The Charity Law & Practice Review

FINANCING TRADING COMPANIES OWNED BY CHARITIES

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This article considers some tax and charity law problems which arise when a charity wishes to provide funds for a trading company wholly owned by the charity. In this area charities will need professional advice and if they do not receive it, they are likely to find themselves in difficulty with the Charity Commission or the Revenue or both.

Charity Commission Views and Charity Law

The Charity Commission have a good deal to say on this topic. Their views are set out in Charity Commission publication CC35 (Charities and Trading).[3] We set out the relevant passage in full, interspersed with our comments:-

> "**Funding by the charity**
> 52. This should always be viewed in the context of the charity making an **investment** in the subsidiary trading company. Charity law requires trustees to follow low-risk investment policies. The charity should not guarantee any liabilities of the company. This is because if the trustees allow the charity to guarantee the liabilities of the company they will, in

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3 Accessible on www.charity-commission.gov.uk. It is only fair to say that this document is aimed at the layman, not at professionals, so some of the points made are basic, an element of repetition is excusable, and some over-simplification is inevitable.

> effect, lose the protection of the charity's funds (gained by the separation of the activities) by leaving them liable to the debts of the company. By doing so the trustees may well lose their own protection from personal liability. They should note that if they give guarantees themselves, they will be personally liable if the company cannot meet the liabilities."

This paragraph would be more accurate if every sentence (except the last) was qualified by the word "generally".

> "**Powers of investment**
> 53. Where trustees intend to finance a subsidiary trading company from the charity's own resources, they should first make sure that they have the power to do so."

This is correct but following the Trustee Act 2000 charity trustees will usually have this power.

> "Where a suitable power exists, it must be **exercised** consistently with the fulfilment by the trustees of their usual investment duties (in particular the need for diversity of investment and obtaining professional advice). As a first step, the financial viability of the subsidiary trading company needs to be assessed by the charity. Appropriate advice will need to be taken based on the business plan, cash flow forecasts, profit projections, risk analysis etc provided by the subsidiary trading company. The trustees must take all reasonable steps to minimise any loss to the charity should the venture fail, and must be particularly careful in situations where the subsidiary trading company is operating at a loss and requires new capital. Investing too high a proportion of the charity's funds in its subsidiary trading companies will not be consistent with the discharge of the trustees' usual investment duties. Our publication **Investment of Charitable Funds: Basic Principles (CC14)** gives details of these duties.
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> 54. We would advise trustees to pay particular attention to the length of time funds may be tied up in investments in subsidiary trading companies. Funds needed in the short to medium term may not be easily realised when invested in this way."

This is all sound common sense.

> "**What form should the investment take?**
> 55. Normally, investment in a subsidiary trading company should take the form of secured loans by the charity on market terms. Charities should not ordinarily subscribe anything more than nominal sums for the issue of

> share capital by the subsidiary trading company (in order to satisfy the formal requirements of company law). The subscription of shares in the subsidiary trading company by the charity normally exposes the charity's investment to greater risk (because the repayment of share capital, in the event of the liquidation of the subsidiary trading company, has a lower priority than the repayment of loans)."

It must be the case that secured loans offer more safety to a charity than unsecured loans or share capital, so secured loans are to be preferred in the absence of special circumstances.

> "56. Trustees should ensure that loans which they make are properly serviced by the subsidiary trading company. This means that interest payments should actually be made to the charity (and not simply be rolled up with the outstanding principal of the loan)."

This reflects an ideal rather than any formal requirement of charity law, and may at times be impractical. Where the trading company has no liquidity, there is no alternative but to roll up interest, or to pay the interest and lend it back, or waive interest, or make the loan interest free. All these come to the same thing in economic terms. This may happen because of a downturn in trade, sometimes unforeseeable, or because the trading company needs time to develop. The trustees are certainly entitled to take a long term view.

> "The loans will need to appear in the charity's accounts."

Of course. Ideally there would be a formal loan agreement. If there is none, which will often be the case, the accounts would be important evidence that the transaction was a loan.

> "A programme for the repayment of capital should exist. Please see paragraphs 55, 62, 71 and 72."

Once again, this reflects an ideal and may be impractical: see below.

> **"Unsecured and interest free loans**
> 57. Charities should not normally make unsecured or interest free loans to subsidiary trading companies. Such loans are not compatible with the proper discharge of the duties and responsibilities of charity trustees. If the subsidiary trading company fails the trustees may find themselves personally liable for any losses to the charity's funds if they have acted in breach of trust (see paragraph 5 above). ..."

The disapproval of unsecured loans is merely the converse of the point made in CC35 paragraph 55. The disapproval of interest free loans is consistent with the point made in paragraph 56.

> "**Continuing funding by charities**
> 59. There is an inevitable conflict surrounding the continuing funding of a subsidiary trading company by a charity. The situation often arises where, to be tax efficient, the subsidiary trading company covenants the whole of its profits to the charity (i.e. whole profit-shedding) leaving no funds for internal investment and, therefore, creating cash flow difficulties etc. In this case it is little more than a shell and it is usually necessary for the charity to make a return investment (i.e. lend cash) to the subsidiary trading company to enable it to continue. Such payments or loans must be considered as investments but, as the subsidiary trading company has little or no substance (if it can retain no profits), the charity cannot often justify the investment under trust law."

We are at a loss to follow this.

> "60. Recognising this, some charities may prefer to accept the tax consequences of a measure of profit retention by the subsidiary trading company. This can enable the subsidiary trading company to function in a normal commercial way, and reduce or eliminate the need for the charity to invest (and risk) its own money in the subsidiary trading company."

We think no sensible charity would or should prefer to leave taxable profits in a trading company. Tax apart, it makes no difference to the economic risk to the charity whether the company's profits are retained by the company or paid out by gift aid and re-invested.

> "61. As with all other forms of investment, the arrangements for the transfer of profits should be reviewed periodically and charities should not restrict themselves to only one of the options."

This is unobjectionable.

> "**Advice for whole profit-shedding**
> 62. Where the whole profit-shedding option is adopted, we recommend that trustees give careful and objective consideration (after taking their own legal and accountancy advice) as to:
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> [1] whether they should provide or continue to make loans to the company;

[2] whether they have the power (either in their governing document or under statute) to make any necessary investment in the subsidiary trading company; and

[3] structuring the investment in a way which minimises the risk to funds which belong to the charity.

63. The trustees will also need to recognise that if the subsidiary trading company fails, there is a "pecking order" in liquidation with unsecured creditors coming second to last, and the shareholders coming last of all."

This repeats the points made above.

"**Advice for profit retention**
64. Where a subsidiary trading company is planning to adopt the option of retaining profits notwithstanding the tax consequences, it should not make unnecessary retentions. This is because retained funds would reduce the relief from tax which the company is able to obtain and hence decrease the payments available to the charity. In particular, trustees should note that VAT zero-rating on the sale of donated goods by a subsidiary trading company (in those circumstances where zero-rating is applicable - see paragraph 26) only applies where the subsidiary covenants 100% of its profit to charity.[4] The fund-raising events exemption from VAT only extends to trading subsidiaries which are wholly owned by a charity, and covenant all of their profits to the charity."

In our view any profit retention is unnecessary.

"**Non-financial support**
65. Non-financial support of a subsidiary trading company can be as important to its viability as loans and other investments made by the charity. Such non-financial support often takes the form of the use of the charity's land or staff and equipment: trustees need to ensure that a business relationship between the two bodies is maintained in this respect.

Use of the charity's land by the subsidiary trading company
66. Such use should be covered by a formal lease or licence of the property concerned from the charity, to the subsidiary trading company. The subsidiary trading company should pay a rent or fee which is comparable to that which would be payable for letting the property on the

4 See VATA 1994, Schedule 9, Group 12.

open market. The granting of a lease will (and a licence may) constitute a disposition of the charity's land. Any such disposition will need to be authorised by Order from the Commission under section 36(1) of the Charities Act 1993 (because the trading company is a "connected person" in relation to the charity within the meaning of Schedule 5 to the 1993 Act). See our publication **Disposing of Charity Land (CC28)**.

Shared use of staff and/or equipment
67. The costs of this should be apportioned on a pro-rata basis between the charity and the non-charitable subsidiary trading company. Equipment used exclusively by the subsidiary trading company should be purchased by it."

A business relationship between charity and trading company is certainly desirable. This also has the beneficial effect of reducing trading profits. The VAT implications will need to be considered.

"**Points to consider when establishing and funding a subsidiary trading company**
68. Based on our experience of cases, where substantial amounts of a charity's money have been lost as a result of ill-considered investments in subsidiary trading companies, we recommend that trustees bear in mind the following points of good practice before agreeing to fund such a company:

[1] The financial structures of the charity and the subsidiary trading company ought to be kept separate.

[2] The separate identities of the charity and the subsidiary trading company should be made clear in all publicity material and in dealings with suppliers.

[3] The names of the charity and the subsidiary trading company should be distinguished from each other to prevent confusion between the activities of the two organisations."

So far, we would respectfully agree.

"[4] Investments in subsidiary trading companies have to be specially justified to the Inland Revenue before they are treated as qualifying investments for tax purposes. Unless the charity is in a position to demonstrate clearly that:

(i) a particular investment in a trading subsidiary is beneficial to the charity; and

(ii) it is not connected with tax avoidance,

it may well have difficulty in avoiding a restriction of its charity tax reliefs."

We consider the tax issues in more detail below.

"[5] The establishment of a trading subsidiary, where the directors of that company are the same people as the trustees of the charity, cannot be used as a means of paying the charity's trustees "by the back door"."

Quite so.

"[6] The charity must not settle the debts of the subsidiary trading company."

But the charity may lend to the company to put the company in a position to pay its debts. The discipline of doing this may focus the mind on the viability of the company.

"[7] The charity should not feel any moral obligation to fund the subsidiary trading company."

Point [7] is questionable, and creditors in particular are unlikely to agree! This issue, like many issues of commercial morality, depends on precise facts and cannot be encapsulated by a generality.

"[8] The financial support required by the subsidiary trading company must be carefully assessed with due regard being given to non-cash commitments (eg staff, office space and equipment).

[9] The charity must not buy stock and donate it to the subsidiary trading company.

[10] The subsidiary trading company should be financially viable as soon as possible. Normally, it is expected that this will be within its first 5 years of operation.

[11] Where a lease of property by a charity to a subsidiary trading company is proposed, the lease will need to be authorised by an Order under section 36 of the Charities Act 1993.

[12] In addition to the above, the trustees must be aware of what rights ownership of shares in the subsidiary trading company will give to the charity (or themselves). Examples of such rights are:

- voting powers;
- appointment of directors;
- remuneration; and
- dividends."

This is all unobjectionable.

"**Commercial funding**
69. We advise that proper consideration should be given to the possibility of the financing of subsidiary trading companies through commercial funding, as an alternative to funding by the charity. This is on the grounds that the involvement of a commercial lender will ensure:

[1] that the economic viability of the trading operation is assessed by someone whose objectivity is not affected by direct involvement with the business; and

[2] that the lender's assets, rather than the charity's, are exposed to the financial risks of the business.

70. The additional cost of commercial lending, as compared with lending by the charity, may be regarded as a reasonable price to be paid for the acceptance by the commercial lender, rather than the charity, of the risk of loss.

Problems with commercial funding
71. Arranging external funding can cause practical difficulties in some cases. Given that all the profits of the subsidiary trading company, after any loans have been serviced, are often transferred to the charity each year, the trading company itself may remain a shell with little substance. In these circumstances, commercial lenders may wish to secure loans to the trading company on the charity's own assets."

The last sentence is certainly correct and the consequence is that the point made in paragraphs 69-70 seems commercially naive.

> "72. Whether such security takes the form of an indirect loan arrangement, a guarantee, or a charge over charity property, it essentially has the effect of re-exposing the charity's assets to the financial risks of the business. This negates the effect of involving the commercial lender at all and we would not normally regard the giving of such security as being in the best interests of the charity. Accordingly, we would not ordinarily be prepared to authorise entry into a transaction of this nature, or to give consent which may be required under section 38 of the Charities Act 1993."

Tax Problems of Funding the Trading Company by Outside Finance

Loans from banks or others at arm's length raise no tax difficulty. The Charity Commission say:-

> "73. Where commercial funding is not possible, the charity may need to accept that a viable trading company cannot be established. However, it is sometimes possible to find one, or more, "well-wishers" who are prepared to fund the trading company by giving it money, or lending to it on favourable terms."

It is not desirable for supporters of the charity to make gifts to the trading company to provide finance: such gifts will not qualify for the Gift Aid reliefs; nor will they qualify for the charity exemption for Inheritance Tax. Such gifts should be made to the charity itself, which will then finance the trading company.

Supporters may also be prepared to make interest-free loans to the trading company. Loans from individuals may give rise in principle to an income tax charge under section 660A ICTA 1988.[5] Individuals should not make substantial loans without informal clearance that the Revenue will not take this point; but corporate loans may be a practical possibility, as there is a reasonable argument that the settlement provisions do not apply to corporate settlors.

5 The problems are discussed in *Tax Planning and Fundraising for Charities*, Chapter 16.

Tax Problems of Funding the Trading Company by the Charity

A charity is at risk of losing its income tax and capital gains tax reliefs if it incurs expenditure which is not qualifying expenditure.[6] Non-qualifying expenditure includes investments which are not "qualifying investments". This section considers whether investments in a trading subsidiary are "qualifying investments". For this purpose investments are "qualifying investments" if and only if:

> "the loan or other investment is made for the benefit of the charity and not for the avoidance of tax (whether by the charity or by any other person)".

See Schedule 20 para 9 ICTA 1988.

There are two separate conditions both of which must be satisfied:

(1) the investment is made for the benefit of the charity; and

(2) the investment is not for the avoidance of tax.

"Made for the benefit of the charity"

It is well established that "benefit" is a word of wide import.

The words do not mean "in a manner which proves ultimately to be for the benefit of the charity". The context clearly excludes this interpretation. The ultimate result can only be discovered with the benefit of hindsight, perhaps years after the investment is made. One needs to know almost immediately an investment is made whether or not it falls within paragraph 9. So whatever the test is, it should be applied at the time that the expenditure is incurred, and without the benefit of hindsight. The passage from the Guidance Notes set out below confirms that the Revenue accept this.

The more difficult question arises whether one should apply:-

(1) an objective test: i.e., whether an objective observer would regard the investment as "for the benefit of the charity", having regard to the circumstances at the time it was made; or

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6 For a detailed discussion of the Qualifying Expenditure Rules see *Tax Planning and Fundraising for Charities,* Chapter 2.

(2) a subjective test: i.e., whether the charity subjectively considered the investment to be for its benefit at the time it was made (applying the appropriate company law principles to attribute the views of the trustees or senior management of the charity to the charity itself); or

(3) a mixture of objective or subjective.[7]

There is very little guidance in the statute. The question only arises in the unusual situation where trustees act in good faith but negligently or otherwise in breach of charity law.

We think the better view is that the test is wholly subjective. This is supported by a purposive construction. The purpose of the qualifying expenditure rules is to prevent tax avoidance and to deny charity tax relief in cases where it is not appropriate. It is certainly the intention to deny relief where those making investments do not do so in order to benefit the charity. It is difficult to see the purpose of provisions to withdraw tax relief in the case where they *bona fide* intend to benefit the charity, even if they fail to meet some objective standard.[8]

Purposive construction (as so often) can be argued both ways. The Revenue may argue for an objective test along the following lines:

(1) Charity tax reliefs are effectively a subsidy by other taxpayers. Where a charity makes bad investments, even in good faith, these subsidies are inappropriate.

(2) The charity itself may not lose out by any loss of tax relief. The trustees are in breach of trust and must reimburse it.

But the effect of this construction is to put an unreasonably harsh burden on trustees. Moreover, charities would in practice lose out because trustees will often be unable to meet claims against them by the charity.

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7 This mixture may take many different forms, such as *Mallalieu v Drummond* 57 TC 330 applies to section 74(1)(a) ICTA 1988 or *R v Ghosh* [1982] QB 1053 applies to "dishonesty" in criminal law or such as *Re Hampden* [1977] TR 177 and belatedly reported in [2001] WTLR 195 applies to the exercise of trustees' powers.

8 This is perhaps supported by the comments of the Special Commissioners in *IRC v Levy* [1982] STC 442, applying a subjective test of "bounty" for the purposes of the income tax settlement provisions.

The Inland Revenue Guidance Notes provide:

"III.4 **For the benefit of the charity**

III.4.1 An investment or loan will normally be "for the benefit of the charity" where it is made on sound commercial terms. Whether or not an investment or loan is commercially sound should be considered by reference to the circumstances prevailing at the time it was made.

III.4.2 There is no one test of commercial soundness, and each case must be viewed on its own facts. Where a loan or investment:

- carries a commercial rate of interest; and
- is adequately secured; and
- is made under a formal written agreement which includes reasonable repayment terms

we will normally accept that the investment or loan is for the benefit of the charity.

III.4.3 Where one or more of the factors in paragraph III.4.2 is not present, we may ask the charity for full details of the investment or loan and for the reasons it was considered to be for the benefit of the charity.

III.5 Investments and loans to trading subsidiaries

III.5.1 Many charities have subsidiary companies that pass their taxable profits to the parent charity. Where an investment is made in, or loan to, such a subsidiary company, the charity is unlikely to be able to obtain normal security for the investment or loan. In such cases we may ask to see the business plans, cash-flow forecasts and other business projections which informed the charity's decision to make the investment or loan.

III.6 Probity of investments and loans.

III.6.1 When deciding whether to make an investment charities should bear in mind the requirements of charity law relating to:

- objectivity in the selection of investments
- the need to avoid undue risk or speculation; and
- the need for a proper spread of investments."

This guidance conflates four conceptually distinct requirements:

(1) the tax rule that income must be applied for charitable purposes only (see section 505 ICTA 1985);

(2) the tax rule that the loan or investment must be for the benefit of the charity;

(3) the charity law rule that charity trustees must act prudently in making investments;

(4) the Charity Commission's views on trustee loans/investments set out above.

These different rules certainly contain a large element of overlap.

The basis of the Revenue's approach to the question of whether an investment is for the benefit of a charity is to ask whether the Charity Commission guidelines have been followed. But this is not by any means the correct approach because

(1) part of the guidance is questionable, as we indicate above;

(2) much of the guidance reflects best practice.

Investments which are made in breach of Charity Commission guidance may nevertheless be made for the benefit of the charity.

A standard Revenue enquiry in the case of a charity "audit" is to require copies of the relevant correspondence in respect of the loan/investment including copies of trustees' meetings which details the arrangements in respect of that loan/investment. Proper records of trustees' meetings and investment decisions will be essential. Trustees must be in a position to show that its trading subsidiary was reasonably efficiently run and had a reasonable expectation of making a profit: and that the trustees took proper care in carrying out their duties of investment.

"For the avoidance of tax (by the charity or any other person.)"

The avoidance of tax by a person other than the charity is a comparatively straightforward notion.[9]

The idea of avoidance of tax by the charity itself is more difficult. Charities benefit from so many exemptions from tax that they can be expected to and generally do arrange their affairs so as to ensure that income and gains which accrue to them are of a type which is tax exempt. Thus some tax planning strategies adopted by charities are so widespread and so well established that Parliament could reasonably be said to acquiesce in their acceptability. It is most unlikely that the Revenue intended to counteract them in introducing the qualifying expenditure provisions, and it is considered that it has not done so. The Courts have given "tax avoidance" a narrow meaning: any tax advantage must be contrary to the evident intention of Parliament: *Willoughby v IRC* [1997] STC 995. An arrangement which for decades has been carried on with the approval of the Revenue can hardly be regarded as "avoidance" by this test.

Further, in principle, the charity will usually be able to say that the use of trading companies is needed for bona fide commercial purposes.

Note that it is only the *investment* which must not be made for the avoidance of tax. It does not matter if the investment forms part of a scheme or arrangement whose purpose is the avoidance of tax - provided that the investment itself is not for the avoidance of tax (contrast s.137 TCGA 1992). Thus the scheme in *IRC v Campbell* 45 TC 45 might be described as a tax avoidance scheme; but the purchase of the business by the charity, if it is to be described as an investment at all, is in the authors' view a qualifying investment.

Circular Arrangements

Arrangements where the charity extracts the profits of the trading company by gift aid, and immediately returns them back to the company, by way of loan or further equity investment are referred to as "circular arrangements".

The Revenue found this objectionable even before the introduction of the qualifying expenditure rules in 1986:

9 For a detailed discussion of the concept of "tax avoidance" see James Kessler's forthcoming article in the *Offshore Tax Planning Review*: Vol 10, Issue 2, "The Section 741 Motive Defence".

> **"Question [from ICAEW]**
> The second question arises where a charity wishes to carry on a trade the profits of which are to be used for the benefit of the charity which do not meet the requirements of [what is now ICTA 1988 section 505(1)(e)]. In these circumstances it will be arranged that the trading activity will be carried on by a separate company the profits of which are covenanted to the charity so that no tax liability arises.
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> **Revenue Response**
> We would not normally challenge the covenanting to a charity of the profits of its trading subsidiary - *provided, of course, that no circularity was involved, such as:-*
>
> *[1] the charity providing an interest-free loan back to the trading entity ...*[10]

See ICEAW Memorandum TR 588 [1985] STI 568 (our italics). The Charity Commissioners make a similar point in their report for 1988.

A Revenue attack on circular arrangements failed in *Nightingale* v *Price* [1996] STC (SCD) 116. Here covenanted payments were made by a trading subsidiary, and lent back to the company. The Revenue had two arguments:

(1) The payments were not genuinely "made".

(2) *Furniss v Dawson.*

Both arguments failed and after *MacNiven v Westmoreland* [2001] STC 237 it is clear that *Furniss Dawson* has no application here.

The assessments were for years before the FA 1986 reforms, so the impact of the qualifying expenditure rules was not discussed. In the authors' view the qualifying expenditure rules will not help the Revenue here, for the reasons set out above. This may be the subject of further litigation, but since nothing has happened since *Nightingale v Price*, this now looks unlikely.

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10 The statement concludes:

> or [2] if the trader effectively controls the charity and uses it as a tax free moneybox."

This is an entirely different arrangement, potentially involving serious breaches of charity law. In particular, it involves an application of funds in a manner which is not for charity purposes only, and therefore forfeits charity tax relief.

Nevertheless, it would where possible be wise to avoid a strategy of extracting profits each year and returning the same amount. For any substantial charity this should not be too difficult to arrange without either incurring substantial tax charges or unnecessarily restricting the operation of the trade.

What is the real objection to circular arrangements? Leaving aside the technicalities, the Revenue objection has little rational basis once it is accepted (as it is) that accumulated income of charities should qualify for tax relief. It is hoped that *Nightingale v Price* will be the last word on the matter.