Not-for-profit, not for tax?

General Features



01 August 2015

Graham Batty considers some of the tax issues facing practitioners dealing with not-for-profit organisations

Key Points

What is the issue?

Not-for-profit bodies come in many sizes, but a not-for-profit motive does not equate to a tax exemption

What does it mean for me?

You need to be able to ask the right questions to decide what type of not-for-profit body you are dealing with and what its tax position is

What can I take away?

An overview of the principal not-for-profit bodies and their normal tax treatment

One challenge for the tax adviser working in the not-for-profit (NFP) sector is the assumption that because an organisation's intention is to plough any profits back into its activities excuses them tax. Nothing could be further from the truth. The other complication is the variety of organisations that are typically regarded as NFP bodies and the fact that some benefit from specific statutory tax exemptions (***Table 1***), while others do not (***Table 2***) and have to depend on case law and general principles.

Image



Non-charitable registered social landlords and arm's length management organisations (ALMOs) are few and are unlikely to cross the average tax practitioner's desk. What, then, of the other NFP bodies?

Charities

Charities are perhaps the most common NFP organisations that the tax practitioner must deal with, although there is a popular misconception that charities enjoy a blanket tax exemption. The reality is that they have a series of specific tax

exemptions and, as long as they work within these and any surplus is applied for charitable purposes only, they should not suffer a tax charge. In particular, charities have specific tax exemptions on the profits of any property rental business, interest income and capital gains. However, trading activities are an area in which charities may face difficulties. Tax exemption is restricted to profits arising from a trade carried on in the delivery of a charity's charitable objects, as set out in its constitution, or which are directly ancillary to them. These are normally referred to as primary purpose trading.

A common problem area is the letting of charity premises for meetings, conferences, weddings and such like. This is normally not a property business. The charity remains in occupation and the hirer does not acquire any rights over the premises, but a hotel-type activity involving the provision of additional services, such as catering and event management, is a taxable non-primary purpose trade. It is sometimes argued that the service elements can be invoiced separately by a non-charitable trading subsidiary, leaving the rental element in the charity. However, the reality is normally that the hirer has no option to acquire the services other than as part of a composite package.

Community amateur sports clubs

The community amateur sports clubs (CASC) scheme was introduced in April 2002. CASCs are companies or unincorporated associations established to provide facilities and promote amateur sports recognised by the National Sports Councils to the whole community. Like charities, they must have fit and proper management and be established in the UK, Norway, Iceland or Liechtenstein.

CASCs are members' clubs established for their members' social and recreational purposes. As such, transactions with members do not amount to the carrying on of a trade within the charge to corporation tax since they lack the necessary degree of commerciality (BIM24205). However, if services are provided to non-members, such as visitors or temporary members, any surplus is liable to tax as trading income. Other income of a members' club, for example savings, investment income and gains, are chargeable to tax in the normal way.

However, unlike normal members' clubs, CASCs can claim a limited range of tax exemptions and gift aid, are eligible for the gift aid small donations scheme and are entitled to 80% mandatory business rates exemption. Although there is no limit on

the income – other than property income – that a club can generate from members to remain in the CASC regime, the gross trading and property income from a non-member must be below £100,000 a year.

The tax reliefs a CASC can claim are:

- exemption from corporation tax on UK trading profits if the turnover from that trade is less than £50,000 a year (£30,000 a year before 1 April 2015);
- exemption from corporation tax on UK property income if the total income from property is less than £30,000 a year (£20,000 a year before 1 April 2015);
- exemption from corporation tax on interest received; and
- exemption from corporation tax on chargeable gains.

The exemption for chargeable gains can prove particularly useful because many CASCs have town centre grounds that are prime development sites that can be sold to fund a move to new and better out-of-town facilities. This would satisfy the condition, mirroring the similar condition for charities, that all income and gains must be applied for qualifying purposes.

The exemptions for trading and property income available to CASCs are limited. If the income limits are exceeded, the whole of the profit is taxable. There is no taper relief. In this case, it will be necessary to calculate the trading profit attributable to non-members. A typical club will have income and expenses that fall into three broad categories:

- attributable wholly to members (wholly exempt);
- attributable wholly to non-members (wholly taxable); or
- attributable to members and non-members (mixed).

In apportioning mixed activities, for example a bar, it will be necessary to take a supportable ‘just and reasonable’ approach that can create practical problems. It is also important to remember that, if services or facilities are provided gratuitously or at undervalue, it may be possible to claim a deduction for the full commercial cost of these following the Peterhead principle (British Legion, Peterhead Branch, Remembrance and Welcome Home Fund v CIR [1953] 35 TC 509).

Community interest companies

A community interest company (CIC) is an asset-locked body that must ensure any profits or assets are used principally for the benefit of the community. Unlike a charity, a CIC is not entitled to any specific corporation tax exemptions. Accordingly, a CIC's profits are fully taxable unless it can be shown that the terms of the contract are such that, in tax law, the organisation does not amount to a taxable trade.

Whether a CIC is carrying on a trade is a question of fact that is difficult to prove in practice.

A trade for corporation tax purposes is only briefly defined in statute as 'including any venture in the nature of trade' (CTA 2010 s 1119). This is unhelpful and, not surprisingly, there is considerable case law (the badges of trade cases) on what does and does not characterise a trade for tax purposes. However, in recent times the courts have taken a fairly broad view and regarded the essence of trading as a commercial relationship in which the trader provides goods or services to a customer for reward (*Ransom v Higgs* [1974] STC 539).

Given that, in most cases, a CIC will be entering into a contract with an independent party to provide goods or, more commonly, services, it is difficult to see the contract as anything other than a commercial arrangement freely entered into. This leaves the question of whether the services are provided for reward or, perhaps more meaningfully, with a view to profit. The crucial issue is whether any surplus for the year is attributable to the customer or the CIC. If a surplus must contractually be rolled forward and applied to providing services under the contract in future years, or alternatively be refunded, it will be attributable to the customer and no profit can arise to the CIC (*BBC v Johns* [1964] 1 All ER 923).

A CIC is, of course, required under its articles of association to apply any profits for the benefit of the community. However, this not-for-profit motive does not affect the corporation tax position on earning profits; it merely directs how those profits are to be applied. A CIC's not-for-profit motive does not, therefore, affect its corporation tax status.

Mutuals

Mutuals are perhaps the most widely misunderstood of the NFP bodies. Mutuality is a legal concept with a rich case law based on the principle that it is not possible to trade with oneself (*Dublin Corporation v M'Adam* [1887] 2 TC 387). Mutual

‘exemption’ applies only to the extent that a body is carrying on a trading activity with its members. If it is not carrying on a trade, an organisation cannot be a mutual. The flip side is that a mutual body cannot claim the benefit of losses or capital allowances on the mutual trade. Mutuals are fully taxable for all other income and gains.

Identifying that a body trades with its members is often as far as many practitioners go in claiming mutual status but additional, more complex, structural requirements are often overlooked. To be a mutual trade:

- There must be complete identity, as a class, between the contributors to the mutual surplus and the participators in it. This is not the same as the members at the date of dissolution because there will be contributors who are not now members. It is not, though, necessary to trace back to everyone who has ever been a member as long as the return takes into account current contributors and those who ceased to be contributors in the previous five years.
- The surplus must ultimately find its way back to the contributors and nobody else. It is surprising how often the constitution of a supposed mutual provides that any surplus on a winding-up is to go to charity or another body with similar aims rather than its members.
- There must be a reasonable relationship between a person’s contribution to the surplus and the amount distributed to them on winding up. This can be complex where a range of goods or services with different profit margins is provided.
- The contributors to the common fund must control it.

Conclusion

NFP bodies are a diverse and interesting sector to work in, but there is an assumption that a not-for-profit motive means that you can forget about tax. In approaching any NFP body it is essential to start by asking yourself several basic but important questions:

- What are the sources of income?
- What is the normal tax treatment?
- Is there a specific exemption?
- Does this body qualify?

Further information

Read more about CASCs in Richard Baldwin's article 'Howzat for complicated?' from the March 2015 issue of Tax Adviser.