MonLife: Application of Charity Law

Monmouthshire Council

Advice in relation to charity law implications of establishing and participating in a new charity

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BACKGROUND AND INTRODUCTION

Monmouthshire Council (the "Council") is creating an Alternative Delivery Model ("ADM") for the delivery of a range of leisure, youth, and culture and heritage services. The group structure is described in more detail in earlier advice, but in brief includes a Teckal vehicle which will provide services directly back to the Council and a charity ("MonLife") which will provide leisure services and cultural and heritage services to the wider population.

In this advice note we set out some further considerations in relation to the workings of MonLife and the way in which MonLife will interact with the Council. In particular, we address the following points:

- the Council's role as Charity member and trustee;
- how the first directors will be appointed and thereafter how the Charity will appoint its directors;
- who the other members of the Charity will be – and whether the Charity will admit users of the various facilities as members;
- the Charity's relationship with the Council under a Grant Agreement including any State aid implications; and
- the Charity's ability to trade, and the need for a trading company.

We consider each of these points in detail below.

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DETAILED ADVICE – CHARITY LAW

THE COUNCIL'S ROLE IN THE CHARITY

There are two central options for the Council in its relationship with the Charity: (1) act as a corporate trustee, with an appointed representative acting in that role; or (2) nominate directors to the charitable company, who will individually be trustees of the Charity.

Unless there is compelling reason, the Charities Commission would not normally accept the Council as sole trustee in the Charity. Charity Commission operational guidance indicates:

> In order to be a Charity, a body must be established for exclusively charitable purposes. It cannot be established to further the purposes of some noncharitable body such as the local authority itself. Local authorities and charities often both have close interests in local topics. The Charity needs to be independent of the local authority in the sense that decisions about the administration and operation of the Charity need to be taken solely in the interests of the Charity, with a view to furthering its charitable purposes, and for no other purpose.
>
> Against this background, although there may be benefits in a particular case in having a local authority as trustee, in general there are potentially serious disadvantages… Therefore, in exercising our power under s.69 of the 2011 Act to appoint Charity trustees, unless there is a compelling reason for appointing the local authority, we will generally try to make some other trustee arrangement.[1]

In this sense, Charity Commission Operational Guidance makes it clear that the Charity Commission is not likely to accept the Council as sole corporate trustee of the Charity.

Traditionally, the directors of a charitable company are also its charitable trustees, and this is generally the simplest and most straightforward arrangement. For the purposes of the Charities Act 2011, Charity trustees are "the persons having the general control and management of the administration of a Charity" (section 177, Charities Act 2011). And so a meeting of the company's Board of Directors (from a company law perspective) is the same as a meeting of the Charity's Board of Trustees, and a decision of the Directors and a decision of the Trustees amount to the same thing.

The Council could choose to be a "corporate" director (i.e. a director who is a corporate entity not a natural person) and a corporate trustee. It would then need to appoint an individual representative to

[1] See Charity Commission operational guidance OG56 A1 at: http://ogs.charitycommission.gov.uk/g056a001.aspx#tab2

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perform this role in meetings of the Board. The articles of association would need to recognise that individual appointed by the Council as representing the Council in its role as director and trustee.

However, the Small Business, Enterprise and Employment Act 2015 ("SBEEA") introduced provisions which propose to abolish the concept of a corporate director. Section 87 of the SBEEA replaces section 155 of the Companies Act 2006 with a new section 156A, which requires all company directors to be natural persons.

This provision is not yet in force, and so it is still possible for the Council to act as a corporate director for the time being. However, for companies with corporate directors, those corporate directors will cease to be directors one year after the new section 156A of Companies Act 2006 has come into force (subject to any exceptions set out in regulations made under section 156B of CA 2006) (section 156C). As such, the Council may wish to "future proof" the governance of the Charity to anticipate the coming into force of the relevant provision of the SBEEA and avoid a situation where the Council is no longer a Charity trustee.

An alternative role is therefore suggested:

- the Council is a member of the charitable company (a similar role to that of shareholder in a company limited by shares);
- the Council, in its capacity as member of the charitable company, has the ability to appoint all or part of the Board of Directors (who are also the Charity's Trustees).

The Council would therefore not be a Charity trustee, but would appoint individuals to the Board who would each individually be trustees.

In either case, it will be important for the individuals appointed to the Board to understand the role they are playing:

- are they there because they are trustees? I.e. the Council has appointed trustees to the Board – in which case the individuals have responsibility for the administration of the Charity and will have personal liability (as they do as company directors in any case); or
- are they carrying out the Charity's business on behalf of the Council because the Council is the trustee of the Charity? If the Council itself is trustee, the individuals appointed by the Council will be managing the Charity's affairs on the Council's behalf.

The Council will also need to give thought to the benefit of the Board being made up from a wider pool of people than just Council nominees.

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APPOINTMENT OF THE BOARD

Assuming the decision is made that the Council will be a member of the charitable company, rather than a corporate director and trustee, the first Board of Directors and Trustees will be made up of those individuals who make up the Shadow Board prior to incorporation. In essence, these are appointed by the Council. The draft Articles are currently drafted so that directors can be appointed either by ordinary resolution (i.e. by the company's members) or by a resolution of the existing directors.

This gives the Council, alongside any other members, the ability to appoint to the Board of Directors and Trustees. The current draft Articles do not give the Council an explicit right to appoint a certain number or proportion to the Board, to avoid any suggestion of inappropriate control by the Council over the Charity. This can be reconsidered if there is a particular need for the Council to have specific rights to appoint to the Board (aside from other charitable company members) but would need to be discussed with the Charity Commission to ensure the Commission were comfortable. The decision made in this regard may depend on the decision made as regards who the other Charity members will be.

WHO THE OTHER MEMBERS OF THE CHARITY WILL BE

The Directors of the Charity will also become members. In addition to the Council and the Board, it has been suggested that users of the leisure, cultural and heritage facilities that will be managed by the Charity could be offered membership in the Charity (with the potential to offer discounts to those members).

For the time being, the draft Charity Articles provide simply for a power for the Board to admit individuals or organisations as members on application. The Board has absolute discretion as to who it admits as members. The Board can create different classes of membership (with different rights attaching to those classes). This could be used to allow for a "service user" membership class or, likewise, a staff membership class.

If admitted as company members, individuals would have a say in the overall management of the charitable company. Different classes of membership could be created, however, with a weighting attached to the class of membership offered to individuals, to ensure a proportionate approach to the management of the company. Any weighted voting rights which gave the Council significant control over the company would need to be considered in the light of charity law (and see above our commentary in relation to the Council as trustee).

1. GIFT AID

In the context of these individual members, we are asked whether their contributions could be the subject of Gift Aid. The key point to note is that it is donations that benefit from Gift Aid – as to benefit from Gift Aid, there must be a gift. Membership subscriptions that are made to gain access to the Charity's facilities and services (such as leisure centres) are not gifts, so are not eligible for Gift Aid. For example,

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the Income Tax Act 2007 is clear that membership fees paid to community amateur sports clubs are not gifts, in particular (section 430(2), Income Tax Act 2007).

Even where there are genuine donations (as may be the case at museums managed by the Charity, for example), there are limits on the donations that can qualify for Gift Aid and, in particular, the donor must not receive significant benefits from the Charity in return for his or her donation – the Charity can give only modest benefits to the donor in return for the donations.

These limits are set by the Income Tax Act 2007, which provides two tests:

The relevant value test (section 418(2), ITA 2007): gifts of up to £100 can receive a benefit of no more than 25% of the donation; gifts between £101 and £1,000 can give a benefit of £25, and gifts of £1,001 and more can receive a benefit of 5% (with a maximum of £2,500). So the relevant value test means that, for a "donation" by a member to benefit from Gift Aid, the benefit to the member must be under these limits. This will place a limit on any discounts that the Charity offers to members, if it wants to benefit from Gift Aid;

The aggregate value test (section 418(3), ITA 2007): any individual donor cannot receive more than £2,500 in benefits in return for donations in any tax year (across his or her donations to that Charity).

This does not, of course, stop the Charity from offering discounts or benefits outside of these ranges, but doing so would mean that it did not benefit from Gift Aid on the donations received. However, to the degree that benefits are offered to individual members, therefore, it may be unlikely that their payments to the Charity will benefit from Gift Aid, because they are receiving too great a benefit from the Charity in return for payments.

DETAILED ADVICE – THE CHARITY'S RELATIONSHIP WITH THE COUNCIL UNDER A GRANT AGREEMENT

Given the considerations discussed above in relation to the charity law implications of the Council's role as a Charity member or trustee, the Charity's main relationship with the Council is likely to be via its grant agreement.

It is important to stress that, as the Charity will not be a Teckal subsidiary of the Council, the Public Contracts Regulations 2015 will apply to any public services contract that the Council entered into with the Charity. However, given the range of services and facilities to be managed by the Charity, it is not envisaged that the Council will required the degree of control over the arrangements that a public services contract implies. It is therefore proposed that a grant funding agreement be entered into between the Council and the
Charity.

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By way of a brief and general summary, the characteristics of a contract include:

- an obligation to deliver something to the paying public body which is often for the benefit of that public body, and to a detailed specification;
- an obligation on the public body to pay for the services provided;
- the requirement to charge VAT on the supply of those works, services or goods to the paying public body; and
- provisions setting out what happens when either party fails to comply with the terms of the contract, including the ability of the paying public body to recover from the recipient organisation financial losses it suffers as a result of a failure of that recipient organisation to deliver the works, services or goods it is contractually required to provide.

By contrast, the characteristics of a grant include:

- it is a gift of funds, often given for a specified purpose;
- it is often given to enable the grant recipient to provide works, services or goods to third parties rather than for the public body's direct benefit;
- the ability for the grant recipient simply to hand back the grant without there being an obligation on them to deliver the works, services or goods which it was given to enable them to provide;
- VAT not being payable on the grant; and
- the financial obligation of the grant recipient is limited to paying back all or part of the grant on clawback, rather than compensating the paying public body for losses it has incurred as a result of the non-delivery or failed delivery by the recipient organisation.

For this reason, local authorities will generally prefer contracts over grants for "statutory" services (where there is a need to ensure certainty of delivery), but likewise contemplate grant funding for services the local authority is not under a duty to provide (where the outcome can more readily be entrusted to a third party and the local authority can still demonstrate the benefits to the residents in its area of providing the funding).

It is relatively settled law that grant agreements, where a grant is given to another organisation for the benefit of either that organisation or to enable a third party to receive services, supplies or works from that organisation, do not fall within the remit of the EU procurement rules. This opinion has been reinforced by a European case, Commission v Ireland[2]. The case concerned the provision of emergency ambulance services by Dublin City Council. The Eastern Regional Health Authority gave the Council funding towards the costs of providing the services. The court held that "the mere fact that, as between two public bodies, funding arrangements exist in respect of such services does not imply that the

[2] Commission v Ireland, Case C-532/03

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provision of the services concerned constitutes an award of a public contract which would need to be assessed in the light of the fundamental rules of the Treaty".

While grant funding is not subject to the EU procurement rules, it may nevertheless be open to challenge in individual cases whether something is in fact a grant or a contract. It is possible for an agreement to demonstrate a mixture of the characteristics of both. If the arrangements are challenged in court, the court will analyse each of the relevant factors and decide whether it thinks the arrangements constitute a grant or a contract. This means that clear drafting of the grant agreement is vital to avoid legal challenge. However, this does not change the basic point that, where an agreement is very clearly a grant agreement, it is not subject to the EU procurement rules.

The drafting of the grant agreement will need to ensure that the right balance is struck – sufficient clarity to enable the Charity to know how it is permitted to apply the grant, while not binding the Charity to provide anything to the Council in return for the funding.

The Council will also need to give consideration to State aid rules and how they might apply to the grant to the Charity, and we consider the rules around State aid below.

DETAILED ADVICE – APPLICATION OF STATE AID RULES

Not all public funding will constitute State aid. State aid relates to financial assistance given by a Member State or through State resources in whatever form (in this case the Council), to an organisation, where such assistance gives that organisation an advantage over competitors. This advantage either distorts or threatens to distort competition in the organisation's field of work and affects trade between Member States. For this reason, State aid is generally prohibited. However, State aid is permitted in limited circumstances where it can be shown to be necessary to achieve certain EU specified objectives compatible with the common market.

The State aid test is derived from Articles 107 and 108 of the EC Treaty. Article 107(1) says that:

> "Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States be incompatible with the common market."

This definition can be broken down into four main tests:

(a) Is there aid granted by the State or through State resources?
(b) Does the aid favour certain undertakings or the production of certain goods?
(c) Does the aid distort or threaten to distort competition?
(d) Does the aid affect trade between Member States?

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For there to be State aid, all four of these tests must be met. We consider each in turn below.

STATE RESOURCES

Funding by the State, or through State resources, may be State aid. Funding received from the Council would be considered State resources. This test is therefore met.

UNDERTAKINGS

One of the key terms used in Article 107(1) is "undertaking". An undertaking is any organisation carrying out "economic activity" in a market. The activity or activities are what is important, rather than the type of organisation, and so charities, trusts, voluntary sector bodies, and 'not-for-profit' companies can all count as undertakings for the purposes of State aid rules. Indeed, even local authorities carrying out "economic activities" can be "undertakings".

However, an organisation may be an undertaking for some purposes and not for others, if it carries out both economic activities and non-economic activities.3

"Economic activity" is a broad concept, encompassing situations where an entity offers goods and services on a market where there either is, or could practically be, competition.[4] The European Commission's consideration of this in its "Notice on the notion of State aid"[5] confirms that, following European case law, "any activity consisting in offering goods and services on a market is an economic activity". It follows, therefore, that if there are no goods or services offered on a market, then there is no economic activity.

The Notice on the notion of State aid also confirms that the question of whether or not a market exists for any particular services "may depend on the way those services are organised in the Member State concerned and may thus vary from one Member State to another. Moreover, due to political choice or economic developments, the classification of a given activity can change over time". There is a recognition that, because it may vary from time to time and between different Member States, it is not possible to draw up a list of what does (and does not) constitute economic activity.

However, there is helpful guidance in connection with culture and heritage conservation which is perhaps informative in the circumstances by way of analogy. This guidance recognises that some activities at least relating to culture, heritage and nature conservation can be organised in a "non-commercial way and thus be non-economic in nature". The example given is of public funding of a cultural or heritage conservation activity accessible to the public free of charge (or for a contribution that only covers a fraction of the true costs), which fulfils a purely social and cultural purpose. Where the cultural offer of the Charity (including museums) is offered free of charge or for a nominal sum,

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therefore, funding from the Council will not constitute State aid, as the Charity is not engaging in an economic activity. This may also be the case for parts of the outdoor education offering.

[3] Aéroports de Paris v Commission, Case T-128/98
[4] See, for example, Commission v Italy, Case 118/85, and Aéroports de Paris v Commission, Case T-128/98 [5] Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016/C 262/01) of 19th July 2016

This argument is not applicable to the leisure offer of the Charity, where we anticipate that it will be clearer that there is a service offered on the market for a fee which is more than just token.

We have therefore considered the other State aid tests below as they remain relevant to the funding of the leisure services.

ADVANTAGE

Following DCLG guidance, an "advantage is established where the beneficiary is, or has the potential to be, in a better position as a result of the measure. In most situations, such as a grant of money, it will be clear that an advantage has been provided to any individual organisation receiving the funding, as compared to other economic undertakings which have not received it".[3] So an advantage is any economic benefit which could not have been obtained under normal market conditions (in the absence of the State intervention).

For there to be unlawful State aid, the advantage must be "selective" – i.e. it must favour one particular undertaking rather than being made available as a general measure. As the funding will be granted to the Charity, and is not available to others, there will be an advantage to the Charity, and this test is therefore met.

We therefore consider that there is a risk that a selective advantage is given to the Charity by the funding from the Council.

DISTORTION TO COMPETITION

Support through State resources will only be State aid if it distorts, or threatens to distort, competition. So it is enough for there to be the threat of a distortion of competition. Following case law, a measure is considered to distort or threaten to distort competition "when it is liable to improve the competitive position of the recipient compared to other undertakings with which it competes"[4]. So there must be competition, or at least the potential for competition.

[3] DCLG guidance, Chapter 2
[4] The Notice on the Notion of State aid, referencing Philip Morris, Case 730/79

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The relevant marketplace for determining whether or not competition could be distorted may vary; it can be described as the geographical area in which undertakings compete to win business. A dim view would normally be taken of attempting to restrict the view of what the market is to an unrealistically tight geographical location. Even a small amount of aid will be considered to have the potential to distort competition within the marketplace. In this context, there is an obvious risk that the funding will distort competition, as the Charity's position in the leisure "market" is improved through the funding.

EFFECT ON TRADE BETWEEN MEMBER STATES

There will only be aid insofar as the measure affects trade between EU Member States. This includes not only situations where it is clear that there is an actual effect on inter-State trade, but also where the aid is liable to affect trade.

This effect on trade "cannot be merely hypothetical or presumed, it must be established why a particular measure distorts or threatens to distort competition and is liable to have an effect on trade between Member States, based on the foreseeable effects of the measure".[5] Trade between Member States may not be affected where the activity has a purely local impact (sports and leisure facilities have, for example, been considered not to affect trade between Member States[6]). It was held in the case of Dorsten that there was a clear distinction between providing aid to a swimming pool used by the inhabitants of a town and the surrounding area, compared with that of providing aid to promote major theme parks targeting a national or even international audience. The latter, as it was aiming to attract international visitors, would be considered to affect trade between Member States, whereas the Commission took the view that there was practically no likelihood of intra-Community trade being affected by the former.

The Dorsten case is directly applicable to the proposed leisure offering of the Charity. While the leisure offering will be available to visitors to the area as well as residents, it is hard to see that there would be any effect on intra-Community trade though the funding of local leisure services.

We therefore consider that, to the extent that funding is provided by the Council to support the Council's leisure offering, there is no effect on trade between Member States and therefore no aid. This is reinforced by the Notice on the notion of State aid, which specifies a number of possible categories which might be considered not to affect trade, including "sports and leisure facilities serving predominantly a local audience and unlikely to attract customers or investment from other Member States"[7].

[5] The Notice on the Notion of State aid, referencing AITEC and others v Commission, joined cases T-447/93, T448/93 and T-449/93

[6] For example in Dorsten, Case N 258/2000

[7] Notice on the notion of State aid, page 43

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An equivalent argument is available concerning cultural events and institutions, on which the Notice on the notion of State aid indicates "the Commission considers that only funding granted to large and renowned cultural institutions and events in a Member State which are widely provided outside their home region has the potential to affect trade between Members States"[8].

While not specifically referred to in the Notice, it is arguable that the same is also true of the youth services and outdoor education offering.

CONCLUSIONS

Following through the different sections of the State aid test, it is clear therefore that the majority of the Charity's activities (and the funding of them by the Council) will not constitute State aid. In the case of the sports and leisure facilities and the cultural offer (including museums and art galleries) there is a strong argument for saying that there is no effect on trade between Member States following the Dorsten case referred to above. There are further arguments for suggesting that some of the cultural activity (that connected with cultural conservation) does not constitute economic activity and so in undertaking those activities the Charity would not be acting as an undertaking.

The Council and the Charity will need to consider whether there are further activities not caught by the above descriptions for which the Council is going to provide grant funding. This may in particular include the Charity's proposed activities in the context of youth engagement / education and outdoor education, if these are not felt to be caught by the descriptions of cultural and heritage conservation (in the context of "economic activity") or it is felt that there is a risk that the proposed funding will have an effect on trade between Member States (which we consider highly unlikely).

To the extent that there are activities to which the State aid rules might apply were the Council to be funding them, it would seem likely that these activities would be traded in a commercial manner and would therefore likely be housed within the trading subsidiary to the Charity (and see our advice below in relation to the separation of activities between the Charity and the trading subsidiary).

DETAILED ADVICE – TRADING ACTIVITIES AND THE NEED FOR A TRADING SUBSIDIARY

To the extent that the charity is selling goods or services, it will need to certain whether its activities are considered "trading" and, for any trading activity, what type of trading this is.
This is important for two reasons:

- the Charity can only act in accordance with its objects – and so trading which is not part of the Charity's trading will need to be done separately (usually by a trading subsidiary); and
- some trading income may be subject to tax.

[8] ibid

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A distinction is made between "primary purpose" and non-primary purpose" trading by charities. Selling goods or services to directly further the Charity's charitable purposes is "primary purpose" trading and can be undertaken by the Charity itself. This would include the Charity charging admission for an exhibition at an art gallery, for example, as the Charity's objects extend to the maintaining of art galleries. Trading that is ancillary to this – i.e. which supports the primary purpose trading – is also permitted within the charity.

Income from primary purpose and ancillary trading may be exempt from tax if it is used solely to support the Charity's aims.

"Non-primary purpose" trading is trading with a view to raising funds, with no direct link to the Charity's objects. Charities can carry out non-primary purpose trading so long as there is no significant risk that the Charity could lose money from the trading. Profits are usually taxable, even if they are used to support the Charity's main objects. For this reason, it can be prudent to create a trading subsidiary to the Charity, to ring fence risk and to enable the trading to be undertaken without the restrictions that would exist within the Charity.

SMALL SCALE EXEMPTION

For tax purposes there is a "small scale" trading exemption, through which the Charity, if it were trading within the constraints of the exemption, will not be liable to tax. The constraints are:

- the annual turnover of the non-charitable trading (including any incoming resources from miscellaneous activities that might potentially qualify for the exemption) must not exceed the following thresholds:

Total of all incoming resources[9] of the chargeable period	Maximum permitted turnover from charity in the relevant non-charitable trading activities in the chargeable period
Under £20,000	£5,000
£20,000 to £200,000	25% of total gross income
Over £200,000	£50,000

- If the trading does exceed that threshold, there was a reasonable expectation at the start of the relevant chargeable period (either a tax year for income tax purposes or the Charity's accounting period for corporation tax purposes) that it would not exceed the threshold.

[9] the total receipts of the charity for the chargeable period from all sources, calculated in accordance with normal charity accounting rules.

THE BOARDS OF THE CHARITY AND THE TRADING SUBSIDIARY

The Charity may choose to appoint one or more of its trustees or employees as directors of the trading company, but should bear in mind when doing so:

- a charity trustee cannot be paid for their services as a director (or an employee) of the trading subsidiary, unless specifically authorised by the Charity's governing document or the Commission;
- the trading subsidiary must be kept at arm's length from the Charity;
- the interests of the two companies may conflict, and these conflicts of interest need to be managed. Charity Commission guidance is for at least one person on the Board of each entity (the Charity and the trading subsidiary) to have no links with the other – i.e. one Charity trustee who is not on the Board of the trading subsidiary, and one Director of the trading subsidiary who is not on the main Charity board or an employee of the Charity.

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