

Toolkit

Setting up a Trading Subsidiary

Governance

This guidance will be useful for: community transport providers looking to set up a trading subsidiary.

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Introduction

CTA has developed this toolkit to support community transport operators (CTOs) to set up a trading subsidiary. You will need to do this where you have decided to obtain a Public Service Vehicle (PSV) Operator Licence to enable you to deliver transport for 'hire or reward' with a view to making a profit. This may be so you are able to 'gift' profits back to the CTO, which may be a charity or incorporated in some other way, who is providing not-for-profit transport using section 19 or 22 permits in Great Britain or section 10B permits in Northern Ireland; it may be because you are seeking to diversify your income streams to reduce your reliance on grant funding; or it may be because you have a wider range of services that could be offered than are permitted under community transport's normal operator licensing. All of these are valid reasons to explore adapting your operating model via setting up a trading subsidiary.

This guide aims to:

- Offer information about one of the most common ways of preserving charitable and financial integrity – setting up a wholly-owned trading subsidiary, which may pass profits from the contract back to the parent charity, without incurring tax liability.
- Give a straightforward 5-point guide to getting started on your path towards setting up a trading subsidiary
- Provide an action checklist for deciding whether a trading company is needed.

Why a trading subsidiary?

A trading subsidiary (sometimes known as a 'trading arm') is useful where a CTO wants to provide passenger transport that is:

- Beyond the powers set out in the CTO's governing documents, for example providing services for the public when the charity is established to only serve a certain beneficiary group (if this is the case, it is worth exploring the possibility of changing the governing documents to allow this activity, as this may well be a simpler solution than setting up a trading arm).
- Not allowed under the permits granted to voluntary sector operators, such as running services for the general public using a section 19 permit.
- More commercial in nature to support the financial sustainability of the CTO, e.g. private hire airport transport or bus tours to tourist destinations available to the general public.

Where a CTO wishes to operate with a view to making a profit, you cannot do this using a permit, therefore you must obtain a PSV Operator Licence (O licence). In order to obtain an O Licence where you are already operating services using section 19, 10B or 22 permits, a new organisation must be created as the same legal entity cannot hold both an 'O' licence and a section 19 or 22 permit under the Transport Act 1985, regardless of whether an organisation is carrying out all services for

exclusively non-commercial purposes. This newly established organisation would be the Trading Subsidiary.

Companies owned by charities are liable to pay tax on trading profits in the same way as other companies. However, they will often donate their total profit to the charity, which means that they get tax relief. In the hands of the charity, the donation will not be regarded as trading income but as a donation, so that it will be exempted from tax; provided, of course, it is used for charitable purposes.

Companies owned by charities can make payments to charities under the [Gift Aid scheme](#), which means that tax is not deducted and therefore does not need to be reclaimed.

Getting started

If your CTO is a registered charity, you will have already taken precautions to protect your trustees, management committee members, or board members from liabilities incurred by the charity – for example, by setting the charity up as a company limited by guarantee, trustees are protected by ‘limited liability’ from having to pay any debts incurred by the charity. Setting up a trading arm creates fantastic opportunities to diversify your operation and bring in new sources of income that would otherwise be unavailable to you – it is essential however that you also consider the additional risks, liabilities and obligations that will be created by taking this step.

The following information provides some guidance on how to get the ball rolling and will help you take some positive action towards setting up a trading subsidiary, including understanding and managing these new responsibilities.

The Charity Commission has published guidance that applies to charities in England and Wales: [Trustees trading and tax: how charities may lawfully trade \(CC35\)](#). Within this guidance, they describe a ‘trading subsidiary’ as:

“a company, owned and controlled by one or more charities, set up in order to trade. The purpose of a trading subsidiary is usually to generate income for its parent charity. Trading subsidiaries must be used for non-primary purpose trades involving significant risk.”

Similar guidance is available for Scotland [here](#) and Northern Ireland [here](#).

Step one: check your governing documents

If your organisation is a registered charity you must first check it has the powers to set up a trading subsidiary. This should be written within your constitution and gives trustees the powers to trade in the course of carrying out any of its objects and carry on any other trade which is not expected to give rise to taxable profits, or establish or acquire subsidiary companies to carry on any trade.

If your constitution does not give the trustees these powers, you will need to review the constitution to:

1. See how you can amend the powers
2. Amend the powers, perhaps as part of an extraordinary general meeting
3. Inform the Charity Commission (if you are a Charity) that you have changed the constitution and submit your new constitution
4. Where the organisation is also a company limited by guarantee, inform Companies House that you have changed the constitution and submit your new constitution;
5. Register a new Private Limited Company with [Companies House](#).

Step two: choose a legal form for the trading subsidiary

Trading subsidiaries can take any legal form appropriate for businesses and this could be a Company (including a Community Interest Company or CIC), a Co-op, or an Industrial and Provident Society.

Any CTO considering tendering for contracts will need to have taken the basic steps to protect trustees and members by incorporating the parent company in some way, most likely as a company limited by guarantee. Your legal advisor or a specialist support advisor may be able to assist you in identifying the most appropriate structure for your trading arm. Support of this kind is available from organisations such as [Business Wales](#), [Social Enterprise UK](#), the [Wales Coop Centre](#), [Scottish Enterprise](#) and [Enterprise Northern Ireland](#).

It is just as important for any subsidiary to have limited liability as it is for the parent charity. The main options for the legal structure are:

1. A company limited by shares
2. A company limited by guarantee

The parent charity would usually own all the shares in a company limited by shares, or control all the votes in a company limited by guarantee.

The most common choice for a trading arm is a company limited by shares where a company can be formed with only one member, with the parent charity holding the single share.

Setting up the company

It can take somewhere between three and six months to set up a trading arm, depending on the complexity of your organisation. You may well have had experience of the process in incorporating your own CT. Your legal advisor or a specialist support agency can assist you in developing the memorandum and articles of association for the trading arm, and it is possible to purchase templates to support this from organisations such as [Law Depot](#). More information on setting up a company can be found on the [Companies House](#) website.

The memorandum of association is likely to contain general trading objectives allowing the company to carry on trade or business, and a general power to do anything incidental or conducive to this. It may also include as an object the procurement of profits or gains to give them to the charity.

The Senior Traffic Commissioner offers some guidance within their publication: [Statutory document no. 5: legal entities](#), and we recommend organisations who are interested in setting up a trading subsidiary read this. The Statutory Guidance explains how the Senior Traffic Commissioner believes that traffic commissioners should interpret the law in relation to different legal entities and lays out the approach to be taken by staff acting on behalf of individual traffic commissioners.

Step three: investing charitable funds into the trading subsidiary

Your trustees must be able to justify financial support for the trading subsidiary as an appropriate investment of the charity's resources. In all cases, the interests of the charity must be paramount and any investment should be consistent with the charity's overall [investment policy](#).

To avoid losing out on tax exemptions, a charity must only invest in a trading company if:

- You can show evidence that the investment was made to benefit the charity
- There are terms and conditions setting out how the company will pay you back (this should include a rate of interest and the date when the repayment is due)
- Your charity gets a fair return that's actually paid, which is then spent on your charity's primary purpose.

Your charity must keep records of:

- All the investments it makes, for example, in a business plan or a document projecting future profits
- The details on why it decided to choose each particular investment, for example, a record of your cash flow forecast

The Senior Traffic Commissioner offers some guidance within their publication: [Statutory document no. 2: finance](#), and we recommend charities read this alongside the Charity Commission publication: [Trustees trading and tax: how charities may lawfully trade \(CC35\)](#) to ensure that any investment complies with both Regulator requirements.

If the trustees of Anytown CT, in setting up “Anytown Transport Trading Ltd”, decide that Anytown CT should use its resources to fund the subsidiary, they must first be sure that they have the legal power (as set out in the Memorandum and Articles) to make loans and investments. Failure to do this may mean that the trustees are acting beyond their permitted power which may have serious consequences down the line.

Any investment should usually be in the form of secured loans at market rates.

The trustees should consider very carefully the financial viability of the trading arm and take appropriate advice based on the financial information and projections supplied by the subsidiary. CTA recommends trustees read thoroughly this Charity Commission guidance [CC14 Investment of Charitable Funds](#) and the relevant sections of Charity Commission and HMRC documents already mentioned.

The Charity Commission make the position clear, saying that funding by the charity:

“...should always be viewed in the context of the charity making an investment in the subsidiary trading company. The charity’s assets should not be exposed to any guarantee of the liabilities of the company. This is because if the trustees allow the charity’s assets to be exposed to a guarantee of the liabilities of the company they will, in effect, lose the protection for those assets (gained by the separation of the activities) by leaving those assets liable for the debts of the company. If the trustees give personal guarantees, they will be personally liable if the company cannot meet the liabilities which they have guaranteed.”

If trustees intend to invest charity funds in a subsidiary trading company, they should first make sure that they have the legal power to do so, please check with your solicitor if you are unsure. The majority of trustees have such a power, either in their governing document or as a result of the [Trustee Act 2000](#) which came into force on 1 February 2001. Where trustees do have power to invest in a subsidiary trading company they must have regard to the standard investment criteria outlined in the Act before making any investments. This asks questions like, is this a suitable investment for the charity? Is this the kind of investment the charity should be making? We would recommend that trustees take professional investment advice, to protect the charity, consider the need for diversity in investments made, and whether the charity will receive an adequate return on their investment.

Tax implications

As previously mentioned, the principle behind the arrangement of parent company and trading subsidiary is that any profits earned by the trading activities of the subsidiary will be passed back to the parent.

However, the subsidiary, as an ordinary limited company without charitable objectives, has none of the exemptions or concessions available to a company that is also a registered charity; any profits it makes will be taxable. But there is a way of transferring the profits to the parent and eliminating tax liability.

The Gift Aid Scheme

From April 1 2000, HMRC introduced the Gift Aid scheme. The Gift Aid Scheme enables a trading company to donate its trading profits to the parent charity without deduction of tax. The company gets relief for the actual amount of the donation, and does not have to deduct tax; the recipient charity no longer has to claim the tax back from the revenue.

Making the donations

HMRC makes a number of recommendations about donating trading profits:

When deciding how much of their profits to give to charity, companies may need to take into account

- The limits on the amount they can pay out, which are set out in the [Insolvency Act 1986](#)
- That they must keep sufficient profits to avoid a cash drain
- Any restrictions imposed by the company's Memorandum and Articles of Association and any other requirements that may be imposed upon them.

How much profit should the trading company donate?

If the trading company donates its entire profit every year, it may be left without enough funds to maintain and develop its business, which could in turn mean the trading company going back to the CTO parent charity for additional funding. This could affect both the charity's tax exemption and the trading company's deductions for Gift Aid payments. However, if it retains some profit for development and administration, this profit will be liable for tax.

The HMRC recommendation for avoiding this problem is for the CTO charity to ensure that the trading company is established with enough capital to allow it to shed all of its profits every year, while staying in business. **It is CTA's view that setting up a trading arm should not be considered without seeking the relevant legal and accounting advice from your professional advisers.**

Step four: choosing directors

In order to ensure that the trading subsidiary is managed in the interests of the CTO parent charity, and to monitor its performance, some of the trustees and/or employees of the charity will sometimes become directors of the trading subsidiary. Where this happens, they must remember that the charity and the trading subsidiary are different entities. Anyone involved with the administration of both entities has two distinct responsibilities, and it can at times be difficult to balance conflicting pressures.

Charity Commission [guidance](#) states that as a matter of good governance, there should be both:

- at least one person who is a trustee, but not a director or employee of the trading subsidiary
- at least one person who is a director of the trading subsidiary, but not a trustee or employee of the charity

These people are described as ‘un-conflicted’ as they have no conflict of interest in their roles. These un-conflicted trustees and directors should advise their colleagues as to the proper course of action where the duties of those with dual responsibilities are in conflict. This reduces the risk of any transaction between the parent charity and the trading subsidiary being challenged or questioned.

So who can be a director of the subsidiary

The parent CTO can appoint anyone it wishes to be a member of the governing body of the subsidiary, including members of its own governing body. Members of staff of the parent CTO could also be appointed, and could receive additional pay for their service as a director.

However, clear boundaries need to be kept to avoid dangerous confusions and conflicts of interest. It is advisable to have some people on the governing body of the trading company who are not directly linked to the parent organisation, and vice versa.

The charity commissioner specifically addresses this point [as follows](#):

“42. People who are trustees of a charity often become directors of a subsidiary trading company owned by that charity. Clearly, there may be some need for the trustees to be represented on the board of the subsidiary trading company. There are however, difficulties if all the trustees become directors of the trading company, or if all the directors are trustees.

43. An individual who is both a trustee of the charity and a director of a subsidiary trading company will have two different sets of responsibilities to fulfil even though the company was established as a means of raising funds for the charity. It can be difficult to balance these responsibilities.

44. We recommend that there should be at least one person who is a trustee of the charity and not a director of the trading company, and at least one person who is a director of the trading company and not a trustee of the charity. The people without dual interests can be

expected to give suitable advice to their colleagues as to the proper course of action in a conflict of interest situation and this should reduce the risk that any transaction between the charity and the company being challenged or questioned.

45. A charity trustee cannot be paid for his or her services as a director, or employee, of the subsidiary trading company (or, of course, as an employee or trustee of the charity) unless the governing document of the charity specifically provides for this.”

Constitutional separation

Even though they may share some staff and directors, the CTO charity and trading company must be legally and financially separated. This includes separate bank accounts and financial records. All paperwork, records, contracts and other legal documentation must make it absolutely clear to which of the two organisations they apply or belong. Steps should be taken to avoid the possibility of confusion, such as the board of directors making a decision at the wrong meeting. This will be especially important for contracts for non-primary purpose trading. In the example of Anytown CT, the contract will be between its subsidiary, “Anytown Transport Trading Ltd” and the Passenger Transport Authority. It is essential that you can demonstrate a clear separation between the two legal entities.

What about staff and other resources?

The parent CT’s staff may be asked to work for the subsidiary. There is no legal impediment to this, but suitable clauses should be inserted in contracts of employment, with due regard for employment law regarding changes in terms of employment. [ACAS](#) can offer useful tools and advice with regards to employment law and regulations.

If staff of the parent company do work for the subsidiary, the parent will need to charge the subsidiary accordingly. This payment for staff time should be set out in a legally-binding agreement which can also cover use of shared resources and equipment, facilities and other overheads. [HMRC guidance](#) on calculating these figures emphasises the need for accuracy.

They say if the trading company shares the charity’s premises, staff or services, it should include an appropriate allocation of the costs in its accounts. The amount the charity charges for the shared resources should generally not exceed the cost, as any profit it makes in this way would be regarded as non- exempt trading income.

Step five: clear boundaries

It is important to establish and maintain a clear boundary between the parent charity and its trading subsidiary to avoid any possibility that charitable resources are used for non-charitable purposes. Particular attention should be paid to the following areas:

- **Financial management:** Separate accounts should be established for the parent charity and its subsidiary, and any transfer of funds between the two should be recorded as transactions. The rules governing investment by charities in subsidiaries applies not only to start-up finance but also to ongoing finance and support.
- **Sharing resources:** If the trading subsidiary uses the charity’s premises it must pay an open market rent. Employees that work both for the charity and for the subsidiary must have their employment costs correctly apportioned. The same applies to equipment, services, consumables or resources that are used by both the charity and the subsidiary.
- **Trading profits and Gift Aid:** One of the main reasons for setting up a trading subsidiary is to generate funds for the charity. A trading subsidiary can donate its profits to its parent charity and claim Gift Aid tax relief on the donation, if it is liable for corporation tax. Caution should be taken when deciding how much of the profit should be donated, because the subsidiary will need to retain and reinvest some profit to ensure its sustainability.

It is essential that you can demonstrate a clear separation between the two legal entities.

Ownership and control

As noted in “[Choose a legal form for the trading subsidiary](#)” above, the trading subsidiary will most likely be a company limited by shares, in which all the issued shares are held by the parent CTO.

This means that the trading subsidiary is wholly owned by parent body, which has final legal control over the subsidiary, including the power to remove members of its governing body, should it so wish. This could be seen as a useful safeguard to ensure that the subsidiary always reflects the parent CTO’s wishes in management and operation.

Assets

It would be possible for the parent charity to own all assets and lease these to the subsidiary.

Further support and assistance

This toolkit is only a guide and organisations may find that their situation is slightly different from those outlined in this document. Should you require additional help or support, please don’t hesitate to contact us at advice@ctauk.org. It may also be useful to explore guidance at:

- knowhow.ncvo.org.uk/organisation/financial-management/tax-and-trading/trading-and-charities
- sayervincent.co.uk/wp-content/uploads/2015/07/SubsidiariesMadeSimple-SayerVincent-July2015.pdf

Trading subsidiaries checklist

Key points to remember

The Charity Commission lists a number of key points, which any charity operating, or intending to operate, a trading subsidiary should bear in mind:

- The financial structures of the charity and the subsidiary trading company ought to be kept separate.
- The separate identities of the charity and the subsidiary trading company should be made clear in all publicity material and, in dealings with suppliers.
- The names of the charity and the subsidiary trading company should be distinguished from each other to prevent confusion between the activities of the two organisations.
- The establishment of a trading subsidiary, where the directors of that company are the same people as the trustees of the charity, cannot be used as a means of paying the charity's trustees "by the back door".
- The charity must not settle the debts of the subsidiary trading company.
- The charity should not feel any moral obligation to fund the subsidiary trading company.
- Any financial support the charity can give to the subsidiary trading company including non-cash commitments (e.g. staff, office space and equipment) should be carefully assessed.
- The charity buying stock and donating it to the subsidiary trading company should be avoided.
- Plan for the subsidiary trading company to be financially viable as soon as possible. Normally, this will be within its first 5 years of operation.
- The need to obtain the Commission's authority to any proposal for a lease of property by a charity to a subsidiary trading company.
- To ensure that investments in a subsidiary trading company are qualifying investments for tax purposes.

In addition to the above, the trustees must be aware of what rights ownership of shares in the subsidiary trading company will give to the charity (or themselves). Examples of such rights are:

- Voting powers
- Appointment of directors
- Remuneration
- Dividends

Action checklist

You may wish to use the following list as a starting point to help you make decisions about setting up a trading subsidiary. You will, of course, want to add to/adapt it for your own particular situation.

1. Check your governing documents to identify if you have the power to invest in a trading subsidiary.
2. How much trading are you planning?
 - 2.1. Is the trade you are considering primary purpose or non-primary purpose?
 - 2.2. How much income will be generated?
3. Look at the [guidance](#) - is this within the allowable limits?
 - 3.1. Do you need to set up a trading subsidiary?
 - 3.2. Even if there isn't a legal or tax imperative, would it be prudent good practice?
4. Do you think a subsidiary trading company is appropriate?

If so, you will need to consider the implications for your parent organisation of:

 - 4.1. Tax law
 - 4.2. Charity law
 - 4.3. Employment law
5. Now, take legal and financial advice, considering, amongst other things:
 - 5.1. How much will you need to invest to set up a subsidiary?
 - 5.2. Will this be a prudent use of the charity's funds?
 - 5.3. Can a trading subsidiary you set up meet the legal requirements for obtaining a PSV Operator's Licence?
 - 5.4. Do you have the expertise to set up the management/administration systems required for a trading subsidiary?
 - 5.5. Can existing agreements be transferred over to the new trading arm?
 - 5.6. How much will this cost?