Technical Release

ICAEW Technical Release

TECH 16/14BL
REVISED

Guidance on donations by a company to its parent charity

(Guidance on the status under company law of charitable donations by a company, formed and registered under the Companies Act 2006 or predecessor legislation, to the company's parent that is a registered charity, issued on 31 October 2014 by ICAEW)

REVISED FEBRUARY 2016 (Paragraphs 1, 6, 7, 12, 13, 21-26, 28-31, 33-34)

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Introduction

1. It has been common practice for companies that are wholly-owned trading subsidiaries of charities to donate all taxable profits to the parent charity and to claim charitable donations relief under Part 6 (s189 et seq) of the Corporation Tax Act 2010, even if, in some cases, the amount donated exceeds the amount of profits available for distribution under the Companies Act 2006. This practice was endorsed by the Charities Commission in section D5 of Guidance Note CC 35 (section D5 was withdrawn in October 2014 but is reproduced at Appendix A to this Technical Release for reference purposes), to the effect that the donation to the parent was not a distribution. Tax relief on the payment meant that no tax was payable by the subsidiary.

2. However, ICAEW understands that the position in CC 35 was being questioned and given the importance of this issue to charities and their advisors and the absence of clear and simple Court precedent, ICAEW has sought Counsels' opinion on the matter. This legal advice has confirmed that the payments in question are distributions and, therefore, to the extent that any payment exceeded profits available for distribution, payment of the excess was unlawful. ICAEW has therefore issued this guidance to minimise the risk of members (and other practitioners) and those who they advise continuing with the practice, but also to give guidance about what charities and their subsidiaries might do to correct the situation.

3. Based on the legal advice referred to above, Appendix B to this Technical Release sets out a set of illustrative but typical facts and the legal position. The main body of this Technical Release sets out the key points and gives guidance on the accounting consequences and steps that may be taken in respect of past payments and in relation to future donations for which tax relief may be sought. This is intended to assist charities that have adopted the approach outlined in paragraph 1 above to address accounting issues that may arise in correcting any past unlawful payments and to provide other practical guidance on certain issues arising.

4. Counsel have confirmed that the guidance is consistent with the law at 30 June 2014. Counsel accept no responsibility (other than to ICAEW) in relation to advice ascribed to them in this guidance. ICAEW is grateful to its Counsel, James Kessler QC and Mary Stokes, who have kindly acted on a pro bono basis in view of the importance of this matter to the charitable sector.

5. Notwithstanding this Technical Release, charities, their subsidiaries and advisors may wish to take legal advice in relation to their specific circumstances, in particular if there is any reason to suppose that the facts differ from those considered here for illustrative purposes.

6. Further to discussions between ICAEW and HMRC, HMRC have issued revised guidance, stating that they would expect the guidance in this Technical Release to be followed by all charities and their subsidiaries for subsidiary accounting periods commencing on or after 1 April 2015. This HMRC guidance can be found here, and an understanding of the key tax issues to be considered in relation to the application of this guidance is included in this Technical Release. However, it is recommended that tax advice is sought in particular where any excess payments, or repayment of previous excess payments are in point.

7. As noted above, the relevant section of CC35 has been withdrawn by the Charity Commission, and new guidance has been issued indicating that they expect compliance with this Technical Release for the first subsidiary accounting period commencing on or after 1 April 2015. This Charity Commission guidance can be found here.

Key points

8. In the illustrative facts considered in this guidance (see Appendix B), the payment by the subsidiary company is a distribution by that company. Although the facts considered are illustrative, they are typical and likely to be widely applicable.

9. To the extent that the amount exceeds the subsidiary company's profits available for distribution, which will often be the case, the excess payment is unlawful.

10. Where the subsidiary company has made unlawful distributions, its parent is liable to repay the excess and those who were directors of the subsidiary at the time of that distribution may be liable in certain circumstances.

11. This liability includes such excess amounts arising over the previous six years.

12. In accordance with the new HMRC guidance, the tax treatment is as follows:

    - A gift aid payment that represents an unlawful distribution is not allowable as a qualifying donation, and
    - A repayment of a previous unlawful distribution is not taxable.

13. The practical application of these rules to unlawful distributions made in previous periods will need to be considered on a case by case basis, although the likely position based on discussions with HMRC is set out in paragraphs 23 to 26 below.

Accounting for the consequences

14. In the illustrative facts considered in this guidance, the parent charity has a liability to repay the unlawful distributions received (subject to time limits), and the company has a right to receive that sum, under s847 Companies Act 2006 (paragraph B22 of Appendix B).

15. The parent charity's liability and the company's asset are not a financial liability and financial asset (respectively), because they arise from operation of law and not from contract (FRS 25.11, FRS 102 Glossary[1]). The recognition of the liability and to some extent the asset are therefore determined by standards addressing provisions and contingencies (FRS 12, FRS 102.21). Under those standards they are not a contingent liability and contingent asset, as there is little if any uncertainty that the amounts are repayable (FRS 12.2, FRS 102 Glossary).

16. Since a reliable estimate can be made of the parent charity's obligation (it is known how much is repayable), then whether it recognises a liability is a question of whether it is probable that an outflow will be required to settle the obligation (FRS 12.14, FRS 102.21.4). It is certain that the full outflow is due immediately. The only reason why there could be any uncertainty about an outflow is that the parent charity might default on its obligation to repay and might not be pursued by the company for non-payment. However, it would be inappropriate for an entity not to recognise a liability on the grounds that the entity itself intends to fail to make payment. Accordingly, the full amount is required to be recognised by the parent charity. This is similar to the outcome were the liability a financial one.

17. With regard to the company's position, accounting standards make provision for non-recognition only of contingent assets (FRS 12.31, FRS 102.13). The company's asset is not contingent. Accordingly it is recognised at cost, being the unlawful payment, subject to write-down for any irrecoverability.

18. The question arises as to whether the liability and asset are recognised in the current year or by way of prior year adjustment for error (FRS 3.7, 29, FRS 102.21). An error needs to be material (FRS 102.10.19) or fundamental (FRS 3.7) to warrant prior year adjustment. Errors are defined as misstatements arising from failure to use known information or information that could reasonably have been expected to have been obtained and taken into account in the preparation of the prior year's accounts (FRS 102.10.19 – though note that FRS 3 did not have a definition).

19. In order to meet this accounting definition of an error in these particular circumstances, it is reasonable to say that the parent charity or the company (as the case may be) would need to have known that the payment amounted to an unlawful distribution and hence that the amount was repayable. In the illustrative facts considered here, the parties did not know of that illegality. Accordingly, the liability and asset would usually be recorded by current year entries and not a prior year adjustment. Charities, companies and their advisors may wish to take their own accounting or other advice on this matter in relation to their specific circumstances.

20. So far as the accounting is concerned, the company's rights against the directors are unlikely to change the company's accounting from that described above. This is because the company can recover the unlawful payments only once. If it is already recognised in full in respect of the parent charity's debt due then there is no need to consider accounting for the rights against directors. (The case may be different if the parent charity is financially unable to repay but the directors are financially able to make up the shortfall – perhaps an unlikely situation.)

[1] These and subsequent references to FRS assume that the trading subsidiary is not applying IFRS.

Overview of tax considerations

21. HMRC have issued specific guidance on the tax treatment of accounting entries that may arise in relation to the application of the matters set out in this Technical Release.

22. This guidance confirms that, to the extent that any gift aid payment is an unlawful distribution in accordance with this Technical Release, the unlawful distribution is not a qualifying charitable donation for the purposes of section 189 Corporation Tax Act 2010. This analysis is primarily based on the view that the unlawful distribution is repayable, as noted above, and the conditions attaching to the tax deduction for donations are therefore not met (section 192 Corporation Tax Act 2010). HMRC have stated that they will apply this analysis to any gift aid payments made in any accounting period commencing on or after 1 April 2015 (the 'commencement period').

23. In relation to any gift aid payments which have been made in prior years, and which are now considered to be unlawful distributions, it will be necessary to consider whether any adjustment will be required to disallow any tax deduction previously claimed.

24. HMRC's new guidance does not deal with this matter, but the likely tax considerations, based on discussions between ICAEW and HMRC, are set out below. In this regard, the period in which the unlawful distribution was made will clearly need to be considered:

- If the relevant period is outside the statutory enquiry window (as defined in Schedule 18 Part IV Finance Act 1998), then HMRC would need to use discovery legislation in order to make adjustments in that period. This legislation can only be used where a matter has not been adequately disclosed to HMRC, and it cannot be used where the return was made in accordance with the practice generally prevailing at the time. On the basis that the claim for the donation was adequately disclosed in the subsidiary company's return, and that the previous treatment was in line with both HMRC and Charity Commission guidance and practice, it is considered unlikely that discovery would be used by HMRC unless there were additional specific circumstances that prompted such an approach.

- If the relevant period is still within the statutory enquiry window, then HMRC are of course entitled to challenge any treatment of donations made in that period by opening an enquiry. HMRC have, in their discussions, reserved the right to open an enquiry into any such period, and the charity will need to consider the likelihood of challenge in periods before the 'commencement period' noted above.

25. Turning to the repayment of prior unlawful distributions, HMRC's guidance states that such repayments do not represent taxable income. This analysis has been reached as a consequence of the general point that unlawful distributions are amounts that are repayable by the charity to the subsidiary. A repayment of an amount owed by a parent to its subsidiary would not be taxable income in the subsidiary under general principles and it would therefore follow that the repayment of that unlawful distribution should not be taxable. It should be noted that HMRC have confirmed that this analysis is not dependent on the tax status of the original payment.

26. On the basis that unlawful distributions are considered to be repayable, as noted above, the potential application of the rules relating to loans to participators has been considered. With regard to a possible liability of the subsidiary company to a charge under section 455 CTA 2010, HMRC has pointed out that the draft Finance Bill 2016 includes an exemption from this charge for loans made on or after 25 November 2015 to charitable trusts that are applied to charitable purposes only.

Practical remediation steps open to a charity and the company in relation to past payments

27. It is sometimes the case that companies that have followed the practice of paying up amounts equal to taxable profits will have amounts owing to the parent charity of a similar amount to that repayable. In such a case the repayment could be settled by agreement to off-set the amounts against each other.

28. If, on the other hand, the company wishes to release the parent charity from its liability to repay the unlawful distribution, then such a release would itself amount to a distribution for company law purposes, and the company would need distributable profits in the amount of the release. It would also be necessary to consider whether the release would give rise to taxable income in the hands of the parent charity (for example, pursuant to section 416 Income Tax (Trading and Other Income) Act 2005). If there were sufficient distributable profits, an alternative way of eliminating the parent charity's liability to repay the unlawful distribution might be for the company to declare a dividend and for the dividend to be set off against the parent charity's liability.

29. If the company does not have sufficient distributable profits then, in the case of a private company limited by shares, share capital or share premium could be reduced (by special resolution supported by a solvency statement pursuant to s641(1)(a) Companies Act 2006) to create realised profits[2]. Alternatively, if there is insufficient capital, or the company is a private company limited by guarantee, but there is a loan from the charity to the subsidiary, then consideration can be given to the charity waiving all or part of that loan, which can also give rise to realised profits. However, in relation to this latter alternative, consideration would need to be given to the tax consequences of such a waiver. The Charity Commission's updated guidance includes a note on the issues that the charity trustees will need to consider to satisfy themselves that the waiver is an acceptable step for the charity to take (eg, in the genuine interests of the charity).

30. It would be possible, under company law, for a parent charity to subscribe for new shares in the company, and then for the company to immediately undertake a capital reduction, so that additional distributable reserves were created. However, HMRC have indicated that they would have concerns over any such arrangements made solely to enable a company to make gift aid payments. It is considered likely that the circular nature of the transactions involved could call into question the deductibility of any gift aid payment made out of reserves created in this manner. Furthermore, any additional investment would need to be carefully considered in the context of the charitable investment guidance, both for tax and charity law purposes. HMRC have indicated that they would expect the charitable investment rules to be considered in detail before this action is taken and would, as a general statement, seek assurance that these rules have been met[3]. A tax charge for the charity could arise if the rules are not met

31. If the company is expected to generate distributable profits in the future, then the company could each year waive an amount of the repayment debt equal to its profits available for distribution and hence progressively waive the debt due. It would be necessary to consider whether the company can claim tax relief for the amount involved. This option would also need to take into account the risk that the reduced level of distributable profits might not be sufficient to cover a subsequent gift aid payment relating to the taxable profits of current or future accounting periods.

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[2] Refer to TECH 02-10 for more details.

[3] For more details refer to Annex iii of HMRC's 'Charities: Detailed guidance notes': https://www.gov.uk/government/publications/charities-detailed-guidance-notes/annex-iii-approved-charitable-investments-and-loans

Steps in relation to future payments

32. Tax relief is available in one year if the relevant payment is paid within nine months of the end of that year. Therefore the company could, in the first nine months of year-two, make a top-up payment out of year-two's profits available for distribution, but for tax purposes it would confer tax relief in year-one. In order to rely on year-two's profits available for distribution it would be necessary for the company to prepare interim accounts under ss836, 838 Companies Act 2006[4]. This is unlikely to be a permanent solution unless the company's distributable and taxable profits are expected to come back into line over a period of a few years.

33. If taxable profits are likely to continue to exceed distributable profits in the future, then a long term solution would need to be found, which could include:

- Restructuring the balance sheet of the subsidiary (e.g. capital reduction, loan waiver etc. already noted above);
- Transferring assets and/or activities to the charity or another subsidiary for market value consideration, on a tax neutral basis.

34. However, the legal, commercial, accounting and tax implications of all of these would need to be considered. There is a risk that the provision of funds to the subsidiary by the parent charity solely for the purpose of facilitating a gift aid payment would be challenged by HMRC. In the absence of any suitable alternatives, the need for the subsidiary to pay tax in the future may need to be accepted.

[4] Refer to TECH 02-10 for more details.

Appendix A

Extracts from Charity Commission's Guidance CC35 (withdrawn in October 2014)

'D5. Can a trading subsidiary pay more to its parent charity in Gift Aid than the level of trading profits (in accounting terms) which it has earned?

The short answer

Yes. This issue will generally arise when the trading subsidiary's level of trading profits for tax purposes is greater than its level of profits for accounting purposes. Any tax liability will depend on the level of taxable profits. If that liability is to be eliminated entirely, the whole of the taxable profits will have to be paid to the charity, even if that is greater than the profits for accounting purposes. The balance will, in most cases, need to be financed out of share capital, since the trading subsidiary is otherwise likely to be insolvent.

In more detail

If a trading subsidiary earns, in an accounting period, taxable profits in excess of its profits for accounting purposes, it may pay to its parent charity a greater sum in Gift Aid than it has profits for accounting purposes, in order to eliminate its corporation tax liability. As a result, all or part of the Gift Aid payment may be made out of the company's subscribed share capital, including any share premium account. Although there are differences of legal opinion on this issue, it is considered that such Gift Aid payments may be made out of the trading subsidiary's subscribed share capital, provided that the objects of the trading subsidiary authorise such gifts. The parent charity can, by subscribing additional share capital in the trading subsidiary, enable the subsidiary to do this, without making the subsidiary insolvent. It is possible that the trading subsidiary may prefer to acquire the resources needed to make the full Gift Aid payment out of funds borrowed from the parent charity. However HMRC Charities take a critical view of any apparently circular arrangements. Parent charities and their trading subsidiaries contemplating such a course of action should take professional advice, and take into account the investment propriety and insolvency issues discussed in D8.'

Appendix B

Legal context

General Background

B1. It is often the case that a charity has a non-charitable, wholly-owned trading subsidiary, for example selling charity-branded merchandise. The subsidiary is liable to corporation tax. However, a tax deduction is available to any company for donations to charities (if the conditions for relief are met). The donation may be made at any time within nine months of the year-end and be carried back into the tax computation for that previous year.

B2. It is therefore desirable on the part of such a company and its parent charity that, during the year or after each year-end, the company makes a charitable donation in the amount of the whole of what would otherwise be its taxable profits for that year. It is common practice for such companies to make the gift to its parent charity. In this way the subsidiary company pays no tax and instead its entire resources are available, undiminished, to the charity.

B3. In such circumstances the company's donation has sometimes exceeded its profits available for distribution under Part 23 of the Companies Act 2006. This is because:

- The donation is set at the amount of taxable profits.
- Taxable profits may exceed accounting profits for various reasons. For example, some expenses are disallowable for tax. As another example, adverse timing differences arise, such as in relation to defined benefit pension contributions, which are tax relieved on payment but which may be expensed for accounting purposes much earlier on.
- Profits available for distribution are based on, albeit that they are not necessarily identical to, the accumulated accounting profits[5].

B4. The question arises as to whether such a company's donations to its charitable parent are distributions for company law purposes. If so, then such donations in excess of profits available for distribution would be unlawful.

B5. The Charities Commission has taken the view that it was lawful for such a company to make charitable donations to its parent in excess of its profits available for distribution: see the Charities Commission's guidance note CC35, section D5 (now withdrawn but reproduced in the Appendix A to this technical release for reference purposes). However, the guidance notes that there are differences of legal opinion on the issue and the guidance does not address all the matters considered here.

Scope and illustrative facts

B6. This guidance is written in terms of a private company limited by shares, but applies to one limited by guarantee or to a public company or even to an unlimited company.[6] It addresses donations whether or not eligible for charitable donations relief.

B7. The Courts have not articulated any clear and straightforward test as to the meaning of 'distribution' in this context. Any individual case will turn on the particular facts of that case. This guidance assumes the following facts for the purpose of illustration:

- The company's directors have decided on a practice of making payments to its parent charity in the amount of the company's taxable profits.

[5] There are various rules for adjusting the accounting profits to arrive at the profits available for distribution, but they are not of practical concern here. Refer to TECH 02-10 for a fuller description of such matters.

[6] Note that there are important differences between these different sorts of companies, which are of significance in relation to the possible practical remediation steps and in relation to future payments addressed at paragraphs 18-23 of the main body of this Technical Release.

- They are aware on each occasion of making such a payment that it exceeds the amount available for distribution by the company under Part 23 of the Companies Act 2006.
- In relation to distributions made prior to any withdrawal of Charity Commission guidance note CC35 section D5, the company's directors were aware of that guidance and considered that it acknowledged that the payment practice was a reasonable one under the law. They were also aware that such a practice was common among trading subsidiaries of charities in such circumstances.
- The trustees of the parent charity (or the directors of the parent charity, if it is a company) were also aware of all of the above.

The question of distribution

Statutory definition

B8. S829 of the Companies Act 2006 defines distribution as 'every description of distribution of a company's assets to its members, whether in cash or otherwise,' with certain exceptions that are not relevant here.

Case law

B9. There is also a common law rule that restricts a company limited by shares from returning capital to its members. The case law on distributions relates generally to the identification of a distribution for the purpose of the common law rule rather than the statutory rule. However, there is no reason why the same authorities should not apply for the purpose of the statutory definition. Indeed, it has been assumed in some of the cases dealing with the statutory definition that this is the case.

B10. The state of the case law is that:

- The label attached to the transaction is not decisive. Whether it is a distribution is a matter of substance and not form. It is for the Court to characterise the transaction as either a distribution or not.
- If a transaction involves a transfer for an inadequate consideration, the Court's task will be to inquire into the true purpose and substance (or essence) of the transaction, which will involve an investigation of all the relevant facts.
- The state of mind of the directors will sometimes be irrelevant to the Court's determination, but, conversely, sometimes their subjective intentions will be relevant. It is likely that the Court's inquiry will ask whether the transaction is entered into because the other party is a member.

The gift

B11. In the matter in hand the company makes what it thinks of as a gift, described as a gift. So it is not necessary to look to the cases that deal with transactions which are presented as commercial ones, but where it is alleged there is a gratuitous element, because the gift in question is necessarily a gratuitous transfer.

To a member

B12. The gratuitous transfer is in fact made to a person that is a member of the company – ie, its parent charity. However, is it entered into by the company because the other party is a shareholder (referred to here for convenience as a 'company-shareholder' transaction)?

B13. It is possible to envisage situations where the gift to a charity may not be characterised as a company-shareholder transaction, even if the charity is a shareholder in the company. For instance, the directors of a company with widely held shares may not be aware that the charity is one of its shareholders; or the directors may be aware, but the gift may have nothing to do with the charity being a shareholder, for instance if the company makes gifts to a number of charities and there were reasons why a gift to this particular charity was made, independently of its status as a shareholder.

B14. However, where, as in the illustrative facts addressed in this guidance, the company has been established as a wholly-owned trading subsidiary that habitually pays all its taxable profits to its charitable parent, the only plausible reason or explanation for the gift will typically be the company-shareholder relationship. This is so even if the directors of the company contend that the explanation for the gift is the desire to make a gift to charity.

B15. This does, of course, lead to an apparent anomaly: a gift by a company to a person, including a charity, that is not a member would not be caught by the rules on distributions; yet this particular gift is caught by those rules and so is liable to be unlawful. However, any other conclusion would permit trading subsidiaries of a charitable parent to ignore the statutory and common law rules for the maintenance of capital, which were intended to protect creditors. That cannot have been intended.

Relationship with tax law

B16. The Corporation Tax Act 2010[7] provides that a payment (other than a dividend) made by a company which is wholly owned by a charity is not to be regarded as a distribution for relevant purposes and that Act permits relevant donations to be deducted for tax purposes. However, this does not affect the analysis in respect of the company law on distributions one way or another.

It is a distribution

B17. In the illustrative facts described in this guidance, the donation by a company to its parent charity is, therefore, a distribution of the company's assets to a member. It is a distribution as defined in s829. Accordingly, the rest of Part 23 of the Companies Act 2006 applies to that donation.

B18. This is the case irrespective of any explicit object clause in the company's constitution. A company cannot give itself power by its constitution to do something that is prohibited by statute. Were this not to be the case, any company could circumvent the statutory code by including in its articles an object to make distributions to members unconstrained by the rules on distributions.

B19. It is also the case even if the only creditor of the company happens to be the parent charity. The underlying objective of the statutory provision (and the common law rule) is to protect creditors by ensuring that the company's capital is not diminished by distributions. These rules on distributions are applied generally and do not alter depending upon whether there are any creditors at any given time or who they might be.

B20. It is not the role of this guidance to describe the application of Part 23 for the control of distributions, but, put briefly, the distribution would be unlawful where it exceeds the company's profits available for distribution as shown in its relevant accounts (usually the last annual accounts circulated to members)[8].

Consequences of past unlawful distributions

Right of the subsidiary against the parent charity

B21. In the illustrative facts addressed by this guidance, the charitable parent would be liable to repay the unlawful distribution to the company under s847 of the Companies Act 2006.

B22. Under that section, if the charity knows or has reasonable grounds for believing that a distribution made by the trading subsidiary was an unlawful distribution, it is liable to repay the distribution (or that part of it that was unlawful). The test of knowledge relates to the facts that constituted contravention, rather than knowledge of the legal restriction. Accordingly, if the charity knew or had reasonable grounds for believing that the subsidiary had paid to the charity profits in excess of those available for distribution, the obligation to repay will arise. The obligation arises without further formality; it is not necessary for the company to take action against the charity. Claims would be time-barred after six years from the date on which the cause of action accrued (absent fraud).

B23. The company may have other causes of action against the charity to recover these amounts, for example under principles of 'mistake' or 'knowing or unconscionable receipt' (under which the charity would be a constructive trustee for the payments received). This guidance does not address those matters as the most significant practical consequence is that under s847 described above.

B24. Once the payments have been repaid, the causes of action will fall away.

Rights of the company against its directors

B25. A director who authorises the payment of an unlawful distribution, being a misapplication of company assets, may be in breach of his duties (as, in effect, a fiduciary or trustee of the assets) and so may be personally liable to repay the company to the extent the relevant amounts are not repaid by the charity. It is not clear from the case law as to whether or not this is a strict liability to repay (ie, it is not necessary to prove fault on the part of the director) or subject to the test that the director knew or ought to have known that the payment was a

7 S194 thereof
8 Refer to TECH 02-10 for a fuller description of such matters.

misapplication. In the illustrative facts considered here, it is likely that the director would have the requisite knowledge.

B26. If, however, the director acted honestly and reasonably, the court has discretion to relieve the director of liability if it concludes that in all the circumstances he ought fairly to be excused under s1167 of the Companies Act 2006. Even in the illustrative facts addressed here, and assuming that the director acted honestly, it is difficult to give clear guidance as to whether a director would be granted relief as this will depend on all the facts. However, it is thought that the director would have a very strong argument that he had acted reasonably. Claims by the company against the directors would be time-barred after the lapse of six years from when the cause of action accrued (absent fraud).

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