July 2019

Pulse – Deloitte's Charities and Not for Profit Group Newsletter

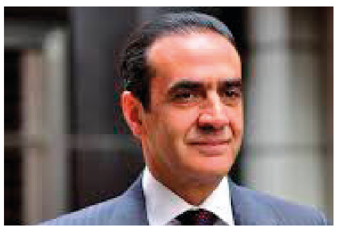
Welcome to the new edition of PULSE.

In this edition, we cover the topical issues facing the sector at the moment. Reserves have been under scrutiny for a while now, particularly after the fall of Kids Company – so we have an article on this subject. There are also new rules affecting taxation of charities; IR35 changes are particularly important so note the article on this development. As ever, we have a great article from our legal colleagues; this time on why charities have/should have trading subsidiaries.

Thanks for reading!

Please note that the views expressed in this publication are those of the authors and not of Deloitte. In the complicated environment in which we all operate, always seek professional advice specifically and don't rely on contents of articles that have been written for general guidance only.

Reza Motazedi



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Do you still need your trading subsidiary?

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It is important that the Board of Trustees take time to consider this question, particularly in light of recent changes to the small trading (de minimis) exemption.

While charities can trade relatively freely in pursuit of their charitable purposes (known as primary purpose trading), there are restrictions on a charity's ability to trade simply for the purpose of raising funds for the charity (non-primary purpose trading).

Non-primary purpose trading can include; (amongst other things) charity Christmas cards, the acceptance of sponsorship providing advertising benefits to the sponsor, sale of merchandise, and cause related marketing activity.

Previous limits meant that a charity with an annual total income of under £20,000 could trade up to a maximum trading income of £5,000. Those with a total annual income between £20,001 and £200,000 could have a non-primary purpose trading income of 25% of their charity's annual turnover and those with annual incomes over £200,000 could trade up to a maximum of £50,000 without incurring corporation or income tax on their trading income.

The change to the exemption which was introduced in the 2018 budget, but only came into force in April 2019, means that those charities with an annual total income of up to £32,000 can now trade up to a maximum of £8,000, those with incomes between £32,000 and £320,000 can have a non-primary purpose trading income of 25% of their annual turnover and those with a total annual income over £320,000 can trade up to a value of £80,000.

The increase in the small trading exemption limits for charities that apply to non-primary purpose trading activity have led some charities to question whether their trading subsidiary is still necessary, or whether the costs of running it outweigh the benefit.

Benefits

If you are thinking of ditching your subsidiary it is worth considering the following:

- Consider restrictions in your governing document – the change in the small trading threshold does not give you the ability to trade through your charity if your charity's governing document prohibits trading activity.
- Although you may start the year thinking your trading income will be modest and within the small trade exemption, a transformative deal e.g. an unexpected cause related marketing or sponsorship deal could suddenly mean that you need to divert that trade through your subsidiary. There has been an increase in corporates trying to raise their profile and CSR credentials by entering into these commercial deals with charities.
- A trading subsidiary is a good way to ring fence risk, and it may even be prudent from time to time to run primary purpose activity through a subsidiary for this purpose.
- Trading subsidiaries are a useful vehicle for licensing your charity's name and logo to third parties and for arrangements where it is not 100% clear whether or not HMRC would view the activity as trading activity.
- It may be better to run your trading activity though your trading subsidiary for VAT purposes, as trading subsidiaries may be better placed than the charity to reclaim VAT.
- Your trading subsidiary can be left dormant rather than removed from the register of companies and this may be worth thinking about in case it is needed in the future to avoid future set up costs if a trading subsidiary is later required.

Charities which are concerned about their trading activity or potential direct tax liabilities and are not sure whether or not they require a trading subsidiary should seek specialist help. Additional trading exemptions may also apply depending on the trading activity being carried out. HMRC's guidance for charities on this topic has been recently updated and can be found at **https://www.gov.uk/guidance/charities-and-trading**

Risks

As with all things there is never just one side to the story and charities should also consider the latest guidance from the Charity Commission on connections with a non-charity which includes a helpful checklist to support Charity trustees in analysing the risks and benefits of their relationship with a subsidiary that can be found at **https://www.gov.uk/guidance/guidance-for-charities-with-a-connection-to-a-non-charity**

IR35 – What does it mean for you?

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The new off-payroll workers legislation in the private sector will come into effect from April 2020. Whilst draft legislation is not expected to be published until late-2019, it is widely expected that these rules will mirror those already in place for the public sector.

The new rules mean that where you pay an off-payroll worker, you are likely to have an obligation to undertake an employment status assessment and may need to pay the individual via a payroll.

These changes represent a significant increase in compliance responsibilities and ultimately risk for organisations. Failure to comply with this legislation could result in you being liable for any underpaid PAYE, National Insurance, penalties and interest.

An off-payroll worker, as it suggests, is anyone paid outside or off the payroll. This can include (but is not limited to) consultants, senior advisors, interim appointments, volunteers, agency workers, IT workers, workers on projects and cleaners.

Small entities exemption
This legislation may not apply to a significant number within the not for profit sector where they are classed as medium or small entities and meet two of the following three tests:

- annual turnover must be not more than £10.2 million;
- the balance sheet total must be not more than £5.1 million;
- the average number of employees must be not more than 50.

Therefore if you currently don't meet two of the above you may be exempt from this legislation.

Requirements if the legislation does apply

For those not for profit entities who must apply this legislation, there will be a requirement to identify who in your organisation is an off-payroll worker whether provided directly or indirectly by an intermediary (often, but not limited to, a Personal Service Company). This can include those provided via agencies or third parties so you will need to gain an understanding of your contractual chains. In addition it may include some workers considered to be volunteers if they are paid for the services they provide.

In addition to identifying these workers you will also be required to consider if they provide an outsourced service and, if not, whether they would be considered a deemed employee. Both of these questions are open to interpretation so it will be important to retain evidence to support the conclusions you reach.

HMRC tool to assess employment status

HMRC have provided a tool (Check Employment Status for Tax or CEST) to aid you identify if someone is a deemed employee and have confirmed they will be bound by the conclusion, if they agree with the answers provided. However within the Public Sector, where the rules were introduced in April 2017, there have been several situations where HMRC have challenged the CEST findings as they disagree with the answers provided by the Public Body.

There have been concerns raised over the CEST and, as such, we understand HMRC are considering revising it in advance of April 2020.

Process

You will be required to design a process which allows you to:

- identify off-payroll workers provided directly or indirectly via intermediaries;
- assess if the service provided is an outsourced service or personal service;
- assess whether the off-payroll worker is a deemed employee.

In addition evidence of how you have reached your conclusions will be required to provide support should you be challenged by HMRC or the off-payroll worker.

Communication

Communication will also be key as off-payroll workers are often found at all grades within not for profit organisations. Having assessed whether this legislation applies a communications programme will be required to minimise any distress to the worker but also to ensure that the outcome does not impact on your ability to perform your day to operations.

It is currently proposed that a dispute resolution process is also put in place should the off-payroll worker disagree with the conclusion reached. This will require additional on-going communication with the off-payroll workers after this legislation is introduced.

Final Thoughts

For those not for profit organisations not excluded from this legislation this has the potential to create administrative, financial and operational issues. The impact of this legislation will depend on how many off-payroll workers you engage with. Therefore the first step is to identify them in order to establish the size of the potential task.

Whilst April 2020 seems some way off, there is a significant degree of work required to prepare for the introduction of this new legislation. We therefore strongly recommend not for profit organisations identify if this will apply to them and, if it does, that they prepare for it as soon as possible.

Reserves and sustainable delivery

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The importance of managing your reserves is not in question, failures such as Kids Company have clearly demonstrated the need to build and maintain reserves. However, for all charities there remains a tension between helping beneficiaries now and managing for the future.

The trustees' annual report should include a statement of the policy on reserves stating the level of reserves held and why they are held. If the charity has no policy it should explain why it has no policy.

With that in mind and feeling that there was a lack of transparency around the reserves held and the basis for the calculations, the Charity Commission published a review of 106 accounts submissions.[1] The review showed that while 97% of the charities sampled included at least a reference to their reserves policy in the trustees' annual report only 64% of charities included all of the following: the policy on reserves; stated the level of reserves held; and stated why reserves were held.

[1] The sample was from charities with an income of more than £500,000 covering accounting years ending during the twelve months to 31 December 2016.

The Charity Commission also considered whether the reserves figure was in line with the guidance included in **Charity reserves: building resilience (CC19)** which sets out a process for calculating the level of reserves. Results showed that only 22% of the charities sampled disclosed a reserves figure in accordance with the guidance and 33% of the sample did not state a reserves figure at all.

The SORP sets out how reserves should be explained. The review of the charity's reserves should (but not must):

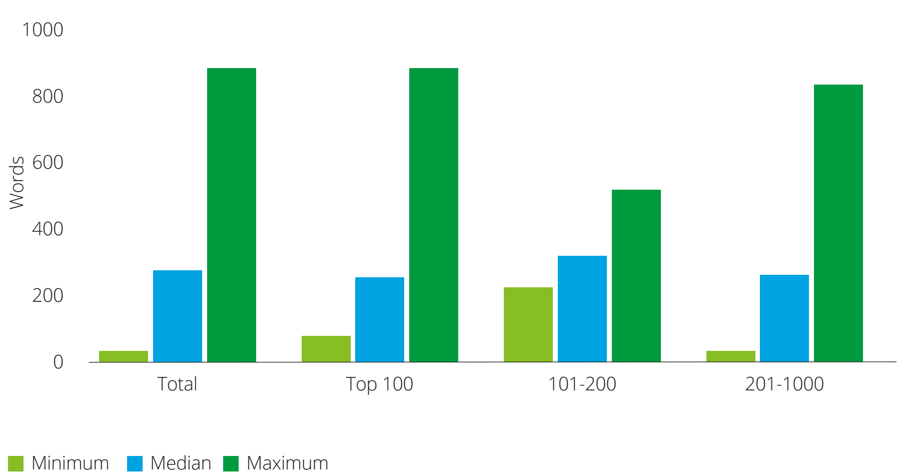
- state the amount of the total funds the charity holds at the end of the reporting period;
- identify the amount of any funds which are restricted and not available for general purposes of the charity at the end of the reporting period;
- identify and explain any material amounts which have been designated or otherwise committed as at the end of the reporting period;
- indicate the likely timing of the expenditure of any material amounts designated or otherwise committed at the end of the reporting period;
- identify the amount of any fund that can only be realised by disposing of tangible fixed assets or programme related investments;
- state the amount of reserves the charity holds at the end of the reporting period after making allowance for any restricted funds, and the amount of designations, commitments (not provided for as a liability in the accounts) or the carrying amount of functional assets which the charity considers to represent a commitment of the reserves they hold; and
- compare the amount of reserves with the charity's reserves policy and explain, where relevant, what steps it is taking to bring the amount of reserves it holds into line with the level of reserves identified by the trustees as appropriate given their plans for the future activities of the charity.[2]

How charities are currently reporting

In our survey of trustees' reports[3] , we also reviewed the reserves policy included as part of the financial review. All charities sampled in our survey included a section on the reserves policy although the usefulness of this section varied considerably.

In terms of the length of the section, the median length of the statement was 275 (2017: 270) words. The longest statement was 884 (2017: 720) words and the shortest was 33 (2017: 30) words.

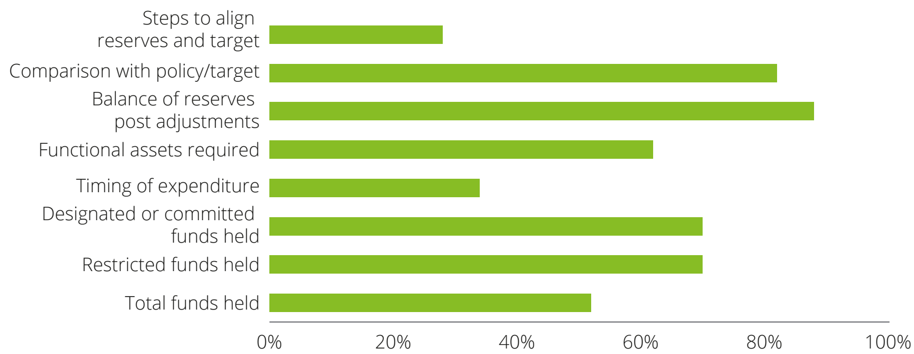
Length of the reserves policy



[2] FRS 102 SORP 1.48

[3] The sample was from the top 1000 charities by income, with 10 from the top 100, 10, from 101-200 and 30 from 201-1000 covering accounting years ending in the period from 30 September 2017 to 31 March 2018.

Amount of detail included in the reserves policy (%)



The chart above illustrates how the charities in our sample responded to the SORP requirements.

The charities in the Top 100 group typically gave more detail arriving at their level of available general reserves or 'free' reserves, called 'reserves post adjustment' here. Although less than 35% of the charities surveyed gave details about the timing of expenditure, almost 70% talked about designated reserves.

Many charities jumped straight to an adjusted figure of available reserves effectively leaving the reader of the accounts to work out how the figure was derived using the notes rather than repeating or walking the reader through the process. An issue which was identified by the Charity Commission review.

82% of charities surveyed compared their reserves with a target and although 52% of charities clearly stated that they did not meet or exceed their targets, only 23% gave further detail about how targets and reserves would be brought in line. A number of charities stated in the current uncertainty they were satisfied that reserves targets were exceeded, however this does question whether the reserves target had the confidence of the trustees to start with.

59% (2017: 53%) of those stating a target included their target in terms of period of months of operating expenditure and 41% (2017: 47%) in terms of an absolute monetary amount.

12% of charities gave no target but half of those charities still made a comment that their reserves were considered at satisfactory levels.

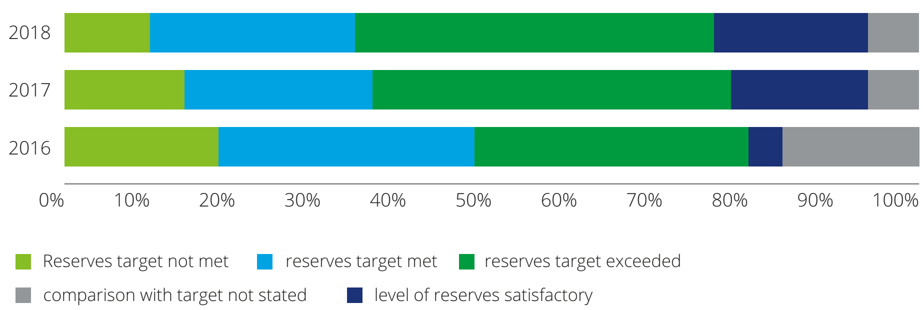
There is not a one size fits all approach available for reserves and each charity will need to decide the target, monitoring and reporting most suitable for its circumstances. This may mean setting a monetary target or a number of months; having some or no designated funds; describing clear commitments or none.

Reserves and targets should be subject to regular review so that they continue to be fit for purpose.

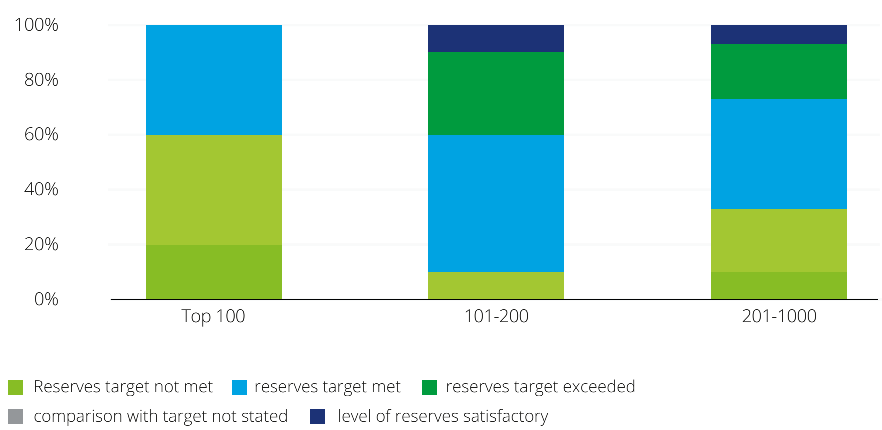
The results reported

Over time it can be seen that charities surveyed have given more information on reserves and there has been a consistent decrease in charities not meeting their reserve targets. The figures below look at the results over time and then for this year of the survey by sample banding.

Level of reserves against target (%)



Level of reserves against target by group (%)

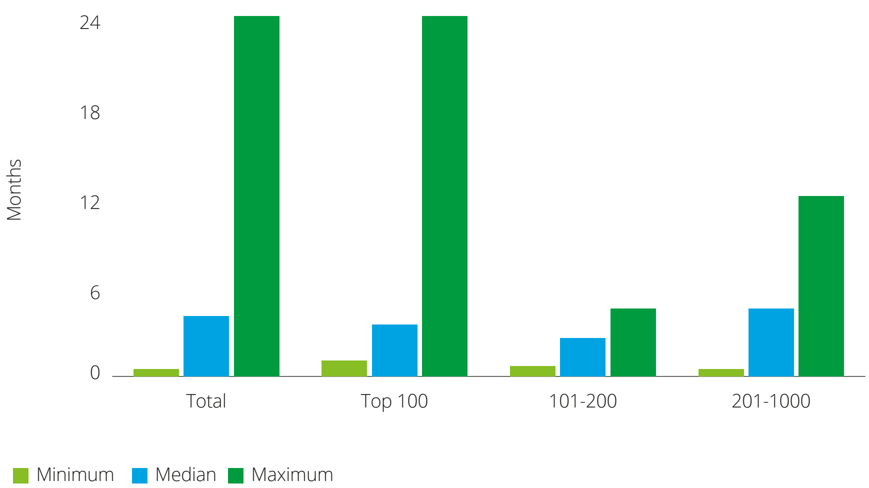


All charities in the top 100 of our sample discussed their reserves against targets. The 101-200 group has the lowest number of charities disclosing unmet targets but the highest percentage of targets not disclosed.

Although targets varied from cash amounts to months of expenditure we have approximated all targets given to months of total expenditure to allow comparison of those charities giving targets.

From the survey it was noted that a higher number of charities in the top 100 were stating targets in absolute monetary amounts than those in other groups.

Targets for reserves (months of total expenditure)



72% of the charities sampled had targets of 6 months or less of their total unrestricted expenditure. The median target was 4 months (2017: 4 months). The greatest target 24 months of expenditure and the smallest three weeks of expenditure also unchanged from the prior year.

What should charities be doing?

It is important that reserves are kept under review; policies and decisions are expected to change and align with the charity's strategic planning. Therefore, at the next review, charity trustees should challenge themselves and management to make sure their reserves policy reflects the charity's strategic priorities, its budgeting and risk management processes.

A charity that gives grants and has a secure, regular source of funding is by its nature going to have a different reserves policy to a charity that employs significant number of staff and relies on donations and legacies as its main sources of income. Therefore each charity needs to consider its unique circumstance and the greater or lesser impact of each of the considerations shown in the diagram upon the policy and the reserves target.

Two key elements of a reserves policy are:

- to ensure it is connected to the strategic aims of the charity; and
- to ensure it is reviewed on a regular basis, at least once a year.

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