

# Charity Briefing

Recent issues and events affecting the charity and not for profit sector.

## Welcome

**Welcome to the final Charity Briefing of 2011. It has been a very challenging year for charities and not for profit organisations with the ever increasing demand on the services they provide in an uncertain economic climate, and we look forward with anticipation to 2012.**

In this edition, we look at how charities might be exposed if they incur non-charitable expenditure and what the consequences are for trustees should a charity fall foul of the rules. Following our recent seminar on the topic, we provide you with an overview of PAYE and NI and how to remain compliant. Our guest contributor this edition is Sarah Clune from Stone King Solicitors, and her article discusses public benefit and the implications of the recent Upper Tribunal ruling on the Independent Schools Council case.

We hope you find the articles of interest, and if you have any questions about any of the topics covered or how we may be able to assist you, then please don't hesitate to contact me or any other member of the charity team.

All of us at Chantrey Vellacott DFK wish you a peaceful and prosperous new year.

### New Midlands charity group

We have recently expanded the charity group for the Midlands region. This dedicated local team provides a full suite of audit, accounting and business advisory services to charities and not for profit organisations in the Midlands area.

We also bring you updates on investment guidance for charities, trustee recruitment, and we look at the level of profit that a charity shop might expect to make. The VAT column in this briefing deals with the final instalment of the Reed case which we have been following, and offers some guidance on VAT for business-non-business / partial exemption methods.

## Non-charitable expenditure

**Non-charitable expenditure is an area where clients often seek clarification. So what are the rules, and what are the consequences for getting it wrong?**

A charity that incurs non-charitable expenditure faces two exposures:

- The charity may lose some tax exemptions
- If the charity is a trust, the expenditure might be in breach of trust, thereby rendering the trustees personally liable to make good any loss suffered by the charity.

- Payments to an overseas body where the charity has not taken reasonable steps to ensure the payment will be applied for charitable purposes.

The two dangers are independent; expenditure may be in breach of trust without causing loss of tax relief, or may involve a tax cost without being a breach of trust.

**Non-charitable expenditure includes:**

- Expenditure which is not incurred for charitable purposes only.
- Losses on trading activities, property or miscellaneous transactions which, had they been profits, would not have fallen within a specific exemption.



**Sally Jayne Bonner**  
Head of Charities  
M: 07768 328 891  
E: sbonner@cvsdfk.com



**Tony Steintal**  
Partner  
M: 07967 216 408  
E: asteintal@cvsdfk.com

- Investments and loans made by the charity which are not qualifying investments and loans.
- Some amounts arising from transactions with a person who was a 'substantial donor' to the charity before 1 April 2011.

#### Losses

Charities are allowed to earn profits from trading activities that are not themselves charitable; such profits escape tax **providing** they do not exceed the upper limit (usually the lower of 5% of the charity's gross income and £50,000).

Where these activities produce losses, there is no de *minimis* limit; the losses are non-charitable expenditure.

The same is true of fundraising activities such as galas, auctions or fêtes – if the event makes a loss this could be non-charitable expenditure.

#### Payments outside the UK

Much discussion has resulted from HMRC guidance because it provides illustrations, rather than objective rules. Trustees thus have less reassurance that their actions will not be criticised with hindsight.

HMRC guidance condenses to these principles:

- A payment is not necessarily charitable just because the recipient is accepted as a charity in its own State.
- Trustees' responsibility for ensuring money is properly disbursed extends through to the ultimate recipient or use of the money.
- Trustees should retain records of correspondence, assessments of grant applications and other records sufficient to demonstrate the probity and integrity of their actions.
- In assessing the degree of evidence required, trustees may have regard to the amount of the payment both in absolute terms and relative to their charity.
- Depending on the value of payments to be made, trustees may wish to consider collecting evidence about the recipient of their support in these areas:

- Whether the laws of the country in which the recipient belongs – and the recipient's own constitutional document – prevent the recipient from making payments that would be non-charitable under UK law.
- Whether the recipient has a credible plan for using the money which has all relevant regulatory permissions (planning permission, building permit etc).
- Whether the recipient has a robust system of financial control sufficient to ensure payments are directed where they are intended and that accurate reports of the goods or services obtained by those payments are compiled.
- What steps the charity has taken to confirm the accuracy of those reports of goods or services acquired and deployed.
- Whether and how the charity measures outcomes from their support and assesses value for money.

HMRC's guidance covers donations ranging in value from £500 to £1m and clearly acknowledges that the level of evidence required to support a contribution of £500 towards a specific building project is tiny compared to the evidence that would be required to support a £1m payment to fund a grant-making charity in a failed State.

What is clear is that, in the absence of an objective standard approved by HMRC, trustees should be cautious and collect all such evidence as they can to demonstrate that their support of a non-UK recipient is a clearly charitable application of funds, relying on professional advice where appropriate.

#### Investments and loans

Even though the making of an investment or a loan is not 'expenditure', charities that make investments or loans that are not 'qualifying' are treated as incurring non-charitable expenditure.

Qualifying investments and loans essentially include almost all investments in listed companies, regulated investment products, investment-grade bonds and deposits with recognised banks.



Any other investment or loan (including those to a company wholly-owned by the charity) will also be qualifying if it is "made for the benefit of the charity and not for the avoidance of tax (whether by the charity or any other person)".

This rather subjective test can be made objective by obtaining confirmation from 'an officer of HM Revenue & Customs' that the criteria are met.

Trustees concerned that investments or loans they have made may fall within the scope of the subjective test may well wish to seek certainty by filing a claim, either by preparing a tax return or by filing a claim specific to the loan or investment.

#### **Substantial donor**

Although the substantial donor rules have been replaced in most cases, they are not finally abolished until 1 April 2013. If an individual was a substantial donor in relation to a particular charity on 1 April 2011, they remain so until final abolition

Some payments may be questionable but are not necessarily non-charitable, these include:

- Payments outside the terms of the charity's objects.
- Accumulations.

#### **Ultra vires**

Payments that are outside the terms of a charity's objects may be *ultra vires*. They are not necessarily non-charitable

however. A payment to relieve the immediate poverty of an elderly person is not non-charitable but, if it is paid by an educational charity, it may well be *ultra vires*.

Trustees may be personally liable to make good any loss the charity has suffered as a result of making *ultra vires* payments and should therefore approach them with caution.

For tax purposes, it is only *ultra vires* payments that are specifically prohibited by the charity's constitutional document that will be treated as non-charitable expenditure.

#### **Accumulations**

There has been considerable uncertainty as to whether HMRC would challenge the availability of the charitable exemptions in cases where substantial sums are accumulated in reserves.

HMRC do challenge accumulations of income where:

- income is not invested but kept in cash or a current account; or
- investment decisions appear not to be made exclusively for the benefit of the charity.

It remains the case that reserves should only be accumulated within the terms of an appropriate reserves policy.

If you are concerned that your charity may be falling foul of any of these rules, please contact Tony Steintal or your usual Chantrey Vellacott DFK contact.

## **VAT update**

#### **Reed VAT tribunal – agency staff**

In our previous briefings we updated you on the Reed case. The case concerned whether VAT was due on the full cost of temporary staff or merely commissions. HMRC have finally issued their view and, as expected have rejected the conclusion that the Reed VAT tribunal sets a precedent which means that VAT is not normally due on the full value of the charge. This is obviously a disappointment to the sector but it is unlikely the issue will go away. We understand that there are already a number of new appeals in the pipeline testing the point.

#### **Partial exemption and business non-business methods**

We have recently received a number of queries about the possibility of setting up joint business non-business and partial exemption methods. Until 2011 this was not possible as theoretically HMRC did not have the ability to formally approve a business non business apportionment. This is the apportionment that is used to determine how much overhead or residual input VAT can be said to relate to an organisation's business activities.

However, it is now possible to obtain formal approval for a business non-business method. If you are also partially exempt then it will probably be necessary to work out a combined method for approval. There are circumstances where this is desirable and if you do operate a business non-business or partial exemption method and have not reviewed it within recent years it is worth doing so as very often savings can be made.

If you suffer a restriction on your VAT recovery and would like us to consider if improvements can be made then please contact Peter Ladanyi or your usual Chantrey Vellacott DFK contact.



**Peter Ladanyi**  
VAT Director  
M: 07971 883 946  
E: pladanyi@cvdfk.com







**Sarah Clune**  
Charity & Education team  
Stone King LLP  
T: 01225 326760  
E: sarahclune  
@stoneking.co.uk

## Public benefit: where now for independent schools?

**In mid-October, the Upper Tribunal delivered its long-anticipated decision on the Independent Schools Council (“ISC”) case, which it heard in May. The ISC challenged how the public benefit requirements should apply in the context of independent schools and the lawfulness of the Charity Commission’s guidance on this point.**

The outcome of the case has been reported in a variety of ways. It is true that the Tribunal has told the Commission that it must re-write key parts of its public benefit guidance because in certain respects it is incorrect or unclear **but** the requirement for ALL charities to provide public benefit has not disappeared.

Whilst the decision supports much of the Commission’s interpretation of the law, the ISC has claimed the decision as a victory because the Tribunal was very clear that **the provision of public benefit offered by a given school is a matter for the charity’s trustees and that it was not for the court or the Commission to impose any generally applicable standards of “appropriate” or “reasonable” provision.**

What is clear is that the Commission’s guidance will be much less prescriptive so that it will no longer necessarily be a requirement on every school, irrespective of its size, type or location to fund means-tested bursaries for the poor. Neither are “the poor” necessarily to be interpreted as “the destitute” – indeed, they may simply be unable to afford full school fees. **However, because public benefit will need to be assessed on a case-by-case basis, the Tribunal was unable to provide any clear guidance on what is and what is not sufficient to meet the public benefit requirement.**

### **What is public benefit?**

An organisation aspiring to be a charity under the Charities Act 2006 must have a purpose that is for the “public benefit”. In the absence of a clear definition from Parliament the Tribunal’s analysis of what public benefit means is helpful:

1. The nature of the purpose has to be a benefit to the community, in other words “a good thing”; and
2. The people who benefit from the implementation of that purpose have to be a sufficiently broad section of the public.

In looking at public benefit “*in the first sense*”, as the Tribunal put it, the purpose or object needs to be *prima facie* of benefit to the community at large. Whilst there is no presumption that education of any sort is for the public benefit, the Tribunal did conclude that mainstream education provided by schools in the independent sector was generally for the public benefit. However, the Tribunal specifically declined to consider political arguments as to whether independent schools provided disbenefits to the great majority of schools in this country which are run by the State.

Public benefit “*in the second sense*” was also discussed by the Tribunal, which accepted that it was right, as a matter of principle, that a trust which excluded the poor from benefitting could not be a charity. It had been accepted by the Commission when amending its original draft guidance that the follow-on from that principle was not that the poor must be included in any benefit offered but rather that the poor should not be excluded. The Tribunal went further and said that “poor” did not mean “destitute”, nevertheless a school which was established for the purposes of educating only those who could pay full fees would not be charitable.





#### **Non-exclusion of the poor**

The Tribunal concluded that, provided the poor were not excluded and that more than “token provision” was made for them, the whole range of benefits which the school provides to the community was able to be taken into account in assessing whether the public benefit requirement “*in the second sense*” was met. The Tribunal looked at activities that might indicate a reasonable amount of public benefit provision, which included:

- scholarships and bursaries for the “not so well off”;
- inclusion in certain activities of pupils from local state schools;
- sharing of teachers/ teaching facilities with local state schools;
- providing know-how or teaching materials e.g. on the internet or otherwise; and
- making facilities (e.g. sports fields, swimming pools) available to pupils from local state schools.

It is also permissible for some wider benefits to the community to be taken into account provided that they are a consequence of the trustees advancing the objects of the school. The weight to be attached to any such benefits will depend upon the nature of these benefits and the precise objects of the school – in some cases the weight may be slight. Interestingly, the Tribunal declined to include in the list of wider benefits the availability of sports facilities to the community at large, including adults.

The Tribunal addressed the issue of “gold-plating”, where schools that charge high fees and / or provide education at the ‘luxury’ end of the market, stating that a stringent examination of how the public benefit requirement is satisfied would be required in order to justify such provision.

#### **A matter for trustees / governors**

The Tribunal’s judgement states “*There will be no one right answer. There will be one or more minimum benefits below which no reasonable trustees would go but subject to that, the level of provision and the method of its provision is properly a matter for [the trustees] and not for the Charity Commission or court*”. Patently, provision for “the poor” has to be more than minimal or “token” but the quantity and quality of that provision was for the trustees to decide “*acting reasonably in an objective sense*”. Clearly, what the reasonable trustees should do in relation to their school is to undertake “*their own considered assessment in the circumstances pertaining to their charity*”.

And what if, for example, a relatively wealthy school made no more than a token gesture towards the poor. The Commission’s previous guidance suggested that such an organisation could be struck off the Register of Charities. However, the Tribunal’s approach, which is more logical, is that the organisation would remain a charity but, if necessary, the trustees could be removed from office.

#### **What next?**

The Commission’s guidance will be re-written in a much less prescriptive fashion. In our view, independent schools should continue to take seriously the provision of what they offer to those who cannot afford full school fees but it is for the trustees / governors of each school to decide how that is best done, considering the type of school, its financial viability and the local situation. Trustees / governors will also need to turn their thoughts to how they report on the public benefit they deliver when preparing their next annual report, in order to ensure that a full and accurate picture is given.

If you would like further information please contact Sarah Clune, or a member of the Chantrey Vellacott DFK Charity Group.



**Elliot Harris**  
Partner  
M: 07977 064 629  
E: eharris@cvsdfk.com

## FAQ

**Q: What level of profit should a charity shop be making?**

**A:** It depends! (A personal viewpoint)

I apologise for the apparent fence sitting but after 40 years of experience working with the retail sector in all its forms there are genuinely a number of reasons why there is no right answer. In the recent 2011 Charity Shops survey, published by Charity Finance magazine, the range of net profit to sales was quite startling. For hospice related shops the top 20 ranged from 31.7% to 67.7%. For non-hospice charity shops the range went from 15.9% to 52.7%.

Just why is the range so great? Let us look at some of the factors:

- Mix of donated and bought in goods
- Ability to reclaim gift aid
- Cost control and use of volunteers
- Location and catchment area of shops
- Layout and fit-out
- Competition with on-line, high street, discounters etc
- Availability of competitive leases because of high street vacancies
- Specialists shops e.g. books, furniture, antiques
- Range of average weekly income per shop in the survey from £689 (11 shops) to £5,132 (1 shop)

So what if any conclusions can we draw from all this information?

Well my first thought is that the old retail adage still applies; location, location and location. Those already running or thinking of opening a charity shop need to know their catchment area. There is a big difference between, for example, North London, a market town such as Loughborough and a new town like Milton Keynes.

It is that catchment area which would inform you of your customer base and the type of donated or bought in goods that would sell well. We then might look at the potential size of the unit available. In turn that might inform you as to the potential footfall, throughput and staff needs. The catchment area might also inform you as to the potential pricing structure that might be appropriate.

Having then established the cost base, this would in turn, when applied to a perceived quantum of weekly return enable you to calculate prospective weekly sales and compare it with what you believe would be achievable in the location.

Does that location produce the footfall to give you those sales with that mix of stock?

Does the location lend itself to a specialist shop?

And so on...

As you can see, one simple question leads to a whole lot more. You do however need to answer these questions before deciding whether a shop will make sufficient contribution to make all the effort and investment in time and resources worthwhile.

One thing is quite clear from my own client base; those with the best results know their location and catchment area.

If you require further information please contact Elliot Harris or your usual Chantrey Vellacott DFK contact.



**Jon Higginbottom**  
Manager  
T: 01604 639257  
E: jhigginbottom@cvsdfk.com

## Charities urged to nurture diverse board of trustees

**With the launch last month of National Trustees' Week 2011, charities are being encouraged to think creatively about trustee recruitment. New research by the Charity Commission revealed that many new charities applying to register may be missing out on the best possible candidates.**

The findings, which are based on a survey conducted with over a hundred new applicants to the register, show that over a third (39%) of respondents are looking to recruit more trustees, but that most (56%) draw on existing volunteers or staff members, use personal contacts (48%), or word of mouth (32%) to identify possible candidates. Only a small minority advertised externally online (7.6%) or in the press (5%).

The Commission says that, in the long run, these charities may find that their board is lacking a diverse range of skills – for instance the input of younger people. Previous research carried out by the Charity Commission into **young people and trusteeship** revealed that only half a percent of all

trustees are aged between 18 and 24, and that the average age of charity trustees is 57.

The Charity Commission's guidance, Finding New Trustees: What charities need to know (**CC30**), highlights the advantages of a diverse trustee board, including:

- a broader range of trustee skills, knowledge and experience;
- greater assurance that a charity is fair and open in all its dealings, for example in the way it delivers services; and
- increased accountability for a charity's actions, and public confidence in its work.



**Jon Higginbottom**  
Manager  
T: 01604 639257  
E: [jhigginbottom@cvcdfk.com](mailto:jhigginbottom@cvcdfk.com)

## Investment guidance for charities

The Charity Commission has published updated guidance on Charities and Investment Matters, available on [www.charity-commission.gov.uk](http://www.charity-commission.gov.uk).

The new online guidance, which replaces the Commission's previous advice on investments, describes the legal duties and principles that apply to charity investments and the risks that trustees must address. It offers a clear framework for decision making, but emphasises that it is up to trustees to decide on the most appropriate overall investment strategy for their charity.

The guidance reflects the Commission's new regulatory approach and wider changes in policy and practice within the charity sector. In recent years, increasing numbers of charities have been considering investing funds in ways that serves to directly further their charitable aims. In the past, charities usually invested solely for a financial return.

The updated guidance confirms that trustees can invest ethically, sustainably, for a financial return or to achieve charitable aims or for a mix of all or any of these. But it emphasises that trustees must be clear about their motive in making an investment and must be able to justify that they are using their charity's resources in its best interests.

Charities and Investment Matters comes as part of a wider review of the Commission's financial guidance to charities, which began in 2008 in response to the economic downturn. Like all the Commission's financial guidance, it encourages trustees to take a risk-management approach to decision making.

Charity Commission Chief Executive Sam Younger said:  
*"Charities currently command a total of nearly £81 billion in investment assets. In challenging economic environments it is especially important that trustees are enabled to make those assets work harder for their beneficiaries. This guidance*

*is designed and drafted to encourage charities to make confident decisions about investment that serve their charities' interests – it reassures trustees that, so long as they can demonstrate that they have reached a reasonable decision having considered the relevant issues, they are unlikely to be criticised for adopting a particular investment policy."*

As Charities and Investment Matters explains, there are three investment approaches that charities can use. **Financial investment** aims at achieving the best financial return within the level of risk considered acceptable. When trustees make financial investments, they have to make sure they are aware of and acting within their charity's powers to invest and must exercise care and skill.

**Programme-related investment**, or PRI, on the other hand, is aimed at helping the charity further its objects directly in a way that might also yield a financial return. When deciding whether to make a programme-related investment, trustees must be confident that doing so wholly furthers the charity's aims for the public benefit.

The guidance also covers **mixed motive investment**. This is an emerging area which enables charities to make investments that cannot be wholly justified either as financial or programme-related investments, but which the trustees still consider likely to be in the best interests of the charity. Trustees making this type of investment should be satisfied that it can be justified by the combination of the anticipated return and the contribution to the charity's aims.

If you require further information please contact Jon Higginbottom or your usual Chantrey Vellacott DFK contact.

## Who to contact

For further information or advice, please contact the author of the relevant article, your usual Chantrey Vellacott DFK partner or one of the following:

### Birmingham

Nick Simkins  
0121 454 4141  
[nsimkins@cvcdfk.com](mailto:nsimkins@cvcdfk.com)

### Croydon

Richard Willis  
020 8686 3915  
[rwillis@cvcdfk.com](mailto:rwillis@cvcdfk.com)

### Northampton

Chris Hindle  
01604 639257  
[chindle@cvcdfk.com](mailto:chindle@cvcdfk.com)

### Brighton & Hove

Ken Touhey  
01273 421200  
[ktouhey@cvcdfk.com](mailto:ktouhey@cvcdfk.com)

### Leicester

Elliot Harris  
0116 247 1393  
[eharris@cvcdfk.com](mailto:eharris@cvcdfk.com)

### Reading

Ian B Johnson  
0118 952 4700  
[ibjohnson@cvcdfk.com](mailto:ibjohnson@cvcdfk.com)

### Colchester

Dawn Lay-Flurrie  
01206 549303  
[dlay-flurrie@cvcdfk.com](mailto:dlay-flurrie@cvcdfk.com)

### London

Sally Jayne Bonner  
020 7509 9000  
[sbonner@cvcdfk.com](mailto:sbonner@cvcdfk.com)

### Stevenage

Mark Stevens  
01438 741147  
[mstevens@cvcdfk.com](mailto:mstevens@cvcdfk.com)

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