

**Cyclists' Touring Club
Tax implications of merger**

February 2010

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Background

This report is a review of the main tax implications of the merger of CTC Charitable Trust ("the Trust") with Cyclists' Touring Club ("CTC").

This report is based on information provided to us, a meeting with Peter Jackson and Anne Redston held on 3 February 2010 and a review of the CTC website. We have not audited your tax and accounting systems and accordingly cannot be certain that this review covers all possible issues but it will cover all key issues.

The report is divided into six sections:

1. Current tax issues – this covers current issues you have asked us to consider
2. Tax implications of the merger – the tax implications of CTC registering as a charity and the Trust then transferring its assets and activities to CTC
3. Post merger tax position - the tax position after merger
4. Using a trading subsidiary – this section explains, from a tax perspective, how to use a charity trading subsidiary to undertake non-primary purpose trading
5. Gift aid – a perceived major benefit of the merger will be the ability to reclaim gift aid on membership subscriptions. This section examines how the membership subscriptions may be gift aided
6. Steps to be taken – a summary of the key issues to be addressed leading up to the merger

This report is only for the use of the Council, management and membership of CTC.

Current tax issues

This section considers current tax issues you have asked us to consider.

CTC Cycling Holidays & Tours Limited

We refer to this company as “CTC Tours”. You have asked us what the advantages and disadvantages of bringing CTC Tours into the CTC/Trust VAT group are.

Advantages

Bringing CTC Tours into the VAT group should improve VAT recovery in the group overall. This is because CTC Tours has entirely taxable activity but there is currently no inter-company charge from the VAT group to CTC Tours that will be “lost” as a result of inclusion. Therefore group taxable turnover will increase as a proportion of overall turnover, resulting in a higher rate of residual VAT recovery under income based business / non-business and partial exemption methods.

Based on the group's VAT calculations for the period Oct 07 – Sept 08 (as supplied), we estimate that including CTC Tours' margin (per CTC Tours' 07/08 statutory accounts) improves group residual VAT recovery by approximately £2,000.

The gain is therefore unlikely to be significant.

Disadvantages

The main disadvantage is administrative. CTC Tours operates the statutory “tour operators' margin scheme” which is administratively burdensome.

CTC Tours staff will have to provide VAT return information to CTC in good time for the group to perform the quarter end calculations. This may mean CTC Tours staff have to compile the VAT return information more quickly than they do currently and therefore have less time to investigate quarter or year end issues. Bringing CTC Tours into the group will also complicate the group's VAT return and so this may also take longer.

The overall risk of submitting an incorrect or late VAT return may therefore increase. Penalties for later returns are a percentage of the VAT payable, so the increased group turnover as a result of including CTC Tours will act to increase the amount of any penalty.

VAT status of cycling events

We understand some of CTC's subsidiary companies put on cycle rides, competitions and other cycling events and charge fees for entry. Such events do not include the provision of accommodation (in which case they would be operated by CTC Tours and hence be within the Tour Operators Margin Scheme). You consider these fees are VAT standard-rated but would like advice on this. The events include CTC national events operated by CTC (Central) and local events run by CTC Member Groups. The various subsidiary companies have specifically been set up to avoid the complexities of VAT, although this does mean that any VAT incurred cannot be recovered.

The first point to consider is if all events are always within the scope of VAT. Very small scale and ad-hoc arrangements will fail the business test. For example, where a local group puts on an event that is effectively limited to members and members just contribute so as to cover the event's costs, then a case can be made that this is not a business activity and the members' contributions are outside the scope of VAT. However this will depend on the circumstances and accordingly may vary from branch to branch. These events would therefore not affect VAT registration anyway.

The next issue to consider is, assuming the event is within the scope of VAT, whether any of these activities fall within any of the VAT exemptions for sport and physical recreation in VAT Act schedule 9

group 10. Please note there are separate VAT exemptions for sports education and training (eg cycling proficiency training) and for certain lets of sports facilities (eg cycle tracks) but we assume these are not relevant here. The VAT exemptions in schedule 9 group 10 are:

1. The grant of a right to enter a competition in sport or physical recreation where the consideration for the grant consists in money which is to be allocated wholly towards the provision of a prize or prizes awarded in that competition
2. The grant, by an eligible body established for the purposes of sport or physical recreation, of a right to enter a competition in such an activity
3. The supply by an eligible body to an individual, except, where the body operates a membership scheme, an individual who is not a member, of services closely linked with and essential to sport or physical education in which the individual is taking part. An individual is only considered to be a member of a non-profit making body for the purpose of this item where he is granted membership for a period of three months or more.

So:

Competitions, races etc: If a fee is charged to enter a competition and all entry fees go towards prizes, then the entry charges will be VAT exempt under item 1. If the entity putting on the event is an eligible body established for the purposes of sport or physical recreation, then any entry charge to a competition is VAT exempt under item 2. The meaning of eligible body is explored below.

Non-competitive events: entry charges to non-competitive events will be VAT exempt under item 3 if the entity putting on the event is an eligible body, the membership condition is met and the entry charge comprises "the supply of services closely linked with and essential to sport or physical education".

Our opinion is that HMRC and the courts would regard entry charges to non-competitive cycling events as meeting the definition "the supply of services closely linked with and essential to sport or physical education". This is because the situation is analogous to entry charges to leisure facilities such as swimming pools and gyms which are considered to meet this condition and where there is no requirement for there to be any competition. For example HMRC's Revenue & Customs Brief 13/09¹ states:

HMRC is amending its interpretation of the law and therefore its guidance on the VAT treatment of membership schemes allowing unlimited access to leisure facilities in a leisure centre. Businesses that will be most affected are community leisure centres that are run by non- profit making trusts.

Supplies of services closely linked with and essential to sport or physical education, in which an individual takes part, are exempt from VAT when supplied by an 'eligible body' (essentially a non-profit making body not subject to commercial influence) as set out in the Value Added Tax Act 1994, Schedule 9, Group 10 (Sport, Sports Competitions and Physical Education).

Usually most of these facilities would, if supplied individually, be exempt as 'services closely linked with and essential to sport or physical education in which the individual is taking part', (for example use of the swimming pool, showers, changing rooms). Therefore, in cases where the predominant reason for purchasing an all-inclusive package is to use the range of available sports facilities, the single supply is exempt.

The exemption of such supplies has also been accepted in various court cases.²

To be VAT exempt under item 3 above, the following conditions must also be met:

¹ See <http://www.hmrc.gov.uk/briefs/vat/brief1309.htm>

² Eg Highland Council [2007] ScotCS CSIH_36 http://www.bailii.org/scot/cases/ScotCS/2007/CSIH_36.html

- (1) The body putting on the event must be an eligible body, and
 - (2) The person taking part must be an individual, and
 - (3) Where the body operates a membership scheme, the membership must last at least three months.
- Going through these conditions:

(1) Eligible body

For the purposes of items 2 and 3 an eligible body is defined as a non-profit making body which:

- (a) Is precluded from distributing any profits it makes, or is allowed to distribute any such profit by means only of distributions to a non-profit making body
- (b) Applies any profits from such supplies to the continuation or improvement of any facilities made available in or in connection with the making of such supplies or for the purposes of a non-profit making body
- (c) Is not subject to "commercial influence". The commercial influence test is a complex anti-avoidance test designed to block extraction of profits from a non-profit making entity by an individual or by a profit making entity. We consider this is unlikely to apply to supplies made by CTC or its subsidiary companies.

The exemption will therefore depend on the status of the body making the supply – broadly it will only apply if the entity putting on the event is non-profit making or must distribute any profits to a non-profit making body and any profits from events are ring fenced to events and facilities for events.

(2) Individuals

This condition has in the past been interpreted as limiting the exemption to supplies made to natural persons. However the ECJ in *Canterbury Hockey Club*³ ruled that the UK law was ultra-vires in restricting the exemption to individuals (meaning natural persons). The ECJ stated:

Article 13A(1)(m) of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes Common system of value added tax: uniform basis of assessment is to be interpreted as meaning that, in the context of persons taking part in sport, it includes services supplied to corporate persons and to unincorporated associations, provided that which it is for the national court to establish those services are closely linked and essential to sport, that they are supplied by non-profit-making organisations and that their true beneficiaries are persons taking part in sport.

So the exemption may also apply to entry charges made to other organisations such as not-for profit cycling clubs and charities.

(3) Membership scheme

The condition here is - if there is a membership scheme in place, only supplies to members of three months or more are VAT exempt. For supplies by CTC subsidiaries, it is not clear if any requirement that participants are CTC members affects this. However given that CTC membership lasts for at least a year this condition should not be a problem - either there is no membership scheme or there is but membership lasts for at least three months. It is worth noting that the validity of the three month requirement in UK law has also, following the ECJ *Canterbury* case referred to above, been questioned.

³ *Canterbury Hockey Club & Anor* [2008] EUECJ C-253/07, see <http://www.bailii.org/eu/cases/EUECJ/2008/C25307.html>

Conclusion

You must always first apply the business tests to see if an activity is within the scope of VAT. This will be especially relevant for events put on by volunteers in local branches.

If the business test is met:

- For competitive events, entry charges will be VAT exempt if all charges go towards the prizes or if the body putting on the event is an eligible body established for the purposes of sport or physical recreation. However we understand you do not currently run any competitive events.
- For non-competitive events, we consider that both HMRC and the courts would consider entry charges to be within the meaning of "services closely linked with and essential to sport or physical education" in item 3 above, and such charges will therefore be VAT exempt if the body putting on the event is an eligible body.

The critical issue is therefore the eligible body test and this must be applied on a company by company basis. Any charges for events run by the charitable company (whether for members or non members) should not therefore be subject to VAT either as they are non-business or because they are exempt. However charges for business events put on by trading subsidiaries will be subject to VAT if the trading subsidiary exceeds the VAT threshold.

Transferring events income to CTC will increase its non taxable income and therefore reduce its VAT recovery on overheads but not by very much as the income from events is so low.

Tax implications of the merger

We understand the merger will comprise two steps:

1. CTC registers as a charity
2. The Trust then transfers its activities, assets and liabilities to CTC

VAT implications

We understand CTC and the Trust are members of a VAT group with CTC as the representative body of the group.

Step 1: CTC registers as a charity

The act of registering as a charity does not have any VAT implications in itself, although it may change the VAT status of some supplies made by or received by CTC – this is explained in the next section.

Step 2: the Trust then transfers its activities, assets and liabilities to CTC

HMRC VAT Notice 700/9⁴ states:

4.1 Transfers of businesses between members of the same VAT group

The formation of a VAT group creates a single person for VAT purposes and as such any supply by a member of a VAT group is considered to be made by the representative member of the group. Therefore any assets transferred by a group member as part of the transfer of a going concern are considered to be transferred by the representative member.

The transfer of assets within a VAT group, like most supplies between the members of a VAT group, is disregarded for VAT purposes.

HMRC should therefore accept that the transfer of the business from the Trust to CTC can be ignored for VAT purposes because it is a transfer within a VAT group.

Corporation tax implication

HMRC recommend you confirm with your local tax office that the act of registering as a charity does not trigger any tax charge.

Once CTC becomes registered as a charity you should notify HMRC. HMRC state⁵:

2.2.3 Once a charity is registered with the Charity Commission it can apply for recognition as a charity for tax purposes. A written application should be made enclosing the following details:

- The Charity Commission register number.
- The full address, including postcode, for correspondence.
- The names of the trustees.
- The date to which accounts will be prepared.

⁴ See

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_CL_000093

⁵ See http://www.hmrc.gov.uk/charities/guidance-notes/chapter2/chapter_2.htm#22

On registration CTC becomes eligible for the various charity tax reliefs, such as exemption from corporation tax in most situations and the various charity VAT reliefs.

No tax liability should arise from the transfer of assets and business from the Trust to CTC as it is a transfer between charities.

Stamp duty land tax implications

The transfer of the property from the Trust to CTC will be exempt from stamp duty land tax.

Post merger tax position

VAT

As already explained, because CTC and the Trust are in a VAT group, the VAT implications of the merger should be minimal.

Changed VAT treatments

Normally supplies by a VAT group are considered to be made by the representative member of the VAT group (CTC), so merger should not make much difference for VAT purposes. However, this rule is ignored where the VAT status of a supply depends on the status of the customer or supplier. HMRC's VAT Notice 700/2⁶ explains:

5.9 What happens if one of the members (of a VAT group) assumes a special status?

In some cases the liability of the supply, acquisition or importation depends on the status of the supplier (for example, the provision of exempt education by an 'eligible body'). In such cases, the VAT liability is decided by looking at the status of the person actually making the supply, even though for other VAT purposes the representative member is treated as making the supply.

This also applies where the receipt of certain supplies depends on the status of the recipient (such as water and certain supplies to charities). In such cases, the VAT liability is decided by looking at the status of the person actually receiving the supply, even though for other VAT purposes the representative member is treated as receiving the supply.

So where any of CTC's transactions (as customer or supplier) would qualify for charity specific reliefs, you will be able to obtain these on registering as a charity. Note that the merger will not affect any transactions on which the Trust obtains charity specific reliefs – the grouping would have been "see through" prior to merger and post merger they will still be made to or by a charity.

Our review of CTC's activities suggests there will not be any significant changes as a result of charity registration. However possible changes are:

- The purchase of advertising: supplies of advertising to a charity (and therefore to CTC once it becomes a charitable company) are zero-rated. The advert must be in a third party's "space" to qualify. Any advertising services supplied to CTC will currently be standard-rated and, to the extent the services are used for non-business or exempt activities, the VAT will be irrecoverable. Being able to zero-rate such costs will therefore save CTC the irrecoverable VAT.
- The sale to CTC of equipment and appliances designed solely for use by a disabled person is zero-rated if those goods are to be made available by CTC to a disabled person for their domestic or personal use. Also zero-rated is the service of adaptation of general purpose goods for use by disabled persons (though not the cost of general purpose goods). For example if, after registering as a charity, CTC purchased cycling equipment designed solely for use by disabled persons, it would be able to zero-rate the purchase.

Membership subscriptions

We understand CTC as a non-profit making membership body currently uses HMRC's extra-statutory concession 3.35 to apportion the membership subscription between the different benefits for VAT

⁶ See

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_PublicNoticesAndInfoSheets&propertyType=document&columns=1&id=HMCE_CL_000094

purposes. CTC will still be able to use this concession when it becomes a charity and activities are transferred from the Trust, so there should be minimal effect on the VAT treatment of the subscriptions. We understand other advisers are currently negotiating this apportionment for you.

Corporation tax

CTC's 08/09 accounts state:

Corporation tax is payable only in respect of income arising on investments and short term deposits and capital gains arising on disposals of certain tangible fixed assets and investments.

As a charity CTC will be exempt from corporation tax on any income and gains arising on investments and fixed asset disposals provided the income and gains are applied towards the charity's purposes. In practice, we understand that since the Trust was established, CTC's donations to the Trust have exceeded CTC's corporation tax liabilities so CTC has not paid any corporation tax.

Trading income

Previously trading income was not taxed in CTC as it was regarded as mutual trading between members. This is no longer applicable once the organisation is a charity.

Charities are exempt from corporation tax on most types of income as long as the profits on that income are applied towards the charity's purposes. However there are some exceptions, the key one being the restriction on charity trading. A charity is only exempt from tax on the profits from trading activities if at least one of the following conditions is met:

1. **Primary purpose trading:** the trading activity is exercised in the course of carrying out a primary purpose of the charity, or the work in connection with the trade is mainly carried out by the charity's beneficiaries
2. **Fundraising events:** the trading is part of a "qualifying fundraising event". The activity must be an event (this precludes ongoing trading activities) and it must meet the conditions for VAT exemption in VAT Act schedule 9 group 12.
3. **Small trades exemption:** the turnover from the trade (together with the turnover from all other trading that does not meet any of the above conditions) is less than £50,000 per annum.

If a trade comprises a mix of primary purpose and non-primary purpose components ("mixed trading"), each component is, for tax purposes, treated as a separate trade. The primary purpose trade is exempt whereas the non-primary purpose trade is taxable, though it may still be covered by the exemptions for fundraising events or small trades.

It is therefore necessary to consider if CTC's trading income will be exempt. In practice, for CTC's existing trades, this amounts to establishing if they are primary purpose or if the small trades limit is not breached. If none of these conditions are met the non-exempt trading activities may have to be transferred to a trading subsidiary to avoid corporation tax.

CTC's primary purposes

CTC's proposed objects (in February 2010) are:

- 1.8 To promote cycling, cycle touring, and fellowship between cyclists for the public benefit as a means of furthering the following charitable purposes:-
- 1.8.1 the advancement of amateur sports which involve physical or mental skill or exertion by:
- 1.8.1.1 promoting, assisting and protecting the use of bicycles, tricycles and other similar vehicles on the public roads and public rights of way; and

- 1.8.1.2 promoting and safeguarding the interests of riders of bicycles, tricycles and other similar vehicles (hereinafter referred to as "cyclists"); and
- 1.8.1.3 encouraging cycling and cycle touring as a means of adventure, recreation, character training and other forms of education, to stimulate by all possible means interest and participation, and in particular the interest and participation of young persons, in cycling, and to promote cycling competitions, rallies, rides and other events;
- 1.8.2 The promotion of the conservation and protection of the environment by any charitable means including, but not limited to:
- 1.8.2.1 promoting and increasing appreciation of the countryside and places of public interest, and
- 1.8.2.2 establishing and protecting access thereto by cycle and on foot, and
- 1.8.2.3 preserving and improving amenities, and
- 1.8.2.4 taking appropriate action to advance this charitable aim in Parliament and in and before Government departments, local and other public authorities, bodies and officers, landowners, developers and others
- 1.8.3 the advancement of education by any charitable means including, but not limited to, education in road usage, road safety and in particular the safety of cyclists the preservation and protection of the health and safety of the public by encouraging and facilitating safe cycling by any means including, but not limited to, the provision of legal assistance for the riders of bicycles, tricycles and other similar vehicles in the enforcement of their rights to use the public roads and public rights of way;
- 1.8.4 the preservation and protection of the health and safety of the public by encouraging and facilitating safe cycling by any means including, but not limited to, the provision of legal assistance for the riders of bicycles, tricycles and other similar vehicles in the enforcement of their rights to use the public roads and public rights of way;
- 1.8.5 the promotion of cycling, including cycle touring, as an amateur sport by catering for the needs of cyclists by collecting and furnishing information for the planning and conduct of cycling tours, publishing and supplying books, routes, guides, brochures, accommodation lists, maps, periodicals and newspapers, badges and emblems, by arranging for insurance and any necessary documentation, and to organise and conduct cycle tours both at home and overseas and make all appropriate arrangements for participants therein, and to promote and safeguard the interests of cyclists in all such ways as the conditions of the times may render desirable;
- 1.8.6 the promotion of community participation in healthy recreation in the interests of social welfare

HMRC guidance on primary purpose trading

It can be difficult to determine if a charity's trade is primary purpose, so it is useful to refer to both the Charity Commission and HMRC guidance on the subject. The Charity Commission guidance states⁷:

C6 What is 'primary purpose trading'?

'Primary purpose trading' is trading which contributes directly to one or more of the objects of a charity as set out in its governing document. For present purposes, it includes trading in which the work in connection with the trading is mainly carried out by beneficiaries of the charity, as that will normally be primary purpose trading. Whether it is so or not, both the charity law and the tax treatment are similar.

C7 What is 'ancillary trading'?

'Ancillary trading' contributes indirectly to the successful furtherance of the purposes of the charity. This is treated as part of 'primary purpose trading' for both charity law and tax purposes.

C8 What is 'non-primary purpose trading', and when may charities engage in it?

⁷ See <http://www.charity-commission.gov.uk/publications/cc35c.asp>

'Non-primary purpose trading' is trading intended to raise funds for the charity, as distinct from trading which in itself furthers the charity's objects. Charities may engage in such trading only where no significant risk is involved.

The Charity Commission guidance suggests the distinction is between trades that directly or indirectly further the charity's objects and trades that do not further the charity's objects but merely seek to raise funds for the charity.

The main HMRC guidance on primary purpose trading supports the Charity Commission's guidance and provides the following examples of primary purpose, ancillary and mixed trading⁸:

12. Tax. Primary Purpose Trading

- (a) the provision of educational services by a school or college in return for course fees
- (b) the holding of an exhibition by an art gallery or museum in return for admission fees
- (c) the sale of tickets for a theatrical production staged by a theatre
- (d) the provision of health-care services by a hospital in return for payment
- (e) the provision of serviced residential accommodation by a residential care home in return for payment
- (f) the sale of certain educational goods by an art gallery or museum.

13. Tax. Trading which is ancillary to the carrying out of a primary purpose

- (a) The sale of relevant goods or provision of services, for the benefit of students by a school or college (text books, for example)
- (b) the provision of a crèche for the children of students by a school or college in return for payment
- (c) the sale of food and drink in a cafeteria to visitors to exhibits by an art gallery or museum or in a restaurant or bar to members of the audience by a theatre
- (d) the sale of confectionery, toiletries and flowers to patients and their visitors by a hospital

14. Tax. Trading which is not wholly primary purpose

The trade might deal in a range of goods or services only some of which are within, or ancillary to, a primary purpose. Or the trade might deal with some customers who cannot properly be regarded as beneficiaries of the charity. Examples include:

- (a) a shop in an art gallery or museum which sells a range of goods, some of which are related to a primary purpose of the charity (i.e. education and the preservation of property for the public benefit e.g. direct reproductions of exhibits and catalogues), and some of which are not (e.g. promotional pens, mugs, tea towels, stamps, etc)
- (b) the letting of serviced accommodation for students in term-time (primary purpose), and for tourists out of term (non primary purpose), by a school or college
- (c) the sale of food and drink in a theatre restaurant or bar both to members of the audience (beneficiaries of the charity) and the general public (non-beneficiaries).

In these circumstances, S505 (1B) ICTA 1988, (introduced by S56 FA 2006), deems the primary purpose and non-primary purpose parts of the trade to be two separate trades.

⁸ See <http://www.hmrc.gov.uk/charities/guidance-notes/annex4/sectionb.htm#13>

CTC's trading income

CTC's potential trading income from the 2008/09 accounts is:

| | Turnover per 08/09 accounts (£) |
|---|---------------------------------|
| Membership subscriptions | 1,519,734 |
| Shop sales and commissions | 65,316 |
| Cycle magazine | 143,216 |
| Other publications | 24,883 |
| Grand draw | 32,843 |
| Other income - collective conditional fee agreement | 31,612 |

Going through this income:

Membership subscriptions

CTC's draft governing documents give CTC the power to receive subscriptions in pursuit of its objects:

1.9.9 To collect, receive and hold funds and property by voluntary contributions, subscriptions, gifts or legacies for the objects of the Club or any of them as the donors may direct (but not by means of taxable trading);

The current benefits of membership almost all clearly promote CTC's charitable objects, so, if the provision of these benefits in return for a subscription is considered to be trading, then we consider it will be primary purpose trading.

Shop sales, insurance and other commissions and cycle magazine advertising

CTC receives commission on member sales of cycle goods from wiggles.co.uk, cycle insurance from Butterworth Insurance Services and it receives income for adverts placed in the Cycle magazine.

The tax status of these streams is not clear and arguments can be made both ways. For simplicity and to avoid disputes many charities route all such income through a trading subsidiary. We recommend you either transfer such income streams to a trading subsidiary or clarify the status of each of these income streams with HMRC Charities in advance of the transfer.

Other publications

We understand this is from sales of cycle related publications such as "Guide for Cycling" and "How to Design a Cycle Track". We consider this directly fulfils CTC's objects and that HMRC would accept this.

Other sales

Sales of t-shirts and badges – such as those confirming members have cycled from Land's End to John O'Groats – are not primary purpose trading and so can only be sold in the charity if the income in a year – together with any other non primary purpose income – is under £50,000. Otherwise such sales should be routed through the trading subsidiary.

Grand draw

This will be exempt from corporation tax as long as any profits are applied towards the charity's purposes and the lottery is a Gambling Act exempt lottery or is promoted in accordance with a lottery operating licence⁹.

Other income - collective conditional fee agreement

The status of this income stream is not clear. We recommend you confirm the tax status of this income with HMRC charities. As the amount involved appears to be small, if HMRC insist it is non-primary purpose trading, it can fall within CTC's small trades exemption.

Business rate relief

We understand the Trust already qualifies for mandatory rate relief. Mandatory rate relief is given if two conditions are both met:

- The ratepayer is a charity, and
- The property is used mainly for charitable purposes

The transfer of activities from the Trust to a charitable CTC should therefore not affect business rate relief.

Inheritance tax

Any legacies given to CTC will be exempt from inheritance tax. If the Trust is wound up, Charities Act 2006 makes it possible for legacies left to the Trust to take effect as a gift to CTC provided the merger is registered with the Charity Commission. However the Charity Commission recommendation is to take legal advice before winding up a shell charity that may be in receipt of significant legacies¹⁰.

⁹ See TA 1988 s505 (1)(f)

¹⁰ See section 10 OG 60: http://www.charity-commission.gov.uk/supportingcharities/ogs/g060a001.asp#_Toc197247236

Using a trading subsidiary

As outlined in the previous section, where a charity wishes to carry out non-primary purpose trading above the small trades limit, where mixed trading is involved or where it is simply too onerous to establish the status of multiple border-line income streams, the usual approach is to undertake the activity in a trading subsidiary.

The trading subsidiary is subject to corporation tax on any profit, as for any other private company, however it has the option of gift aiding its taxable profits to the charity. The gift aid payment is a tax deduction in the subsidiary's tax computation and is not seen as trading income for the charity. This approach is accepted as effective and recommended by both HMRC and the Charity Commission.

Note that while most trading subsidiaries of charities will gift aid all their taxable profits to charity each year to avoid a corporation tax charge, this is not necessary (unless required by the subsidiary's Memorandum & Articles of Association) and some or all the profits can be retained in the subsidiary, after paying tax on them, to provide working capital and or reserves as is currently the case with CTC Tours.

The trading subsidiary is usually set up as a wholly owned company limited by share capital. It is advisable to have the company wholly owned as this allows profits to be gift aided up to 9 months after the year end. If the company is not wholly owned, gift aid payments are only effective in reducing the subsidiary's tax liability if made in the year. As taxable profits are usually not known by the year end, this generally makes it impossible to precisely eliminate any tax liability.

For CTC the obvious choice of trading subsidiary would be the currently dormant CTC Sales Ltd. We understand this is a member of the VAT group. Most of the income that may be transferred (apart from the insurance commissions) appears to be taxable, so keeping the activity within the VAT group should avoid any adverse effect on the group's VAT recovery. CTC Sales should also not create the administrative problems that CTC Tours may have for the group (as explained above).

The charity must charge the trading subsidiary for its use of charity resources such as premises, equipment and staff. The charity is not permitted to subsidise the trading subsidiary, as that would be an inappropriate use of charity resources, so the charge must at least cover cost (including apportioned overheads). However, if the charge is made at a profit, this risks being seen as non-primary purpose trading by the charity. This charge should therefore be carefully calculated to be at cost. HMRC accept where the charge is at cost no tax liability arises in the charity¹¹. This charge should be made regularly (eg quarterly) and physically paid over by the trading subsidiary. If the trading subsidiary builds up a liability to the parent charity, this could be seen as a "non-qualifying loan" by the charity to the subsidiary. The impact of non-qualifying loans is explained below.

In order to fulfil contracts with third parties, the trading subsidiary will often require use of the charity's intangible assets, such as its name, logo and membership list. The usual approach is to set up an ongoing agreement which gives the trading subsidiary a non-exclusive right to use the required assets for a fixed fee per annum. This fee may or may not be trading income for the charity, however, even if it is non-primary purpose trading, once the substantial non-primary purpose trading has been transferred to the subsidiary, the fee can then fall within the charity's small trades limit.

Particular care needs to be taken over how the trading subsidiary is financed. Any investment or loan by the charity in the subsidiary risks being seen as non-charitable expenditure, and subject to corporation tax, unless it is "made for the benefit of the charitable company". HMRC state¹²:

¹¹ See for example <http://www.charity-commission.gov.uk/publications/cc35d.asp#23>

¹² See http://www.hmrc.gov.uk/charities/guidance-notes/annex3/annex_iii.htm#iii4

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 term 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.

There are also many non-tax issues to be considered with trading subsidiaries. The Charity Commission Guidance CC35 - Trustees, trading and tax, section D¹³ deals with trading subsidiaries in detail. Some key points are:

- A charity trustee cannot be paid for his or her services as a director or employee of the charity's trading subsidiary unless either: the governing document of the charity specifically provides for this; or there is some other specific authority, such as an order from the Charity Commission.
- As a matter of good governance, there should be both: at least one person who is a trustee, but not a director or employee of the trading subsidiary; and at least one person who is a director of the trading subsidiary, but not a trustee or employee of the charity.

These people are described as 'unconflicted' as they have no conflict of interest in their roles. These unconflicted trustees and directors should advise their colleagues as to the proper course of action where the duties of those with dual responsibilities are in conflict. This reduces the risk of any transaction between the parent charity and the trading subsidiary being challenged or questioned.

If trustees have delegated responsibility for monitoring the operation of the trading subsidiary to a committee made up entirely of people who are directors or employees of the subsidiary, they should ensure that systems are in place for ensuring that advice is obtained from an unconflicted trustee wherever appropriate.

- Trustees must always put the interests of the parent charity first. This will sometimes mean liquidating, or selling, a failing trading subsidiary. If trustees keep a failing trading subsidiary going at the charity's expense, they may be personally liable for consequential losses to the charity.
- Trustees must routinely monitor the performance of all trading subsidiaries, and of the parent charity's investments in them, with a view to ensuring the good and proper use of the charity's assets. They must be prepared to assert the rights of the parent charity as shareholder.

¹³ See <http://www.charity-commission.gov.uk/publications/cc35d.asp#16>

Investment in CTC Tours

CTC has invested in shares in CTC Tours in order to give CTC Tours sufficient capital to meet its bonding requirements. If the activities of CTC Tours are considered primary purpose or within the objects of CTC once it is a charity, then there will be no need to worry about whether or not the investment is a qualifying investment as there would be for a trading subsidiary.

However CTC Tours provides holidays, albeit cycling holidays, and only to CTC members so it may not be considered primary purpose by HMRC. Any *new* investment would therefore have to meet the above criteria for a qualifying investment. The existing investment should not provide a problem however as it was made before charitable status was obtained. However as part of being good trustees and ensuring good use of all assets of the charity, Council members should review the investment from time to time and ensure it makes good commercial sense as above.

Gift aid

Background

A UK charity can claim gift aid on gifts if the following conditions are all met:

- (a) **Payment of money:** the gift takes the form of a payment of a sum of money to a charity or CASC
- (b) **Donor benefits:** the donor (or a person connected to the donor) does not receive any benefit in consequence of making the gift. However certain benefits are ignored and other benefits valued below certain limits can be ignored:
 - For a donation of under £100, the total value of benefits provided in connection with the donation (including to connected persons) must be under 25% of the donation value. For donations between £100 and £1,000, the total value of benefits must be less than £25. For donations between £1,001 and £10,000 the total value of benefits must be less than 5% of the donation.
 - In addition, the total value of all benefits provided to a donor (and persons connected to that donor) in respect of gift aided donations in any tax year (6 April to 5 April) must be less than £500. You must add up the cumulative value of all gifts from the start of the tax year. Any gift that would take the total level of benefit above £500 is blocked and cannot be gift aided.
- (c) **Tax to cover:** the donor is a UK tax payer who has paid sufficient income or capital gains tax to cover the gift aid reclaimed on the donation. The charity can accept the donor's assurances on this but it must have drawn the donor's attention to this requirement
- (d) **Gift aid declaration:** the donor gives the charity a "gift aid declaration". This can be oral or in writing. A written declaration must include the donor's name and home address, a description of the gift and a statement that they wish to gift aid the gift. An oral declaration must obtain the same information and must be either recorded or confirmed in writing to the donor.

If these conditions are met the charity can reclaim, from HMRC, the basic rate income tax the donor paid on the donation¹⁴. A higher rate taxpaying donor can also claim higher rate tax relief – in effect the donation is moved from the donor's higher rate income pot to their basic rate income pot.

Gift aiding membership subscriptions

There are two approaches that can be taken to gift aid membership subscriptions to a charity:

- If the value of all benefits provided as a result of the subscription is within the above donor benefit limits (point (b) above), the whole subscription is a gift and can be gift aided, provided the other conditions outlined above are met.
- If the value of the benefits provided in connection with the subscription exceeds the above donor benefit limits, the subscription can be split into a benefit element and a gift element and gift aid claimed on the latter. HMRC state¹⁵:

¹⁴ In addition, for donations received before 5 April 2011, HMRC will pay "gift aid transitional relief" on any claim. This tops up the gift aid to allow for the reduction in the basic rate of income tax from 28% to 25% on 6 April 2008.

¹⁵ See <http://www.hmrc.gov.uk/charities/guidance-notes/chapter3/sectionf.htm#au>

3.46.9 Where a charity separates that part of the membership subscription that simply gives the basic rights of membership from any part that relates to the provision of services or facilities the membership element can be treated as a gift.

So, for example, a sports charity that charges a basic membership subscription, with additional, variable, training or playing charges depending on the member's standard, could regard the basic membership as a gift. The additional training or playing charges could not be treated as gifts.

A charity that charges a standard membership fee that covers membership and participation could not treat the subscription as a gift if participation in the activities involved personal use of services or facilities.

Membership subscriptions that secure the right to personal use of facilities or services would not be accepted as gifts. So, for example, subscriptions that are made in order to obtain for an individual or individuals' tuition, coaching or other educational instruction would not be viewed as gifts. Similarly, subscriptions to a sports charity would not be acceptable if they secured for members the free or discounted use of, say, a golf course or a swimming pool that are not available on similar terms to non-members.

The last parts of this guidance suggest that if membership "secures the right to personal use of facilities or services" then it cannot be gift aided. However in practice HMRC will usually accept, where the access to facilities is not the main purpose of the subscription, that a single payment can be split between the benefit element and the gift element. HMRC state¹⁶:

3.34 Split payments

3.34.1 Where the value of benefits would exceed the limits in the donor benefit rules, the donor may specify that part of his or her payment is to be treated as payment for the benefits and part is to be treated as a donation.

This treatment can only apply where the item has a readily ascertainable value and the excess has a clear donative purpose. Provided the donor specifies this before, or at the time of making the donation, the part of the payment that is specified as a donation may qualify as a Gift Aid donation, provided it satisfies all the conditions for the tax relief.

The charity and donor should keep evidence of how the payment was to be split – a copy of a dated letter accompanying the payment, for example. Alternatively, separate payments could be made.

HMRC require the donor to have known the gift / benefit split at or before the time of the payment. So you could, for example, in the subscription invoices and reminders, include a statement of the split of the payment between its gift and payment components for gift aid purposes.

Valuing member benefits

It is therefore necessary to value the member benefits and compare them with the various membership subscription rates. Separate exercises must be undertaken for each type of membership and each package of benefits. If benefits or subscription rates change, the calculations must be updated.

As there are usually significant uncertainties when valuing member benefits, you should agree the valuation and proposed treatment with HMRC Charities well before starting to claim gift aid on subscriptions. HMRC Charities staff are instructed to adopt a co-operative approach when dealing with gift aid issues, and indeed we generally find this to be the case.

HMRC may be prepared to accept the same valuation basis as is agreed for VAT purposes. Often a cost based apportionment is used for VAT purposes, so a cost based apportionment may be

¹⁶ See <http://www.hmrc.gov.uk/charities/guidance-notes/chapter3/sectiond.htm#ah>

acceptable for gift aid purposes. Note that some benefits such as the Cycle magazine will have a value for VAT purposes but will be deemed nil value for gift aid purposes.

For multi-year memberships the benefit value is the value of all benefits that will be received over the lifetime of the membership. You may have to agree with HMRC how the benefits attributed to family memberships are to be valued.

Practical points

Declarations - you will have to obtain gift aid declarations from members and set up a system for storing the declarations so they can be retrieved easily and linked to a member and that member's subscriptions and other gift aided donations. HMRC conduct periodic gift aid audits to check the validity and accuracy of gift aid claims, so these systems are likely to be subject to HMRC audit at some time. We understand you have experience in handling gift aid donations in respect of donations to other group charities and have systems in place to deal with these.

Back-claiming: you should check with HMRC to see if they will accept backdated declarations are effective in gift aiding any part of subscriptions paid before CTC became a charity. If not, you will only be able to gift aid subscriptions going forward, however if the declaration is backdated and also covers donations to other group charities such as the Trust, it can be used to gift aid any past donations from the individual.

Steps to be taken

We recommend the following are carried out leading up to the merger:

Corporation tax

- Notify your local tax office that CTC will be registering as a charity and confirm that registering will not trigger a tax charge in CTC.
- Decide if you wish to route all commission type income through a trading subsidiary or attempt to retain any of it in CTC. For existing contracts, check if they can be transferred to a trading subsidiary or need to be terminated and replaced.
- If you wish to retain any commission type income in CTC, confirm (in writing) with HMRC Charities that they accept it is primary purpose.
- Clarify with HMRC Charities the tax status of the CCFA income.
- If you wish to or need to transfer any such income to a trading subsidiary, amend or replace the relevant contracts and set up relevant agreements between CTC and the trading subsidiary for use of its name, logo, data etc.
- Once CTC is registered as a charity, notify HMRC in writing enclosing the Charity Commission register number, the full address including postcode, the names of the trustees and the date to which accounts will be prepared. Note that registering as a charity does not trigger the end of a corporation tax reporting period.
- The transfer of assets and activities from the Trust will trigger the end of a corporation tax period.

Gift aid

- The first step will be to value the benefits provided to the different categories of member and establish, for each category, if the 25% / £25 donor benefit limits are broken. Based on these calculations you should then decide if you want to restructure the membership subscriptions and associated benefits. You will also need to take into consideration any VAT implications.
- You should then present your preferred interpretation to HMRC Charities for approval. This may require flexibility and negotiation so it may take some time to agree. You should also agree what pre-registration subscriptions gift aid can be recovered on.
- You will need to set up systems for obtaining and storing gift aid declarations from members. If you ensure gift aid declarations can be backdated and cover donations to other group charities then gift aid can also be claimed on the member's donations to other group charities in the last 4 years

VAT

- You need to decide whether or not the additional VAT recovery from including CTC Tours in the VAT group makes it worthwhile including it despite the additional time pressures of filing a group return.