VAT focus
Charitable grants and VAT

SPEED READ **Charities are obliged to see the fruitful application of the funds they receive and donate. They also need to keep their VAT expenditure to a minimum and would be loathe to charge VAT to a benefactor. A delicate balancing act is involved. Broadly speaking, the key issue is the extent to which an arrangement is commercial in nature. There are three key considerations. Does the funding recipient undertake something in return for payment? Is there a direct link between the funding and a supply of services? Is the funding recipient carrying on a business? An existing grant agreement can become a taxable supply and possibly vice versa.**

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Charities can find themselves in a tough spot when it comes to the application of the VAT regime to voluntary funding arrangements. As a grant recipient, a charity can be required to charge VAT to its funder if it is deemed to supply services to the funder. From the other perspective, where the charity is itself the grantor, and unwittingly receives a supply, it may have to pay VAT. This is an unhappy predicament for any charity which makes few, if any, taxable supplies and so cannot defray the cost. And pity the charity that acts as a conduit and does both, first receiving grant funds and then itself making onward grants. The image of a rabbit caught in the headlights seems apt.

The subject has been considered by the courts many times, both in the UK and, in respect of the underpinning VAT principles, at the European level. Whether any given funding arrangement will fall into the VAT net is highly fact sensitive, meaning that definitive guidance is hard to extract. That said, in most instances there are three key considerations, and this article explores these and highlights points to bear in mind.

A supply 'for' consideration

One of the basic requirements for a transaction to fall within the VAT regime is for there to be a supply '*for*' consideration. In other words: Does the recipient undertake something in return for payment? This is sometimes expressed as the 'reciprocity' requirement.

It is important to be aware that the supply need not be made by the funding recipient to the funder, it can be made to a third party. In the case of *Keeping Newcastle Warm (KNW) Ltd v C&E Commrs* [2002] STC 943 householders contracted with KNW to receive energy advice. Meanwhile, KNW received subsidy payments from a grant agency for giving this advice. The payments from the grant agency were held to be taxable as the consideration for the supply by KNW to the householders.

Furthermore, there may be more than one supply associated with any one payment. The famous case of *C&E Commrs v Redrow Group Plc* [1999] STC 161 is an example. Redrow, a house builder company, wished to incentivise customers to buy new Redrow-built homes by covering the estate agent cost to them of selling their existing homes. Redrow paid an estate agency to undertake this work. The estate agents were found to have made a supply both to Redrow and also to the customers whose house sales they arranged.

A supply for consideration will typically take place when a funder ceases to carry on an activity which it asks the funding recipient to take on. In this instance the activity is said to have been 'contracted out' to the recipient. Sub-contracting agreements usually attract VAT because the recipient fulfils the funder's own obligation, thereby rendering him a service. In *Edinburgh Leisure & Others v C&E Commrs* [2004] UKVAT V18784, Edinburgh Leisure entered into what it believed to be a contract for services with the council and accordingly tried to recoup its input VAT. The tribunal allowed the input tax claim, agreeing that the council had contracted out the leisure activities which it had previously provided to the public itself. Similarly, in *Bath Festivals Trust v C&E Commrs* [2008] (Decision 20840), the court accepted that the council had outsourced the provision of the music festival because the council no longer had the resources or expertise to do it.

The role of the funding can also shed light on this point. One needs to ask: would the recipient continue to do the activity in any event, whether or not it is funded by that particular funder? The answer will help distinguish between (i) funding to enable an entity to operate *for its own purposes* – a grant, and (ii) a payment to procure fulfilment of the *funder's* duty – a service agreement.

In the charities sphere, a typical instance of a supply for consideration is sponsorship. If a charity is sponsored it will make a taxable supply to its sponsor. HMRC gives limited guidance as to what constitutes sponsorship. For example, according to the *VAT Notice 701/41*, naming an event after the sponsor or displaying the sponsor's company logo/trading name is sponsorship; whereas naming the donor in a list of supporters or naming a building after the donor is not. The distinction between sponsorship and acknowledging the source of funding can be unclear.

Points to consider:

- Where the recipient uses the funds to provide a service to a third party, the payment may be consideration for that onward supply or consideration for a separate supply back to the funder.
- An entity which undertakes an activity which its funder will then cease to carry on should likely charge VAT, especially if it is the funder who has sought out the recipient, rather than vice versa. These are viewed as indicators of sub-contracting.
- Where a donor intends a single payment to cover both sponsorship and a gratuitous donation, only the payment for sponsorship should be subject to VAT. The amount attributable to the sponsorship must be realistic in relation to the benefits provided; and it must be clearly distinguishable from the donation element.

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Direct link

Case law dating back to a 1981 case of *Dutch Potato Case (Staatssecretaris van Financien v Cooperatieve Aardappelenbewaarplaats GA* [1981] ECR 445 has established that, for a supply to be subject to VAT, there must be a 'direct link' between the funding and the supply of services. A direct link will exist where the funder receives a benefit which corresponds to the payment, rather than an indirect or incidental benefit. In *Apple and Pear Development Council v C&E Commrs* [1988] STC 221 a mandatory annual charge was imposed on UK apple and pear growers in return for which the council would advertise, promote and improve the quality of apple and pears in the UK. It was decided that the payer received no direct benefit in return for the payment because the benefit accrued collectively to all the UK apple and pear growers. In contrast to this, a scheme named the Kingdom Scheme where payment was voluntary and where the growers received services directed to their specific products *did* have the necessary link and was therefore within the scope of VAT.

How important is the wording in the contract when determining a direct link? A Court of Appeal judge in *Esporta Ltd v HMRC* [2014] EWCA Civ 155 explained that 'the contractual terms are the starting point and the Court has to consider whether those terms reflect the economic and commercial reality of the transaction'. This principle was applied in *South African Tourist Board v C&E Commrs* [2014] UKUT 0280 (TCC). The tourist board was charged with promoting tourism in South Africa and received the majority of its funding from the South African government. The contract was worded as a service contract and included commercial terms such as performance indicators and targets. Nonetheless, the tribunal held that in reality the parties lacked the necessary 'reciprocity' and the arrangement was not taxable.

Points to consider:

- Where the benefit to the funder is immediate and measurable, a 'direct link' is likely to exist. Charities which fund research are vulnerable in this respect.
- Contractual terms alone cannot determine grant status; however, examples of grant-friendly terms are:
  - performance targets which determine the appropriate level of funding rather than a standard to which the recipient will be held accountable;
  - audits which monitor correct use of funds rather than whether or not the activity is carried out to a standard dictated by the funder; and
  - where the recipient has no right of recourse if funding is withdrawn.
- Where the funder is the recipient's only source of finance, the risk of incurring VAT is greater.

Economic activity?

In some instances, even where there is both a 'supply for consideration' and a 'direct link' between the funding and the supply there may still be a question mark over whether the funding recipient is carrying on a business and is therefore within the scope of VAT in the first place. This issue has been approached in two ways:

- The court may consider whether the funding recipient is a body which has the *capacity* to make taxable supplies. In *Staatssecretaris van Financien v Hong Kong Trade Development Council* [1982] ECR 1277, the court held that the Council was not acting as a taxable person because all of its activities consisted exclusively in providing a free service.
- Alternatively, the court may ask whether the particular supply itself falls within the sphere of economic activity. In *ICAEW v C&E Commrs* [1999] STC 398, it was decided that the service of licensing and monitoring accountants was a function of the state and not a trading or commercial activity that could be described as 'economic'.

In practice the 'economic activity' consideration is of limited value for charities as they are usually in a position to make economic or business supplies, even if the majority of their activities are non-business and in accordance with their charitable objects.

Point to consider: Does the funded activity constitute a service which others would typically pay a monetary value to receive?

Is the relationship set in stone?

Can parties convert a grant agreement to a service agreement or vice versa? In the case of *Bath Festivals Trust* (ibid), Bath Festival Society had originally received grants from Bath City Council to promote a music festival. After the Society ran into financial difficulties the Council's successor entity established a new company, Bath Festival Trust, to provide cultural services including the music festival. The Revenue argued that the new arrangements could not over-write what had previously been a grant relationship. This was rejected by the tribunal which determined that the relationship had changed. Interestingly, the trust received payments simultaneously by way of grant from one funder (the Arts Council) and by way of payment under a service agreement from another (Bath Council) so the two contracts could be directly compared.

One of the factors which persuaded the tribunal was that the activity undertaken by the trust was funder-led, whereas previously it had been recipient-led. In a grant scenario, the recipient typically presents an activity to the funder for which it seeks funding. In contrast, under a service agreement, it is the funder who proposes the activity and specifies the terms according to which it will pay for those services. In theory, it should be possible for a conversion to go the other way (i.e. from service agreement to grant), although this may be more challenging as it involves effectively reverse-engineering the relationship and severing existing links between payment and performance.

Final thoughts

HMRC is adept at arguing both for and against grant funding arrangements depending on which of the two maximises tax receipts. It will argue *for* a grant where they wish to deny input tax recovery and argue *against* a grant in order to require that output tax be paid.

How then can the many cases inform sensible judgements about whether VAT will intrude on an otherwise benevolent relationship between a charity and its funder? Broadly speaking, the key issue is the extent to which the arrangement is commercial in nature. Where the funding is clearly aligned with a benefit received by the funder which it would otherwise need to pay someone else to provide, VAT is likely to be in play.

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