

# Too much gift aid?

**OLIVER MARRE** examines a problem that can arise for charities trading through charitable subsidiaries.

There is no relief generally available for a charity's trading profits. Standard practice when a charity wishes to trade, for example, by running high street shops, endorsed by HMRC (see *Charities guidance notes annex IV*), has been for the charity to incorporate a subsidiary company, which would carry on the trade and then donate the profits to the charity.

The subsidiary is liable to corporation tax on its trading profits, but can claim gift aid relief under CTA 2010, part 6 "charitable donations relief", while the charity pays no tax on donations received and applied for charitable purposes. In recognition of the fact that a company may not know its total amount of profits by the end of its accounting period, CTA 2010, s 1999 allows a claim to be made for donations made up to nine months after the end of the accounting period to be carried back for tax purposes.

In this way, the subsidiary company pays no tax; instead its entire profits are available, undiminished, to the charity.

Matters become more complicated, however, when the taxable profits of the trading subsidiary exceed the amount of its profits as computed for company law purposes. This could happen for various reasons; for example, if an expense is allowable in computing accounting profits but is not allowable for tax purposes, or because defined benefit pension contributions, which are tax relieved on payment, have (in accordance with accounting principles) been treated earlier as expenses for accounting purposes.

The difficulty this presents is that a company is not permitted, as a matter of company law, to make a distribution of an amount greater than its profits (as calculated for company law), under Companies Act 2006, s 830.

## KEY POINTS

- Charities pay no tax on donations received and used for charitable purposes from their trading subsidiaries.
- A payment from the subsidiary company is a distribution which cannot exceed the company's profit.
- It may be difficult for HMRC to recover tax relief on past incorrect gift aid claims.
- Charities should confirm their position and, if necessary, contact HMRC.



The first question must be whether such a gift is a distribution. If it is, this in turn creates a tax problem, because the company (unable as a matter of company law to "distribute" an amount greater than its company law profits) would be left with taxable profits against which it cannot claim relief for a donation to charity. Until now, this has been a largely theoretical issue. Any doubts have been allayed by the Charity Commission's publication CC35, which (at the time of going to press) states:

"If a trading subsidiary earns, in an accounting period, taxable profits in excess of its profits for accounting purposes, it may pay to its parent charity a greater sum in Gift Aid than it has profits for accounting purposes, in order to eliminate its corporation tax liability."

Some company lawyers have doubted this and the Institute of Chartered Accountants in England and Wales recently took advice (pro bono) from two counsel, James Kessler QC and Mary Stokes, to clarify matters. The ICAEW has now published guidance for accountants active in this area ([www.lexisurl.com/lAyS7](http://www.lexisurl.com/lAyS7)).

The ICAEW's position, on counsels' advice is that, in principle a payment from the subsidiary to the charity is a distribution, on the basis of, for example, *Progress Property Company Ltd v Moorgarth Group Ltd* [2010] UKSC 55, and it is unlawful for a distribution to be made in excess of profits as calculated for company law purposes.

The complications that this will create can be split in two: what should be done about previous illegal distributions; and what can be done in the future?

## Past distributions – tax

The question is whether charitable subsidiaries have been right until now to claim gift aid relief in respect of unlawful distributions and what can be done.

Gift aid relief only applies if there is a "payment" (CTA 2010, s 191(2)). The first question whether an unlawful distribution

## WHAT NEEDS TO BE DONE?

- Confirm each client's position.
- Check the amounts at stake.
- Take remedial action, including discussing past events with HMRC.
- Plan for the future.

constitutes a payment. An unlawful distribution gives rise to a claim for the funds transferred, which the charity parent holds on constructive trust for the company. Because of the constructive trust, there is no "payment" (*Ridge Securities Ltd v CIR* 44 TC 373).

Therefore, the unlawful distribution does not qualify for gift aid, so the company's transfers of funds to the parent company only qualify for gift aid to the extent that there are company law profits.

HMRC would, however, face two difficulties if they wished to recover tax on gift aid claims wrongly but innocently made and accepted in the past:

- They would have to assess within one year of the submission of the relevant tax computations because those usually have given full disclosure of the facts. They would have been accompanied by the accounts in which the facts would be apparent.
- It would in principle be unfair of HMRC to change with retrospective effect their long established practice which accepted the applicability of gift aid relief.

It is a good idea to approach HMRC with a view to their agreeing that they will not seek to recover tax where gift aid claims have been allowed in the past.

At the same time, it might be sensible also to seek confirmation that HMRC will not take any point under CTA 2010, s 455 (loans from close companies to participators) which might extend to charitable trusts (not charitable companies) following the 2013 reforms.

## Past distributions – company law

If the parent charity knew or ought reasonably to have known that the subsidiary company made distributions otherwise than out of company law profits, the parent charity would be liable to repay the unlawful element of the distribution (Companies Act 2006, s 847). In practice, a demand for repayment is only likely to be made if the subsidiary goes into insolvent liquidation. A

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liquidator may then seek to enforce any available rights on behalf of the creditors.

## Future distributions

In general, it would be sensible to arrange matters as far as possible so that company law profits are, in the future, not lower than taxable profits.

To the extent that is not possible, given that relief is available in one year if a payment is made within nine months of the end of that year, the company could, in the first nine months of year two, make a top-up payment out of year two's profits available for distribution, which for tax purposes could be applied in year one. It may be impractical to arrange matters like this, and it would create a requirement for interim accounts to be drawn up, adding complication and cost, which is not ideal.

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As an alternative, the charity could subscribe for new shares in the trading subsidiary company, which could then be reduced, creating a buffer of distributable profits that could be used to cover the differences in taxable and distributable profits from trading for a period of several years. This too is more complicated and costly than would be ideal.

There also remains limited tax relief available for "charitable trading". The right charity, carrying out an appropriate trade, may fall within this definition, found in ITA 2007, s 525:

- “(a) the trade is exercised in the course of carrying out a primary purpose of the charitable trust, or
- “(b) the work in connection with the trade is mainly carried out by beneficiaries of the charitable trust.”

## New tax relief?

The ICAEW's new technical note may prompt some consideration at a policy level of how matters can be simplified.

One option would be to introduce a tax relief for charities carrying on their own trades, although this has been considered a number of times previously and rejected as undesirable for policy reasons. Instead, there could be a new tax relief for the trading profits of companies wholly owned by charities.

In the meantime, charities may wish to consider the solutions outlined above. ■

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