Gift Aid payments from charity subsidiaries

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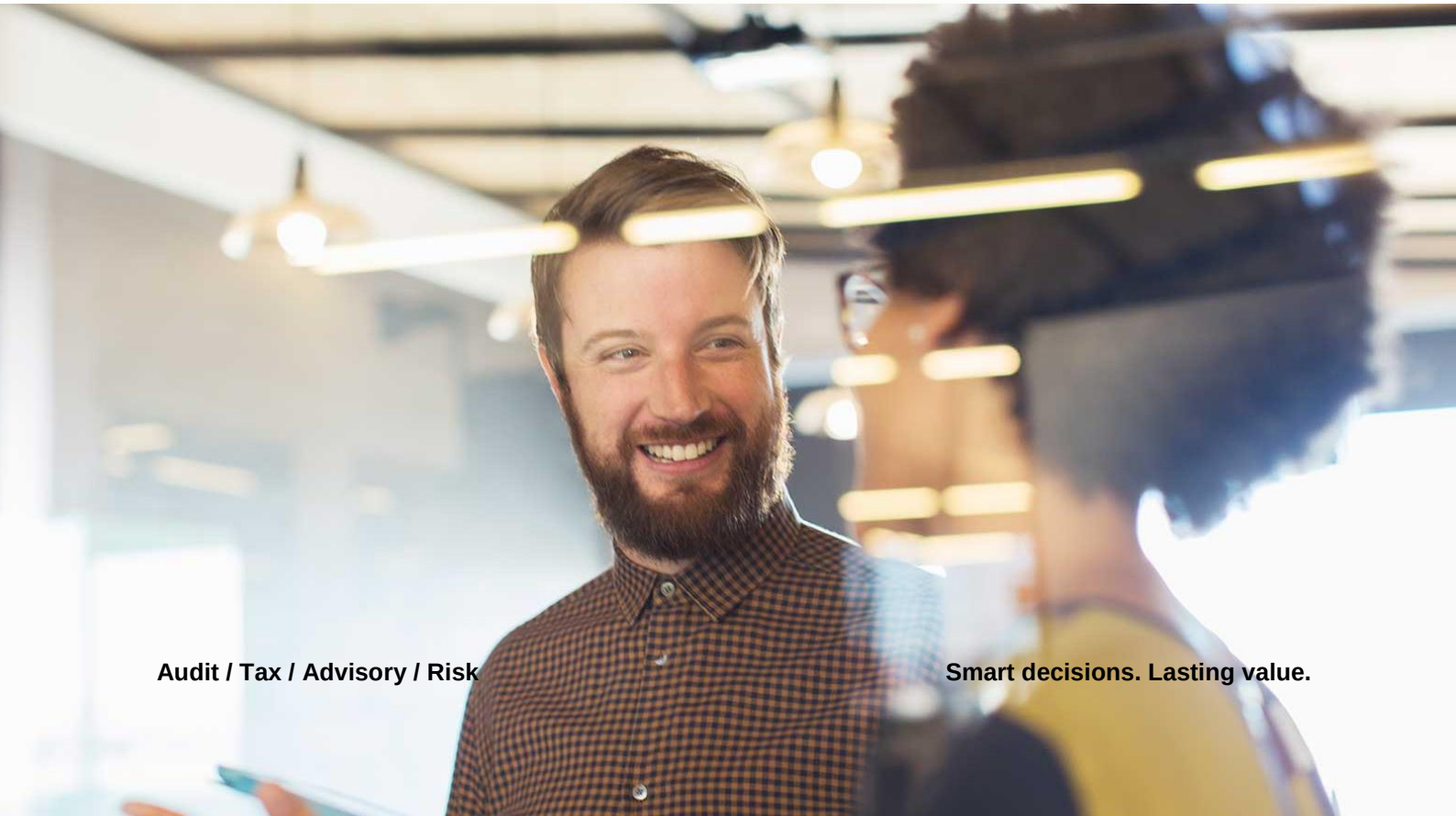

The Charity Commission published, on 24th February 2016, updated guidance on Charity Trading. Tucked within this is an important change to their views on Gift Aid payments from trading subsidiaries where there is a shortfall in distributable profits. The Commission's guidance has been published on the same day that HMRC and the Institute of Chartered Accountants in England & Wales (ICAEW) updated their own material on the matter.

Pesh Framjee has been involved from the outset in all stages of the deliberations, and this guidance explains the issues and solutions.

Background

- Non-charitable subsidiaries of charities are liable to pay tax on trading profits in the same way as other non-charitable companies. All companies can get tax relief for charitable payments to a charity under the company Gift Aid scheme.

- This means that any company donating its taxable profits to a charity will get a tax deduction equal to the amount of the profits donated. If all the taxable profits are donated no corporation tax will be payable.

- It is therefore common practice for subsidiaries of charities to Gift Aid all their taxable profits to the charity.

- Company law makes it unlawful for any company to make distributions in excess of distributable profits. If the taxable profit is higher than the value for distributable profits, only the lower figure can be paid across under Gift Aid and tax will be payable.

- Distributable profits are determined as accumulated realised profits less accumulated realised losses. Unrealised profits / losses are not taken into account.

- The definition of a distribution under company law covers every description of a distribution of a company's assets to its members, whether in cash or otherwise, with only limited exceptions.

What is the problem?

The problem arises when the accounting profits are different from the taxable profits. This usually happens because there are fixed assets held by the subsidiary and there is a difference between the depreciation charge, (which is allowed as a deduction in computing accounting profits) and the capital allowances (which are allowed as a deduction in computing taxable profits). The taxable profits can also be higher because there are disallowable expenses such as business entertaining, unpaid employer's pension contributions etc.

The previous version of the Charity Commission's guidance explained that it was acceptable to donate all taxable profits of a subsidiary to the parent charity, even in cases where this amount exceeded the profits available for distribution under Companies Act 2006. This was also in line with HMRC's position that a Gift Aid payment is not a distribution under tax law.

However, following Counsel's opinion sought by the ICAEW the view is that a Gift Aid payment is a distribution for Company Law purposes. To highlight this, the ICAEW issued Technical Release 16/14 'Guidance on donations by a company to its parent charity' on this matter in October 2014. This explained that in cases where payments exceeded the profits available for distribution this is deemed to be an unlawful distribution.

The Technical Release explains that when unlawful distributions have been made, the parent is liable to repay the excess amounts arising over the previous six years. The full text of the updated Technical Release is available on the ICAEW website.

HMRC's view

HMRC's updated guidance explains that "Any part of a payment from a subsidiary company to a charity which exceeds the subsidiary company's profits available for distribution is therefore unlawful under the Companies Act 2006. **The company will not get a tax deduction for any unlawful distributions for accounting periods commencing on or after 1 April 2015** (our emphasis).

"If unlawful distributions have been paid by a subsidiary company to a charity in earlier accounting periods, TECH 16/14BL sets out that (subject to time limits) the parent charity has a liability to repay the unlawful distributions and the company has a right to receive the sums. **The repayment of such prior unlawful distributions by the charity to the company will not be taxable income in the hands of the company"** (our emphasis).

What are the solutions?

The ICAEW Technical Release refers to a number of options. We have discussed the ones that we see as being most applicable:

I. Using the nine month rule:

Where a company is wholly owned by one or more charities, it has up to nine months after the year end (there are special rules for longer accounting periods) to make the Gift Aid payment.

This means that if the company did not have sufficient distributable profits but has earned profits during the nine months these can be used as the rules require distributable profits at the time of the distribution.

Where the subsidiary's most recent annual accounts do not show sufficient distributable profits, a Gift Aid payment cannot be paid unless more recent interim accounts have been prepared for the company that show sufficient distributable profits to support the Gift Aid payment. For a private company, these accounts do not have to be audited and can be management accounts. They must be sufficient for the directors to make a reasonable judgement as to profits, losses, assets and liabilities, provisions, and share capital and reserves. This can be a balance sheet derived from the audited accounts with movements based on the nine months trading.

This option is acceptable if the "shortfall" in distributable profits is small and can be covered by the nine months' trading or is a result of timing differences that will reverse by the time the payment is made.

If this option is being used there should be a record that the directors have considered the nine months results and have evidence to support the reasonable judgement that there are distributable profits.

II. Offsetting the repayment requirement by waiving a debt due to the charity from the subsidiary

This is the option that we have been using for some time. In practice, the negative net profit and loss account reserve in the subsidiary invariably matched by an amount owing to the charity. Trading subsidiaries do not usually have large amounts of external creditors.

The key issue is that charity is not ordinarily able to waive a loan to a non-charitable company. However, in this case there are a number of circumstances that could be used to rebut this presumption. Following the requirement the "overpaid" Gift Aid would need to be returned this option considers how this can be done.

In essence, charity trustees have an overarching duty to act in a way that is expedient in the interest of the charity and the Commission has explained that using the approach of waiving a debt from the subsidiary is acceptable if the trustees are able to show that:

1. The decision is genuinely in the charity's interests, using the principles in the Commissions publication it's your decision.

2. The only purpose of the write-off is to rectify a technical problem resulting from the need to align the arrangements with this clarified company law position.

3. The relationship with the trading subsidiary is itself a legitimate and justifiable arrangement that is clearly operating in the charity's interests.

4. There has not been a previous history of the writing-off of loans advanced by the charity to its trading subsidiary due to the subsidiary's non-performance in repaying loans.

5. The trading subsidiary is otherwise financially viable and a going concern.

If the conditions listed are fulfilled then trustees do not need to seek any waiver or prior agreement from the Commission. If these conditions are not all fulfilled then the Commission will not issue any waiver or approval except under the most exceptional circumstances and only after the trustees have taken professional advice and made a case outlining all relevant facts including a reasoned justification for their request.

For charitable companies with corporate trading subsidiaries intercompany debt can be forgiven without giving rise to a taxable income in the subsidiary (a tax deduction in the charitable parent is not available). The intercompany debt can arise from two different types of transaction:

1. The formal lending of money which is treated as falling within the loan relationship legislation

2. Non-lending transactions, where the transaction didn't arise from the lending of money, such as an unpaid business expenses.

The general rule in Corporation Taxes Act 2009 is that the credit on the release of a debt arising from the formal lending of money to a connected party is left out of the charge to tax. 'Release' is understood to have a formal legal meaning. Therefore, it is not enough to simply write back the amounts in the company's accounts and consideration should be given for a formal deed of release drawn up. For so called non-lending transactions, FA 2009 indicates that the above provisions will apply to the write off of such balances – again subject to the debt being formally released.

There are other options explained in the ICAEW Technical Release which explains that if the company does not have sufficient distributable profits then, in the case of a private company limited by shares, share capital or share premium could be reduced (by special resolution supported by a solvency statement).

We have also seen advice that it is possible for a parent charity to subscribe for new shares in the subsidiary company and then for the company to immediately undertake a capital reduction to create additional distributable reserves were created. However, HMRC has indicated that they would have concerns that the circular nature of the transactions involved could call into question the deductibility of any gift aid payment made out of reserves created in this manner. In addition, this additional investment would probably fall foul of the charitable investment rules, both for charity law and tax purposes.

We have seen cases where charities and their subsidiaries have been advised to make, what is in our view, unnecessary prior year adjustments, pay tax and / or enter into a questionable circular transaction.

Avoiding the mismatch between taxable an accounting profits

The problem will recur if charities continue to hold fixed assets in the subsidiary where the allowable deductions are different for tax and accounting purposes. We have for a long time advocated the route that all such assets should be owned by the charity with an appropriate charge for their use being made to the subsidiary. The problem is common in the hospice sector as some years ago hospices were
ill-advised to hold their shops in the name of the subsidiary. In such circumstances I have advised that the assets should be transferred to the charity at fair value.

Note that if the assets are transferred at undervalue this itself would be a distribution. Any gain arising from such a transfer should not be taxable. The no gain/no loss rule in tax law ensure that assets can generally be moved around a group of companies without any immediate capital gains consequences. This recognises that business activities carried on within the overall economic ownership of a corporate group, within the charge to corporation tax, should, in broad terms, be tax neutral. This assumes that the charity is a company, but there are capital gains reliefs available on transfers to charities generally which may apply on a transfer to a charitable trust or unincorporated association.

Similarly care should be taken to avoid tax disallowable expenditure in the subsidiary. In our experience most if not all of the business entertaining expenditure charged to the subsidiary would be allowed as fundraising expenditure in the charity.

Notes

Start the conversation

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