

General Tax Guide

**For Arts & Heritage Organisations
Registered as a Scottish Charity**

Contents

Introduction	02
A guide for Cultural Charitable Organisations	03
Corporate Tax Exemptions	04
What Trading Income is Exempt from Tax?	05
Trading Risks	06
Creative Industries Tax Reliefs	08
Charitable Donations and Gift Aid	10
Value Added Tax (VAT)	13
Basic Principles	14
Registration Requirements	15
The VAT Liability of Income and Activities	17
Recovery of VAT Incurred on Expenditure	23

Introduction

This General Tax guide has been created for arts and heritage organisations registered as Scottish Charities in response to requests for support and guidance in this area.

It is the first of four tax guides to be produced by Azets for Arts & Business Scotland; designed to help cultural charities have a better understanding of tax laws. It raises specific issues that cultural organisations should be aware of and details specific benefits that they could also be making the most of.

The guide is divided into three sections

- Corporate Tax Exemptions
- Charitable Donations and Gift Aid
- Value Added Tax (VAT)

This guide has been written to accompany the 'A General Tax Guide for Arts and Heritage Organisations' event, also delivered by Azets.

We hope you find this publication a useful and a valuable addition to the resources and training programme provided by Arts & Business Scotland.

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A guide for Cultural Charitable Organisations

Charities and Tax

Most arts, heritage and cultural organisations in Scotland are registered charities. Contrary to popular belief charities are not exempt from all taxes; indeed the opposite is often closer to the truth.

Arts organisations need to be aware of the taxes they are liable to, when they are liable to them and how to account for them. As the activities of arts organisations diversify so their exposure, liability and awareness to tax must increase. Arts organisations are potentially liable to the full range of taxes in the UK. This includes corporation tax on trading income and gains, income tax and VAT. In practice unexpected liabilities and costs arise because arts organisations are unaware of the application of tax or consider it too late.

Charities may be required to complete tax returns reporting their income and gains to HMRC. HMRC policy has been to issue a formal notice to file a return to a sample of charities each year. It is normal practice for larger charities to submit returns on an annual basis.

When charities are required to submit a tax return they will have to provide detailed information on income, expenditure, investments and loans. The return will also contain a declaration which, once signed, confirms that the charity has applied all income and gains for charitable purposes.

Even if a tax return is not requested by HMRC a charity with non-exempt income must complete and submit a return. Any corporation tax due on the non-exempt income must be paid to HMRC within 9 months of the end of the tax accounting period, assuming the charity is established as a company.

Corporation Tax Exemptions

Charities don't receive a blanket exemption from taxation; however there are a series of tax exemptions from which they can benefit. In order for a charity to benefit from the tax relief available it must register its charitable status with HMRC.

Charities are exempt from tax on the following types of income as long as the income is used for charitable purposes:

- Genuine Donations (both from individuals and companies) that are not linked to any business activity and do not provide benefits to the donors. (This is distinct from business sponsorship which is discussed later)
- Rental income - income derived from an interest or right over land. For example, income received from renting out spare office space. Where additional services are provided this will not amount to rent
- Bank interest and dividend income
- Capital gains – gains

As a basic rule, trading income does not qualify for tax relief and it is generally liable to tax. That said if the trading income falls under one of the following categories it will be exempt from tax:

WHAT TRADING INCOME IS EXEMPT FROM TAX?

1. Primary purpose trade

A primary purpose trade is one that is undertaken in the course of carrying out the primary purpose activities of the charity. For example:

- Provision of educational services by an educational body
- Admission fees to an exhibition in an art gallery or entrance to a museum
- A theatre's sale of tickets for a theatrical production
- Entrance fees charged at a leisure centre to use facilities

2. A trade that is ancillary to a primary purpose activity

Exemption from tax is extended to other trades that are ancillary to a primary purpose activity. For example:

- A shop at a gallery or museum that sells reproductions of exhibits or educational goods
- The sale of food and drink in a theatre restaurant and bar to members of the audience but not the general public (the sale of food and drink to the general public will not be exempt from tax)

3. Trades where beneficiaries of the charity carry out work

This exemption covers all trades where work is mainly carried out by beneficiaries of the charity, for example income from:

- An art college selling students works of art

- A restaurant operated by students as part of a catering course
- The sale of goods manufactured by disabled people who are beneficiaries of the charity

Not all of the trade needs to be carried out by the beneficiaries. Employers, contractors or volunteer workers may carry out part of the work. The requirement is, however, that beneficiaries of the charity carry out the greater part of the work.

4. Exemption for small trading

Only after all of the above exemptions have been considered should charities look at whether the following exemption applies. Income that would ordinarily be liable to tax will be exempt where it does not exceed the limits shown in the table below.

Charity's gross annual income	Maximum permitted small trading turnover
Under £20,000	£5,000
£20,001 to £200,000	25% of your charity's total annual turnover
Over £200,000	£50,000

The exemptions allow charities to operate small scale trading such as selling Christmas cards without suffering tax.

TRADING RISKS

There are certain types of activities that regularly provide charities with questions and risk. They include:

- Shops
- Property lettings
- Business sponsorship

Shops

In cultural organisations, it will be common for charities to have retail sales. For example, merchandise linked to an art gallery or museum. To the extent that this is linked to the charitable objectives of the organisation – this will be exempt, for example, educational art books sold in an art gallery. However, if it is commercial sales of items unrelated to the primary trade, this may well be taxable. For example, a museum/art gallery selling general gifts which have no connection to the charity, e.g. mugs, sweets etc.

Property Lettings

All rental income from land and buildings received by a charity is exempt from tax as long as it is used for charitable purposes. Where services are provided along with the use of land, the enhanced letting activities can amount to a taxable trade. For example, income generated by a charity that simply lets out excess space in its office to a third party will be exempt from tax. However a charity that lets out excess office space and also provides a receptionist, telephone, photocopying, basic refreshments and technical support may be carrying out a trade, as would renting out space, for example a conference and providing full IT equipment and staff.

Business Sponsorship

Business sponsorship arrangements that link the

name of a business to specific projects are usually regarded by the business as a valuable advertising arrangement.

The tax treatment of income received for business sponsorship will ultimately depend on the nature of each arrangement, for example:

- **If the charity does not provide goods or services in return for the payment, the payment will normally be regarded as a donation and not trading income. (see Charitable donations and gift aid)**
- **If the charity provides goods or services in return for the sponsorship payment it may be treated as trading income.**

Even if the sponsor exploits and publicises its links to the charity, the nature of the payment will not change unless the charity also seeks to publicise the arrangement.

If the charity agrees to publicise the sponsors involvement or affinity and this is no more than an acknowledgement (for example a small reference to a sponsor in a publication) it should not result in the receipts being taxable. However, where the publicity amounts to advertising, it will result in the payment being classified as trading income which would be subject to corporation tax.

An acknowledgement of sponsorship, which would amount to advertising and therefore treated as trading income in the hands of the charity, could take place where a charity displays the sponsor's logo prominently or provides services in return for the sponsorship payment such as:

- **Promotions included in mailing lists**
- **The use of the charity's logo**
- **Endorsement of the product or services**
- **Exclusive rights to sell goods**

Sponsorship in kind also needs to be considered. This is where a sponsor provides some kind of service or goods for free or at a reduced rate

to the charitable organisation. The value of the 'in kind benefit' would need to be recognised in the accounts of the charitable organisation. For example, a local company provides accountancy services for free in return for the use of the charity's mailing list. The company also receives a large endorsement of their services in the charity's quarterly publication. The value of the accountancy services should be quantified and included as sponsorship income.

See *Membership Subscriptions* on page 22 for the related VAT consequences.

Trading Subsidiary Companies

Where a charity has a large amount of trading activities which are not tax exempt (and the charity pays tax or there is a potential risk to charitable status or objectives), it is normally prudent to consider setting up a subsidiary company to operate the trading activities. For example, a charitable organisation operating a museum may also have a café which is open to the general public. The profits from the café would be subject to corporation tax (assuming none of the exemptions, numbered 1-4 above are appropriate).

The subsidiary company will not itself be a charity, and its profits will be chargeable to corporation tax. However, profits can be donated to the charity thus reducing the company's taxable profits to nil, and because the donation is exempt in the charity, no corporation tax is payable by either party. This "trading subsidiary" structure is commonly used by charities to shelter from tax any profits arising from trades which are not charitable trades. There may also be non-tax reasons for putting such a structure in place; if for example the trading activity is one which the trustees of the charity may feel the charity itself is not permitted to carry on under the terms of its Memorandum or other constituting documents.

As long as the trading company is a wholly owned subsidiary, the charitable donation can be made up to nine months after the end of the accounting

period and the payment made will be allowed as a deductible expense by the subsidiary company. This normally allows the trading company to finalise accounts and tax position before having to make a charitable donation. The trading subsidiary must ensure it pays over the full amount of the payment within a nine month period. It should be noted that the payment must be an actual payment and not just a journal entry in an inter-company accounts. For this reason, the charity and the trading sub must have separate bank accounts.

In practice, there may be commercial reasons why all the taxable profits are not donated to the charity. These would include the need to fund the trading subsidiary. In this case, the subsidiary would have to pay tax on the profits it has realised and retained.

Setting up a subsidiary is not always the best option because there are associated administration costs and internal arrangements; for example the cost of preparing accounts, tax returns and legal fees. One of the biggest practical issues is how to fund the subsidiary initially and beyond. Equally, if the trading subsidiary gets into financial difficulties further complications could arise. Lending to the subsidiary can be seen as non-qualifying expenditure for tax purposes and the charity could be liable to tax on the equivalent amount of income.

Depending on the level of trading activity and income and the cost associated with setting up a subsidiary company, it may be more beneficial to leave the trade in the charity and simply pay corporation tax. This point needs to be assessed and considered on an individual case basis. For example, if a charity had a small trade and had profits of £10k (assuming the turnover exceeds the small trade exemption mentioned above), corporation tax of £2k would be payable. This could be less than the cost of maintaining a separate trading company, for example associated accountancy and legal costs.

CREATIVE INDUSTRIES TAX RELIEFS

Theatre Tax Relief

Theatre Tax Relief (TTR) was introduced in Finance Act 2014 to provide a tax break for production companies engaged in qualifying theatre productions. The relief is designed to recognise the unique cultural value that theatre brings to the UK and encourage greater and more diverse productions.

TTR provides companies with either a reduction in their corporation tax liability or a repayable credit.

The relief applies to various theatrical productions including:

- **Theatre**
- **Ballet**
- **Dance and opera**
- **Other live performances**

Any company (charitable or not) that meets the definition of a production company can claim TTR. A production company is a company that produces, runs and closes the production, is engaged in decision-making and makes creative, technical and artistic contribution to the production. The production company can either be a commercial company or it can be a charitable company.

The company must be a 'production company', and in order to claim the relief the company has to treat the theatrical production activity as a separate trade for the purposes of its corporation tax return.

The production company may be able to claim a repayable tax credit from HMRC. This is calculated as up to 20% of a non-touring production's core qualifying expenditure and 25% of a touring production's core qualifying expenditure.

Orchestra Tax Relief

Orchestra Tax Relief (OTR) took effect from 1 April 2016 to promote British culture in a sustainable way. The relief provides a tax break for companies engaged in a qualifying concert by an orchestra, ensemble, group or band.

OTR works in a similar way to TTR (Theatre tax relief) as companies can claim a reduction in their corporation tax liability or claim a repayable credit. As with TTR, any company which meets the definition of a production company can claim OTR.

A concert will qualify where the number of instrumentalists is at least 12 and none of the instruments are electronically or directly amplified (the sound as a whole may be amplified to enable each person in the concert hall to hear). The instrumentalists must be the main focus of the concert; if they are the backing band for a singer then the concert will not qualify. If the concert's main purpose or one of the main purposes is to advertise goods or services such as a competition, or the primary purpose is to make a recording the concert will not qualify.

Again, like TTR, each qualifying concert must be treated as a separate trade for the purposes of its corporation tax return. However, here there is the option to elect to treat a number of concerts in a series as one separate trade.

Where loss making, the company may claim a repayable tax credit from HMRC amounting to 25% of the loss available for surrender.

Museums and Galleries Tax Relief

Museums and galleries tax relief is available from 1 April 2017.

The tax relief will be available to museums and galleries with charitable or educational objectives. The relief can be claimed by a charitable company,

a company wholly owned by a charity or a company wholly owned by a local authority. To qualify for the relief the entity will need to be within the charge to corporation tax.

Tax relief will be available for the creative and set up costs of temporary and touring exhibitions.

Relief will take the form of an additional deduction from taxable profits or a repayable credit if the deduction results in a loss.

The rates of relief will be set at 25% for touring exhibitions and 20% for permanent exhibitions. Museums and galleries will be able to claim a credit worth up to £100,000 on exhibitions that toured and £80,000 on non-touring exhibitions.

An exhibition is defined as 'an organised and temporary display of a selection of works of art or items held in a qualifying museum or art gallery.'

Costs which are eligible for the relief include curator and research costs, installation, digital, insurance and transportation but not the costs of running the exhibition, marketing, storage and financing.

Unlike TTR, two entities will be able to make a claim for the Museums and Galleries tax relief where they jointly create an exhibition.

Charitable Donations and Gift Aid

For charities, there tend to be two or three main sources from which donations are received, each of which comes with different tax implications. The main sources are individuals, companies and charitable trusts and foundations.

Donations by Companies

Under current rules, all a company has to do to make a Gift Aid payment to charity and qualify for a tax reduction is to make the payment. There is no requirement for any forms to be completed or for income tax to be deducted. There is also no minimum amount. The company simply makes the donation and books this in the accounts. If the company is profit making, corporation tax relief is available. A charity cannot claim any tax repayment or supplement from HMRC on donations received from companies.

Companies that are wholly owned by a charity or charities can make a donation up to nine months after the end of an accounting period in which the corporation tax deduction is sought. All other companies must make the payment in the accounting period in order to qualify for relief.

Donations or Grants by Charitable Trusts and Foundations

From the point of view of a charitable organisation receiving a donation or a grant from a charitable trust or foundation, this will not be paid under the Gift Aid scheme. The payment of net donations only applies to giving from individual donors. The receipt from the charitable trust or foundation will therefore simply be received gross with no further relief to be claimed by the charity.

As such, from a Gift Aid perspective there is no restriction on the level of acknowledgement which can be made to the donor, or indeed on any benefits which are made to the donor. This is because there is no additional relief being claimed by the charity in respect of the payment received. However there will be VAT implications where a funder requires specific deliverables to be provided in return for its funding. This is explained in more detail in the VAT section below.

Donations by Individuals (Gift Aid)

Like donations made by companies, there is no minimum amount. However, that is the only common feature for both company and individual donations.

Individual donations are made net of basic rate tax. The individual therefore must pay sufficient tax in the year to cover the tax on the gross donation they make to a charity. From 6 April 2016, HMRC has changed the wording of the Gift Aid declaration to make it very clear that if the individual has not paid sufficient tax to cover the amount reclaimed by the charity, they will be responsible for settling the shortfall.

There is a requirement for the individual to provide the charity with a valid Gift Aid declaration. Most charities design their Gift Aid declaration and request donors complete these. Declarations may be written or oral and there are different requirements for each. A written declaration must contain the following details for it to be valid:

- **The donor's name and home address, minimum postcode**
- **The charity's name**
- **A description of the donation or donations covered by the declaration**
- **A note explaining the requirement that the donor must pay an amount of income**

tax and/or capital gains tax equal to the tax deducted from the donation, and will be responsible for making up any shortfall if this is not the case.

The donation must be a genuine payment of a sum of money. It must not be repayable, there must not be associated supplies of goods or services and it cannot be conditional on the charity acquiring property or services from the donor.

HMRC accept that an acknowledgement of a donation does not affect the tax position. However, if any benefits are provided and the value of the benefits exceeds the following limits the tax status of the donation will be affected:

Amount of donation	Value of benefit
Up to £100	25%
£101 to £1,000	£25
Over £1,000	5% up to a maximum of £2,500

Where the value of benefits exceed these limits, the donor may specify that part of his payment is a payment for the benefit and the other part of the payment is a donation. As long as the donor specifies this before or at the time the donation is made the donation may qualify for Gift Aid. This concept is often used in charity auction dinners where a specific donation is included in the price for either a lot at a charity auction or a place at a charity dinner.

Calculating the value of donor benefits can be difficult. Where benefits have a genuine commercial value this will generally be the value for tax purposes. Where the value is less obvious the charity should consider how much someone acquiring the benefits at arm's length would pay for the benefit. Evidence should be obtained from similar transactions in the commercial sector. For example, if a donation for £100 was made and in

return the charity sends a quarterly arts magazine to the donor for a year, assuming the value of this is under £25, there are no issues. This is easy to value if you can buy the magazine online. See also reference to valuing benefits included within the VAT section.

There are many specific areas within fundraising where Gift Aid plays a large part, for example sponsorship of events, entrance to charity property, operating discounts within shops and our detailed guide to Gift Aid contains in depth examples of how these interact.

Gift Aid Small Donations Scheme (GASDS)

This was introduced in relation to small cash donations made to charities from 6 April 2013. It allows charities and 'Community Amateur Sports Clubs' (CASCs) to claim a top-up payment equivalent to Gift Aid. A small donation is anything below £20 which is given in cash, coins or notes. No individual Gift aid declaration requires to be signed, nor are any details for the donor provided when the charity claims the top-up payment.

Currently, in order for a charity to benefit from this top-up payment, there are a number of conditions that must be met. These include the need to have been registered as a charity (or CASC) for at least the two previous complete tax years, and to have made a successful Gift Aid claim in at least two of the previous four tax years. In addition, the charity must not have incurred a penalty in respect of a Gift Aid or top-up claim. For claims relating to years between 2013 and 2015 the top-up could be claimed on small cash donations of up to £5,000, and from 6 April 2016 the top-up can be claimed on small donation income of £8,000.

There are further rules relating to charities which may be connected with other charities, and in relation to donations which have been collected in community buildings. These will also be covered in the more detailed Gift Aid guide to be produced later in the year.

Value Added Tax (VAT)

The following notes provide a summary of the key VAT rules and procedures that apply to arts and heritage organisations. The notes have been arranged in an order that should assist arts and heritage organisations to assess and monitor their VAT position. These notes are intended to highlight the most common VAT rules and principles. It is worth noting that VAT rules and guidance do change and can be interpreted in different ways by different people. Professional advice or confirmation from HMRC should be obtained whenever there is uncertainty or doubt.

The notes are arranged in the following order:

- **Basic principles – an overview of how the VAT system works**
- **Registration requirements**
- **The VAT liability of income and activities**
- **The recovery of VAT on expenditure**

BASIC PRINCIPLES

VAT is a tax on consumer expenditure and it is the final customer or the consumer of goods or services that ultimately suffers the cost of the tax.

While there are a few concessions for charities, VAT applies to arts and heritage organisations in exactly the same way as it does to all other organisations.

The UK VAT system requires suppliers of goods and services to charge VAT on their sales as a percentage of the sale price and to pay that VAT to HMRC. In practice, the rules require VAT to be charged on business supplies of goods or services that are made in the UK by suppliers that are VAT registered.

In the UK, supplies can be liable to standard (20%), reduced (5%) and zero rates of VAT. The rates applied in the UK can change depending on Government policy. Supplies that are liable to the standard, reduced and zero rates of VAT are commonly known as taxable supplies and these are the supplies that must be considered when evaluating a requirement to register for VAT.

Arts and heritage organisations must register for VAT as soon as the value of their taxable supplies exceed the current VAT registration threshold. Once registered, they will be required to complete and submit VAT returns to HMRC. These are normally completed on a quarterly basis however, with HMRC approval, arts and heritage organisations could elect to complete VAT returns on a monthly or annual basis.

Once registered for VAT an arts or heritage organisation is entitled to reclaim the VAT it incurs on purchases and expenditure that is linked to taxable supplies.

However, not all supplies are taxable. Some business supplies are exempt from VAT. Exempt income should be ignored when evaluating the requirement to register for VAT. When all of an arts

or heritage organisation's supplies are exempt from VAT it cannot register for VAT. As a consequence it will not be able to recover the VAT it incurs on expenditure.

If the organisation makes both taxable and exempt supplies it may have a requirement to register for VAT however it may also be required to block or restrict its recovery of the VAT it incurs on expenditure.

In practice, VAT registration normally results in additional administration costs for arts and heritage organisations and as a result many attempt to delay their registration for VAT as long as possible. Care should be taken to ensure that statutory requirements to register are not overlooked as this could result in penalties or interest charges. Penalties and interest charges are also applicable if VAT returns are submitted late or errors are made when accounting for VAT.

Services Made and Received from Outside the UK

Arts and heritage organisations are required to "self-account" for VAT on the value of the services they obtain from non-UK suppliers.

For example an arts body that is VAT registered in the UK would need to account for UK VAT on the value of consultancy services it receives from suppliers in the USA or Europe. In practice the organisation would record the purchase as if it was a UK purchase and sale. VAT would need to be charged and accounted for on the sale to HMRC. This VAT would also be recoverable according to normal VAT rules.

This procedure can also result in a non-registered arts or heritage organisation having an obligation to register for VAT when the value of taxable UK income plus the value of overseas purchases exceeds the VAT registration threshold.

Charges raised for admission to cultural, artistic, sporting, scientific, educational and entertainment

events (services ancillary to them) are liable to VAT wherever the event takes place. Admission to an event in the UK will therefore be subject to UK VAT rules and if the income is taxable it will count towards the VAT registration limit in the UK. Admission charges raised for events that take place overseas will not be liable to UK VAT but could result in a requirement to register and to account for VAT in another country.

VAT rules are often perceived to be subject to more change than other taxes and consequently arts and heritage organisations would be advised to ensure (whether they are registered or not) that they regularly review the VAT status of their income and activities, that they register for VAT as soon as they have a statutory requirement to do so and once registered they monitor their recovery of VAT on expenditure.

When VAT rules are misinterpreted or changes to VAT rules are not implemented correctly additional unbudgeted costs can be incurred. Staff responsible for the VAT position of any organisation should ensure that they regularly update their knowledge of the VAT rules that apply to their organisation.

REGISTRATION REQUIREMENTS

Whenever an arts or heritage organisation's taxable income (standard, zero rate and reduced rated income) exceeds the compulsory VAT registration threshold (currently £83,000) it has a statutory requirement to register for VAT. It must notify HMRC of this requirement within specific timescales (generally 30 days). Failure to do this could result in financial penalties being applied by HMRC.

It is important to be aware that an arts body that has a requirement to register for VAT (but has failed to do so), is still obliged to account for VAT on its supplies.

Compulsory Registration

To establish whether an organisation has a requirement to register for VAT it should apply two tests.

Test One

When the value of taxable income received in any rolling 12 month period exceeds the VAT registration limit (currently £83,000) an arts body must notify HMRC of its requirement to register within 30 days. HMRC will then register the arts body from the 1st day of the following month.

For example if an arts body exceeded the VAT registration limit in March it must notify HMRC by 30 April (30 days from the end of the month the VAT registration limit was exceeded). It would then be registered and have to account for VAT by HMRC from 1 May.

Test Two

In this case a “look forward” test applies. When an arts or heritage organisation expects to receive taxable turnover that exceeds the VAT registration threshold (currently £83,000) it will be required to notify HMRC of that expectation within 30 days. HMRC will register it for VAT from the day the expectation arose.

For example, an organisation secures two new corporate sponsors in the same month. The income received from the sponsors will be invoiced in the next 30 days and the combined value will exceed the VAT registration limit. The organisation must notify HMRC of its requirement to be registered within 30 days of the sponsors being confirmed. HMRC will register it from the date the expectation arose which means the sponsorship income will be liable to VAT.

Organisations that are not registered for VAT should monitor the value of their income and overseas purchases and ensure they register as soon as they have a statutory requirement to do so. It is prudent to monitor the position at the end of every month, especially if the value of income is close to the VAT registration threshold.

Arts and heritage organisations should also consider their VAT position when they enter into any new contracts where the income received exceeds the VAT registration limit.

It should be remembered that interest and penalties are normally applied by HMRC for any late registration.

Voluntary Registration

Some arts and heritage organisations choose to voluntarily register for VAT – even when the value of their taxable supplies is below the statutory VAT registration limit. They normally do this to recover the VAT they incur on expenditure.

As arts and heritage organisations are frequently prevented from recovering all the VAT they incur on expenditure it is worth confirming this point (and estimating the benefit of VAT registration) before applying for voluntary VAT registration.

If an organisation has incurred a significant amount of VAT on expenditure it may be beneficial for it to voluntarily register for VAT and recover the VAT incurred even if this means accounting for VAT on taxable income.

The VAT rules allow arts and heritage organisations to go back 4 years (from the date they register) to recover the VAT incurred on goods and 6 months on services. Organisations should therefore consider whether they would benefit from delaying VAT registration as long as they can recover the VAT incurred on historic expenditure at a future date.

THE VAT LIABILITY OF INCOME AND ACTIVITIES

For VAT purposes activities that take place on a regular basis for any form of consideration are classified as business activities. Unless business supplies are exempt from VAT or liable to the zero or reduced rates they will attract standard-rate VAT.

Supplies that are made for no charge are classified as non-business supplies. Income that is not linked to any specific supplies of goods or services e.g. grants and donations are normally outside the scope of VAT.

The following list summarises the supplies that are made by arts and heritage organisations and classified as exempt or liable to the zero and reduced rates.

Exempt Supplies

- **Cultural services – admission to museums, galleries, arts performances, collections, exhibitions and shows.**
- **Educational activities**
- **Fundraising events by charities and qualifying bodies**
- **Works of art – the supply of artworks**
- **Land and property transactions**
- **Memberships of professional bodies**
- **Betting, gaming and lotteries**

It should be noted that VAT exemption is different from zero-rating. A zero-rated supply is a taxable supply and this income must be included and considered when evaluating registration requirements. VAT incurred on costs that are attributable to zero-rated supplies can be recovered from HMRC. Conversely, VAT incurred on costs that are attributable to exempt supplies cannot normally be recovered. Exempt income can be ignored when

evaluating registration requirements.

The following notes provide more information on the VAT exempt activities listed above.

Cultural Services – Admission Charges to Cultural Events

Charges raised for admission to museums, galleries, art exhibitions and zoos and theatrical, musical or choreographic performances are exempt for VAT when the arts body raising the charges is classified as culturally exempt.

A culturally exempt arts or heritage organisation is one that:

- **Applies all profits made from admission charges to the continuance or improvement of its facilities**
- **Is managed and administered on an essentially voluntary basis by people who have no direct or indirect financial interest in the activities of the organisation. In practice this usually means that the arts body has a board of trustees, none of whom are entitled to a salary**

It is important that arts and heritage organisations are aware of and monitor their VAT status for cultural exemption as this can be affected by changes to their board and the use of profits.

The addition or removal of a senior member of staff to/from a board (e.g. a chief executive who is paid a salary and involved in day to day activities and decisions) can change an arts or heritage organisation's VAT status. This affects the VAT liability of the organisation's admission charges and will have an impact on the recovery of VAT incurred on expenses and profits.

If an organisation is not culturally exempt, its admission income will be liable to standard rate VAT. This will affect the value of income received (and retained) and the price of tickets. It will also

allow the VAT incurred on the associated costs to be recovered. When standard-rated the income will also count towards the VAT registration limit.

Cultural exemption only applies to the admission income received by a culturally exempt arts or heritage organisation, while it is acting as principal and the charges are for admission to its own collection, exhibition, performance or show. VAT incurred on costs wholly associated with culturally exempt admissions will normally be blocked from recovery. This includes performance costs as well as the general and capital expenditure incurred.

Commission or income received by an arts or heritage organisation that is acting as a ticket agent or box office for another party and is providing a venue to exhibit or perform is normally liable to standard rate VAT. This income will count towards VAT registration limits.

Training/Education

The supply of training or education by an arts or heritage organisation is exempt for VAT when:

- **The charity is precluded from distributing any profit it makes, and**
- **It only applies the profit it makes from the delivery of education or training to the improvement of educational or training services or facilities**

In practice, to meet the first condition and to qualify for VAT exemption, an eligible arts body should document that any profits will be “ring-fenced” and only used to improve and deliver training or education.

Where an arts or heritage organisation does not meet the above conditions, its supplies of education will be liable to standard rate VAT. The VAT liability of educational activities and income will affect the value of income received (and retained), the ability to recover the VAT incurred on associated costs and VAT registration requirements.

Fundraising Events

Income generated by arts or heritage organisations at qualifying fundraising events is exempt from VAT when:

- **The events are organised for charitable purposes**
- **The event is organised by a charity or a subsidiary exclusively for the benefit of the charity**
- **The event is organised jointly by one or more charities exclusively for charitable purposes**

The following events are recognised by HMRC as being fundraising events:

- **A ball, dinner, dance, dinner dance or disco**
- **A live performance (e.g. concert or stage production)**
- **The showing of a film video or DVD**
- **A fete, fair or festival**
- **A horticultural show**
- **An exhibition**
- **A jumble or car boot sale**
- **Sporting events such as sponsored walk or swim**
- **Contests, games of skill and quizzes**
- **Participation in an endurance event**
- **A dinner, lunch or barbeque**
- **Firework displays**
- **An auction**

Where a charity fundraising event qualifies for VAT exemption VAT does not have to be charged on admission charges or entrance fees to the event. The exemption also applies to associated sponsorship income and merchandise sales. This also means that the VAT incurred on associated

costs and expenditure will normally be blocked from recovery.

To qualify for VAT exemption the event must not be a continuous trading activity and accommodation must not be provided for more than two nights. No more than 15 fundraising events can be held by an arts or heritage organisation in single location in any one year. Once the 15 event threshold is exceeded none of the events qualify for exemption. This limit does not apply where the gross takings from the events, are less than £1,000 per week.

HMRC will not allow trading to be undertaken through a series of events. The event must be promoted as having a charitable purpose.

While VAT exemption is not optional, if the above conditions are not met the income will be liable to standard rate VAT.

Supplies Involving Land and Buildings

A supply of land or a building or part of a building is normally exempt for the purposes of VAT. This applies to the sale or rental of existing commercial, residential and charitable land and buildings. The supply of new commercial property is liable to standard rate VAT and the supply of new residential property is liable to zero-rate VAT.

The owner and /or landlord of any area of commercial land or property can make an option to tax (for VAT purposes), which results in any subsequent sale or rental of that area of land or property being liable to standard rate VAT. An option to tax would be made by an owner/landlord to allow it to recover the VAT it incurs on associated expenditure.

Whenever an arts or heritage organisation decides to rent or purchase an area of land or a building it should initially expect that supply to be exempt from VAT. The application of VAT could result in an additional irrecoverable VAT cost. If the owner or

landlord of the land or building states that standard rate VAT will be applicable to the supply. the organisation should confirm the VAT status of the property with the landlord and where appropriate be prepared to ask for evidence that a valid option to tax has been made over the property.

A charity can block or remove an option to tax where the land or property will be used by the charity for non-business purposes (the provision of free services or activities).

Room Hire Charges

The exclusive use of a room, office or area of land is normally exempt from VAT (subject to the option to tax).

However the supply of a room or an area in a building with additional services (for example specialised equipment, technology or catering services) results in the supply being classified as the provision of services rate than the right over land and this means the whole supply is liable to standard rated VAT.

For example if a theatre was to rent out an auditorium or hall to a touring performer that supply would be exempt from VAT (subject to the option to tax). However if the theatre was to rent the hall and provide sound and lighting services, the use of specialised technicians, front of house staff and box office services, the supply would not be the supply of land and would be liable to standard rate VAT.

Taxable Supplies

In the UK, VAT is charged at the following rates:

1. The standard rate – which is currently 20% but can be varied by UK Government. This rate applies when no other VAT rates apply and the supply is not exempt from VAT.

2. The reduced rate – which is currently 5%. This rate applies to:

- Supplies of fuel or power for domestic or charitable non-business purposes
- Installation of energy-saving materials in residential accommodation
- grant-funded installation of heating equipment, security goods etc, certain residential conversions, renovations and alterations of residential buildings

3. The zero rate – which is 0% and applies to supplies of the following categories of goods or services:

- Food
- Books and selected printed matter
- Charities – sale of donated goods, advertising and the repair and maintenance of relevant goods
- Children’s clothing and footwear
- Talking books for the blind and handicapped and wireless sets for the blind
- Construction of residential and charitable buildings
- International services
- Transport
- Aids for handicapped people
- Imports and exports
- Tax free shops

Business/Non-Business Activities

Business is not defined in UK or EU VAT law. An arts or heritage organisation can therefore be carrying on a business activity for VAT even when it is undertaking primary purpose activities on a non-for-profit basis.

Activities that simply cover costs or make a loss can still be liable to VAT. For example, the sale of tickets to an event or the rent of a room or venue by an arts charity would normally be regarded as a tax exempt activity for corporation tax; however it is a “business” activity for VAT purposes.

Confirming that an activity is business for VAT is important because this determines whether or not there is a requirement to register for VAT, a liability to account for VAT and an entitlement to recover the VAT incurred on related expenditure.

It is worth noting that for an activity to be a supply for VAT purposes it must be carried out in the course or furtherance of business. Where a supply (of goods or services) is made on a regular basis in return for a consideration (cash or otherwise) the activity is likely to be regarded as a business activity for VAT purposes.

The term supply includes anything that is undertaken for a consideration. Consideration means anything paid by a purchaser where there is a direct link to the goods or services supplied. It is important to note that consideration does not have to be monetary; consequently barter transactions are liable to VAT. For example where an arts or heritage organisation agrees to provide advertising to a sponsor in return for a cash payment, the supply is normally regarded as a “business” supply. Equally, where the sponsor provides goods or services in return (in kind) and no cash payment, the supply is still made in the course of business and the transactions must be correctly recorded for VAT purposes.

Income and the Recovery of VAT

Where taxable supplies (supplies that are liable to the standard, zero and reduced rates of VAT) are made (or intended to be made) there is an entitlement to recover the VAT incurred on related expenditure. However, VAT incurred in expenditure that is directly or indirectly related to non-business (free of charge) activities is not recoverable. VAT on expenditure that is attributable to exempt activities

and supplies is blocked from recovery when it is greater than specific limits (£7,500 per annum and 50% of all VAT incurred) thresholds. The recovery of VAT is explained in more detail in Section 4 below.

Donations and Grants

For VAT purposes donations and grant income are not normally regarded as payments for any specific supply and are classified as outside the scope of VAT. This applies when the income is freely given with no strings attached - it is essentially a gift.

A grant or donation that has conditions attached to it (on how it can be used) can still be outside the scope of VAT, as long as nothing specific or measurable is provided to the funder in return for the funding. Where the funding is received in return for specific or measurable supplies being supplied, VAT may have to be accounted for and this income will count towards VAT registration limits.

Where a funder requires specific deliverables to be delivered in return for its funding, it suggests that the funding is payment for a supply. For example, where the funding is only payable when specific milestones or outcomes are achieved and these outcomes benefit the funder, and the value of the payment is determined by the level of service supplied by the recipient, the arrangement could be recorded as a standard rate supply for VAT purposes. This can make the funding liable to VAT. Arts and heritage organisations should always consider the substance of the funding arrangements they enter into and determine whether or not a supply is being made.

In an attempt to ensure there is no unbudgeted VAT cost, professional or HMRC advice should be taken if there is any doubt or question over the VAT liability of any source of income.

Outsourcing by Public Bodies

The distinction between grants and contracts is an important issue for public bodies that outsource services to arts and heritage organisations. Two different funding methods are normally used by public bodies:

1. The provision of grant funding

2. The procurement of specific services under contract and procurement process

The provision of grant funding is not a business transaction for VAT purposes, however the procurement of services is. It is worth noting that where services are procured under contract as well as being regarded as a business supply for VAT purposes by the arts body the activity could be classified as a trading activity for direct tax purposes.

If the services supplied are subject to VAT and as long as the associated agreement states the funding is exclusive of VAT the public body will be required to pay VAT in addition to the funding it provides. If the terms of the agreement are VAT inclusive, (or VAT is not mentioned), the arts or heritage organisation may be required to account for VAT from the funding it receives. This would result in a reduced value of funding being received by the arts body.

Where an arts or heritage organisation charges standard, zero or reduced rate VAT on the income it receives, it will be able to recover the VAT it has incurred on associated costs. However if the service and income is exempt no VAT will need to be charged however the arts body may not be entitled to recover the VAT it has incurred on associated costs.

Membership Subscriptions

The provision of benefits to friends, patrons and members of an arts or heritage organisation is

a business activity for VAT purposes. The VAT liability of the membership subscription ultimately depends on the type of benefits provided. In practice, arts and heritage organisations must decide whether they are making a single or multiple supply and should account for VAT accordingly. They will make a single supply where the benefits are not available separately. In this case, the predominant element of the membership will determine the VAT status of the income. Where the membership scheme has a number of benefits and the arts or heritage organisation is a charity, it may be entitled to record the VAT treatment of each benefit separately. This could reduce the amount of VAT that is paid to HMRC where the membership includes zero rated or exempt benefits. For example supplies of printed matter can be zero rated and includes:

- **Books and booklets**
- **Brochures and pamphlets**
- **Leaflets**
- **Journals and periodicals**
- **Music**

Professional or HMRC advice should be obtained before reducing the amount of VAT paid on membership subscriptions

The interaction of VAT and Gift Aid on memberships should always be considered to ensure the outcome is affective for both. It is prudent to ensure the value of the benefits included in the membership is clear as this will confirm the value of any VAT due to HMRC and the value of Gift Aid that can be claimed (where the membership is provided to an individual). Where VAT is accounted for on membership income the VAT incurred on associated costs should be recoverable to some extent.

Postage and Delivery Charges

Postage and delivery charges are normally liable

to VAT – even if the charges are identical to the exempt service provided by the Post Office.

A supply may involve the delivery of goods or tickets to a customer.

Where goods or tickets are delivered to a customer and postage is charged, the VAT liability of the postage charge follows the VAT liability of the goods or tickets being delivered.

However, where delivery is provided under a separate arrangement or contract, the supply and charge for delivery is made by the arts body, this is considered to be a supply in its own right. VAT is charged on the postage element regardless of the liability of the goods or tickets being delivered

Arts and heritage organisations will still make a single supply of delivered goods if, under their sales contract, they must deliver the goods to a place specified by the customer. This might include the customer's:

- **Own address**
- **A friend's or relative's address**
- **Own customer's address**

The VAT position of the delivery charge is not affected even if the charge is separately itemised or invoiced to the customer. In this case there is a single supply of delivered goods and the VAT liability of this is based on the liability of these goods.

Sponsored Events

For VAT purposes the term sponsored events covers walks, runs, swims and other sporting activities. These events are normally regarded as qualifying fundraising events. However, they will not qualify for VAT exemption if one of the following conditions is present.

The charitable arts organisation purchases places in an external event (e.g. a marathon). In this

case, the entry fee will be liable to standard-rate VAT. The sponsorship and donations generated by the participant over and above the entry fee are normally outside the scope of VAT.

If the charity does not stipulate that the individual needs to pay a specific entrance fee or raise a minimum amount of sponsorship, all the funds raised and donated by the individual will be outside the scope of VAT. Where the charity provides specific and expected benefits or gifts the entire amount raised by the participants could be liable to standard-rate VAT.

If a charitable organisation provides travel and accommodation as part of an event ‘package’ and this includes more than two night’s accommodation, the supply will be liable to the Tour Operators Margin Scheme (TOMS). In this case the arts body will be required to account for VAT on the profit or “margin” (the difference between the cost and the minimum entry fee) for events held in the UK and European Union.

If the organisation requires individuals to pay a registration fee or insists that they raise a minimum amount of sponsorship the registration fee or minimum sponsorship value may be liable to standard-rate VAT. If the arts or heritage organisation asks individuals to ‘pledge’ or ‘commit’ to raising a certain amount of sponsorships, but does not insist upon it, the total amount of raised funds can be treated as a donation and recorded outside the scope of VAT.

VAT incurred on costs attributable to an exempt qualifying fundraising event will normally be blocked from recovery (subject to de-minimis limits, see Partial Exemption section below for further details)

However VAT incurred on events that attract standard-rate VAT will be recoverable in full.

VAT incurred on professional fundraising expenditure should be recorded as a general overhead and recovered according to the charities normal VAT calculations.

RECOVERY OF VAT INCURRED ON EXPENDITURE

General VAT Rules

VAT registered businesses are normally entitled to recover the VAT they incur on purchases however the final consumer (usually an individual) cannot and consequently suffers the cost of the tax.

VAT incurred on expenditure (by VAT registered arts and heritage organisations) is recoverable as follows:

- **VAT on expenditure that is wholly attributable to taxable activities can be recovered in full**
- **VAT on expenditure that is wholly attributable to exempt or non-business activities is blocked from recovery (subject to certain limits - de-minimis)**
- **VAT on expenditure that is not wholly attributable to any one or particular activity is recoverable in part**

Once registered, the organisation is entitled to recover the VAT it incurs on expenditure. However as many arts and heritage organisations have exempt and non-business activities, they normally cannot recover all of the VAT they incur.

Business/Non-Business Apportionment

Arts and heritage organisations are able to recover the VAT incurred on expenditure that is attributable to taxable business activities. They are not entitled to recover the VAT incurred on expenditure that is attributable to non-business activities. Where VAT is incurred on expenditure that is partly used for business activities and partly for non-business an apportionment must be made. The VAT incurred on expenditure is recoverable to the extent that is attributable to taxable business activities.

There is no set or standard method for calculating the business use (and VAT recovery) of expenditure. Whatever method is used it must be fair and reasonable. The objective of the apportionment is to confirm the extent to which expenditure (and associated VAT) is used for the purpose of taxable business activities. While a calculation based on income for example could provide a simple procedure the result may have no correlation to the use of the costs incurred. Consequently this would not provide a satisfactory, fair or reasonable result. Other methods commonly used to apportion or restrict the recovery of VAT include those based on expenditure, time, floor space or transaction counts.

There is no statutory requirement to obtain approval for a business/non-business method from HMRC. However not to do so could leave an arts or heritage organisation open to having its method contested. It is therefore prudent to notify HMRC of the basis under which the business/non-business calculations will be performed. HMRC can use its discretion to remove the need for a non-business apportionment. If such discretion is granted the concession only applies as long as the existing rate of non-business activity continues.

Partial Exemption

Having established the extent to which VAT has been incurred on expenditure for the purpose of business activities, arts and heritage organisations must also consider the extent to which the VAT they incur is attributable to taxable as opposed to non-business and exempt supplies.

Unlike the restriction of VAT incurred on non-business activities, the apportionment between taxable and exempt activities is set out in law. The VAT regulations provide a standard method and give HMRC the power to approve special methods. Capital items are excluded from partial exemption calculations.

The standard method provides an apportionment based on the value of taxable supplies as a proportion of total supplies. The income based

method has relative simplicity however there is no obvious correlation between the value of supplies and the extent to which goods or services are used.

Special methods must be approved in writing by HMRC before they can be used. An application for a special method must be accompanied by a declaration that the proposed method provides a fair and reasonable result. Special methods are typically based on factors such as the ratio of inputs or input tax attributable to taxable supplies, the numbers of staff that engage in taxable activities, the number of taxable transactions or floor space calculations.

De minimis limit – When the VAT incurred on exempt-related expenditure is below specific values (de minimis limits) it can be recovered in full. The irrecoverable VAT will be below the de minimis limits when it is less than £625 per month and 50% of the VAT incurred in that VAT accounting period.

A rule override allows HMRC to impose a special method to the recovery of VAT. This applies when the basis of recovery gives a substantially different result from the use or intended use of the expenses. Substantial means more than £50,000.

Annual Adjustment

The VAT claimed on each VAT return is provisional and can often be affected by seasonal trade and income variations. Consequently an annual recalculation over a 12 month period is required and this can often result in an adjustment for underpaid or overpaid VAT. At this point the de minimis position has to be confirmed.

Capital Goods Scheme

The Capital Goods Scheme recognises that certain capital items have a longer life span and the extent to which those items are used to make taxable supplies will change over time. Capital items are defined as:

- **A computer or item of computer equipment costing more than £50,000**

- **Land or buildings with a value of £250,000**
- **A building altered or extended to give an increased floor area of 10% or more at a cost of more than £250,000, or**
- **A building fitted out or refurbished at a cost of more than £250,000**
- **An aircraft with a value of £50,000 or more**
- **A ship, boat or vessel with a value of more than £50,000**

These values are net of VAT.

Where a capital item is purchased the initial VAT recovery will be based on the non-business and partial exemption rules mentioned above. Assuming VAT is recovered by the charity then this needs to be monitored to confirm the extent to which the item is used to make taxable supplies in subsequent periods. There is an adjustment interval for five years for computers and ten years for land and building. Since 2011, capital goods scheme adjustments are also required to reflect changes in levels of non-business use of the asset over the adjustment period.

Charity Purchases – VAT Savings

Arts and heritage organisations incur is not recoverable in full any reduction to the amount of VAT charged could result in a saving. The following supplies are liable to lesser VAT rates when they are purchased by registered charities:

Fuel & Power

The reduced-rate of VAT (currently 5%) applies to all fuel and power that is used for qualifying non-business purposes.

To obtain the reduced-rate fuel and power, a charity needs to provide their utility suppliers with a certificate to confirm the extent of non-business activities.

Where fuel and power is used for non-business use the following rules apply:

- **If at least 60% of the fuel is supplied for a non-business use the entire supply is liable to the reduced rate of VAT**
- **In all other cases an apportionment must be made and the reduced rate only applies to non-business use. This apportionment should be reviewed and confirmed annually**

The same rules apply to the application of climate change levy. When the supply of fuel and power qualifies for the reduced-rate of VAT it will qualify (to the same extent) to be exempt from climate change levy.

Advertising

Normally, advertising is liable to VAT at the standard rate. However, charity advertising can be zero rated providing a zero rating certificate is issued by the charity. The scope of zero-rating goes beyond traditional advertising (a newspaper advert provision), including the design process.

HMRC guidance confirms that the following qualify for zero-rating:

- **A finished article like a film or recorded cassette**
- **An element to be incorporated in the advertisement such as a photograph, picture or a sound track; or**
- **All alternative versions of an advertisement produced, to see which works best, even if it is the intention that only one version will be used**

Zero-rating will not apply where the advertising is to selected people i.e. is not at random. Direct mail and telesales are also excluded from zero-rating.

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