals are signed up. Shop staff should also ask people to confirm they are an income tax or capital gains tax payer and able to make Gift Aid donations. HMRC expect records of staff and volunteer training to be kept and may ask to see records of staff volunteer training and guidance, to demonstrate that shop staff and volunteers are implementing the process correctly.

Enduring Gift Aid declaration

The owner of the goods should complete a Gift Aid declaration. This should be an *enduring* Gift Aid declaration under which the donor agrees to Gift Aid all future donations (and, if appropriate, past donations). As an enduring declaration it should specify the declaration date.

Selling commission

It is advisable for owners to be charged a selling commission. This is in order to enable VAT recovery on scheme costs and helps avoid potential income tax or corporation tax problems if the agency sales are carried out in the charity (see below).

Identifying sales

All participants in the scheme should be given a unique reference number, which should be used to identify all the goods they donate, for example, by including the reference on goods labels. Many shops give scheme participants an ID card and ask them to bring it with them every time they donate goods.

Notifying the owner

When any of the owner's goods are sold, the owner must be notified and given at least 21 days to claim the net proceeds. The net proceeds are the sales proceeds less any commission charged and less any VAT chargeable on the commission. From 6 April 2013, HMRC accept that owners can agree they do not need to be notified if the net proceeds in any tax year do not exceed an agreed amount. (See below).

Gift Aid claim

If the owner does not claim the net proceeds within the claim period, or if the owner has signed up to one of the post-6 April 2013 methods and net proceeds are below the agreed amount, the charity can assume the owner consents to the net proceeds being Gift Aided. If the Retail Gift Aid Scheme is being run by a trading subsidiary the net proceeds must be passed to the charity. The charity can then make a Gift Aid claim. It is only the net proceeds that can be Gift Aided.

Illustration – Gift Aid on donated goods

St Jude's Hospice decides to introduce Gift Aid to shops gradually, piloting the scheme in one shop initially. The shop's annual takings from the sale of donated goods are approximately £50,000. The hospice estimates that by the end of the financial 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
20% move to Gift Aid scheme	10,000
Commission at 5%	500
VAT on commission (VAT at 20%)	100
Total commission to deduct	600
Eligible for Gift Aid (exclude commission + VAT)	9,400
Gift aid at 25%	2,350

Scheme methods

Before April 2013, HMRC provided only one way to operate the scheme (the standard method). From April 2013, there are two new methods for operating the scheme in addition to the existing standard method:

The standard method: the owner of the goods must be informed of all net sales proceeds generated before Gift Aid can be claimed. The owner must be given at least 21 days to claim the net proceeds. If the owner does not claim within the set period, the net proceeds can be assumed donated to the charity under Gift Aid. From 6 April 2013 the owner must be notified of the net proceeds using HMRC template wording.

Method A: this is for use where either a charity or trading company handles the

agency sales. There is no need to send notification to the owner if net sales proceeds are for an agreed amount of no more than £100 per tax year. This must be agreed by the owner in the agency agreement. The tax year runs from 6 April to the following 5 April. If net proceeds in any tax year exceed the agreed amount, the agent must notify the owner and give them at least 21 days to claim the excess as for the standard method. The agent can either notify the owner every time a sale is made above the threshold or notify of all sales above the threshold at the end of the tax year. In either case Gift Aid cannot be claimed until 21 days after the notification has been sent.

Donors must be sent year-end statements setting out the total amount Gift Aided in the year. These statements must be sent by 31 May each year setting out the amount gift aided in the year. HMRC template wording (method A end-of-year letter) must be used. The end-of-year statement can be sent by email or by post. However if an email address is rejected, the letter must be sent by post. HMRC template letters must be used for the owner communications.

Method B: this is similar to method A but for trading company operated shops only. The agreed amount must be no more than £1,000. HMRC end-of-year-template letter method B must be sent by 31 May following the end of each tax year.

Conditions for using RGAS: HMRC impose the following conditions on use of all versions of the scheme:

- all shop staff involved in the process must undergo training and records of training undertaken must be kept
- operating incentive bonus schemes or other monetary rewards systems relating directly to operating a retail Gift Aid Scheme is unacceptable
- inappropriate schemes, specifically designed to increase Gift Aid income are also unacceptable. These include: targets for Gift Aid take up, publishing league tables of shops, giving bonuses, incentives, or otherwise rewarding increased Gift Aid claims from individual shops. Charities with inappropriate schemes cannot claim Gift Aid on the proceeds from the sale goods sold on behalf of individuals. Where targets or other schemes are in place, they should only be used for monitoring performance and identifying training needs, rather than to directly reward shop staff
- charities must undertake regular audits on a periodic or sample basis, as appropriate, to ensure the processes are being followed correctly. Records of such audits must be kept

Moving to methods A or B: HMRC accepts a charity or trading company can write to existing scheme members and explain that the process has changed. It can tell members that they will assume they are content for the new process to apply unless they reply within 30 days. The charity or trading company should remind the individual of the need to have paid sufficient tax to cover the agreed limit as well as donations to other charities. It must also offer the individual the opportunity to receive a statement letter at the end of the tax year if the individual wants one.

VAT consequences of the Retail Gift Aid Scheme

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 as such.

If the agency agreement is correctly drawn up, the owner is selling their goods to the purchaser, with the charity acting as the donor's agent in offering and arranging the sale.

It will normally be advisable to limit the scheme to personal goods donated by private individuals. 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 on such sales.

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

To avoid this, the charity can charge the donor a commission on the sale. This commission is VAT standard-rated and makes the activity of selling goods as agent a taxable business activity, thus protecting the shop's VAT recovery. HMRC state that the commission must be set at a reasonable rate to reflect the costs of operating the scheme, for example the cost of printing and sending donors the various letters and

notifications required, and charities need to be able to provide a rationale for how they've set the commission rate. If the commissions charged do not reflect the real costs of acting as agent to sell goods on behalf of individuals, it will not constitute a business for VAT purposes. As a result VAT incurred in operating RAGS will be attributable to a non-business activity and as such will normally be irrecoverable.

If shops are operated by a non-VAT grouped subsidiary, then another option is to charge the charity a commission for Gift Aid donations generated. See the section *Using a trading subsidiary*.

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.

Changes for income or corporation tax

Acting as an agent in selling goods on behalf of a private individual is likely to be a non-charitable trading activity. If the proportion of Gift Aid agency sales is low, so that the charity's small scale trades exemption limit is not exceeded, then it may be possible to undertake agency sales within the charity. The agency commission will normally count towards the small scale trades limit.

If agency sales rise significantly then it will generally be advisable to transfer the agency sales activity to a wholly owned trading subsidiary. Trading company operated shops are considered in the next section.

Changes for business rate relief

The switch to agency sales may also affect mandatory business rate relief. This is only available if a charity is ratepayer for the shop and the shop is mainly used for charitable purposes. Use for the sale of donated goods is treated as use for charitable purposes, but agency sales are unlikely to be so. So switching sales to agency sales is likely to decrease the level of charitable use and at the same time increase the level of non-charitable use of shop premises. If the level of charitable use drops below 50%, mandatory business rate relief for the shop

will be lost, though some local authorities may still be prepared to grant discretionary relief.

Other aspects

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.

Illustration of VAT changes

St Aidan's Charity 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 charity's other income is approximately £5 million, from grants, donations and other fundraising.

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

$$\frac{£1.6\text{m}}{£1.6\text{m} + £5\text{m}} = 24\%$$

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

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

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:

$$\frac{£0.89\text{m}}{£0.89\text{m} + £5\text{m}} = 15\%$$

	Gross	VAT
Takings from donated goods	1,500,000	
50% remain as sale of donated goods	750,000	
50% move to Retail Gift Aid Scheme	750,000	
Commission at 5% net of VAT	37,500	7,500
Eligible for Gift Aid (exclude commission + VAT)	705,000	
Gift Aid at 25%	176,250	

Using a trading subsidiary

Charities that have a significant level of sales of non-charitable bought-in goods or have a significant level of agency sales under the Retail Gift Aid Scheme, may need to consider transferring such activities to a trading subsidiary. There are two ways to organise this:

- All shop operations are carried on in the trading subsidiary.
- Channel only the non-charitable trading activities through the trading subsidiary.

Shops operated wholly through a trading subsidiary

The sale of goods donated to a 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 VAT 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 registration threshold and its small scale trades threshold (a maximum 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 for the full net donation amount 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 to donors 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.

Shared premises, facilities, staff

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, e.g. 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.

Illustration – using a trading subsidiary to operate shops

St Aidan's Charity decides to move all its shop operations into a trading subsidiary. It has succeeded in moving 50% of donors over to the Retail 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 Advise Charity will be:

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 (£705,000) 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 charity'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 charity's nominal ledger so that when the management accounts are drawn up it is clear that these were donations generated from shop operations.

Business rates relief

Mandatory rates relief is not available if the charity's trading subsidiary is the ratepayer.

However, the subsidiary 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 Retail Gift Aid donations 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 for non-charitable trading activities only

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. If these are carried out in the charity this 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 scale 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, staff

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). 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.

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:

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

However, if a charity and its trading subsidiary do not form a VAT group, then the trading subsidiary can charge the charity a commission for donations generated. This can help cover its costs of running the Retail Gift Aid Scheme and reduce the level of commission charged to donors, thus improving Gift Aid claims.

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.

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 under the Retail Gift Aid Scheme is an attractive option, offering the potential to increase income from the sale of donated goods by up to 25%. However, commission on a commercial basis should be charged, either to donors or to the charity if sales are made by a non-VAT grouped trading subsidiary, in order to protect the shop's VAT recovery. This commission is VAT standard-rated and, if charged by the charity, likely to be non-charitable trading income. Therefore, this activity may be better 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 retail Gift Aid is attractive, there are hidden costs and complications that must be carefully examined before implementing the scheme.

Further reading

Charity Commission

CC35 – Trustees, trading and tax – How charities may lawfully trade (version April 2007)

www.gov.uk/government/publications/trustees-trading-and-tax-how-charities-may-lawfully-trade-cc35

HM Revenue & Customs

Charities: detailed guidance notes.

www.gov.uk/government/publications/charities-detailed-guidance-notes

Model Gift Aid declaration.

www.gov.uk/claim-gift-aid/gift-aid-declarations

Retail Gift Aid Scheme guidance.

www.gov.uk/government/publications/charities-detailed-guidance-notes/chapter-3-gift-aid#chapter-342-claiming-gift-aid-when-goods-are-sold-by-and-the-proceeds-gifted-to-charities

Charities, trading and the law.

By Lloyd S and Faure Walker A.
2nd ed: Jordan Publishing, 2009



Made simple guides

Made Simple guides are aimed at finance professionals and other managers working in charities. They cover technical areas such as tax and VAT treatments as well as information management areas and aim to provide practical guidance to busy managers and trustees in charities.



The content of guides is correct at the time of going to print (August 2018), but inevitably legal changes, case law and new financial reporting standards will change. You are therefore advised to check any particular actions you plan to take with the appropriate authority before committing yourself. No responsibility is accepted by the authors for reliance placed on the content of this guide.

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