

HMRC's grant vs consideration factors

In February 2022 HMRC updated its grant vs consideration factors, which are used to decide if income is consideration for VAT purposes and within the scope of VAT or if it is a grant and outside the scope of VAT.

Background

For income to be subject to VAT, it must be consideration for a supply of goods or services. This is referred to as the 'supply test'.

Grants generally fail the supply test whilst contract income generally passes it. This is because grants are not usually provided in return for supplying goods or services, whereas fees received under contract generally are. However, this is not invariably the case. Grants can pass the supply test and contract income fail it, so 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 funding from government departments, local authorities and other public bodies. Some funders also structure funding agreements as grant agreements but if the recipient is required to provide goods or services in return for the grant, then the associated income is likely to pass the supply test.

The supply test has been a longstanding VAT problem for charities. After work carried out by the Charity Tax Group, in 2018 HMRC updated the grants section (VATSC06300) of its VAT Supply and Consideration (VATSC) internal staff manual to provide new guidance on the supply test in the context of public body funding. HMRC now provide three sets of factors or indicators to use in order to determine if a source of funding meets the supply test. The guidance is internal guidance for HMRC staff and is now the official HMRC policy in this area.

HMRC's approach

HMRC explain (VATSC06312) 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 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 a grant and outside the scope of VAT (VATSC06317), factors in the second set point to it being consideration for a supply and within the scope of VAT (VATSC06318) and the factors in the third set are neutral (VATSC06319).

The factors that HMRC see as relevant are broadly:

- **The initiation process:** How was the funding process initiated? For example, did the recipient apply for funding from a recognised grant provider? Or did the funder draw up a service specification and tender for the service?
- **The legal form of the funding agreement:** Is the funding agreement a grant agreement or is it a contract for goods or services? If a grant agreement, is this something the funder has the power to do and usually does?
- **Beneficiaries:** Who benefits from the funding? 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 consideration of who sets any performance targets. The greater the degree of control 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 a consideration like factor
- **Description and reporting:** How are the funds described in the recipient's and funder's accounts? If they are described as trading receipts, then this a consideration like factor whilst description as a grant or restricted fund is a grant like factor
- **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 funding agreement has grant clawback provisions this is seen as a grant like feature

Neutral factors are:

- **Described as a grant:** The fact the income is described as a grant in the funding agreement is irrelevant. Whilst the wording of the funding agreement 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:** The fact the recipient's activities and the number of projects undertaken might be influenced by the payment is irrelevant

Recent changes

In February 2022 HMRC reversed the meaning of one of its consideration like factors.

The factor now says 'the relationship between the funder and supplier will not be at arm's length' and 'there will be a clear level of control from the funder in the supplier's decision making process'. Previously it said the relationship would be at arm's length with an absence of control from the funder. This resolves what was previously an anomaly in the consideration like factors and brings them into line with the broad position on control explained above.

Comments on the factors

Many charities will find the HMRC factors useful as they provide a series of HMRC endorsed questions to consider in order to decide if income does or does not meet the supply test.

Most of the factors should not be seen as being decisive on their own. For example, it is doubtful that the way the income is described in the accounts of either the funder or recipient can have a real relevance to the supply test as in strict VAT terms the test simply asks is the income consideration for a supply of goods or services?

However, these are indicators and some factors might be determinative on their own. For example, if a grant is paid per unit of output ('performance related grants') then it may 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 VATSC06315), 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 VATSC06316 HMRC explain this is not a case of comparing the numbers of factors in favour and against a particular VAT treatment. Instead HMRC staff are instructed to take a balanced view taking all the applicable indicators into account. However, at VATSC06317 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 VATSC06318 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 HMRC VATSC guidance how the various factors should be compared and balanced and it would be helpful to have more HMRC guidance or examples on this aspect.

The business test

If income passes the supply test, it must also be 'business income' in order to be within the scope of VAT. This is referred to as the 'business test'. The HMRC grant v consideration factors and the HMRC VATSC manual relate primarily to the supply test, for the business test HMRC provide a separate business/non-business (VBNB) manual.

However the VBNB manual is now out of date in respect of the business test. The business test as currently explained in the VBNB manual (VBNB22000) is based on what are referred to as the Fisher tests, after a UK VAT case from 1981. In the 2016 Longridge on Thames case and again in the 2018 Wakefield College case the Court of Appeal decided the Fisher tests are out of date and should no longer be used. HMRC has yet to update the VBNB manual for this.

However decisions made on the basis of the Fisher tests may still be correct. This is illustrated by the recent Babylon Farm case (September 2021). HMRC argued that Babylon Farm did not carry on a business activity on the basis of the Fisher tests, and as such was not entitled to reclaim VAT incurred on its purchases. Babylon Farm appealed to the First Tier Tax Tribunal (FTT) which decided in favour of HMRC based on the Fisher tests. Babylon Farm then appealed to the Upper Tier Tax Tribunal (UTT) partly on the basis both HMRC and the FTT had applied the wrong business test and should have used the test set out by the Court of Appeal in the Wakefield College case. The UTT agreed with Babylon Farm, it then applied the Wakefield College business test and decided that Babylon Farm did not carry on a business activity.

So even though the Fisher tests are now out of date, they may nevertheless give the correct answer. This is not surprising as there are many similarities between the Fisher tests and the Wakefield tests.

Links

HMRC VATSC manual, main grants contents page <https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc06300>

HMRC VATSC manual, HMRC's approach <https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc06312>

HMRC VATSC manual, Factors in favour of grant treatment: <https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc06317>

HMRC VATSC manual, Factors in favour of consideration treatment: <https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc06318>

HMRC VATSC manual, Neutral factors: <https://www.gov.uk/hmrc-internal-manuals/vat-supply-and-consideration/vatsc06319>

HMRC VBNB manual guidance on the Fisher tests <https://www.gov.uk/hmrc-internal-manuals/vat-business-non-business/vbnb22000>

The Court of Appeal's Decision in Wakefield College <https://www.bailii.org/ew/cases/EWCA/Civ/2018/952.html>

The Upper Tier Tax Tribunal decision in Babylon Farm <https://www.bailii.org/uk/cases/UKUT/TCC/2021/224.html>