



Updated HMRC grants and contracts guidance

HMRC has substantially rewritten its (publicly available) internal guidance on how to decide whether a transaction is a grant or contract for VAT purposes.

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, 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 grant v consideration 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:

- A supply
- A consideration, and
- A direct link between the two

HMRC then provide 5 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 a grant (VATSC51820), factors in the second set point to it being 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 factor
- **Description** How are the funds described in the recipient's accounts? If they are described as trading receipts then this 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

Comments on the factors

Many charities will obviously find the HMRC factors useful as they now provide a series of HMRC endorsed factors to consider in order to decide if income meets the supply test.

Most of the factors should not be seen as actually being decisive on their own. For example, it is doubtful that the initiation process, or the way the income is described in the accounts, can have any real relevance to the supply test as in strict VAT terms it simply asks is the income, in economic substance, consideration for a supply of goods or services by the recipient? HMRC take the position that there is in practice a correlation between the factors and the VAT status, correlation not being the same as causation. The factors should therefore be seen as a series of pragmatic tests for HMRC staff to apply.

However, some of the factors do have relevance to the supply test and might be determinative on their own. For example, if a grant is paid per unit of output then it is likely to be consideration for a supply of the output, irrespective of what the other factors say. In the Keeping Newcastle Warm case (discussed by HMRC at VATSC51950), a charity was paid a grant of £10 per piece of home energy efficiency advice given to local householders under a government grant scheme. Even though the £10 was a grant, because it was paid per unit of output, it was consideration for the charity's supplies of advice services.

How to apply the factors

At VATSC51800 HMRC explain that this is not simply a numerical test, that is, one that looks at the numbers of factors in favour and against a particular treatment. Instead HMRC staff are instructed to take a balanced view taking all the applicable indicators into account. However, at VATSC51820 HMRC do say that the more grant like features there are, the more likely it is that the payment is outside the scope of VAT, and at VATSC51840 that the more consideration like features there are, the more likely it is that the payment is consideration for a supply.

It is not clear from the guidance how the various factors should be compared and balanced and it would have been helpful to have more HMRC guidance or examples on this aspect.

The business test

Passing supply test is a necessary but not sufficient condition for income to be within the scope of VAT. To be within the scope of VAT the income must pass both the supply test and the business test. However, the business test is dealt with in a separate HMRC staff manual (the VBNB manual) which was not updated at the same time.

The business test is the subject of some significant developments, in the form of two court decisions, the 2016 UK Court of Appeal decision in Longridge on Thames and the 2016 Court of Justice of the EU decision in Gemeente Borsele. In the Longridge on Thames case the Court of Appeal appears to have discarded the longstanding UK case law 'business tests', though these remain a key test in the VBNB manual (VBNB22000). However, the Court of Justice of the EU decision in Gemeente Borsele suggests the Court of Appeal's decision may not be entirely correct.

It will be interesting to see how HMRC deals with these cases. We expect HMRC to update its VBNB manual in the light of these decisions but it has not done so yet.

Links

Main grants contents page <https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc51600>

HMRC's approach <https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc51640>

Factors in favour of grant treatment: <https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc51820>

Factors in favour of consideration treatment: <https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc51840>

Neutral factors: <https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc51860>