



Grants and contracts

made simple



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Introduction

Historically, charities have been set up by volunteers to promote a particular cause and as the charity has developed services to meet the needs of its beneficiaries, funding has been obtained. Frequently, this would have been grants. In recent years, the nature of the funding has been changing to more formal agreements, frequently called service level agreements. In addition, charities are more likely to bid for contracts to deliver services.

What is a contract?

A contract is an agreement between two parties. For a contract to exist there has to be an offer and acceptance, but it does not have to be in writing. There also normally has to be consideration, which is payment although that does not have to be in the form of money. A contract is legally binding and if either side fails to deliver they can be sued in a court of law.

What is a grant?

A grant is a gift and as such it is freely given by the donor, with the timing, amount and frequency at the donor's discretion. There is no legal difference between a grant and a donation, it is simply that grants are often awarded by institutions and are more likely to be for specific purposes. Grants and donations are subject to trust law rather than contract law.

What is a service level agreement?

A service level agreement ("SLA") is a document which sets out the services to be provided and it may describe the performance standards expected. An SLA may be used in the context of grant funding or a contract. It is not a legally recognised form in itself.

Can charities trade through contracts?

Charities are permitted to trade in a number of different ways. Charity trading in the course of carrying out the main objectives of the charity is known as primary purpose trading. Primary purpose or charitable trading will include the activities of charities which charge a fee for a service, such as nursing homes and schools, as well as the sale of goods produced by the beneficiaries of a charity. In undertaking these activities, the charity is furthering the objects of the charity and so the activity may take place within the charity.

Non-profit distributing

It is widely thought that charities are not allowed to make a profit – this is actually untrue. Charities are allowed to make profits, but may not distribute them. In contrast to commercial entities where the profits are distributed to the owners or shareholders, charities have to apply all the profits they make to the charitable purposes. A charity delivering services for a fee or selling goods may make a profit. It may then add the profit to its reserves and spend these to further its charitable purposes.

Contracts

Consequently, charities may offer services under a contract providing the activity and the beneficiaries are within their charitable objects. They can undertake these activities in a business-like manner and apply any profits to the charity's objectives.

Some charities may choose to channel certain contracts through a subsidiary company, as they may wish to keep all commercial activity out of the charity or because it suits their VAT planning. Similarly, a charity wishing to undertake a trading activity to generate funds may use a subsidiary. Any profits can be transferred to the charity by donation under gift aid.

Restricted or unrestricted funds

Under charity accounting rules set out in the Statement of Recommended Practice (known as the “SORP”) charities have to account for their incoming and outgoing resources as two different types of funds. These are restricted funds and unrestricted funds.

Unrestricted funds

Unrestricted funds are funds the charity receives to further its objects. These can be donations, grants or fees earned. If a charity has narrowly defined objects, then a grant it receives may be a perfect fit for its objects and so be unrestricted. The recipient charity has to judge whether new incoming funds are restricted or not.

Restricted funds

Restricted funds have to be used for the purpose for which they were given. This purpose will be narrower than the charity’s objects. A donor can require the charity to spend their donation in accordance with their wishes. This creates the restriction, which is an obligation under trust law. If the charity does not use the funds in accordance with the terms of the restriction, then this is a breach of trust, for which the trustees may be personally liable. In practice, this might mean that the trustees would have to replace the funds that had been used inappropriately. Note that this applies to all charitable entities including incorporated bodies such as charitable companies. Limited liability does not remove trustees’ fiduciary duty in respect of donated funds.

Status of grants and contracts

Grants are a form of donation and can be subject to the type of legal obligations that apply to restricted funds. So a funder can specify that they wish their grant to be used to help a specific group of beneficiaries, or support a particular project. In these situations, the grant would be treated as restricted income. The recipient charity is obliged to use the grant for the purposes for which it was given. If some of the grant is not used, then it has to be offered back to the donor.

On the other hand, contracts are by their nature not donations and therefore cannot be treated as restricted funds. Contract income should be treated as unrestricted income. The recipient charity is obliged to meet the terms of the contract, but is not required to spend all of the contract fees on the specified activity. Thus, a charity can make a surplus on a contract, which it may keep and add to its reserves. If either the funder or the charity does not comply with the terms of the contract, then this would be a matter for the courts and it would be covered by contract law.

The new Statement of Recommended Practice for charities (SORP 2015) states that there may be occasions when it is appropriate to treat a contract as restricted income. A contract is categorised as an *exchange transaction*. Paragraph 5.7 of SORP 2015 states:

“Transactions must be accounted for and presented in accordance with their substance and not simply their legal form... The terms of a contract may limit payments to amounts

expended by the charity on purposes specified in the contract and restrict the charity's use of any surplus. Income that is restricted by contractual terms may be presented as restricted in the accounts if the restrictions are in substance the same as would apply to a restricted donation or grant."

Key points

- Grants may be restricted funds.
- Contracts will usually be unrestricted funds, but consider the substance of the transaction.
- The unspent balance on a grant can be carried forward as a restricted fund balance.
- If unused, the unspent balance on a grant should be offered back to the funder.
- If a restricted grant is used for a different purpose, then this is breach of trust and the trustees may have to replace the funds.
- Charities are obliged by contract law to deliver the service or goods specified in a contract.
- Contracts are governed by contract law and disputes would have to be resolved as set out in the contract or in the courts.
- Unspent funds on contracts are a surplus the charity may retain as reserves, unless the contract specifies the return of unspent funds.

Accounting issues

The accounting treatment for grants is different from the treatment for contracts. This is because grants are charitable income, whereas contracts are fees received in the context of a business arrangement. The main areas of difference relate to the recognition of income – in other words, the matching of income to expenditure.

Income recognition criteria

There are three tests for recognising income:

- entitlement
- probability
- measurement

A charity can recognise income when all three criteria have been met. However, income from a contract should be recognised in the accounts to the extent that the contractual obligations have been fulfilled. This will not necessarily correspond to the timing of any stage payments under the contract. Where a contract is partially completed, income should be recognised to the extent that the right to consideration has been earned through performance.

Unspent grants

For both grants and contracts, the timing of expenditure may not coincide with the timing of income. If any part of a grant for a restricted purpose is unspent at the financial year end, it should be carried forward as a restricted fund balance, which should be explained further in the notes to the accounts. If the grant is unrestricted, then this will increase reserves, although it may be appropriate to then designate the amount of funds needed for future expenditure.

Recognising contract income

Usually, contract fees are only due when the charity has delivered the service in line with the contract terms, so the charity is only entitled to the income when it has earned it. If the charity has received funding in advance, then this will be deferred and shown as a current liability on the balance sheet. The same treatment will be appropriate for performance-related grants, where the funding is tied to the delivery of certain outputs. If funding is received in arrears, then you would estimate a debtor for the value of the work done.

The income categories in the statement of financial activities that are relevant here are:

- donations and legacies
- charitable activities

Grants may be in either category, whereas contracts for the charity's services will be included under **charitable activities**. Grants should be included in **donations and legacies** when they have not been obtained for a specific purpose, for example to fund core costs.

Probable rather than certain

The criterion **probable** is new in SORP 2015; it used to be certain. **Probable** means more likely than not, so this is a small shift in the point at which income can be recognised. For both contracts and grants, it would still be expected that there is a written agreement. However, this shift may allow the recognition of income where established custom and practice has been created, even where the documentation is lacking.

Key points

- Treat contract income as you would sales for a business.
- Bring all grant income in to accounts once conditions have been met.
- Contract income and performance-related grants should be recognised as income when entitlement has been earned.
- Contracts are more likely to give rise to deferred income.
- Restricted grants are likely to have fund balances carried forward.
- Grants may be recorded under donations and legacies in financial statements.
- Contracts will be recorded as charitable activities income in financial statements; grants may also fall into this category.

VAT issues

VAT is a significant issue because the VAT treatment of contracts is usually different from the VAT treatment of grants. Consideration provided under a contract is usually within the scope of VAT. By contrast, grants are usually outside the scope of VAT. However, the classification of a funding agreement as a grant or a contract is not the determining issue for VAT, as contracts can be outside the scope of VAT and grants can be within the scope of VAT, for example:

	Non-business or outside the scope of VAT	Business or within the scope of VAT
Grants	A subsidy to purchase an asset, for covering losses, for contributing towards the costs of a project or for restructuring.	A grant provided per unit of output such as per piece of advice provided. A grant paid subject to a condition the recipient makes a supply of goods or services.
Contracts	A contract that does not meet the business tests (see below).	A contract that meets the business tests (see below).

What matters for VAT is whether or not the funding provided under the agreement is consideration for a *business supply*. If it is, then the funding is within the scope of VAT and if it is not, the funding is outside the scope of VAT. The funding will be consideration for a business supply if two tests are both met:

- Under the agreement goods or services are to be provided in return for consideration. This means that in VAT terms the agreement is for a *supply*.
- That supply is a business supply. This means that it is made in the course or furtherance of a business activity of the supplier's. UK case law has developed the *business tests* to see if this condition is met.

Business tests

Business activities are defined to include:

- Any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions
- The exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis

The meaning of business activity in UK case law is in a state of flux at the time of writing. For a long time UK case law used a set of six 'business' or 'Fisher' tests in order to determine if an activity was business or non-business. The tests asked if the activity:

- 1 was a serious undertaking earnestly pursued,
- 2 pursued with reasonable continuity,
- 3 substantial in amount,

- 4 conducted on sound and recognised business principles,
- 5 predominantly concerned with making supplies for consideration and
- 6 consists of supplies commonly made by those who seek to make a profit from them.

However the tests were rejected by the Court of Appeal in the 2016 decision *Longridge on Thames* on the basis they are incompatible with the case law of the Court of Justice of the EU ('CJEU'). In the 2016 *Gemeente Borsele* case, the CJEU explained that the general VAT rule (the second bullet point above) is that anything that constitutes the exploitation of property for the purposes of obtaining income therefrom on a continuing basis is a business activity. In order to determine this, all the circumstances in which the supply takes place must be examined. This includes comparing the circumstances in which the supply takes place with the circumstances in which that type of service is usually provided. Other factors, such as the number of customers and the amount of earnings, may be taken into account along with others.

Relevant comparison factors thus include:

- Whether there is a marketplace for the type of service.
- Whether the supplier is competing in that marketplace.
- Whether the supplier exploits assets (premises, equipment, staff etc.) in a similar way to suppliers competing in the marketplace.
- Whether the supplier carries out marketing and promotion activities similar to those carried out by suppliers competing in the marketplace.

Quantitative factors such as the number of transactions, the frequency of transactions, the number of customers and the level of fees versus costs can be taken into account along with others.

The HMRC internal staff guidance on business activities still refers to the Fisher business tests and hasn't yet been updated for the *Longridge* or *Borsele* decisions (the VBNB manual at VBNB22000).

The HMRC grant consideration factors

For income to be subject to VAT in the hands of its recipient, two tests must both be met:

- 1 The income must be consideration for a supply of goods or services made by the recipient (the 'supply test'), and
- 2 The supply of goods or services must be in the course or furtherance of a business activity of the recipient (the 'business test').

Grants are commonly seen as failing the supply test whilst income from contracts is commonly seen as passing it. This is because grants are generally not provided in return for supplying goods or services, whereas fees received under contract usually are. However this is not invariably the case and grants can pass the supply test and contract income fail it, so in practice the supply test can be problematic and involve more than simply looking at the legal form of the funding agreement.

The supply test can be especially problematic for charities that receive funds from government departments and agencies and local authorities. Some funders also structure agreements as grants even though the recipient is required to supply goods or

services in return for the grant, so despite being structured as a grant, it passes the supply test.

The HMRC factors

In January 2018 HMRC updated the grants section (VATSC5600) of its VATSC internal staff manual on supply and consideration to provide new guidance on the supply test in the context of public body funding. The guidance is for HMRC staff and is now the official HMRC policy in this area, so it should provide a good idea of how HMRC staff following the guidance are likely to assess whether or not a funding agreement passes the supply test.

The HMRC approach

HMRC explain (VATSC51640) that for income to be consideration for a supply (i.e. to meet the supply test) there must always be three things present:

- 1 a supply
- 2 consideration and
- 3 a direct link between the two.

HMRC then provide five key questions to consider in order to decide if these three factors are all present:

- 1 Does the funder receive anything in return for the payment?
- 2 If the funder does not benefit directly, does any third party receive a benefit?
- 3 Are there any conditions attached to the payment that go beyond merely having to mention it in account statements?
- 4 What will the payments be used for?
- 5 Is there a contract and what are the terms and conditions?

HMRC then list three sets of factors or indicators. Factors in the first set point to income being an outside the scope of VAT grant (VATSC51820), factors in the second set point to it being within the scope of VAT consideration for a supply (VATSC51840) and the factors in the third set are neutral (VATSC51860).

The factors that HMRC see as relevant are broadly:

- **The initiation process** How was the funding process initiated? For example, did the recipient come up with a funding request and apply for a grant from a recognised grant provider? Or did the funder draw up a service specification and tender for the service?
- **Legal form** Is the funding a grant provided under a power to make a grant, or is it consideration under a legally binding contract that is commercial in nature?
- **Beneficiaries** Who (if anyone) benefits from the funds? Does the funder benefit directly or does a third party benefit directly? If the funder outsources services or if the funder has a statutory duty to provide the services, HMRC are likely to see the funder as benefiting directly.
- **Control** How much control does the funder exert over how the funds are spent? This includes looking at who sets any performance targets. The greater the degree of control exerted by the funder the more likely it is to be consideration for a supply, the greater the degree of control exerted by the recipient the more likely it is to be a grant.
- **Drawdown** How are the funds drawn down? A cost reimbursement basis is seen as a

grant-like factor and an output or target-linked drawdown as consideration-like.

- **Description** How are the funds described in the recipient's accounts? If they are described as trading receipts then this is a consideration like factor whilst description as a grant or restricted funds is a grant-like factor.
- **The termination process** If the recipient has legal redress for failure to pay (e.g. for breach of contract) then this is a consideration like factor whilst if the funder imposes grant clawback provisions this is seen as a grant-like feature.

Neutral factors are seen as being:

- **Described as a grant** That the receipt is described as a grant in the agreement documents. Whilst the wording is important, what the payment is called does not determine its VAT treatment.
- **Level of detail** The level of detail within the contract/agreement does not point in either direction.
- **Other projects and activities** That the recipient's activities and the number of projects undertaken might be influenced by the payment.

Key points on VAT

- Grant funding is outside the scope of VAT when it is freely given.
- Funding is a business supply when it is directly linked to the service being provided and the business tests are met.
- The substance of the arrangement determines the VAT treatment, not what the funding agreement is called.
- Many business supplies provided by charities are VAT exempt such as health and care services, education, training, cultural supplies and supplies at qualifying fundraising events.
- If in doubt, make a written enquiry to the HMRC charities unit to confirm the correct treatment.

Example – Changing from grant to contract – unforeseen consequences

For many years, St Ethelbert's Hospice has provided services for free, receiving donations from supporters and families, as well as grants from the local authority and health trust. Now it wishes to build a new wing for the hospice, to expand the range of services they offer and allow them to admit more patients. They are negotiating with the local authority, which has indicated that they wish to buy in some daycare spaces at the hospice. They are also anticipating that hospice places will be bought by the health authority.

In terms of VAT, the hospice has moved from non-business activities funded by donations

and grants to business activities funded by contracts. The services provided are exempt from VAT so no VAT has to be charged on them, so there is no apparent difference in day-to-day operations. However, zero-rating for new construction work is only available to charities undertaking non-business or certain residential activities, including use as a residential hospice. So now the hospice may not be eligible for zero-rating relief on the full construction costs of the new wing if it is intended wholly or partly for non-residential business use, and it may therefore cost them more to build it.

Conclusion

Charities may provide services under contract, as long as the service is within the charity's objects. If they receive contract funding, it is a business arrangement and usually treated as unrestricted funding in the accounts. It may be performance related or the funding may be provided for a certain time period. This may give rise to an adjustment at the financial year end so that only the income earned is recognised in the statement of financial activities, with funding received in advance going to the balance sheet as deferred income.

By contrast, a grant is freely given although the grantor may expect certain services to be provided to beneficiaries, so making the funding restricted. A grant will be recognised as income as soon as all recognition criteria have been met, and so balances may be carried forward within the charity's funds for future expenditure.

A contract will usually be business income for VAT, whereas a grant will usually be outside the scope of VAT. However, a contract may be for exempt services and a grant may be a subsidy for a business activity. At an early stage, clarify the VAT status of the activity in a contract situation and in a grant situation. Assess the impact on the organisation under both options so that you can assess how you would like the funding to be treated.

As a precautionary measure, incorporate a clause into all funding agreements, service level agreements and contracts that states that any fees payable under the agreement are subject to VAT if it applies. This will allow you to add VAT to the fees charged. Otherwise the fee has to include VAT.

Further information

Charities SORP (FRS 102)

www.charitySORP.org

Charities and Trading

www.gov.uk/charities-and-trading

Trustees trading and tax: how charities may lawfully trade (CC35)

www.gov.uk/government/publications/trustees-trading-and-tax-how-charities-may-lawfully-trade-cc35



Notes





Made simple guides

Made Simple guides are aimed at finance professionals and other managers working in charities. They cover technical areas such as tax and VAT treatments as well as information management areas and aim to provide practical guidance to busy managers and trustees in charities. .



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