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Cambridge Colleges newsletter

welcome

Welcome to the fourth edition of our updates for Colleges. The aim is to keep Colleges abreast of developments which specifically affect them and is in addition to our regular Charities and Not For Profit bi-monthly newsletter.

In this edition we mainly look at College's trading through a subsidiary company and the Construction Industry Scheme (CIS). Our tax experts at PEM are always on hand to help with any related queries. We also have an article about the key findings from the 2019 audit process as well as a College's obligation to report matters of material significance to the Charities Commission and an update on Off payroll working.

If there are any topics you would like us to cover in further editions, please let us know.

Please look out for our second benchmarking report for Cambridge Colleges Operating Financial Review (Trustees Reports) that we will be circulating shortly.

We look forward to working with you over the next twelve months.

Kelly Bretherick
Partner, Audit

e. kbretherick@pem.co.uk

Contractors & off-payroll working - Changes applicable to Colleges from April 2020

There is currently much press coverage on the planned introduction of off-payroll working rules in the private sector from 6 April 2020. It is often overlooked that these rules have been operating successfully (in HMRC's view) in the public sector since 6 April 2017.

The definition of the public sector covers universities. The off-payroll working rules apply when a public sector body engages a contractor through their own intermediary (often a Personal Services Company "PSC"). Since April 2017, that body (or the recruiting agency if the public sector body engages through one) has been responsible for determining the employment status of the worker engaged through a PSC. If the relationship with the contractor is determined to be that of employment, if it were not for the PSC, there has been an obligation to deduct income tax and National Insurance at source through the payroll on payments made to the PSC. Some public bodies went a step further and made such workers "full" employees with employment rights.

Colleges must continue to apply the rules, however, from 6 April 2020, there are extra responsibilities and risks that will affect you. The key changes from 6 April 2020 are a new requirement for a Status Determination Statement and a new disagreement process.

Status Determination Statement

From 6 April 2020, the end client, usually the engager, must review all contracts for work with PSCs and decide whether it falls to be employment or self-employment tax status for the contractor concerned. The end client must then issue a Status Determination Statement (SDS) to the contractor. The SDS is a new and important practical document informing all those in the contractor chain whether payments to the PSC or other intermediary will need to be made under the deduction of PAYE and National Insurance. The SDS must also include the reasons for the decision. The engager must take reasonable care when making the employment status determination, otherwise their obligations under the off-payroll working will not have been met, and the liability for any unpaid PAYE and National Insurance will rest with them.

Process to deal with disagreement with the Status Determination Statement

Under the new rules, the fee-payer (if not the College) or the contractor can challenge an SDS. It will therefore be necessary for the end client/ engager to have a process in place to handle such disagreements. There is no time limit for making a challenge and there is no appeal possible to HMRC. The engager must reconsider the SDS and respond to the fee-payer and/or contractor within 45 days of receiving the disagreement.

Due to growing pressure, the ex-Chancellor, Sajid Javid, announced a formal review of the new rules, expected to be completed by the end of February, to assess how the implementation of the new regime can be smoothed and also if there is any additional support that can be provided to the self-employed. As yet, there is no plan for the reforms to be cancelled or postponed, and so those engagers and contractors affected by the changes to the proposals should continue to work towards their implementation from 6 April 2020. For Colleges this will mean ensuring that they have processes in place to comply with the new SDS requirements and related appeals procedure.

The Construction Industry Scheme

Colleges often undertake construction operations and they are not required to register as Contractors under the Construction Industry Scheme (CIS) as there is a specific exemption for charities. However, where the construction operations are carried out within a subsidiary, this entity is not exempt from CIS and must ensure it operates the scheme if required to do so. There are various requirements which must be met or penalties can apply.

Registration

A subsidiary must register if either:

- It is a business that pays subcontractors for construction work ("mainstream contractors"); or
- Its average annual expenditure on construction operations over a period of 3 years is £1 million or more ("deemed contractors").

Most "design and build" subsidiaries are within the first category, as their primary business is to arrange for the construction of buildings for their clients, the Colleges.

The scheme covers all construction work carried out in the UK, including jobs such as:

- site preparation
- alterations
- dismantling
- construction
- repairs
- decorating
- demolition

Registration must take place when the subsidiary is about to take on and pay its first subcontractor.

Verifying subcontractors

Before a contractor can make a payment to a subcontractor for construction work, it must verify with HMRC whether the subcontractor is registered. HMRC will let them know if the subcontractor is registered and confirm the rate of deduction which must be applied to the payment, or whether the payment can be made without any deductions. This verification can be done online here.

A contractor does not have to verify a subcontractor if they last included that subcontractor on a return in the current or 2 previous tax years.

If a deduction is required it will be at either the standard rate (currently 20%) or the higher rate (currently 30%). HMRC will provide a verification number, which should be used on the monthly returns for deductions under the higher rate.

Making deductions

If a deduction is required, the contractor must:

- record details of the payment, materials and deduction;
- make the net payment to the subcontractor; and
- complete and give the appropriate statement of deduction to the subcontractor

The deduction does apply to any part of a payment that is for subsistence or travelling expenses, but does not apply to any part of a payment that is for the cost of materials and VAT.

The contractor must provide a written statement to every subcontractor from whom a deduction has been made within 14 days of the end of each tax month, which runs to the 5th of each month.

The statements must include the:

- contractor's own name and employer tax reference;
- end date of the tax month in which the payment was made, or the date of payment where the statement relates to a single payment;
- the name and the unique tax reference for the subcontractor;
- personal verification number if the subcontractor could not be verified and a deduction at the higher rate has been made;
- gross amount of the payments made to the subcontractor;
- cost of any materials that has reduced the amount against which the deduction has been applied;
- amount of the deduction.

Monthly returns and payments

Within 14 days of the end of each tax month, contractors must send HMRC a complete return of all the payments they have made within the scheme or inform them that they have made no payments.

These returns can be filed online with HMRC or by using commercial software.

The return will include:

- details of the subcontractors, payments made, and any deductions withheld;
- a declaration that the employment status of all subcontractors has been considered; and
- a declaration that all subcontractors that need to be verified have been verified.

Contractors who know they will not be paying any subcontractors for several months should contact HMRC who can then make their CIS scheme 'inactive' for 6 months. If the situation changes during that time, the contractor must inform HMRC.

Penalties for non-compliance

If a contractor fails to submit a monthly return on time, there is an immediate fixed penalty of £100. Further penalties apply as follows:

- second fixed penalty of £200 - 2 months after the filing date.
- tax-geared penalty which is the greater of £300 or 5% of any deductions shown on the return - 6 months after the filing date.
- second tax-geared penalty which is the greater of £300 or 5% of any deductions shown on the return - 12 months after the filing date.

HMRC will not charge contractors a penalty for any months for which a return is not due. If they are not informed of this a penalty will be issued and will need to be cancelled by contacting them.

If a contractor submits a monthly return that is incomplete or incorrect (e.g. missing subcontractors, incorrect payment details, failure to make the necessary declarations), penalties may be charged if the error or omission has been caused by negligence or intent on the part of the contractor.

If a contractor fails to produce records relating to payments made under the scheme when asked to do so, it may be charged penalties up to £3,000.

Further guidance can be found here.

Trading through a Subsidiary Company

Many Colleges are working to maximise their income by extending their activities into areas outside of their charitable objects, such as hosting conferences, providing B&B type accommodation or undertaking the development and sale of property.

The income generated from such activities may not qualify for an exemption from corporation tax. Even some sponsorship arrangements and grants may amount to non-primary purpose taxable trading. Colleges should also take care when investing in Limited Liability Partnerships (LLPs) which are undertaking non primary purposes trading as the College will be treated as undertaking a proportion of that trade.

Small trading exemption

Charities can undertake a certain level of non-primary trading without falling into the corporation tax net. From 1 April 2019 the small trading turnover limits are:

Annual charity income	Maximum non-primary purpose trading
Under £32,000	£8,000
£32,000-£320,000	25% of income
Over £320,000	£80,000

This includes the turnover (not profit) of all such trades.

Where the turnover exceeds this the trade is taxable within the College. This can have negative tax consequences even if the trade is loss making.

Tax on charity trading

Any profits from a non-primary purpose trade within the College will be subject to corporation tax (currently at 19%). If the trade results in a loss then this loss is treated as non-charitable expenditure, resulting in an equal amount of the College's income being subject to corporation tax. However, if the trade is run on a commercial basis with a view to a profit the trading loss can be offset against this non-charitable expenditure, giving a net tax neutral position.

Where there is a significant non-primary purpose trade a subsidiary company should generally be used to shelter the College from corporation tax on the profits. However, if a College is contemplating undertaking any property development projects, detailed advice should be sought before transferring property to a subsidiary, as the timing of transfers and whether a subsidiary is appropriate can be a complex matter.

Tax Considerations

The income and profits of a subsidiary trading company are taxable in the same way as the income and profits of any ordinary limited company. However, the subsidiary can gift all or part of its profits to its parent charity, and claim tax relief for those gifts. This means the trading company doesn't have to pay corporation tax on the profits it donates and, as long as the College uses the income for charitable purposes, it won't have to pay tax on the receipt.

A College's wholly owned trading subsidiary can get tax relief on donations made to its parent at any time from the start of a relevant accounting period until nine months after the end of that period. Following recent changes to the accounting treatment, it is recommended that there is a Deed of Covenant in place between the College and its subsidiaries so that the payment to the College can be reflected in the accounts of the subsidiary even

if payment happens after the year end.

It is crucial that there is a payment of cash of the donation from the subsidiary and that this can be evidenced. Movement on an intercompany account will not be sufficient to secure the tax relief on the donation. Sharing a bank account should generally be avoided for this reason.

Investing in the subsidiary trading company

When a College sets up a subsidiary trading company it is likely that it will need to invest some money in the company at the outset and perhaps give the company regular cash injections to expand or develop the business.

Any charity investments or loans that are not 'approved' investments or loans are treated as non-charitable expenditure, and a charity that incurs non-charitable expenditure will lose some or all of its tax exemptions.

'Approved' investments must be made for charitable purposes only and for the charity's benefit - and not to avoid tax. HMRC considers that an investment is made for the benefit of the charity if it is commercially sound. This means that the charity needs to make sure that any investment it makes is secure and gets a fair rate of return that is actually paid.

If the College makes a loan to a subsidiary company, it must be clear that the amount of the loan will be repaid in due course. The College needs to keep proper records of all the investments it makes, as well as details of why it decided to choose those particular investments. Depending on the amount of money the College invests it may base its decisions on the information contained in:

- business plans
- cash flow forecasts
- projections of future profits

If the College chooses to invest via share capital it should bear in mind that shareholders are the last creditors to receive their money back on a winding up so the investment could be considered more risky than a loan.

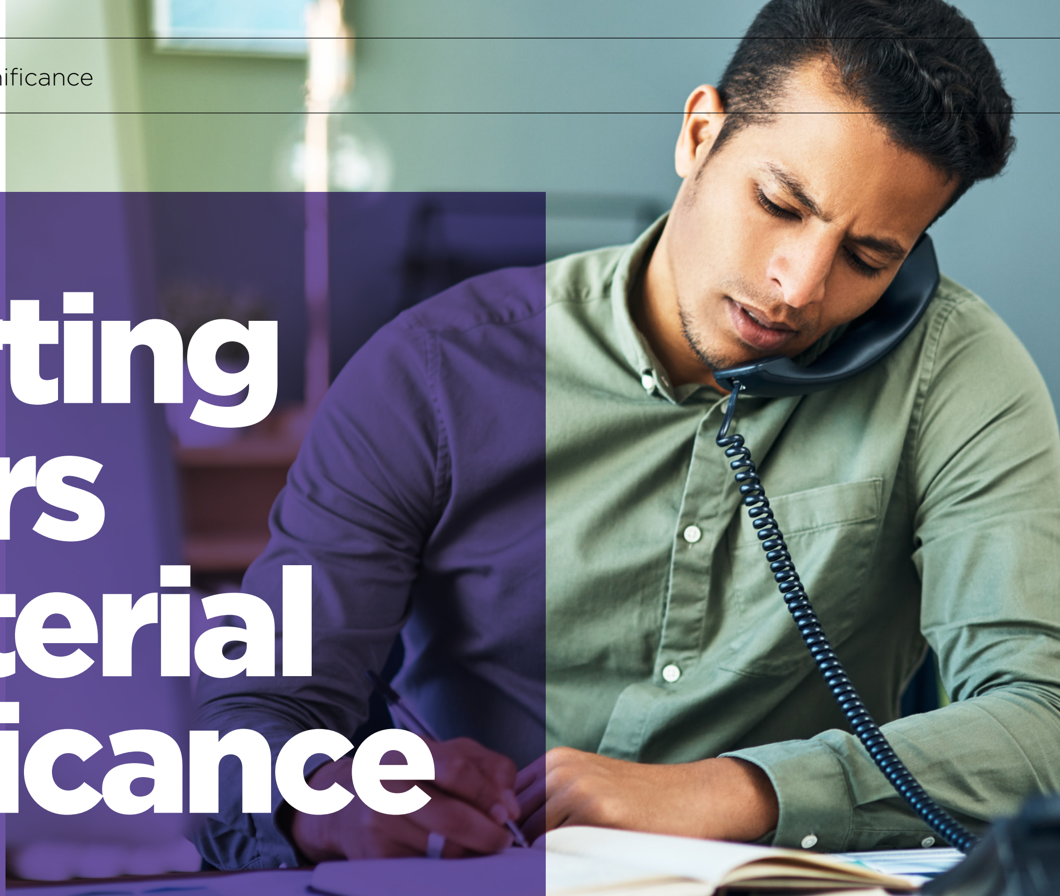
At regular intervals the College should look critically at the investments it has made, to make sure they are performing as expected.

Shared resources

If the College's premises, staff and other services are shared with its trading company, an appropriate allocation of the costs should be recharged to the subsidiary. Due to the size of their income and assets and number of employees, many Colleges fall within the transfer pricing rules, under which connected companies need to charge a market rate for the services provided between them. However, HMRC accept that many charities and their subsidiaries adopt a cost sharing arrangement, so the amount charged by the College for the shared resources (including direct costs and overheads) would generally not exceed the cost. However, where the College is demonstrably trading in the services which it is providing, then there should be an appropriate market rate charge. It is recommended that the methods and rationale for charges made between the two entities is documented and reviewed regularly.

Directors' and Trustees' Duties

It is important to ensure there are no conflicts of interest between the Fellows of the College and the Directors of the trading company. Both of these have legal duties towards their respective entities and if they are one and the same then conflicts could arise. Therefore it is advisable to have some independent Directors who can act purely in the best interests of the trading company. Directors should also carefully consider how much Gift Aid should be paid to the College, as paying out all of the profits immediately may adversely affect the company's cashflow and commercial development. Directors should consider the terms of the Deed of Covenant carefully, balancing saving corporation tax with allowing the company to trade effectively and this document should be reviewed regularly.



Reporting Matters of Material Significance

The Charity Commission requires charities to report serious incidents to them. If a serious incident takes place then the trustees are required to report what happened and importantly let the Commission know how you are dealing with it, even if you have also reported it to the police, donors or another regulator.

A serious incident is an adverse event, whether actual or alleged which results in or risks significant loss of money, assets, reputation or harm to beneficiaries. Serious incidents are:

- Incidents that have resulted in risk or significant harm to beneficiaries or others
- Financial crimes – fraud, theft, money laundering and cyber crime
- Large donations from an unknown or unverifiable source
- Other significant financial loss
- Links to terrorism or extremism
- Other significant incidents including significant data breaches/losses or incidents involving partners that materially affect the College.

More detailed guidance in this area can be found here.

Your auditor also has obligations to report matters of material significance to the Charity Commission as detailed below.

- Dishonesty and fraud
- Failure of internal controls and Governance
- Money Laundering and criminal activity
- Support of terrorism
- Risks to charity's beneficiaries
- Breaches of law or charity's trusts
- Breach of a regulator order or direction
- Modified audit opinion
- Conflicts not properly managed.

Key findings from 2019 Cambridge College Audits

The year-end audit process is behind us therefore now is a good time to reflect on the key findings that came out of the process.

At PEM we identified that the most common area causing issues is donations/legacies. Whether it be income recognition, reconciliation to Raiser's Edge or another donations database, communication with the development office or marketing material.

Donation and legacy Income recognition

There are three criteria to be met when looking at whether a donation or legacy should be recognised:

Entitlement – control over the rights or other access to the economic benefit has passed to the College.

Probable – it is more likely than not that the economic benefits associated with the transactions will flow to the College.

Measurement – the monetary value or amount of the income can be measured reliably.

We found that legacies are the main area where recognition problems arise. Generally, if probate has been granted then a legacy should be recognised in the accounts as a reliable estimate of the amount the College will receive can be made. It is important that throughout the year and in particular, at the year end, the bursary and the development office discuss ongoing legacies to ensure the accounting treatment is correct.

As well as getting the income recognition correct it is also important to ensure the income once recognised is classified correctly. Is it a permanent endowment, either restricted or unrestricted, or is it a restricted expendable donation or a capital grant? Particular care must be taken when allocating restricted donations to existing funds that they are for the same purpose and have the same criteria. In some instances, we have noticed a restricted donation has been credited to a pre existing unrestricted fund whose designated use is the same as the new donation. This results in the restricted donation being incorrectly classified as unrestricted.

We have also come across examples of restricted donations automatically being classified as permanent endowments rather than a restricted expendable fund. This policy of self-capitalising results in donations being tied up with only the income generated from the investment of the donation being spent which may not be in line with the donors wishes. This could present a potential reputational issue in the future. In general, many donations are actually expendable as the donor has not specifically stated that the donation must be invested.

Communication with the development office is essential to ensure that donations are classified correctly. ▶

Marketing material

The wording in marketing material used by the development office should be carefully considered as this can impact how a donation is recognised and subsequently used. Care should be given as to the use of the word endowment which would restrict the College to only being able to spend the income generated from the initial donation. Of course, it all depends on what the College's fundraising objectives are.

Communication with the development office is key to ensure that donations are classified correctly in the financial statements. It is the staff in the development office that have the direct contact with donors and therefore have the best understanding of the donor's intentions. However sometimes we have noticed that staff in development offices are not aware of the different classifications of donations in the financial statements and therefore are not mindful of this when talking with donors.

Donations reconciliation

A donations database whether it be Raiser's Edge or another product can be very useful to help the bursary ensure that donation income in the financial statements is complete. We recommend a reconciliation between the financial statement and Raiser's Edge is carried out at the year end at least but is a more useful tool if carried out throughout the year as well. ■

Kelly Bretherick
kbretherick@pem.co.uk

James Burrett
jburrett@pem.co.uk

Jayne Rowe
jrowe@pem.co.uk

Judith Pederzolli
jpederzolli@pem.co.uk

Rob Plumbly
rplumbly@pem.co.uk

Kate Millard
cmillard@pem.co.uk

Charlotte Young
cyoung@pem.co.uk

PEM
Salisbury House
Station Road
Cambridge CB1 2LA

t. 01223 728222
e. pem@pem.co.uk

pem.co.uk