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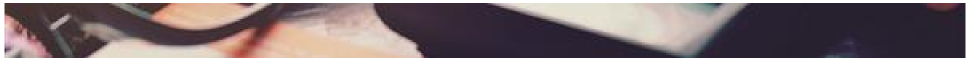
haysmacintyre insight: tax insights for a COVID-19 year end



After many months of navigating through very uncertain times, we are finally starting to see a gradual return to 'normal' life. COVID-19 has, no doubt, impacted your businesses activities and it remains uncertain how long lasting those effects may be.

COVID-19 forced the close of museums, theatres, charity shops, gardens, function and office spaces, and it also forced the cancellation of many fundraising, sporting, challenge and participation events. These unplanned cancellations have had a negative impact on income and in this insight we explore some of the tax specific areas that may now be particularly relevant to you and your organisation.

*We have written some useful guidance on important tax topics below, and also prepared a short 'year end tax to do list' for reference, which can be found **here**.*

Trading subsidiaries

If your trading subsidiary's profit levels have suffered throughout this period, you should consider your Corporation Tax implications alongside your commercial ones. Where profits are normally donated to a parent charity, then two situations may arise:

- Future donations/corporate Gift Aid: unexpected Corporation Tax liabilities may arise due to insufficient cash and/or distributable reserves to pay up previously generated profits
- Historic donations/corporate Gift Aid: not being able to claim tax relief in respect of a previously made donation (a 'wasted charitable donation') due to insufficient profits.

Insufficient cash and/or distributable reserves

The subsidiary may not have paid its (prior period) taxable profits up to its parent charity, which must be done within nine months of the year end in order to be set against those profits for tax purposes.

It is crucial that the payments are made physically and in cash, not just an accounting entry. There must also be sufficient distributable reserves at the time of the payment.

If the payment is no longer able to be made then a Corporation Tax liability may arise, which would claim 19% of profits.

Wasted donations

Corporate Gift Aid/donations cannot create or increase a tax loss. This situation is more likely to arise where donations are made during the accounting period, as opposed to within nine months (as described above).

As such, wasted donations (where donations exceed taxable profits) could result in future difficulty making sufficient donations to eliminate a tax liability, due to depleted cash and reserves, without the benefit of additional brought forward tax losses.

Possible solutions to explore

For any post year end donation payments, where cash and reserves are still available, consider making planned donations sooner rather than later, to ensure Corporation Tax relief can still be claimed against the previous year's profits.

Alternatively, the subsidiary may wish to defer some, or all, of the donation payment, retaining taxable profits and paying Corporation Tax at 19%. Although this may break from convention, a planned retention of profits might be sensible if a full donation would leave the subsidiary in financial difficulty and the parent charity is unable or unwilling to support the subsidiary (see below).

In respect of excess donations, it may be possible for the charity to repay the excess without any adverse Corporation Tax impact. Alternatively, where possible, consider reducing any planned donations where they have not already been paid.

Whilst the tax considerations of a charity making a repayment largely relate to timing, there may also be legal implications, particularly where a deed of covenant is in place. Legal advice should therefore be sought after if this is to be considered.

Depending on the profit or loss profile of the subsidiary for the current year, there may also be opportunity to consider a claim for carry back of trading losses to the previous 12 month period.

It is important to note that this may still result in cash flow issues, as any Corporation Tax for the earlier period would likely need to be paid prior to the loss carry back claim being made.

In addition to the above, it may also be possible for the charity to make an investment or loan to the subsidiary in order to assist with trading through this difficult period. This can be a complex area and must be considered carefully in order to avoid a Corporation Tax charge for the investing charity.

All of these scenarios may assist with one or more of your own trading subsidiaries' current dilemmas.

Maximising Gift Aid on your charity's donation income

With income from planned fundraising and organised events falling, consider looking at your existing Gift Aid processes to ensure that income is being maximised and opportunities are not being missed.

- Consider when the most recent internal review of processes was made. Are your processes robust enough to withstand HMRC scrutiny and are you missing an opportunity to claim on some sources?
- Is your donor database up to date and have you contacted donors where you do not hold valid Gift Aid declarations to ensure that Gift Aid is maximised wherever possible?
- Where your regular donors have continued giving via subscriptions/membership arrangements, is there now an increased opportunity to claim Gift Aid due to a reduction in value of member benefits received by them?
- Do you have historic donations where Gift Aid claims have not been made to date? Consider making a catch-up claim for qualifying donations made in the past four years.
- If you do not already do so, consider whether the Gift Aid Small Donation Scheme (GASDS) could benefit your charity for small cash donations of less than £30.

Professional Institutes and Membership Bodies

Professional institutes and membership bodies are within the scope of Corporation Tax whether or not they are a registered company. Such bodies often suffer little or no corporation tax on surpluses where they are either not conducting trading activities or trading only with their own members (referred to as 'mutually trading').

The question of whether someone is trading involves a series of case law tests around the so-called 'badges of trade'. This requires careful consideration, but an operation conducted commercially and charging a market price for goods or services is likely to be trading.

The concept of 'mutual trading' is a complicated area with various requirements derived from case law that must be met. This includes requirements for complete identity between those contributing to and benefiting from surpluses and the members being entitled to share in any surplus on a winding up. Mutual trading only applies to trading activities with income from other activities such as rental income, interest and capital gains not covered by the exemption.

A membership organisation that is not taxable on its income from members under the mutual trading principle will normally be taxable on any profits from trading with non-members. Any costs associated with the non-member trading, together with a share of overheads, will need to be allocated on a 'just and reasonable' basis against the non-member income to determine the taxable profits.

An example of this type of organisation would be a members club such as a local sports or recreational club. The membership fee received is generally not taxable due to it either not constituting trading income or being exempt mutual trading income, depending on the level of charge and services provided. The same club selling services to a non-member is, however, taxable trading income.

We are seeing a greater level of HMRC interest on membership organisations where the mutual trading principle is relied upon for Corporation Tax purposes including enquiries surrounding:

- Whether the mutual trading requirements are met by the organisation including checking the constitution is compatible with the requirement for members to control the surplus and be entitled to any surplus upon a winding up
- The income streams and categories of membership the mutual trading principle applies to
- The basis on which expenditure is allocated against taxable trading income and whether this is 'just and reasonable'

It is therefore important that membership organisations are satisfied that the existing basis of tax is robust and any challenge from HMRC can be defended. A written agreement of the basis of taxation with HMRC can provide some comfort and act as a defence against any future challenge. However, this may be open to challenge where relying on a very old agreement, particularly if non-member income has been increasing.

VAT recovery

VAT is recoverable on costs used in making taxable supplies, but not on costs used in making exempt supplies. Organisations which make a mixture of taxable and exempt supplies must therefore apply an apportionment calculation known as a partial exemption method to determine how much VAT they can recover.

The standard apportionment method is by reference to the fraction taxable turnover bares to both taxable and exempt turnover. Ordinarily this calculation is carried out for each VAT return, and then at the end of the VAT year when an annual adjustment is carried out which repeats the calculation for the year as a whole to iron out any seasonal fluctuations such as the receipt of subscription income in one quarter of the year.

It is possible to use the VAT recovery percentage calculated at the end of the VAT year on a provisional basis for all of the quarters in the following year until the next annual adjustment becomes due. What you cannot do is chop and change within a VAT year; you must either use the actual recovery rate calculated on a quarter by quarter basis, or the prior year's recovery rate.

The VAT year is not tied in to a calendar year or your financial year: it is the 12 month period ending in either March, April or May depending on your VAT return stagger. The annual adjustment calculation would be performed and the result declared in either this return, or the following June, July or August return period.

As a result of the COVID-19 pandemic, many organisations will find their income streams disrupted. If you normally calculate your partial exemption position on a quarterly basis, but believe that your taxable turnover in 2020/2021 will decrease relative to your total turnover you might find it helpful to use the 2019/2020 annual VAT recovery percentage for the four return quarters in 2020/2021.

Alternatively, if you think that your exempt turnover in 2020/2021 will decrease relative to your total turnover, then you might decide to use the actual quarterly partial exemption calculations.

An annual adjustment will still be due at the end of the 2020/2021 VAT year, but reviewing your likely income streams and the impact on VAT recovery might give you a cash flow advantage.

We have also written guidance on travel and subsistence, as well as termination payments and other practical employment tax advice. You can find these articles, as well as other useful guidance for charities and not for profit organisations on our ***news and insights page****.*

If you have any questions regarding the above or services for the Professional Institutes or Membership Bodies sector, please do not hesitate to contact **Kathryn Burton** at**kburton@haysmacintyre.com**.

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