www.pwc.co.uk

Charity News
The sector responding to challenge

May 2014

In this issue:

- Managing in the new normal
- FRS102 and Charity SORP technical changes
- VAT and Tax updates

Contents

Ian Oakley Smith
tel: 020 7212 6023
email: ian.oakley-smith@uk.pwc.com

Welcome to our new Head of Charities...

I am delighted to be taking up a role as PwC Head of Charities at what continues to be a very important time for our charity clients. As our latest 'Managing in the New Normal' report (page 5) suggests, many charities are starting to feel cautiously optimistic about the future, but most remain fully aware that they continue to operate in a very demanding environment. These demands are, in our experience, increasingly leading to charities looking to ensure that they have the most appropriate internal resources and the best external advisers.

In particular, the sector is experiencing increasing scrutiny from the media and the general public. Many commentators agree that this scrutiny is set to continue and I think it is likely that it will drive different behaviours as it will cause some charities to examine their strategy and activities through a new lens. Again, the role of independent advisers and 'critical friends' will become more and more important as charities seek to understand what changes this will bring.

In that context, I am very fortunate to inherit a large and very broad client base and a very strong and committed team. In our last full financial year, we worked with over 400 charity clients, delivering a wide range of services. Liz Hazell describes on page 2 how our strategy has developed over the last few years and my plan is to make the most of the experience of our team, together with the relationships we have with our clients and more widely in the sector, to support our clients whatever their specific needs.

In order to provide the most valuable support, it is right that we should focus on some of our advisory and consulting work, whether that be in the areas of tax, internal audit, operational consulting, strategy consulting, reserves and scenario planning or a wealth of other services. We already have a long list of external audit clients and will continue to work hard to deliver the best possible service to those.

I wish to take this opportunity to thank Liz Hazell for her achievements as Head of Charities and of course to wish her every success going forward. For my part, I am very much looking forward to working with our clients and my colleagues in order to ensure that PwC plays as active a part as possible in helping our clients achieve their goals this year and beyond.

Ian Oakley Smith is a Chartered Accountant and Licensed Insolvency Practitioner with some eighteen years' experience in the not-for-profit sector, working with a broad range of charities, from those operating at a deficit or in financial difficulty to those seeking to manage their risks to remain robust and sustainable. Ian's work often involves the need for a clear understanding of the impact of a charity's activities in order to understand the strategic options available and how to assess those options.

Ian is a member of the Committee of the Institute of Chartered Accountants in England & Wales Charities and Voluntary Sector Special Interest Group and the Audit & Governance Committee of The Lord's Taverners, a charity supporting disadvantaged young people.

Ian has collaborated with Charity Finance Group and Institute of Fundraising to write seven reports entitled 'Managing in a Downturn/ Managing in the New Normal', issued between December 2008 and April 2014. He has also co-written a book, published by the Directory of Social Change in September 2009, entitled 'Managing in a Downturn: Staying Solvent and Surviving Well'.

Ian Oakley Smith
Head of Charities

Liz Hazell
Outgoing Head of Charities
tel: 020 7804 1235
email: liz.m.hazell@uk.pwc.com

...and a farewell message from his predecessor

Time for reflections...

Some six years ago I was appointed Head of Charities, a national role that reaches across all our services to charity clients (but not the Community Affairs/CSR aspects that are a separate PwC team), with a remit to develop and deliver a strategy building on the foundations laid by my predecessors. What a long way we've come since then...

As a very large professional services firm we couldn't get away from the fact that we were not going to be the best fit for all charities. We have refocused and built our reputation in the sector on the back of the more traditional audit side typically working with the larger or more complex charities, and helping them to be role models for example in transparency of reporting. The 2005 SORP was a catalyst to work with our clients to get the messaging clearer, recognised by a number of clients winning awards for their reporting, including Cancer Research UK, Oxfam, The National Trust, WaterAid and many more. We too consistently achieved the number two slot we sought in the Charity Finance annual auditors survey.

Having consolidated our reputation on the audit side (we now provide external or internal audit to over 40 of the top 200 charities), we refocused on the breadth of other things that PwC does for its clients. Many of you will have heard me talk of what we've termed Social Purpose Organisations (SPOs) – those entities, including charities, social enterprises, mutuals etc., that are driven by a social purpose rather than just profit. Our work across charities and the broader SPOs has helped shape the sector such as Scope's social investment bond, mergers at The Prince's Trust and RNIB, and the restructuring that established Lloyds Register Foundation.

The range of services that we provide has always included tax, VAT, governance, strategy and risk management, business recovery and insolvency; but the boundaries have been pushed forward in new areas too, such as social impact measurement and reporting, and some significant operational restructuring with charities to help them deliver their services to beneficiaries more effectively and more efficiently.

Our core team is now broader and stronger than ever and is constantly being boosted by a highly-motivated new generation who see SPOs and the not-for-profit sector as personal priorities.

I could go on, but I shall soon be laying down my PwC pen… In July I leave PwC after 26 years and will be joining Saffery Champness' charities team in October. Change is important for us all; this move gives me new challenges in a partnership which is complementary in many ways to PwC and the charity business we've built up here.

We would be nothing without you, our clients (past, present and future) – my thanks to all of you for engaging us, for developing long-lasting and highly valued working relationships with us and for the achievements and fun we've had along the way.

I'm delighted that Ian Oakley Smith has been appointed as the new PwC Head of Charities. On the previous page you will see that he has the skills and experience to lead PwC forward in the next phase; we've worked together for many years and I have every confidence that he will be a great success with you all. The last six years has seen significant change in the economy, the sector and within PwC's Charities Team as we respond to those changes; a constant throughout has been PwC's commitment to Doing the Right Thing – for our clients, our people and our communities. It's been at the heart for me – thank you for the opportunities to really live 'Doing the Right Thing'.

Steph Mustoe

tel: 0117 928 1025
email: steph.mustoe@uk.pwc.com

My Financepartner

How can charities make the most of financial information to grow and maximise their impact?

As the economy returns to better times, we believe that quality financial information is essential for the growth and direction of any successful organisation. We have witnessed throughout the recent recession, that many charities have survived and grown because of the benefits of having and using quality management information, whilst others have paid a high price through its absence. This is illustrated further on page 5 by the results of our latest 'Managing in a Downturn' survey.

No matter what size you are, having a route map, a plan to grow, and provide real value from the activities, is really important. There are three key elements to consider:

- Where are you now? – your current financial position and activities;
- Where you want to go? – a forecast over one to five years, with the main activities to drive that forecast; and
- How are you going to get there? – an income and expenditure budget alongside an operational plan.

Regular monitoring of your actual results compared to this plan is the core responsibility of your trustees. 'The essential trustee – what you need to know '(CC33) requires that 'the trustees of every charity must ensure that its finances are used appropriately, prudently, lawfully and in accordance with its objects.'

We frequently see cases where information is not provided on a timely enough basis to allow trustees to perform their duties as effectively as they should. In these cases, the people that ultimately lose out are the charity's beneficiaries.

The Charity Commission website includes a list of 15 questions that all trustees need to be asking, specifically with the backdrop of the recent economic environment; and these include questions around both strategy, including opportunities and risks, and financial health. Areas for consideration on the CC website include:

- What is the impact of the economic climate on the environment in which we operate?
- What do we see in the future?
- Do we have up to date financial information about the charity's finances, cash flow and debts/ obligations?
- Are we clear about the prospects for the longer term?
- Can we make our money go further?

In order to be able to monitor your activities, understand your financial position, make sound judgements on how to distribute income and reserves, trustees and the charity employees need accurate and timely management information. This is particularly relevant for a charity that might have a variety of sources of restricted income and reporting requirements, not only to the trustees but to a variety of other stakeholders – funders, beneficiaries, volunteers and the Charity Commission.

Quality management information can help you to grow, decide the best direction for your charity and look forward to how you'll deliver your strategy to maximise the impact for your beneficiaries. Trustees should expect at least the following:

- Timely and accurate financial information;
- Insight from your current data to help you plan for the future;
- Value from your finance team to allow it to support and drive growth and delivery of your objects;
- Value for money on professional fees;
- Confidence in the information produced (and your stakeholders need to be too); and
- The ability to meet compliance regulations in a timely and cost effective manner.

Improved financial, and non-financial, reporting enables charities to be more transparent and accountable to a variety of stakeholders.

PwC have a lot of experience delivering this type of information and service for larger organisations with concepts of shared services and cloud computing. Our new My Financepartner service has been developed using all of that learning and tailored using our growing business and charity experience to fit the charity sector. My Financepartner is a service from PwC specifically aimed at smaller and medium sized charities to enable them to grow and show value to the communities and people they support.

Our My Financepartner service is made up of four elements:

- A local experienced accountant who will regularly meet with you to provide insight, challenge and understand your charity to help you grow confidently;
- A full suite of management information reports and analysis capability, tailored to your need (see examples below);
- If required, a secure and well structured, feature rich (SORP compliant) finance and information system; and
- A UK based financial shared service centre to support you and help you do your accounting on the system.

Benefits include:

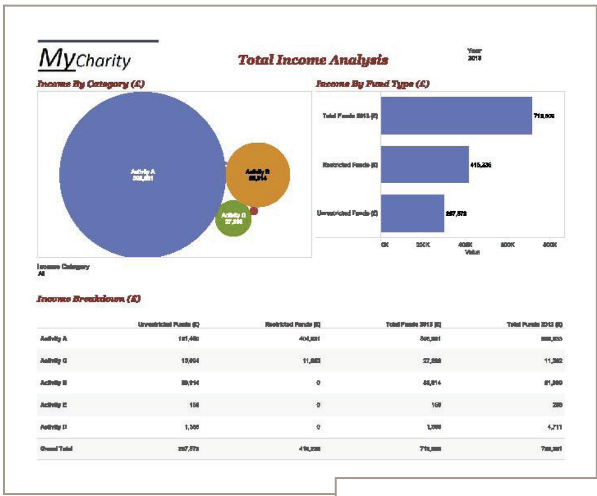
- Timely and reliable information – information delivered in traditional and highly visual ways;
- Scalability and agility – as you grow, the service you receive will flex and be tailored to your needs; and
- Better value for money – clear pricing, defined service levels and pay monthly so you get better value allowing you to spend more time and money on your charitable objectives. There are no upfront fees or set up costs.

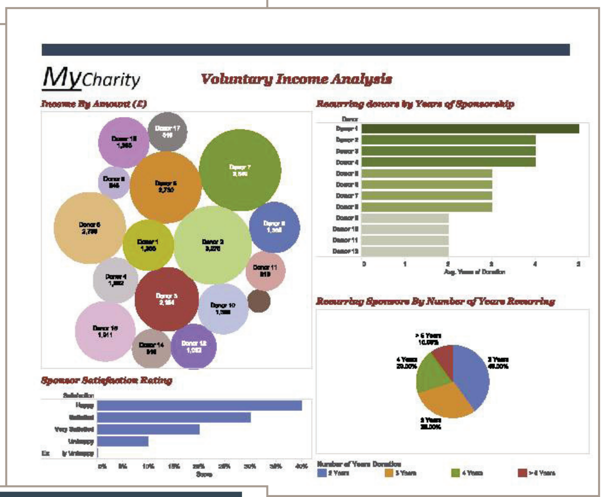
So if you'd like high quality information and insight from a trusted source to help you as you grow then get in touch.

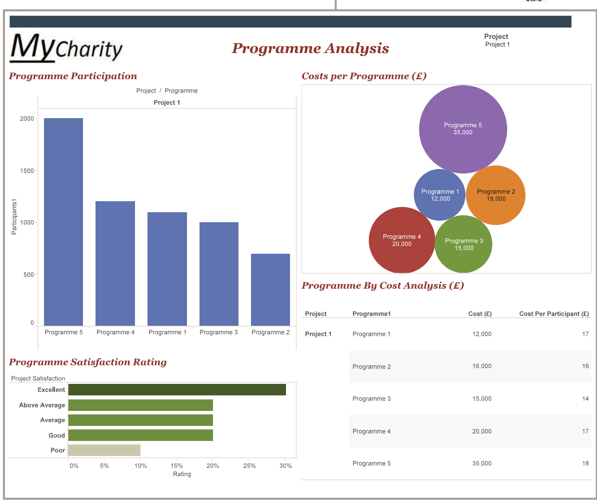
We are happy to meet and talk with you, carry out a free diagnostic and provide a quote tailored specifically to your needs and price point.

For further detail: ***www.pwc.co.uk/myfinancepartner***

Email: ***info@myfinancepartner.co.uk***







Ian Oakley Smith
Head of Charities
tel: 020 7212 6023
email: ian.oakley-smith@uk.pwc.com

Managing in the new normal

As many of our regular readers will know, PwC has worked closely with Charity Finance Group and Institute of Fundraising to prepare a series of survey reports under the 'Managing in a Downturn' style. More recently, the reports have gone out under the 'Managing in the New Normal' heading.

As the reports have come and gone over the last five years, we have sought to change some of the questions in the survey to reflect ongoing developments in the sector. Last year, this involved a series of questions in relation to social investment and loan finance, which have been repeated this time around. This year, the 'new' section includes some questions around the increased scrutiny in the sector and, most importantly, what responses have been made by charities and what further actions are planned.

We have, of course, also retained many of the 'core' questions throughout the series of questionnaires, which allow us to compare trends year on year. This year, we have also prepared what we hope is a useful summary of the conclusions from the previous reports and sought to illustrate the underlying mood of the respondents as the years have progressed.

This seventh survey has given us some interesting food for thought. In the main, the responses suggest a softening in the overall financial environment, perhaps reflecting the fact that many charities have now found ways of coping and becoming more sustainable.

Optimism is higher than before and there is a general sense from the anecdotal responses that the challenges ahead reflect as much a desire to grow, as they do a need to find coping strategies simply to stay afloat.

This is of course good news; however, it is evident that many challenges still remain. Responses in the last few surveys have suggested that more charities have been improving their financial rigour, clarifying their strategies and generally improving the information available to them in order to give themselves the best chance of survival. In our view, it is crucial that there is no let-up in these disciplines as charities look forward to what we all hope will be a more positive future. It is in this context that we introduce 'My Financepartner' on page 3 as a way of accessing the financial and other management information which will continue to be vital for charities to stay ahead.

This is particularly true in light of the responses to questions on increased public scrutiny in the sector, with 22% of those surveyed saying that such scrutiny had already had a negative impact on their fundraising and a majority of charities stating that they were taking action as a result and planned to take more action.

Back in December 2008, at the time of our first survey, we appended to that report a 'Top 10 Tips' for Managing in a Downturn. In the light of the responses to this survey, we have summarised what we call 'Key considerations for a sustainable recovery', which we hope picks up many of the anecdotal observations from the survey responses, together with the authors' own experiences.

We remain hopeful that the increased overall optimism, reflected in the survey results, will be tempered with a realism borne out of the challenges overcome in recent years and a desire to protect, sustain and grow that which has been hard fought to maintain in that period. For those charities that are able to remain robust and well managed, substantial opportunities remain to meet the increasing demands placed upon them.

LINK TO REPORT

(http://www.pwc.co.uk/charities/publications/managing-in-the-newnormal-2014.jhtml)

James Bowman
Director, Consulting
tel: 07841 563804
email: james.bowman@uk.pwc.com

Marc Mazzucco
Director, Consulting
tel: 0141 355 4088
email: marc.mazzucco@uk.pwc.com

A time for more change?

Charities are in danger of becoming the forgotten casualty of the economic downturn. The impact of the downturn in the public sector and private sectors has been well documented and analysed in depth. However, less commented on has been the impact on charities, despite the funding crisis that many are now facing.

So why has this not yet reached the public consciousness? Our view is that despite being under enormous financial pressure, charities have been remarkably successful in maintaining and improving their work to meet their charitable objectives.

However, many charities are now reaching a tipping point. The salami slicing of budgets and the refocusing of priorities has been a relatively successful short term strategy, but it is not sustainable in the longer term. The pressures that have been building are not going away; in fact they are becoming the 'new normal' for the sector.

These growing pressures can be summed up into three key themes:

- ***Increased demand for services:***
  - The demand for charitable services has arguably never been higher. Time and again the sector has innovated and stepped in to provide where public services has reduced provision. Our 2014 **'Managing in a Downturn'**[1] survey of the Charity sector found that 68% of charities expected a surge in demand for their services in the coming 12 months.
  - Coupled with this increased demand, charities are now also providing an ever wider range of services as they respond to the growing needs of the individuals who require them. This diversity of service provision has resulted in the duplication of processes within and indeed between many organisations.
- ***Reducing public sector funding:***
  - Grants from across the public sector are becoming scarcer and will continue to do so.
  - Those bodies that continue to fund charities are rightly looking for evidence of the impact and outcome of the work, making access to the funds more competitive.
  - Many charities rely on public sector contracts. Many of these contracts are both reducing in scale, becoming more onerous to comply with and have a greater focus on demonstrating a reduction in costs.
  - This drop in public sector funding is already having an impact, with 'Managing in a Downturn' showing that charities have already experienced a net reduction in public sector income over the past year.
- ***Increased pressure on donors:***
  - The sector has seen a pressure both on donations from individuals and the public, and corporate sector and donor organisations.
  - This reduction in donations to many charities has been compounded with the increased expectations from donors. How can they be sure their donation is being put to best use and having the most impact?

These are by no means the only difficulties currently facing charities – for example, there are often also increasing legislative and administrative requirements and pressure on charities to provide more transparency in the way they work.

All these challenges mean that a longer term, strategic approach is needed.

1 'Managing in the New Normal', 'Managing in a Downturn' 2014 survey report-PwC, Charity Finance Group and the Institute of Fundraising

Some charities have seen the scale and long term nature of the challenge and have moved early to establish ambitious change programmes. 'Managing in a downturn' showed that charities are becoming more aware of the need for a step change in the way they work. Taking a strategic, long term view can enable charities to develop programmes which reshape the organisations, introducing new ways of working, using technology more effectively and freeing up staff capacity to focus on the delivery of the charitable objectives.

We have observed two main drivers behind successful change programmes in response to the challenges:

1. Reviewing the overall charity business model/strategy

Charities often have only a limited analysis of the impact of the services they provide. Charities are increasingly recognising the importance of measuring the impact of their interventions:

- 'Do we really make a difference to the lives of the individuals, families and communities who use our services or the assets we are stewarding?'
- 'Are we achieving the impact and outcomes we intend?'

Given the pressures from donors, there is a growing need for charities to clearly define who they serve now and who they will support in the future. Only once a charity understands the impact of its existing services and who it seeks to support, can it reshape its services, organisation and staff accordingly.

The development of a new business model should be assisted by agreeing performance measures that allow charities to measure the impact of its services and interventions against its overall objectives and purpose. These activities can help to optimise funding and also to seek to ensure that effort is focused on those areas which provide the most impact.

2. Transforming the underlying charity operating model

With a clear business model and strategy in place, the way charities work (their 'operating models') can then also be reshaped to support the delivery of these new ways of working.

Most charities have grown organically over many years and have evolved to their current ways of working rather than by design. Many have become over complex and operate with fragmented and duplicated processes and poor IT systems and data. Often the ways in which they work do not enable them to focus the maximum effort on their charitable objectives and purpose.

Although cost reduction is often at the top of every charity board's agenda, many charities haven't yet fundamentally restructured their operational costs or the ways they work. Most change is typically focussed on tactical, short term measures. Whilst here is no single model that will work for every charity, we are seeing three key trends:

3. The way services are accessed and navigated is changing – many are starting to look to open up new channels (online, mobile, social media etc.) to improve the efficiency of the way they engage with customers and other stakeholders
4. The efficiency of support functions is improving by simplifying and standardising the way they work, professionalising operations and improving the use of core IT systems to free up front line staff to focus on core charitable work
5. Driving value by exploiting buying power and economies of scale is improving the efficiency of supply chains

There are real challenges facing the sector, but by tackling these challenges head on and taking the initiative to change their organisations, charities can ensure sustainable and lasting improvements that reduce costs and refocus staff, enabling a greater focus on the charity's reason for being – delivering on its values and charitable objectives.

David Wildey

Senior Manager

tel: 020 7213 2949

email: david.w.wildey@uk.pwc.com

Fiona Westwood

Director

tel: 0117 930 7068

email: fiona.westwood@uk.pwc.com

FRS102 – are you ready?

Charities: What it means for you

Financial Reporting Standard 102 is the new version of UK GAAP. In response to this a new Charities SORP has been issued in exposure draft. Charities will be expected to apply this FRS and the new SORP for accounting periods beginning on or after 1 January 2015.

We have highlighted the key changes between current UK GAAP and the new FRS102 and how we expect these to impact on the Charity sector, as well as providing an initial assessment of the main changes expected as a result of the new draft SORP as currently drafted.

FRS 102: Key changes for Charities

General

The language and terminology used is similar to IFRS, so you will see reference to; receivables and payables not debtors and creditors, property, plant and equipment not fixed assets, and a number of other terminology changes. This includes the name of the main statements. Accountants who have qualified under the IFRS regime will feel comfortable and probably more at home with this than current UK GAAP.

Ultimately though – the new Charities SORP will drive such disclosures and terminology.

Financial instruments

Under FRS102 the charity is required to account for financial instruments on the balance sheet at fair value. The Charity will need to look carefully at loan agreements, which often have hidden or associated derivatives and consider what other contracts of this nature they have – such as interest rate swaps.

Multi-employer defined benefit pension schemes

The multi-employer exemption remains. Where there is an agreed scheme deficit, however, with a reduction arrangement in place, a provision should be recognised in respect of contributions due, discounted over the period of contributions. This is required to be recognised as an additional liability on the balance sheet.

Embedded leases

Lease accounting has not materially changed. The charity is, however, now required to identify and account for embedded leases. This might entail significant work for the charity in reviewing all leases and contracts to identify any embedded leases.

Based on the substance over form principle, a situation could arise where a transaction does not take the legal form of a lease, but in substance conveys the right to use an asset. As such this might represent an embedded lease within a contract or transaction.

Prior year adjustments

FRS 102 requires prior year adjustments to be made for material errors in the prior period, and not just fundamental errors as is currently the case under old UK GAAP.

Cashflow statements

FRS 102 does not include an exemption for small charities to dispense with the need to prepare a cash flow statement. As a result all charities will need to prepare a cash flow statement unless they follow the FRSSE.

Investment properties

SSAP 19 required investment properties to be held on the balance sheet at open market value whereas FRS 102 requires valuation at fair value, only if the property can be measured reliably without undue cost or effort. If that is not possible, the property should be accounted for as 'property, plant and equipment', and not as investment property. If the investment property fair value can be measured reliably, it shall be measured at fair value at each reporting date with changes in fair value recognised in the income statement. This is clearly quite a change from SSAP 19 and the use of a revaluation reserve.

Intangible assets and amortisation

If the charity cannot reliably calculate the useful lives of intangible assets, the amortisation period is five years, compared to the current period of 20 years.

Holiday pay accrual

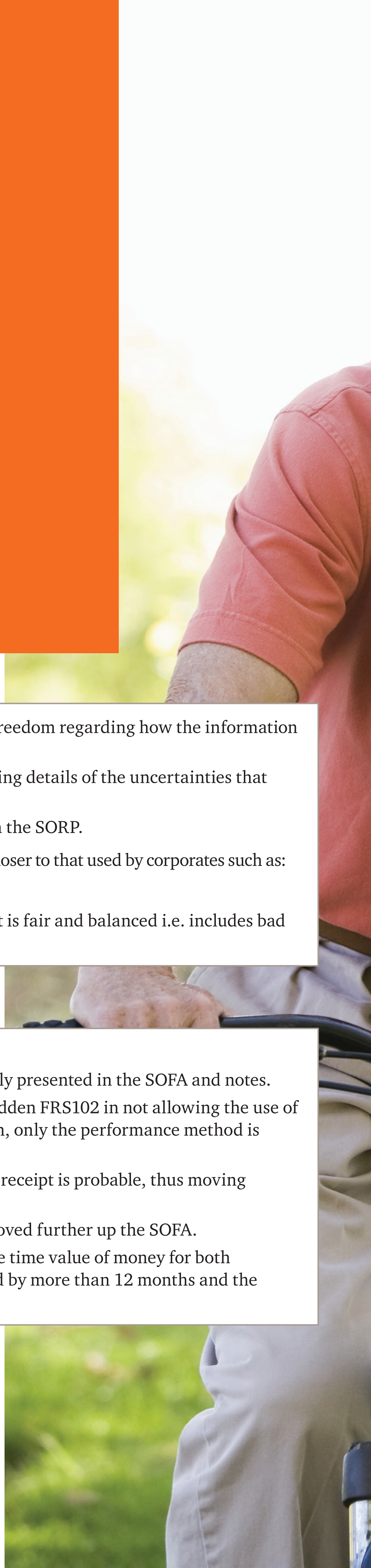
Under FRS 102, it is compulsory for charities to accrue for holiday pay earned but not yet taken, especially where carried over from one accounting period to the next. This is required to be recognised as an additional liability on the balance sheet. It is likely that the information required for these calculations is not currently collected by the charity, so you may need to establish a process by which you can identify these figures.

SORP: Key changes

The exposure draft of the new SORP has proposed a number of changes to the format of the SORP as listed below:

- New modular format;
- Increased clarity regarding disclosure requirements relating to small charities;
- Increased clarity regarding what is an absolute disclosure requirement and what is considered 'good to have'; and
- Increased clarity regarding whether a requirement is driven by FRS102, Charity Law or another regularity requirement.

It is also expected to have the following key impacts on the Trustees' report and main statements.



Trustees' report

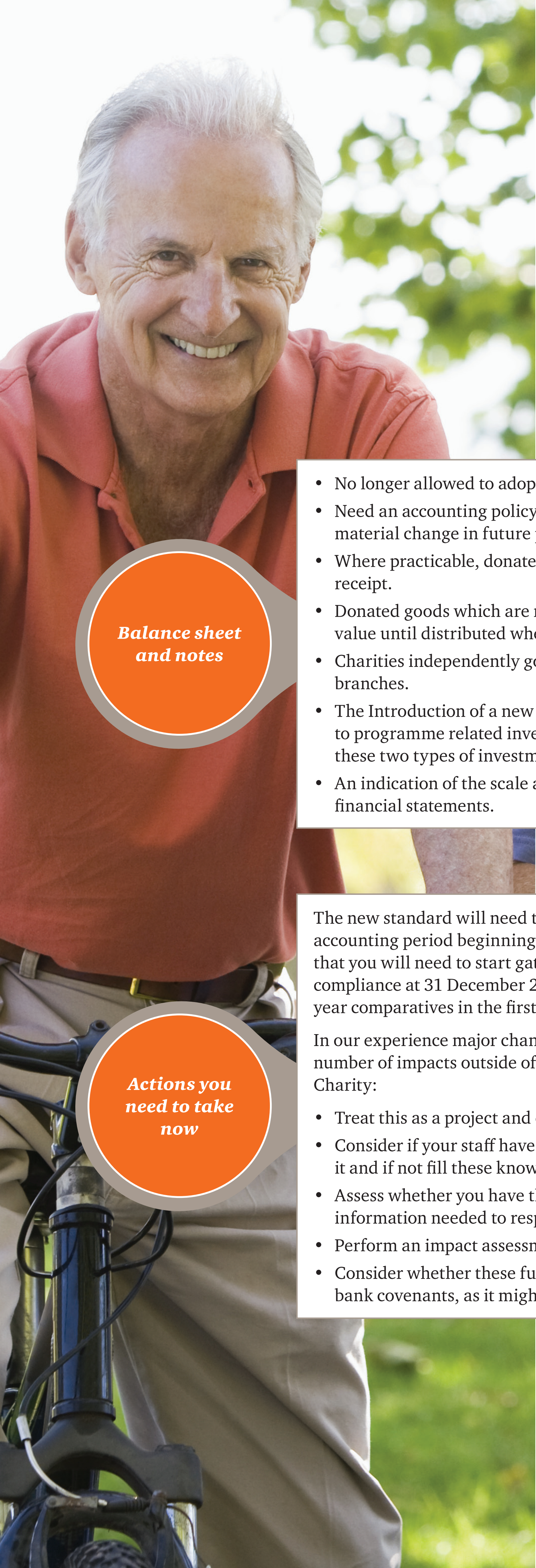
- A re-ordering of the Trustees' report and increased freedom regarding how the information can be presented by the charity.
- Additional going concern disclosure required including details of the uncertainties that exist.
- Public benefit disclosure now specifically required in the SORP.

Inclusion of further requirements to bring the reporting closer to that used by corporates such as:

- Expanded risk disclosures; and
- Increased focus on ensuring that the Trustees' report is fair and balanced i.e. includes bad news as well as good news.

Statement of financial activities

- Simplification of SOFA headings.
- Removal of need for governance costs to be separately presented in the SOFA and notes.
- Income recognition – the new draft SORP has overridden FRS102 in not allowing the use of the accruals model for government grant recognition, only the performance method is allowed.
- Clarification that income is first recognised when its receipt is probable, thus moving towards probate for legacy recognition.
- The disclosure of investment gains and losses has moved further up the SOFA.
- A more extensive requirement for discounting for the time value of money for both income and expenditure where settlement is delayed by more than 12 months and the effect is material.



Balance sheet and notes

- No longer allowed to adopt reduced disclosure framework for subsidiary entities.
- Need an accounting policy on judgements and assets and liabilities where there is risk of a material change in future periods.
- Where practicable, donated goods for sale or distribution are measured at fair value on receipt.
- Donated goods which are received for distribution are expected to be treated as stock at fair value until distributed when it is then treated as expenditure.
- Charities independently governed by a separate body of trustees cannot be treated as branches.
- The Introduction of a new classification of investment; mixed motive investments (separate to programme related investments). The associated gains and losses and impairment of these two types of investments are expected to be disclosed in different parts of the SOFA.
- An indication of the scale and contribution of volunteers to be included in the notes to the financial statements.

Actions you need to take now

The new standard will need to be applied for the first set of financial statements for the accounting period beginning on or after 1 January 2015. For December year ends this means that you will need to start gathering the required information for FRS102 and SORP compliance at 31 December 2014 as these figures will be the opening balances for your prior year comparatives in the first mandatory period of adoption.

In our experience major changes in accounting standards such as these will also have a number of impacts outside of the financial statements. As such, we recommend that the Charity:

- Treat this as a project and establish a project plan to respond to and manage this change;
- Consider if your staff have the knowledge and experience necessary to be able to respond to it and if not fill these knowledge gaps through training;
- Assess whether you have the appropriate systems and processes in place to capture the information needed to respond to the new standard;
- Perform an impact assessment of the changes; and
- Consider whether these future changes will have an impact in relation to new financing or bank covenants, as it might lead to a future breach.

Chris Mortimer

Manager

tel: 020 7804 0708

email: christopher.e.mortimer@uk.pwc.com

Keith Lawson

Director

tel: 020 7804 9064

email: keith.lawson@uk.pwc.com

VAT – Construction of buildings in the Charities sector

Introduction

The construction of a new building is a significant financial event for many charities. The default position is that construction costs are subject to VAT at the standard rate; this VAT will often be irrecoverable and hence represent a cost to the charity.

Reliefs contained in VAT legislation recognise the potentially significant impact that incurring VAT on construction costs can have for charities and seek to relieve this burden where the buildings are to be used for certain charitable purposes.

However, disagreements have arisen between charities seeking to benefit from the reliefs and HMRC when it comes to determining the circumstances in which the reliefs apply. This has led to the scope of the reliefs being considered by the courts in a number of recent cases and charities who are planning to construct new buildings should be aware of the trends emerging from the courts.

Legislation

Group 5 of Schedule 8 of the VAT Act 1994 provides for zero rating reliefs to apply to the construction of buildings which are intended to be used 'solely for a relevant charitable purpose'. HMRC accept that a building can be considered as being used 'solely' for a RCP where such use makes up 95% or more of the total use. Use for a 'relevant charitable purpose' means use by a charity in either or both the following ways:

a. otherwise than in the course or furtherance of a business;

b. as a village hall or similarly in providing social or recreational facilities for a local community.

Both parts of the definition have been considered in a number of cases. However it is the former (non-business use) which is the subject of this article. Distinguishing between a business and a non-business activity can often give rise to a considerable degree of confusion as illustrated by the ongoing discussion concerning how a grant funded non-business activity should be distinguished from a business activity performed under a contract for services. In the case of zero rating reliefs this confusion is often compounded when the concept of non-business is combined with that of the 'use' of a building.

Case law and HMRC's approach to distinguishing between business and non-business use of a building

HMRC has consistently taken the broad view that buildings used by charities to conduct activities in return for consideration are used for business purposes so that zero rating does not apply in respect of their construction. However, this view has been held to be incorrect by the courts and tribunals in a number of cases.

The first decision which challenged HMRC's interpretation was Yarburgh Children's Trust (2002). In this case a charitable trust, which was established for the purpose of providing day care facilities to children, constructed a building and let it to a playgroup charity at well below market rent. The lease provided that the playgroup's use was for the education and occupation of children. Approximately one third of the cost of the building was met by the trust with the remainder funded through charitable grants and donations.

HMRC argued that both the letting of the building by the trust and the operation of the playschool by the trust's tenant were business activities. The court disagreed on both counts:

- **Letting** – far from being commercial or business-like in nature, the court held that this activity was designed to facilitate the use of the building by a second charity whose activities satisfied the objects of the trust.
- **Operation of the playschool** – the nursery was not profit led. It struggled to maintain the balance between remaining affordable and meeting its operating costs and playschool fees were fixed on that basis. This led the court to hold that the playschool was not predominantly concerned with the making of taxable supplies for a consideration and hence was not undertaking a business activity.

The approach adopted by the court in Yarburgh was followed in St Paul's Community Project (2004). This case again considered a building which housed a day nursery. The nursery was operated for social reasons and had an admission policy which favoured disadvantaged children. Some parents were charged a fee but these covered only part of the cost incurred in respect of the child. They were set at a level designed only to cover the short fall on nursery costs after taking into account grants and donations, which made up much of the charity's funding.

The court held that the operation of the nursery was not predominantly concerned with making supplies in return for payment and hence was not undertaking a business activity.

Following the decision in St Paul's HMRC published a business brief in which it stated that it disagreed with the decisions in both Yarburgh and St Paul's. However it accepted as a matter of policy that it would not challenge charities which treated the provision of nursery facilities, along the same lines as those considered in the two cases, as a non-business activity.

It is difficult to see how limiting the application of the decisions to nursery providers can be justified since in both cases the courts based their decisions on broad principles which are clearly relevant in a far broader context. Neither court indicated that their respective judgements depended on the fact that the charities in question provided nursery facilities. Indeed, Yarburgh and St Paul's have since been referred to by the tribunals in a number of cases which considered activities other than the provision of nursery facilities.

A recent example of such a case is Longridge on the Thames (2013). A charity whose purpose was to provide coaching, leadership and training in outdoor activities to young people constructed a training centre. It charged young people for attending courses at the centre and also provided courses for adults and corporates for a higher fee. However, its accounts showed that it operated at a deficit and the deficit was met from donations.

It set its charges so as to be affordable for young people with a view to covering its operational expenses with the benefit of contributions from volunteers. Charges would be discounted or waived to fulfil its charitable objects and all capital projects were financed by donations and grants so that the charges made were not directly or indirectly used for capital expenditure.

The tribunal found that the building was being used for non-business purposes. Most significant, in the tribunal's opinion, was the charity's reliance on the volunteers and donations to carry on its activities. Even where the Appellant charged the full rate for courses for adults (approximately 1% of attendees), without the volunteers and the use of assets funded by donations the course charges would not cover costs. The activity was therefore not operated on sound business principles and not predominantly concerned with making business supplies and hence was not a business activity.

A further twist came in Wakefield College (2013) where the tribunal held that the activities of a further education college in respect of students whose fees were partly supported by state funding (and not donations, as had been the situation with the cases discussed above) were non-business.

Key to the tribunal's judgement were that the criteria applied to determine the level of fees charged to such students included previous academic achievements, receipt of state benefits, low income, and other personal factors. The tribunal also noted that the overall contribution made by these students' payments to meeting the Appellant's operational costs was small.

Conclusion

There is an emerging trend in case law which suggests that activities which rely on donations, volunteers and/or certain types of government funding to be viable should be treated as non-business. It follows that zero rating reliefs should apply in respect of the construction of buildings which house these activities. This is particularly so where fee income earned in connection with the activity contributes towards the charity meeting its operating costs but is not sufficient to cover the capital cost of the building, which is funded via other means such as donations, grants.

However, there has been no indication from HMRC to suggest it might change its approach to distinguishing between business and non-business use. As such, where a building is used by a charity for undertaking activities in return for consideration, there is a real risk that HMRC will challenge the application of zero rating reliefs.

This was vividly illustrated in the 2008 case of Jeansfield Swifts in which HMRC asserted that a children's football team was being run as a business. This was based on the fact that children paid match fees in order to meet the cost of the referee and linesman, tea and pies were sold on match days and the club house was hired out to community groups for £5 per night. The tribunal held in favour of the charity in a short judgment which was highly critical of HMRC's approach to the case.

Charities which are planning to construct new buildings should consider whether reliefs could apply and should not be deterred by the narrow interpretation of the scope of the reliefs which has often been applied by HMRC. However, given the risk of a dispute with HMRC arising at some point in the future, and given the sums of money which will often be involved, it will often be preferable to seek a ruling from HMRC at the earliest opportunity or to disclose transactions which have benefited from zero rating reliefs. Charities wishing to enter into dialogue with HMRC can call on a significant volume of case law which may support their position.

Jill Halford
Director
tel: 020 7804 6020
email: jill.halford@uk.pwc.com

The Cup Trust judgement – Assessing conflicts of interest

Lessons from the recent judgment of the Charity Tribunal ("the Tribunal")

Context

The Corporate Trustee of The Cup Trust ('Cup') appealed against the opening of a statutory inquiry by the Charity Commission and the subsequent appointment of an Interim Manager. A judgment was delivered by the Tribunal in October 2013, which found in favour of the Charity Commission. This judgment can be found using the following link:

http://www.judiciary.gov.uk/Resources/JCO/Documents/Judgments/mountstar-charity-commission-decision-17102013.pdf

In addition, leave to appeal the judgment was refused on 24 December 2013. The judgment, which runs to some 60 pages, provides an insight into both the specifics of the gift aid fundraising scheme ('the Scheme') entered into by Cup and gives a very useful assessment of some of the conflicts of interest which impacted the various parties to the Scheme.

This short article summarises the Tribunal's observations in relation to some of those conflicts of interest and recommends that charity Trustees and Advisors could benefit from reading the judgment.

The parties involved

For the purpose of this article, it is sufficient to know that, in addition to Cup itself, the following key parties were involved in the Scheme and had a role within Cup:

- A corporate charity Trustee, incorporated in the British Virgin Islands ('Mountstar');
- Three individuals, who were Directors of Mountstar; and
- Various other businesses and trusts involved in selling the Scheme to clients and acting on behalf of those clients in claiming gift aid (these businesses and trusts were beneficially owned and controlled at different times by one or more of the three Directors of Mountstar and/or family members).

Cup had a conflicts of interest policy, which was modelled on the Charity Commission guidance, and apparent efforts were made to abide by this policy by the parties involved.

The Tribunal's main findings on conflicts of interest

- A corporate Trustee can itself be governed by Directors who have conflicting interests to those of the charity, provided that there are sufficient independent, non-conflicted, Directors to take independent decisions where necessary;
- Mountstar, as corporate trustee, owed a fiduciary duty to the Charity Commission as regulator to act 'as an ordinary prudent man of business would act, independently of the interests of others'. The Tribunal stated that this duty could conflict with the interests of one or more of the Directors of Mountstar, for example, when disclosing information to HMRC and to the Charity Commission regarding the Scheme; and
- The Directors of Mountstar had several different conflicts of financial interest, either directly (notwithstanding 'complex steps and legal structures' taken to distance any financial gain from successful gift aid claims) or indirectly (in relation to reputational issues for the individuals themselves) and they failed adequately to manage these conflicts.

As a result, the Tribunal found that, whilst there appeared, on the face of it, to have been an attempt by Mountstar to abide by an appropriately written conflicts of interest policy, certain basic assumptions had been made by Mountstar (acting through its Directors) as to what constituted the best interests of the charity. These assumptions, in the view of the Tribunal, were inappropriate and would have been challenged by a truly independent Trustee acting 'as an ordinary prudent man of business would act, independently of the interests of others'. The Tribunal goes on to describe in detail how enquiries made by an independent Trustee may well have led to very different decisions. This detailed description illustrates very clearly how subtle, but very real, conflicts of interest can be overlooked and demonstrates the essential contribution of a fully independent Trustee.

Lessons to be learnt

Whilst Cup is clearly an unusual case, the findings of the Tribunal as regards conflicts of interest should be read and considered by Trustees and advisors, particularly in relation to charities where the Board lacks diversity or where the Board is made up of individuals who are very well known to each other, for example, as members of a family or close working associates. The risk of 'assumed wisdom' or 'groupthink' is highlighted by the circumstances of this case, where there was insufficient truly independent challenge to subtle, but very real, conflicts of interest.

Antony Timmins
Social Business Tax Leader
tel: 020 7212 4524
email: antony.timmins@uk.pwc.com

Interesting times for tax

A Poisoned Chalice?...

Tax has been in the news for the charity sector over the last year. There are some positive stories dealt with below but the headline news is probably the Cup Trust case (referred to pages 15 to 16) which has to some extent cast a long shadow over the entire sector. Cup Trust was a charity which looks on the facts to have been set up as part of a tax avoidance scheme raising £176 million in its first two years from 'donations' in respect of which it claimed £56 million in gift aid relief, all the while giving just £55k in grants to charitable causes. The backlash has been detrimental to the reputation of the sector as a whole (despite this being a very specific set of circumstances) and it has led to adverse scrutiny of the role of both the Charity Commission and HMRC (despite the fact that HMRC has not paid over any tax to Cup Trust or to its beneficiaries).

This in turn has led to frustration and reputational issues for the sector, the Commission and HMRC. This is contributing to a change in public perception of charity (at a time when the pool of tax-paying donors is reducing as allowances are increased), a shift in Commission resources away from helping charity to investigating it and a shift in HMRC to more investigation and more anti-avoidance law. We welcome appropriate investigation but (in particular) smaller charities do value the support from the Commission, and, as noted below, while we sympathise with HMRC and support the need to eliminate behaviour which is clearly damaging we question whether the first proposal they have produced is the best way to achieve this.

Hard cases make bad law...

In response to Cup Trust HMRC want to amend the tax definition of charity to introduce a further anti-avoidance condition, which, if failed would mean that a charity is simply deemed never to have been a charity for tax purposes. Comments from the Charity Tribunal hearing suggest that it appears that HMRC are unable to get the participants in the scheme to accept the rules on qualifying expenditure and donor benefits (not to mention the basic definition of what constitutes a gift) apply so that Cup Trust simply doesn't work. Hence, they say, the existing law is too complex to administer so they need a new simpler law as described above, which they apply against the most offensive cases. The difficulties with their approach are

1. Their proposed definition does not adequately define tax avoidance with the effect that there is the legal potential to apply it more widely than they indicate
2. It deals only with a situation like Cup Trust where a charity is set up for avoidance purposes. It does not deal with a situation where an existing charity is hi-jacked for avoidance purposes.
3. While in a situation like Cup Trust, it seems likely that all the donors would have been well aware of what was going on and it is arguable they have not in fact made gifts and it might therefore be proportionate to remove all prospect of any relief by deeming the organisation never to have been a charity, this might not be the same in all cases.

PwC along with other advisers and organisations in the sector are engaging with HMRC in a supportive way. We acknowledge that something like Cup Trust should not happen again but question whether a broadly based law inspired by one bad example like this would have too much collateral damage and are looking to produce something which would work.

Who is fit and proper to run a charity?

As noted the new anti-avoidance condition will be bolted onto the relatively new definition of a charity for tax purposes. This already contained an element that was thought to be somewhat difficult – the management of 'fit and proper persons' test and in November 2013 that test was changed in a way that the sector thought was unhelpful – although again in the light of Cup Trust one can see what HMRC are trying to achieve.

The background to this is that tax specific definition was introduced in 2010 because it was needed to facilitate HMRC treating charities in the rest of Europe as those in the UK, but it also in some ways helped clarify the position of UK entities which are charitable but are not registered with the Charity Commission. The existing definition can be summarised as follows:

Condition	
1. Charity	Must be set up for charitable purposes in EU or EEA jurisdiction.
2. Jurisdiction	Must be under jurisdiction of High Court or equivalent.
3. Registration	If required to be registered must be registered with relevant regulator.
4. Management	Must be managed by 'fit and proper persons'. 'Fit and proper' is not defined in statute but by regulations and interpretation.

HMRC effectively amended the management condition in November 2013 by changing their interpretation of what a fit and proper person was – involving a suggestion that charities check with trustees and other key managers on the state of their tax affairs and in particular whether they have been involved with tax avoidance. However in the case of smaller charities HMRC make it plain that even if there are people they think are unfit this might not necessarily mean the charity would not be accepted. Again PwC and the sector are working with HMRC on this. The concern is that HMRC's approach is not well targeted or precise and many charities simply do not understand it so compliance is difficult.

Social investment tax relief

This is a welcome development but one which probably needs to overcome the limitations of European State Aid before it can play a major part. The vision is to attract private capital into social business by creating a relief for social business which mirrors EIS for private companies. The essentials are:

Essentials	
Investee organisation	Charity, Community Interest Company or Community Benefit I&PS.
Activity	Must carry on a trade (but not electricity generation, property development for gain, lending)
Size	Less than 500 employees, £15 million assets
Investment instrument	Shares or, for charities, non-secured, non-preferred debt not repaid for three years
Amount of investment per investee	Approx £290k
Investor	UK taxpayer – to control no more than 30% of investee. Annual total for all investments per investor – £1 million.
Relief due	30% of total invested as credit against tax paid

Upstream loans

In 2013 the legislation dealing with loans from close companies to participators was reformed. Unfortunately the reform has led to the consequence that loans from a company controlled by a charitable trust back to the charity may be caught by this legislation. Care therefore is needed if there is a proposal to lend back capital temporarily not required by trading company back to its parent.

Employee taxation

Currently employees earning below £8,500 are not taxed on certain benefits. This includes a number of people in the charitable sector possibly in some cases including people thought of as volunteers. There is a move by the Office of Tax Simplification to remove this limit and generally to overhaul and possibly simplify the code. There is likely to be discussion of how this would impact the sector. A possible outcome of the reform could be an attempt to define what constitutes a volunteer which may help resolve some current issues faced by some volunteer organisations in respect of some expense and other payments.

Gift Aid/Payroll giving

There have been a number of developments here including reports by the National Audit Office and the Public Accounts committee on the effectiveness of the Gift Aid Scheme. Practical issues are:

- The new on line system is now mandatory for all claims after September 2013. However as of March only two thirds of charities on HMRC's books had made claims;
- For the avoidance of doubt HMRC's audit procedures on gift aid remain substantially unchanged since the migration to the E system for claiming so charities still need to keep the same records as before;
- The Gift Aid Small Donations Scheme (GASDS) has generated claims of approximately £3.5 million in its first year as opposed to the £50 million projected. This may suggest some inertia or perhaps that the rules are a little complex and putting potential claimants off;
- A consultation has been announced in the 2014 budget on the gift aid benefit rules. Details are to be published in due course. The aim is to remove difficulties and anomalies in the current rules; and
- A consultation is also under way on Payroll Giving which is also felt not to be fulfilling its full purpose and reforms are being looked at in order to improve its workings and lessen perceived delays and inefficiencies in the system.

Recent charity news and seminars

Managing in a Downturn

Managing in the 'New Normal' – Adapting to uncertainty
April 2014

Charity News

Accounting, tax and risk update
May 2013

Lessons to be learnt: learning from the mistakes of others
November 2012

Thriving in the New Normal
May 2012

Accounting, Tax & Sector Update
January 2012

Seminars

PwC runs an exclusive seminar programme for charities, trustees of charities and non-executive directors. All our contacts who receive Charity News will automatically receive invitations to all our charity seminars.

All our seminars will be held at our More London or Embankment Place offices (addresses below), commence at 4pm and are followed by drinks and nibbles. There is no charge for our seminars and CPD hours can be claimed.

PricewaterhouseCoopers LLP
7 More London Riverside
London
SE1 2RT

PricewaterhouseCoopers LLP
1 Embankment Place
London
WC2N 6RH

Contacts

If you would like to know more or speak to one of our team, please contact:

Ian Oakley Smith
ian.oakley-smith@uk.pwc.com
020 7212 1220

If you want to enquire about seminars or would like to receive Charity News electronically, please contact:

Francis Osei-Bonsu
francis.j.osei-bonsu@uk.pwc.com
020 7804 2183

PwC's Charity News continues to be green

Many of you will have received this edition of Charity News in electronic format; thank you for helping us to reduce our impact on the environment. We hope that more of our readers will switch to receiving an electronic copy in the future. We will, however, continue to mail printed copies to those of you who prefer this format.

www.pwc.co.uk

140506-125628-KH-OS