

Modernising Commissioning: Response to the Green Paper from the Charity Tax Group – January 2011

Outsourcing of Public Sector work to Charities; the “Grants vs Contracts” Issue

Introduction

1. The Charity Tax Group (CTG) is a membership organisation representing all types of charitable activity across the sector. We currently have over 400 members, ranging from local charities to national and international ones such as Oxfam and Cancer Research UK. Since 1982 CTG has attempted to make a serious contribution to the debate on the tax position of charities and we welcome the opportunity to comment on the recent Green Paper on *Modernising Commissioning*. This note addresses what we regard as the major underlying tax problem that may inhibit charities from tendering to supply services. **We believe that solving the problem of the “grants vs contracts issue” and the concomitant VAT problems would go a considerable way towards meeting HMG’s objectives of opening up the commissioning process as part of the Big Society agenda.**

The root of the problem

2. The VAT treatment of outsourced services provided by charities to public bodies has been a cause of concern for many years, particularly where the services are taxable rather than exempt.
3. In the absence of clear documentation it is often difficult to determine whether a charity is performing services under a contract for service when the funding is consideration and therefore within the scope of VAT (whether taxable or exempt) or whether the charity is performing a service funded by a grant and therefore “non-business” because of the lack of a direct and immediate link with anything done in return for the service provided. Even where the charity is clear that the service provision is a business supply within the scope of VAT and proposes that it be provided under a contract of service including a VAT clause that allows VAT to be added, the public body concerned may disagree and insist that the payment is grant funding outside the scope of VAT. This can put charities in a difficult position in competing for public sector tenders because the public body commissioning the service usually calls the shots. The VAT impact of these decisions is often ill-understood by accounts staff in public bodies.
4. This issue – grants *versus* contracts – has been given added impetus by the Government’s *Green Paper on Modernising Commissioning*, whose stated aim is to increase the role of charities, social enterprises, mutuals and cooperatives in public service delivery. There can be no doubt that the present lack of clarity and general confusion about VAT is an important barrier to this.

5. What CTG is seeking is the agreement of all parties – public bodies, charities and HMRC – to establish clear guidelines setting out the circumstances in which it is appropriate to use contracts for service on the one hand and grant funding on the other – and the VAT consequences of each of them. CTG considers that, in principle, where a charity expresses a preference to provide outsourced services under a contract for service subject to VAT, public bodies should not stand in the charity's way – as they do at present, often for reasons that are not wholly rational or properly thought through as far as the VAT consequences and impact are concerned.

Differential treatment

6. Local authorities, their divisions and affiliates and certain other tax or levy-funded bodies are allowed to recover VAT in full on their non-business activities under section 33 VATA 1994, and other public bodies, including central Government departments and the NHS may recover VAT under section 41 VATA 1994 on a defined list of outsourced services. This is a special form of recovery under the principle of matching grant equivalent to the VAT incurred, rather than an integral part of the VAT system, with the result that it is legal under EU law. This is important, because it follows that there can be no legal or policy objection to maximising the effectiveness of these provisions by avoiding sticking input VAT on contracted out services where possible.
7. The intention of the current policy is to mitigate the VAT burden – and therefore the disincentive effect – on contracting out public service provision.
8. Because of these provisions, public bodies which switch from in-house provision to an outsourcing solution do not suffer a VAT disadvantage *so long as the outsourcer is able to charge (and therefore recover) VAT*. But where the outsourcer cannot do so – either because the service is within the exemptions, for example for education, social welfare or care, or because the funding is by grant – the service will be loaded with embedded or sticking VAT suffered by the supplier, and will be that much less competitive as a result. Where exemptions are in play, nothing can be done about it; but grant-funding inevitably produces a VAT-inefficient result because of the effect on the supplier's ability to recover input tax.
9. CTG raised this question at a meeting in November with the Economic Secretary to the Treasury, and was encouraged to pursue it further. A Working Party of charities, other sectoral bodies such as the British Universities Finance Directors Group and their professional advisers was convened to examine the issue on the basis of a number of live examples and to consider possible solutions. The Working Party suggested that the Guidelines would need to include relevant definitions of contracts for service and grants.
10. Numerous examples were cited of inconsistent and confused treatment of outsourced service provision both by public bodies themselves and by HMRC in responding to queries and giving rulings. On occasion, HMRC issued assessments and penalties where it considered that mistaken treatment had been given to a particular transaction. A number of these examples are detailed below.
11. CTG is certainly not suggesting that all outsourced services provision by charities should be under contracts for service rather than grant funding. We appreciate that there will continue to be cases where grant funding is justified under the particular facts and circumstances. As noted already, the choice is less critical where the service is exempt rather than taxable because in those circumstances input tax is in any blocked, with the result that there is no VAT impact.

Is it a contract or is it a grant?

12. As noted above, whether a particular activity is carried out under a contract for service or by way of grant funding is often difficult to decide, as the following examples indicate.

Example – training and support: A contract was concluded with a Regional Development Agency in 2002 and ran for 4 years. It was agreed that the nature of the supplies (providing training, advice and support to a ‘referred’ group of businesses) was a taxable business activity. Towards the end of the project an extension for a further year was agreed on the same output and payment terms; however, the funding was given by way of a grant. The documentation used a range of wording including ‘the provision of services’, ‘grant’ and ‘funding being made available’. The view of the RDA was that it was now a grant-funded programme and that no VAT was chargeable.

Example – consultancy to academies: An educational charity received Government funding under which it was specifically required to ‘provide consultancy days’ at a fixed daily rate to academies. The agreement specified an absolute number of days to be provided over the term of the arrangement giving a total contract sum. The documentation was silent on VAT and the Government Department concerned considered that VAT was not chargeable on the basis that the funding constituted a grant. The advisers, on the other hand, took the view that it was third-party consideration for consultancy services provided to the academies.

Example – beach rescue services: where local authorities paid for beach-rescue services provided by a charity in Devon and Cornwall, HMRC was persuaded that the payments were *not* (as originally supposed) a grant by the local authorities but, instead, made under a contract for a specified level of service provision. This meant that the charity could recover the VAT incurred in providing the services originally considered to be concerned. This allowed the significant amount of VAT on rescue equipment to be recovered going forward.

13. Given these difficulties, we would suggest some pointers in helping to make a determination. The fact that a service previously performed within a public body is to be outsourced and potential bidders are asked to tender or actively enter an application for funds is likely to be an indication that the services are to be provided under a contract for service. In such circumstances, charities and private sector bidders will be competing on a level playing field. If, on the other hand, a charity is itself taking the initiative in applying for funds to carry out activities in line with its charitable objectives which it would be carrying out in any case, that would suggest that the income will be treated as grant funding even where the manner in which the money is spent is to be monitored by the funding body.
14. The treatment of excess funds not spent by the charity may also be helpful in determining the issue. If unspent funds have to be returned to the funder, that may be indication that the funding was a grant. (That need not be determinative, however, since the existence of a form of payment by results does not necessarily imply a grant funding scenario; it may simply be a means of determining the consideration for a taxable supply where this cannot be determined at the time it commences.)
15. Where the parties agree to a contract for service approach, it will be necessary for there to be a clear specification of

- the services to be provided in return for specified considerations (whether or not immediately determined);
- The means of measuring/verifying the service delivery to agreed standards and;
- a clause specifying that fees are exclusive of VAT, which is to be added where legally due.

Conclusion

CTG considers that clarification of this issue by the publication of agreed Guidelines on the lines discussed in this paper, together with a more consistent and rational approach by public bodies in their commissioning policy, will reduce a significant barrier to greater involvement of charities and other not-for-profit bodies in the delivery of public services.

Charity Tax Group
5 January 2011