



## not for profit | school trading

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### Consideration of the principal legal, tax, VAT and accounting implications of trading activities carried out by schools.

This fact sheet summarises the principal issues concerning schools' trading activities and considers the use of a trading subsidiary company.

Provided that a charity is acting within its powers, charity law allows it to derive income from a wide range of sources. Also, the income of charities is generally considered to be exempt from income and corporation taxes, although it is truer to say that a wide range of measures exist to exempt certain sources of income (e.g. income from land and property, interest, dividends, annual payments and certain lottery income).

A notable exception to the generally relaxed attitudes towards how a charity should be able to raise funds is the area of trading and this can prove to be an issue from the point of view of both charity and tax law.

Most schools supplement their income by fundraising and they also generate further funds through other activities. These are permissible to the extent that they are ancillary to the running of the school; however, when they are carried out on a larger scale and more for the purposes of making a profit, they may jeopardise the school's charitable status and the related tax benefits. It can therefore be important to identify which activities of the school constitute trading.

This is a difficult area as the definition of trading (see below) is nebulous.

*"trade includes every trade, manufacturer, adventure or concern in the nature of a trade".*

In practice, the idea of what constitutes a trade has been built up through case law over a number of years and the position is now generally decided by looking at a number of factors known as the badges of trade. These consist of a list of indications, any one of which might or might not in itself indicate a trade. Generally, the more of these badges that apply to a venture, the more likelihood that it will be considered to be a trade.

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Some examples of badges of trade are:

- Profit seeking motive
- Repetition (although a one off sale might still constitute a trade activity)
- Selling organisation (shop, mail order, internet site, advertising etc)
- Nature of assets and interval between purchase and sale (the longer the interval, the less the likelihood of a trade being involved).

It is common practice for many schools to hive off certain trading activities into a subsidiary company where they might otherwise be at risk of breaching charity law and incurring unnecessary tax liabilities. This is considered in more detail below.

### the position generally

Tax - The trading activities of a school are only exempt from tax if certain conditions are met. These are:

- the profits from the trade are applied for the purposes of the charity; **and, either**
- the trade is carried out in fulfilment of the primary purposes of the charity or is ancillary to these purposes; **or**
- the income from the trade is considered "small" in relation to the other income of the charity; **or**
- the "trade" is carried out to raise funds for the charity and falls within the VAT exemption rules for fundraising events.

The education of pupils in a fee charging school is usually a trade carried out as part of its charitable purpose and so profits are generally exempt from tax. Other trading activities which are ancillary to the primary purpose will also be exempt. Additionally, the small trade exemption allows for a school's non-charitable trading activities to be exempt if the aggregate turnover from all such trades does not exceed the lesser of £50,000 and 25% of the school's gross income.

VAT - Whilst school fees are exempt, other trading income, whether or not part of its charitable objects, may be taxable and, if the turnover exceeds the limit (currently £67,000) the school would need to register for and charge VAT on the trading income which is standard rated.

Charity law – Provided that the activity poses no significant risk to the charity's assets, charity law permits charities to carry out non-primary purpose trading in order to raise funds.

Whether or not the risk to the charity's assets is significant depends on a number of factors, including:

- the size of the charity;
- the nature of the business;
- the expected outgoings;
- turnover projections; and
- the sensitivity of the business profitability to ups and downs in the market.

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The assessment of the significance of the risk involves an element of judgment; however, a lottery or trading that qualifies for the small scale trading exemption would generally be considered not to involve significant risk.

In comparison, VAT-exempt fundraising events do not escape consideration and the Charity Commission strongly advises that events with a significant turnover should be carried out through a subsidiary trading company. They go on to say that in some cases charity law will require this.

### recent direct tax developments

It has in the past been possible for charities to directly engage in significant but low risk trade activities (such as letting surplus accommodation) without incurring a tax liability. This was because the activity generated a profit after direct costs, but the level of overheads resulted in a tax loss. Such losses were not previously treated as non-qualifying expenditure as the overheads:

- would have arisen whether the charity traded or not; and
- were accepted as being incurred for charitable purposes under both charity and tax law.

With effect from 2007/08 for charitable trusts, HM Revenue and Customs (HMRC) have taken advantage of the tax law rewrite project (which is meant to clarify the legislation without changing the law) to classify a loss on non-primary purpose trading as non-charitable expenditure. As a result, tax liabilities are much more likely to arise and trusts in this position should consider whether it would be appropriate to continue the activities, restructure their affairs or, if possible, broaden their objects so as to ensure that more of their trading activities are carried out in fulfilment of the primary purposes.

The position for corporate charities will soon follow suit unless HMRC take on board the objections raised during the consultation process on the latest draft legislation.

### the tax and VAT implications of five activities commonly undertaken by schools are summarised briefly below:

- **Lettings**

Tax - The letting of land and buildings is not taxable unless services such as staffed catering and boarding facilities are included. Similarly, the provision of well-equipped computer rooms with support staff, and all related facilities, could also be seen as trading. Whenever services are provided, it is probably best to err on the side of caution and put such activities through a trading company.

VAT - The letting of land and buildings is exempt unless certain kinds of service are included, e.g. where the significance of the letting lies principally with a supply of catering. Subject to certain conditions, bookings for sporting facilities are exempt. When boarding and catering facilities are provided to non-pupils, this is only exempt if the supply is to another eligible body such as another not-for-profit organisation or one that teaches English as a second language.

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- **School Shop**

Tax - Sales to pupils of school specific uniform and necessary sports equipment, as well as basic toiletries and fresh fruit in boarding schools, is exempt as being ancillary trade. Sales of these items to others, or other items such as standard clothing and school uniform to pupils, will be seen by HM Revenue and Customs (HMRC) as not ancillary to the primary purpose of the school.

VAT - Sales of certain items essential for use in the classroom and school meals will be exempt. School uniforms are not seen as essential and are taxable at the standard rate or the zero rate if they qualify as children's clothing. Sales of all other items, including snacks outside normal school meal times, are treated in the same way as for independent retailers: either standard or zero rated. Confectionery sold from vending machines will be standard rated, whether or not it is sold in the dining room during mealtimes.

- **School Trips**

Tax - Educational trips are not taxable whether the income is received as principal or agent. If the trip is non-educational, such as ski trips, or there are unconnected third parties going on it, any profits would be taxable either as trading, or, as 'other profits or gains', subject to the small trading exemption.

VAT - Educational trips within the UK are exempt. Where the School provides foreign travel or holidays it will fall under the potentially complex Tour Operators Margin Scheme (TOMS). The margin (if any) on trips inside and outside the EU are treated as being subject to VAT at the standard rate and zero rate respectively; so, if such trips make a loss or break even, there is no profit margin that can be subject to VAT.

- **Sponsorship**

Tax - Sponsorship income is not taxable if it is effectively a donation and the sponsor only receives their name printed in acknowledgement. If the references to a sponsor amount to an advertisement then the payment could be trading income and may be taxable.

VAT - The VAT and tax treatment is similar: donations are exempt whilst advertisements are standard rated. However, any sponsorship associated with a one-off fundraising event will also be exempt from VAT. As a "rule of thumb", sponsorship tends to be regarded as an advertisement if the sponsor receives more than a bare acknowledgement of their donation, e.g. if their logo is displayed.

- **Commissions**

Tax - Other income, such as insurance commission, may be taxable as 'other profits or gains', subject to the small trading exemption. Such items can often be agreed to be incidental income of the primary purpose of the trade, depending on their precise nature.

VAT - There is VAT on certain kinds of commission income but insurance commission is generally exempt.

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## subsidiary trading company advantages

Hiving off certain trading activities into a subsidiary trading company has the following advantages:

- enables activities to be carried out which are outside the school's charitable objects and when there would otherwise be a significant risk to the charities assets;
- enables unincorporated schools to use a limited liability company to minimise operating liabilities to trustees;
- avoids corporation tax by gift-aiding the profits to the school
- keeps the school and potentially the subsidiary itself below the VAT registration limit so avoiding VAT and related administration costs; and
- may obtain VAT benefits in certain circumstances.

## subsidiary trading company disadvantages

The disadvantages of using a subsidiary trading company include:

- additional administrative, company secretarial, setting up and annual compliance costs, such as the preparation and filing with Companies House of the returns and accounts;
- additional accountancy requirements arising from the need to be able to identify which expenses should be allocated to the subsidiary;
- the rates relief available to a charity occupying non-domestic premises may be lost;
- the tax and VAT exemptions available to the school for meals and items sold through the school shop may be lost if provided through a subsidiary company;
- the VAT exemption for education and for holiday lettings by the school to another eligible body will be lost if they are routed through the subsidiary; and
- the school's ability to finance the trading subsidiary is restricted unless by way of a loan on commercial interest and repayment terms.

## tax issues

Taxable profits of such companies can be paid out under gift aid to the charity, and providing such a payment is actually made within nine months of the end of the period of account, it should be effective to reduce taxable profits. Great care needs to be taken in funding such subsidiary trading companies, as it is all too easy to make non-qualifying loans, which give rise to taxable income in the charity. Professional advice needs to be sought when setting up such a company, and when it needs funding.

## VAT issues

There may be VAT advantages in using subsidiary companies to change the VAT liability of the activity. It can sometimes be advantageous to carry out a trade which is standard rated for VAT purposes, thus allowing VAT to be reclaimed on expenditure, whereas such an activity might be exempt under the educational exemption if it was carried out by the charity itself. This is attractive where there has been a large capital VAT expenditure such as on buildings, although recent cases have eroded the level of this advantage.

Subsidiary companies can also be used for what one might describe as "VAT avoidance schemes", to use HMRC terminology, where transactions are inserted, and extra companies involved, purely in order to create a high level of VAT reclaim. These plans will need to be considered on their merits, but it should be noted that HMRC has been

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successful recently in shooting down such schemes on the basis that they can be very contrived. The arrangements might also have to be disclosed to HMRC, and should not be entered into lightly.

## accounting

The Charity SORP requires the school's income to be shown gross and distinguished between charitable activities (e.g. school fees and ancillary trading income) and activities from generated funds. This would include trading activities such as lettings (if not ancillary) whether or not they were carried out through a subsidiary company, whose activities are consolidated on a line by line basis. Similarly, the related costs of those activities are disclosed under the heading "Costs of generating funds."

For skiing and other trips and certain insurances where the school is acting as agent (banker) on behalf of the pupils and staff, the transactions should not be treated as income and expenditure of the school. However, where the school is acting as principal, the transactions should be 'grossed up' on the face of the statement of financial activities. Any advance payments received from pupils and/or deposits paid on their behalf would be recorded in creditors and debtors respectively.

If a subsidiary company is used, its income and expenditure, where material, should be consolidated in the school's accounts and should be disclosed in a note to the school's accounts together with the gift aiding of any surplus.

## conclusion

These are complex issues and we recommend that you consult your usual engagement partner or Graham Elliott for VAT advice or Anne Gregory-Jones for advice on other tax matters.

## about haysmacintyre

**haysmacintyre, Chartered Accountants and business advisers, works with over 550 charities and not for profit organisations in the UK and overseas. Our services include the full range of audit, tax, VAT and comprehensive advisory services. Our multi-disciplinary specialist team has extensive sector experience working for a diverse range of charities. We are based in one location which ensures an integrated and comprehensive approach to our clients' requirements.**

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