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CIPFA Bulletin 07 - CHARITIES – CORPORATE GIFT AID AND DIRECTOR OBLIGATIONS IN UNCERTAIN ECONOMIC ENVIRONMENTS

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Charities – Corporate Gift Aid and Director Obligations in Uncertain Economic Environments

Key points:

- It is common practice for charities to have trading subsidiaries that pay over their profits in the form of corporate gift aid
- From March 2020 the COVID-19 pandemic and particularly the lockdown period has affected charity trading subsidiaries, many are now loss making
- Corporate gift aid payments are company distributions and as such can only be paid from profits available for that purpose under the Companies Act 2006 (the Act)
- If a previously profitable trading subsidiary is now in a loss making position then this will impact on the amount, if any, that can be distributed as gift aid
- It is important that directors of UK charity trading subsidiaries understand this to avoid making distributions that would be in breach of the Act
- Before making a distribution the directors need to consider the company's financial performance to date and its future requirements
- This may require the directors to retain reserves from prior year surpluses to meet deficits and future operating costs
- Any profits retained for the needs of the company will attract a corporation tax charge

Introduction

Many charities have trading subsidiaries through which they generate income for the charity. The trading subsidiary is a useful vehicle for many reasons;

- It can conduct profit making fundraising activities that are not covered by the charity's objects
- It ringfences the charity's assets from the commercial risks of trading activities
- It allows the charity to generate an amount of trade which would exceed the charity trading exemption

Provided the trading subsidiary is wholly owned by a charity then the gift aid payments are allowed as deductions from the company's total profits when calculating the corporation tax for the accounting period. (Corporation Taxes Act 2010 Part 6, s189). It is therefore common practice for the subsidiary to gift aid all its profits to the charity and bring the taxable profits to nil. The company has up to nine months from its year end to pay the gift aid to the parent charity.

Company director obligations

Corporate gift aid has been confirmed as a company distribution (ICAEW Technical Bulletin 16/14BL). Prior to making a distribution, a company's directors should consider whether a company has sufficient reserves to make such a distribution. It is a breach of S830 (1) of the Act to make a distribution that leaves a company with negative reserves.

For many directors of trading subsidiaries this historically has not been an issue as the company's record of trading is predictable to the extent that the directors are confident, when they make the payment, that the company will continue to generate sufficient funds to meet its own requirements. Therefore, this may be a new consideration which in previous years has not been required.

In order to satisfy themselves that there are sufficient profits to make the distribution, the directors need to consider whether the trading subsidiary is now in a position to make this payment. This may require a detailed consideration of the latest interim accounts and other relevant materials such as market analysis and economic forecasts.

If the directors decide to retain some profits, they will need to reassess the amount of gift aid which can be paid to their parent subsidiary.

Corporation tax liability

Retained profits will give rise to a corporation tax charge. Therefore, the directors need to ensure the amount retained is sufficient to cover that required by the company and the corporation tax charge. This situation is illustrated in the example below:

Illustration

Company A, a wholly owned trading subsidiary of a charity parent, makes taxable profits of £50,000 in the year ending March 2020.

Following the year end, the company's activities have been severely restricted and the predicted 31 March 2021 losses are now £20,000. The directors are confident that new ways of working ensure that the company will return to a profitable position in the 31 March 2022 financial year.

The directors therefore decide to retain £20,000 of the profits for the current year therefore they will need to calculate the amount of profit before tax that will result in a profit after tax of £20,000.

Care needs to be taken when calculating the amount to be retained. The tax due on £20,000 is £3,800. However, if £23,800 is retained then the tax is due on 100% of this figure, is £4,522 rather than £3,800. The retained profits required form 81% of the total including taxation.

Therefore, in this example:

Estimation of Retained Profit to Achieve a Profit after Tax of £20,000:

		£
Retained Profit needed to meet the predicted losses	(81%)	20,000
Grossed up to 100%		24,691
Corporation tax thereon at 19%		4,691
Post tax net profits retained in reserves		20,000
Amount available to gift aid to the parent charity		**25,309**

Carry back of trading losses

A company's trading losses can be carried back one year to provide tax relief on the profits of the previous year. Therefore, the tax suffered on retain profits will be relieved, in whole or part, by the losses of the following year. Overall, through loss relief, the net cash outflow to the subsidiary may be reduced to nil. However, loss relief requires the submission of the following year's tax return, and therefore there is an adverse time lag on the charity's cash flow.

Carry forward of losses

If the losses of the following year exceed the current year profits, the company can carry forward any unrelieved loss to set against future profits. Tax relief from carried forward losses reduce the amount of taxable profits in the company and therefore also limits the amount that can be donated to the charity. This may be of benefit if the directors wish to build up the company's reserves.

If alternatively, the trustees and directors decide that the charity needs the maximum amount that can be donated then this will reduce the application of these losses. The decision of how much to pay will depend on the relative merits of both options and should be considered carefully.

Gift aid paid during the financial year

Some directors may have paid the distribution to the parent charity either during the prior financial year or before unexpected trading losses arose. In this case, providing the directors had acted in good faith with the knowledge and expectation at the time of future trading profits, then there has been no breach of their duty to exercise reasonable care and skill as directors.

In this situation the directors could discuss with the trustees a possible repayment of some of the gift aid, if this is possible and within the time limits. Alternatively, the trustees could consider making a loan from the parent charity to the subsidiary. Such a loan would have to be within the charity's powers and satisfy the legislative prescriptions for the making of loan's to subsidiary bodies.

Charities with covenants

Many charities have signed covenants with their wholly owned trading subsidiaries which oblige the directors to pay over the profits of the company annually. However, such covenants are unlikely to be able to override the directors' duties to make distributions from reserves as defined within Companies Act s830 (2). Therefore, the same duty of care is required before making the gift aid donation from prior year profits.

Management charges

Many charities provide services to their subsidiaries in the form of staffing, back office services and overheads. The costs for these are recharged to the trading subsidiary through a management charge. It is always worth reviewing whether these charges reflect the true costs to the charity. In years where the profits of the subsidiary will not be refunded it is even more important that the trustees ensure that the subsidiary is recharged the full costs for any services provided.

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