



# Charities and Trading Guide

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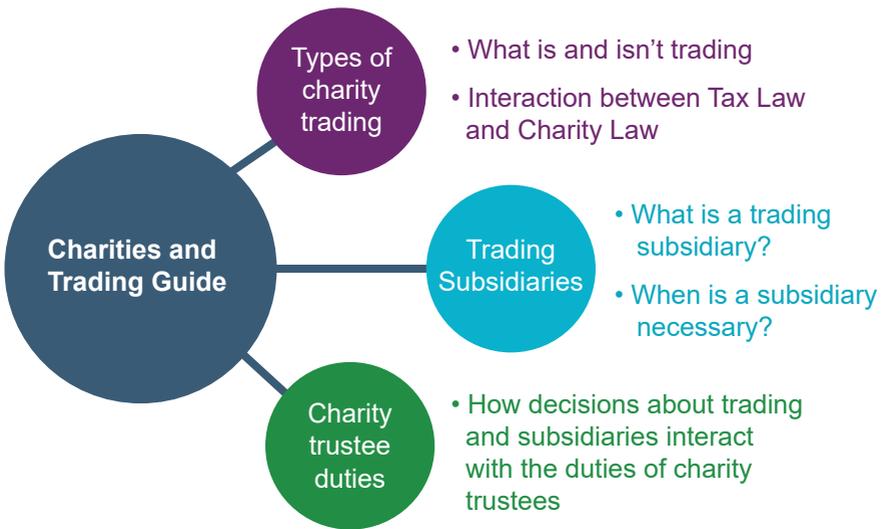
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# Introduction

## What this guide covers

In this Guide we look at the main ways a charity can trade and what charity trustees need to consider in terms of the **charity test and charity trustee duties** as set out in the **Charities and Trustee Investment (Scotland) Act 2005** (the 2005 Act).

This Guide is split into three sections:



This isn't a comprehensive Guide to all the areas to consider with trading or with tax. We recommend that you take appropriate advice before starting any trading activity: **see sources of help and advice.**

## Who is this guide for?

This Guide is aimed at charity trustees, and people working with trustees. It will also be useful to those applying to become a charity which intends to carry out trading.

## How to use this guide

The **glossary** on our website, available at <https://www.oscr.org.uk/charities/guidance/glossary-of-terms>, provides you with further information, definitions and descriptions of some key terms. We have highlighted these key terms in **bold purple type**. Clicking on these terms will take you straight to the glossary or the relevant section of guidance. The Guide also contains many links to external websites for other sources of information.

The Guide is split into sections to help you find the information most relevant to you and your charity. As trading can be a complex area we suggest that you read the Guide in full at first to get a better understanding of the implications for your charity.

## Sources of help and advice

OSCR publishes general guidance for charities, but we can't provide specific advice on the full range of things which can happen in or affect your charity. These organisations can help with some or all of the areas set out in this Guide and more:

- For all tax matters see **Her Majesty's Revenue and Customs (HMRC)**. The HMRC charity pages provide information and questions about tax issues relating to charities and charitable donations.
- The **Charity Finance Group** provides guidance which includes trading and tax.
- **Local Third Sector Interfaces** offer a range of support to voluntary organisations.

- The **Scottish Council for Voluntary Organisations** (SCVO).
- The charity's Auditor or Independent Examiner.
- If you are a Social Enterprise, see our **Social Enterprise FAQs** for more sources of advice.
- The **Development Trusts Association Scotland** is the national body for development trusts in Scotland, and can provide support and advice to its members.

# Section 1: Types of Charity Trading

## 1.1 What is trading?

Trading usually involves the sale of goods or services for the purpose of making a profit. Trading can be carried out directly by the **charity**, if it has the power in its governing document. In some cases it is advisable that any trading is carried out by a trading subsidiary.

Tax law defines different types of trading by charities and in this section we describe these and the implications of them in terms of tax law and **Scottish charity law**.

**The charity test:** To be a charity in Scotland you must meet the charity test. This means a charity must:

- have only **charitable purposes**, and
- provide **public benefit** in Scotland or elsewhere.

HMRC decides on the type of trading activity and what tax rules apply.

OSCR decides if an activity advances charitable purposes.

## 1.2 Primary purpose trading: trading that advances the charity's purpose(s).

**Primary purpose trading** is where the trading activity directly contributes to the charity achieving its purposes. In this Guide we include trading carried out by the charity's beneficiaries in the explanation of primary purpose trading.

**Primary purpose trading**



**Advances charity's purposes**

Examples of primary purpose trading are:

- A health care charity providing therapies and treatments in return for fees.
- A charity for disabled adults selling goods made by the beneficiaries.
- A further education college running a restaurant operated by students as part of their catering course.
- A farm operated by students of an agricultural college.
- A residential care charity providing residential accommodation in return for fees.
- A theatre charity selling tickets for their productions.

**Tax Law implications:** If HMRC are satisfied that the trading is primary purpose trading, and the profits are applied for the purposes of the charity only, you will not pay tax on profits made from this trading.

**Charity Law implications:** If OSCR is satisfied that the trading activity directly advances the charity's purposes and provides public benefit, we would be content for the charity to carry out the trading activity.

### 1.3 Ancillary trading: trading that complements charitable purposes

**Ancillary trading** does not directly advance a charitable purpose; but contributes to its success.

**Ancillary Training**



**Complements a charity's purposes**

Examples of ancillary trading are:

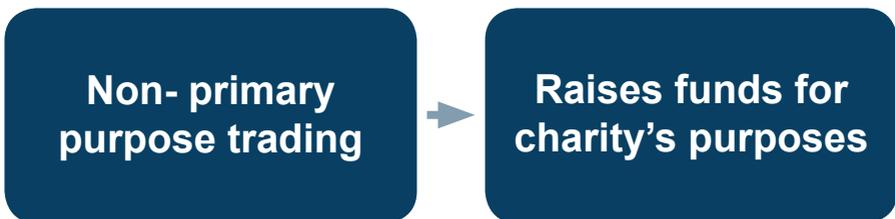
- The sale of stationery or text books by a college to its students.
- The provision of a paid for crèche for the children of parents who are students attending a training course.
- The sale of refreshments to audiences at a theatre performance.

**Tax Law implications:** Ancillary trading can still be said to be exercised in the course of the carrying out a primary purpose. If HMRC are satisfied that the trading is ancillary, it is therefore part of the primary purpose trade and will be exempt from direct tax.

**Charity Law implications:** Trading activities which OSCR is satisfied are being carried out as a by-product of a charity's main activities will not be regarded as activities which contribute to public benefit, but they are unlikely to be a problem in terms of the charity test.

## 1.4 Non-primary purpose trading: trading that provides an income to support charitable activity.

**Non-primary purpose trading** is where the trading itself does not advance the charity's purposes or provide **public benefit**. The trading is carried out to raise funds for the **charity**, but it is not a charitable activity. Anything which is not primary purpose or ancillary trading falls into this category. Charities might carry out non-primary purpose trading to fulfill social objectives outside the charity's main purpose or simply to raise funds.



Examples of non-primary purpose trading are:

- The sale of Christmas cards or calendars to raise funds for

- the charity.
- The operation of a cafe bar at a theatre, which is open to the general public.

**Tax Law implications:** If a charity carries out non-primary purpose trading, it will have to pay income or corporation tax on its profits from those activities, unless the level of trade that isn't primary purpose falls within:

- specific exemptions in tax law (for example a fundraising event) or
- the **charity's small trading tax exemption limit**.

The small-scale exemption is an exemption from corporation tax on the profits from small-scale non-primary purpose trading by charities. It applies only where all the profits or income are applied for the charity's purposes.

**Charity Law implications:** Charities can undertake non-primary trading activities as long as there is no 'significant' risk to the resources of the charity. **Charity trustees** must always act in the best interests of the charity and consider whether it is appropriate to undertake the trading activity.

With non-primary purpose trading it is important to consider the scale of the risk to the charity. Whether this is 'significant', depends on a number of factors, such as:

- ✓ the size of the charity
- ✓ the charity's legal form
- ✓ the nature of the business involved in the trading
- ✓ the expected cost
- ✓ turnover projections
- ✓ investment required from the charity, and the likelihood of return to the charity

If the trading activity is considered to be of significant risk you should first decide if the activity should be carried out at all. If you decide it is worth the risk then you should look at establishing a separate trading subsidiary.

## 1.5 What doesn't count as trading?

In some cases charities can sell things without it being considered trading for tax purposes:

- Selling or letting donated goods – as long as they were given to the charity for that purpose. Where there is a mix of donated goods and other goods being sold, the income from the donated goods must be separated from the other trading profits.
- Selling investments.
- Selling assets the charity uses, or has used, for charitable purposes.
- Letting land and buildings – as long as no additional services are provided to the tenant.

See **HMRC** for detailed information on what constitutes trading for tax purposes and guidance about other taxes that might apply.

## 1.6 Tax exemptions and reliefs

- Being a **charity** does not automatically mean you are exempt from paying tax. Charitable status can bring with it tax exemptions and reliefs in certain circumstances.
- As with all organisations, charities must register for VAT if they fall under the appropriate criteria. See **VAT for charities** for more details.
- We are aware that, while charities and those that want to become a charity must pass the **charity test**, they will also want to be recognised as charities for tax purposes. Recognition as a charity for tax purposes is a separate matter for HMRC.

In UK tax law ‘charitable purposes’ are defined in terms of the law of England and Wales, which differs slightly from Scots law. Any definitions of ‘charitable’ or ‘charitable purposes’ in your **governing document** will need to be acceptable under both the 2005 Act and tax law. More information on these definitions can be found in our **Briefing note with HMRC**. Further information on **Charities and tax** can be found on the **gov.uk website**.

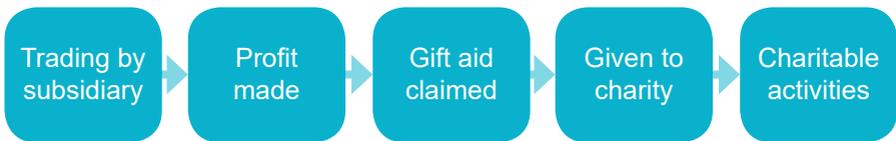
# Section 2: Trading Subsidiaries

## 2.1 What is a trading subsidiary?

A 'trading subsidiary' is a separate legal entity (often a company with share capital) owned and controlled by one or more charities.

The main reason a **charity** sets up a trading subsidiary is to undertake non-primary purpose trading as a way to generate income for the charity.

If a charity engages in significant levels of non-primary purpose trading it will need to pay tax on the profits. If this is carried on by a subsidiary, the subsidiary can donate the profits back to the charity under the gift aid scheme (time limits apply), ensuring that no tax is paid by the trading subsidiary. This allows all the profits to be used for charitable purposes.



Charities may also undertake trading through a subsidiary to protect the charity from the risks of trading, such as risks to the charity's assets, or the risk of incurring trading losses.

A trading subsidiary is not a charity. The role of the subsidiary is usually to generate income to support the charity – not to provide services which should be undertaken by the charity itself. Therefore the activities carried out by the trading subsidiary do not count towards the public benefit provided by the charity's own activities.

**Charity trustees** must be very clear about which activities should be undertaken by the charity and which should be undertaken by the subsidiary. It is important to get the structure of your group right, to make sure that you continue to meet the charity test, and that you are trading in the most efficient manner. If all the activity is undertaken by the subsidiary company then there will be concerns over the level of public benefit the charity itself is providing.

## 2.2 When should a charity set up a trading subsidiary?

When **any** of these apply you should consider undertaking the trading through a non-charitable trading subsidiary:

- The trading activity that the charity wants to undertake does not directly advance its charitable purpose(s) and is not ancillary or small scale.
- The charity does not have the power to trade directly.
- There is significant risk to the charity from the activity. For example, where an unincorporated charity needs to enter into contracts, such as property, service or employment contracts.
- A tax liability is likely to be incurred.



## 2.3 What do you need to think about?

The first thing to think about is whether there is anything in your governing document that prevents the charity setting up a trading subsidiary, such as a restriction on investments. You might need to take advice to decide if that is the case and **make changes to your charity** if necessary.

As charity trustees you need to consider what is in the best interests of the charity, including the advantages and disadvantages of setting up a trading subsidiary.

Where trading is substantial and there is a significant risk to the charity's assets then a trading subsidiary will be essential in order to make sure the assets are protected.

Where the use of a trading subsidiary is not essential you will need to consider the advantages and disadvantages. These will be individual to your charity, but there are general considerations that apply to many charities:

### Potential advantages

- Protects the charity's assets from the risks of trading.
- Allows trading activity that the charity can't carry out.
- Reduces tax liabilities arising from trading activity.
- Provides clarity and transparency as to what the charity does and what the trading subsidiary does.

## Potential disadvantages

- Cost and resource implications of setting up and running a new company.
- Could lead to a loss of rates relief if the trading subsidiary uses the charity's property.
- Charity trustees have additional responsibility over the trading subsidiary as well as the charity.
- Group structures and more complex accounting arrangements.

### 2.4 Setting up a trading subsidiary

As with any company the trading subsidiary will need directors, start up funding and resources. The trading subsidiary must be a completely separate organisation from the **charity**. Generally a trading subsidiary will:

- ✓ Be a registered company (often limited by shares) or **Community Interest Company (CIC)**
- ✓ Have general trading objects
- ✓ Not be a charity
- ✓ Have the charity as the sole shareholder or member
- ✓ Be capable of generating a profit for the charity.

### 2.5 Managing the relationship between the charity and trading subsidiary

As charity trustees you need to **act in the charity's interest and with care and diligence**. This means you should monitor how the trading subsidiary is performing and how well it is meeting the goal of raising funds for your charity. The level of oversight charity trustees have in relation to the trading subsidiary will vary but as the shareholder or member your charity, and therefore you as its charity trustees, are often responsible for:

- ✓ Appointing trading subsidiary directors
- ✓ Deciding on the role of the directors
- ✓ Removing directors
- ✓ Deciding, along with the directors of the trading subsidiary, whether or not it should continue.

There needs to be a clear line of responsibility to the charity for the trading subsidiary operations. The charity trustees need to monitor performance and be aware of what is going on in the trading subsidiary.

The charity and the trading subsidiary could have a written agreement in place that sets out the relationship between the two organisations, the lines of accountability and the oversight the charity must have.

## A. Names

The trading subsidiary and the **charity** are separate organisations and this should be clear from the names so that the two are not confused. The trading subsidiary can have a similar name to the charity, but the difference between the two should be clear.

**For example:** A charity called 'Jelly Beans Children's Charity' may have a trading subsidiary called 'Jelly Beans Trading Ltd'.

There are rules under **company law about names** which you should be aware of before choosing a trading subsidiary name.

## B. Shared resources

Many charities and their trading subsidiaries will share resources such as premises, equipment and staff. Where resources are shared there must be formal agreements in place and the trading subsidiary must pay a fair rate for the use of the charity's resources.

In particular, where the trading subsidiary uses the charity's buildings there should be a formal lease in place and rent paid to the charity at a rate which is comparable to that which could be achieved on the open market. There should also be a written agreement regarding any other services provided by the **charity** to the subsidiary (or the other way round).

## C. Charity trustees and trading subsidiary directors

There needs to be a clear line of responsibility between the charity and the trading subsidiary. Often some of the charity trustees are also directors of the trading subsidiary. This relationship can cause **conflicts of interests** for charity trustees and others, especially where there are transactions between the charity and the trading subsidiary.

Charity trustee duties require you to **act in the interests of the charity**. Where the interests of the charity and those of the trading subsidiary conflict you must put the interests of the charity first.

Because of this duty you should think about the proportion of trading subsidiary directors that are also charity trustees. It is important for the charity trustees to have clear oversight of the trading subsidiary but also for the subsidiary to have directors that are independent of the charity.

## D. Conflict of interest

As a **charity trustee**, you must put the interests of the **charity** before your own interests or those of any other person or organisation including those responsible for your appointment. Where you cannot do that, there may be a **conflicts of interest**.

There are specific rules about **paying charity trustees and connected persons**. These rules do not extend to payments made by the trading subsidiary; however any remuneration paid by a trading subsidiary company will ultimately reduce the level of profits to be received by the parent charity. The charity trustees should have an understanding of the levels of remuneration paid by the trading subsidiary and consider whether these are appropriate.

As a charity trustee you should be aware that the directors of the trading subsidiary will have **legal duties under company law**, many of which are similar to charity trustee duties.

## E. Funding for the trading subsidiary

The aim of a trading subsidiary is to generate income for the **charity**. Whilst a charity may support the trading subsidiary initially we would not expect funding to continue long term. If it becomes the case that the trading subsidiary cannot support itself, and generate income for the charity, the

charity trustees should consider whether they wish to continue with the investment.

Funding for a trading subsidiary should be judged just as any other charity investment and the investment should not be undertaken if it is not expected to produce a profit in the long term. Finance may be provided by means of share capital or loan capital.

Where finance is provided to the trading subsidiary in the form of a loan we would expect there to be formal loan arrangements in place. The loan should be provided on a commercial basis with appropriate repayment terms and a market level of interest charged.

## F. Trading subsidiaries in financial difficulties

As a **charity trustee** you have a duty to put the interests of the **charity** first. If the trading subsidiary is operating at a loss for a sustained period of time then you need to decide if the trading subsidiary should close.

The reason for setting up a trading subsidiary is to generate funds for the charity and to protect the charity's assets. Where the charity is propping up the trading subsidiary and not getting any of the benefits it is difficult to see how this is in the interests of the charity and how the charity trustees are fulfilling their legal duties.

Charity trustees must be clear that if they use the charity's assets to support a failing trading subsidiary then they are putting those assets at risk and failing in their duties. Charity trustees must minimise any losses to the charity, regardless of any sense of moral obligation they may feel towards the trading subsidiary, its directors and employees.

## G. Funds to the charity

Funds can be passed from the trading subsidiary to the **charity** by a share dividend, interest on, and repayments of loan capital, through rental agreements or as **Gift Aid** donations. Where a charity has provided a loan to a trading subsidiary it will be appropriate for repayment and interest to be received under the terms of the loan agreement. Outwith this the most tax efficient way for a charity to receive funds will be through a Gift Aid donation. Gift Aid payments reduce the trading subsidiary's taxable profit by the amount of the payment, and as such a Gift Aid payment can eliminate any corporation tax liability in the trading subsidiary.

# Section 3: Charity Trustee Duties

The charity trustee duties in the **2005 Act** set out a broad framework that all charity trustees must work within. As a charity trustee, you are trusted to look after the charity's **assets** and you are responsible for making sure that the charity fulfils its **charitable purpose(s)**. There are **general duties** that help charities to be run properly and **specific duties** that are legal requirements all charities must meet.

## General duties:

### 1. You must act in the interests of the charity

1.1 You must operate in a manner consistent with the charity's purpose

1.2 You must act with care and diligence

1.3 You must manage any conflict of interest between the charity and any person or organisation who appoints charity trustees.

As charity trustees you must be clear of the benefits that trading or setting up a trading subsidiary will bring to your charity, and act in the best interests of the charity. As charity trustees you must consider the implications of trading for your charity:

- Do you have the power to in your governing document to trade or establish a trading trading subsidiary?
- How will the charity benefit from the trading?
- What are the risks and how will they be managed?
- As a charity trustee, you are trusted to look after the charity's **assets** and you are responsible for making sure that the charity fulfils its **charitable purpose(s)**.

Tax and trading is a complex area and you should make sure you understand the rules before starting any trading activity. Charity trustees should always take appropriate advice where necessary: [See sources of help and advice.](#)

The requirements of charity trustee duties apply equally to trading activity carried out by charities. Charity trustees need to consider what's appropriate for their charity. Key questions to consider are:

- Does it advance the charity's purposes and provide public benefit? (see 3.1)
- Does the charity's governing document allow the activity? (see 3.2)
- Is trading in the interests of the charity? (See 3.3)
- Are the charity trustees acting with care and diligence? (See 3.4)

### 3.1 Does it advance the charity's purposes and provide public benefit?

Generally everything a charity does must advance its **charitable purpose(s)** and provide **public benefit**, or be designed to generate income to advance its purpose, including trading. Where trading would not advance your charity's purposes then you may need to think about whether a trading subsidiary needs to be set up.

### 3.2 Does the charity's governing document allow the activity?

A charity's **governing document** is the written statement that sets out its purpose, structure and describes how it will operate. To be able to trade your charity's governing document must not prevent such activity. If it does the charity cannot trade, although you may be able to amend the governing document to be able to do so. See [making changes to your charity](#) on our website for more information.

### 3.3 Is trading in the interests of the charity?

As charity trustees you must make sure that any activities, including trading, are in the **interests of the charity**. Taking on trading activity can be risky and you need to weigh up the pros and cons before making any decisions that could significantly impact the running of your charity.

### 3.4 Are the charity trustees acting with care and diligence?

As well as acting in the interests of the charity, you as charity trustees must act with **care and diligence** that is reasonable to expect of someone who is managing the affairs of another person. This means when you are dealing with the charity's affairs, you should do so as carefully as you would if you were looking after someone else's affairs, for example a relative or a friend.

Where trading, is concerned, either directly or through a trading subsidiary, acting with care and diligence includes:

- Exercising reasonable commercial sense and developing a sound business case for any proposed trading activity
- Assessing potential risks to help with good decision making
- Seeking and acting upon appropriate professional and technical advice
- Monitoring and reviewing trading performance closely.

Charity trustees are collectively responsible for the charity, they must all work together to protect the charity including its beneficiaries and assets. A charity's reputation is one of its assets and where that reputation is in question this can have a negative impact on how the public supports the charity and whether funding organisations will give the charity money. It can also impact on how the charity sector is viewed in general. Where the **charity** is involved in trading activity, either directly or through a trading subsidiary, the way that activity is carried out can impact on the charity's reputation.

# Notes

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# Notes

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