

VAT Briefing: VAT made simple when working in partnership

2008

NB: Please note this briefing has been updated to include delegate feedback collected at the regional seminars.



The Finance Hub

Charities Aid Foundation
St. Andrew's House
18-20 St. Andrew Street
London
EC4A 3AY
financehub@cafonline.org
www.financehub.org.uk
t (020) 7832 3016
f (020) 7832 3001



Development Trusts Association

National Office
33 Corsham Street
London N1 6DR
info@dta.org.uk
www.dta.org.uk
t 0845 458 8336
f 0845 458 8337

Third Sector Leaders

acevo

acevo
1 New Oxford Street
London WC1A 1NU
info@acevo.org.uk
www.acevo.org.uk
t 0845 345 8481
f 0845 345 8482

Funded by



FUNDED

Abstract

There is a common misconception that charities and other third sector organisations are exempt from VAT because they do not have to pay corporation tax on profits from their charitable activities.

If commercial businesses work together to deliver a contract for a third party, they are obliged to charge each other VAT on the services and goods they provide and sell to each other. Third sector organisations that are not registered charities must pay tax as commercial businesses do.

Although charities enjoy some specific exemptions from charging and paying VAT, in general they must charge and pay VAT just like commercial businesses. So if two charities work together they too are caught by the same VAT rules as businesses.

This briefing explains the most important rules governing VAT on partnerships. It then explains how to make sure that your partnership operates within those rules.

Introduction

Third sector organisations often work together, supported by grant funding provided by local authorities and other government bodies. Sometimes they are subcontracted to provide services. These subcontracts are often to provide welfare and educational services that are exempt from VAT under EU law.

When working together, third sector organisations often provide each other with services and recharge each other for those services. For VAT purposes they have made “supplies” to each other. Unless the supplies fall within the terms of the VAT exemptions or exceptionally can be charged at the zero rate of VAT, the organisations must charge each other VAT on the supplies.

Most businesses and local authorities can recover from H M Revenue and Customs VAT incurred on their costs. However, grant income is outside the scope of VAT. Under EU VAT rules, if income is “outside the scope”¹ of VAT, you cannot recover any VAT paid on related costs. Likewise, if your income is “exempt” from VAT under EU law you again cannot recover VAT paid on your costs.

So, when third sector partners have to charge each other VAT on shared and recharged costs this VAT often cannot be recovered; it is an additional cost. But if a single third sector organisation recharges costs internally between two cost centres there is no “supply” and so no VAT charge.

Third sector partnerships can therefore result in what many regard as an unfair additional VAT bill, leaving them with less money to run their projects.

¹ See the “Key Points” for a brief glossary of these technical terms.

Key points

1. **VAT is a complex tax. Make sure you seek professional advice before undertaking new contracts or varying an existing contract.**
2. Familiarise yourself with the following terms:
 - “Supply for consideration”: the provision of goods or services in return for payment of some kind. This can attract VAT.
 - “Consideration”: does not mean just cash; it includes payment in goods and services and barter transactions.
 - “Outside the scope”: grant-funded services do not count as supplies, so do not attract VAT.
 - “Exempt”: exceptional types of supplies, including some kinds of health, education and welfare services, to which VAT does not apply.
 - “Zero-rated”: further exceptions, such as food, children’s clothing, and books, where the VAT rate is nil.
3. Although charities enjoy some specific exemptions from charging and paying VAT, in general they must charge and pay VAT just like commercial businesses. Do not assume that VAT will not apply, simply because you are a charity.
4. Within a partnership, never assume that services charged between partners will not attract VAT. They may count as a supply for VAT purposes, even if the partnership was set up to deliver a VAT-exempt service.
5. When making a grant proposal, include any VAT payable on your costs in the grant budget. Likewise, when bidding for contracts for the provision of VAT exempt health, education or welfare services, ensure that budgets include the VAT payable on your costs.
6. Consider the secondment of shared staff when you are working in partnership. Depending on the funding model, secondments may sometimes be ignored for VAT. This is a complex area, where specialist advice is required.
7. If you seek advice from H M Revenue and Customs, make sure you get it confirmed in writing. This is partly to ensure you understand the position correctly, and partly to ensure the tax authorities do not later deny or back track on verbal advice given!
8. If a “supply” is liable to VAT, no VAT will be chargeable provided the organisation is not VAT registered with HMRC, and provided the total VAT taxable income of the organisation in any rolling twelve month period is less than the compulsory VAT registration threshold (£64,000 in 2007/08).
9. It is not possible to structure an agreement to turn a supply of services into a grant, or vice versa. Whether a payment is a grant or a fee will depend on the circumstances under which the payment is made. However, ensuring the correct language is used in a contract or agreement will help to prevent grants being wrongly classed as payments for services.

How the VAT system works

VAT is a complex tax and therefore detailed advice should always be sought before undertaking new contracts or varying an existing contract.

VAT is a European tax: it is ultimately controlled by the EU, not the UK government. Third sector organisations that are registered for VAT should always work on the basis that VAT must be charged and paid on any activity they undertake unless it is covered by a specific VAT exemption or the rate of VAT charged on that activity is zero.

VAT is charged on the “supply” of goods and services where “consideration” is received in return. “Supply” broadly means provision or sale. “Consideration” means payment - which can be a payment in money (cash, cheque, credit card etc) or instead by making a supply of goods and services back to the supplier in return.

For example, administrative services are provided by charity Viking to charity Saxon, and Saxon pays Viking by allowing them to use their minibus. This is known as “a barter”. Even though no cash has changed hands VAT must still be charged on top by both Viking and Saxon. Both charities need to ascertain the value of their supplies to each other and send each other VAT only invoices at 17.5% of the value of their supplies. These must be paid in cash, not by a barter!

VAT is only chargeable on supplies that are not exempt from VAT or covered by the VAT zero rate if the supplier is either VAT registered with HMRC (i.e. has a VAT registration number) or should be registered because they have exceeded

the compulsory VAT registration threshold. This threshold is (for the 2007/08 financial year) £64,000 in any rolling twelve month period.

So, if a charity is not registered for VAT, and makes non-exempt and non-zero rated supplies of £40,000 in a 12 month period, then it does not have to charge VAT on those supplies.

N.B. you need to consider the activities carried out by the charity as a whole and not just your particular project. If your project makes VAT taxable supplies of £40,000, and the rest of the charity makes VAT taxable supplies of £30,000, (total £70,000) then the charity will need to register for VAT with HM Revenue & Customs because the £64,000 compulsory registration threshold has been exceeded and you will need to charge VAT on your supplies.

The VAT system means that each person in the chain between the first supplier and the final consumer is charged VAT on taxable supplies made to him (input tax) and charges VAT on taxable supplies made by him (output tax). Most suppliers pay over to H M Revenue and Customs the excess of output tax over input tax, or recover from H M Revenue and Customs the excess of input tax over output tax.

Most suppliers are therefore effectively able to reclaim from HM Revenue & Customs the VAT they are charged on their costs. For example – total VAT charged on supplies made (output tax) is £10,000. Total VAT incurred on related costs (input tax) is £3,000. Therefore only the difference of £7,000 is paid to HM Revenue & Customs.

The broad effect of this is that suppliers making taxable supplies are not affected by VAT, except in so far as they are required to administer it. The burden of tax falls on the final consumer. However, suppliers making VAT exempt supplies cannot recover VAT incurred on their costs, because their supplies are exempted from the VAT system. There is some VAT that, due to special rules, can never be recovered. Examples include VAT charged on business entertaining and some of the VAT charged on the cost of cars.

VAT exemption

VAT tax was created with the assumption that it would be wrong to charge VAT on all supplies, so exemptions exist. These exemptions include the rental of property, provision of postage by the national carrier, burials and cremations, finance, and perhaps most importantly for the third sector, certain services in health, welfare and education.

When the UK joined the EU we decided that the exemptions did not go far enough. There were a number of other supplies we thought should not attract VAT and so agreed with the EU a zero rate of VAT for supplies such as food, children's clothing, books and newspapers, equipment for the disabled and public transport. Although the rate of VAT is nil, organisations that make zero rate supplies are still allowed to recover the VAT they incur on their costs.

The Education VAT exemption

The VAT exemption for education, training, and research is dependent on whether the provider is an "eligible body".

- "Eligible bodies" include schools and universities. They also include charities and other bodies which are precluded from distributing and do not distribute profits.
- A further condition for exemption is that any and all profits made from supplies of education must be used to continue or improve future supplies of education.

"Education" has a wide meaning for VAT and includes any course, class, or lesson of instruction or study in any subject. It doesn't matter whether the education is normally provided in schools, colleges, or universities. When and where it takes place is irrelevant for VAT purposes.

"Education" also includes vocational training, retraining, or the provision of work experience for both employees and charity volunteers.

The Welfare Services VAT Exemption

The welfare services VAT exemption applies to services provided by charities and public bodies that are directly connected with:

- The provision of care, treatment, or instruction designed to promote the physical or mental welfare of elderly, sick, distressed, or disabled people, or
- The care or protection of children and young persons, or
- The provision of spiritual welfare by a religious institution as part of a course or retreat (which is not primarily a holiday).

To qualify for the exemption, the services must be "directly connected" to the above. Services that are peripheral to these areas, such as related administration, will be subject to VAT. For example, imagine that a charity contracts with a local NHS trust to design procedures and protocols to improve communication between patients and hospitals. This work is not directly connected with the care of the sick, and so is subject to VAT.

Grant income

Grant income is not a “supply” for VAT purposes and is therefore outside the scope of VAT. Supplies are two-way traffic – goods and services going one way, and payment in return going the other. Grants on the other hand are seen as one-way traffic down to the recipient. The payer is not receiving goods or services in return. They get no direct benefit from the services carried out by the grant recipient.

If a third sector organisation carries out work that a local authority or other government body is statutorily obliged to deliver, the payment for the work cannot be a grant. It is a fee for subcontracted work. It is therefore within the scope of VAT.

Likewise if the local authority benefits from the work carried out then the payment can not be a grant. For example, imagine a charity carries out a study on accessibility in local government offices. The local authority has benefited from this work, the payment is a fee.

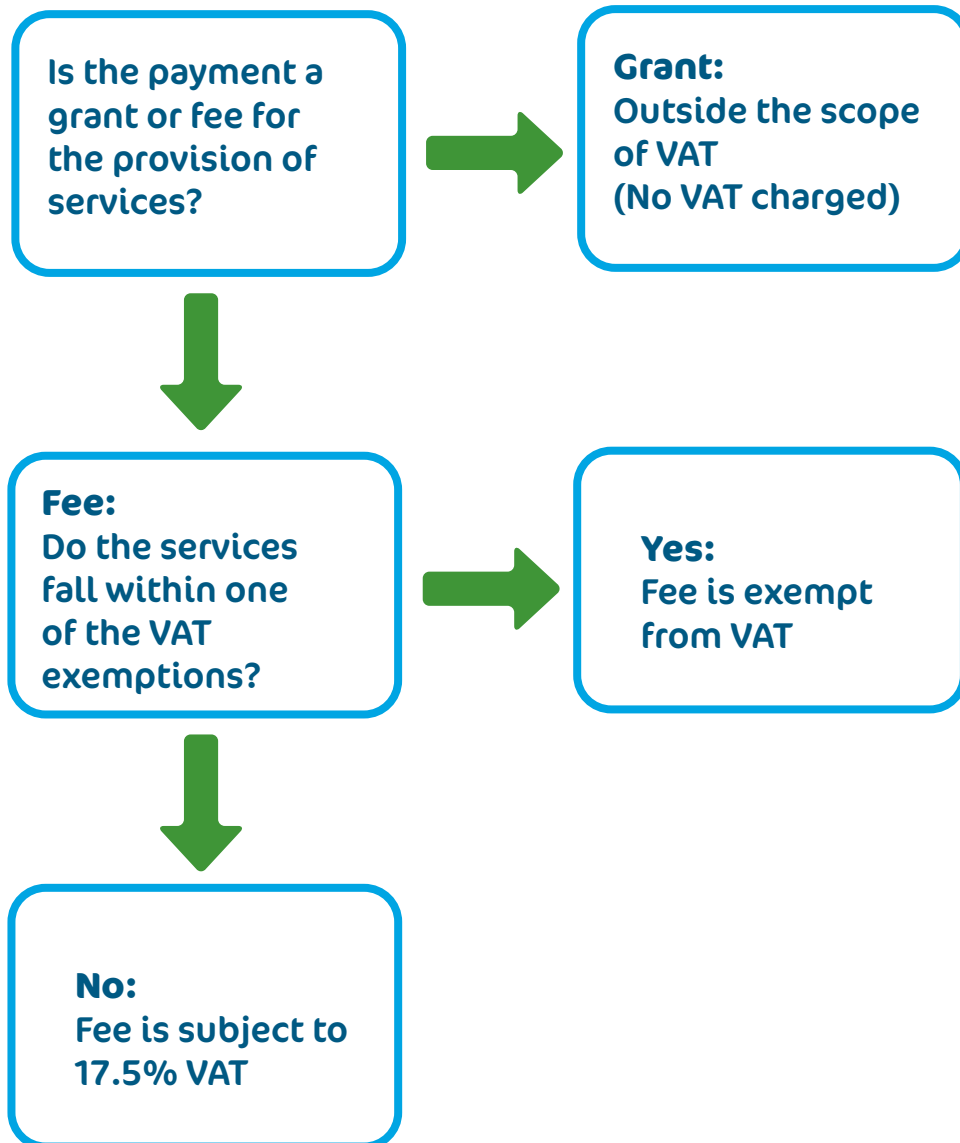
However, recent court cases have indicated that if the local authority or government body is funding work that it is not legally obliged to carry out, then the funding for the work will usually be a grant. For example, imagine a charity is paid by a local authority to provide day activities to disabled people. The level of disability of some of these people is such that the local authority has a statutory obligation to provide care. For others who are not so disabled there is no such obligation. The payments made in respect of the more disabled are a fee, while those paid in respect of the less disabled are a grant.

Other cases have indicated that where a charity is in receipt of grant funding, retains some of that funding to cover administration costs, and then makes grants down to other charities to enable them to carry out work, the administration of the grants is not a supply for VAT purposes; there is no VAT chargeable. Because grants are outside the scope of VAT, the recipients of grant funding are not allowed to recover the VAT incurred on related costs.

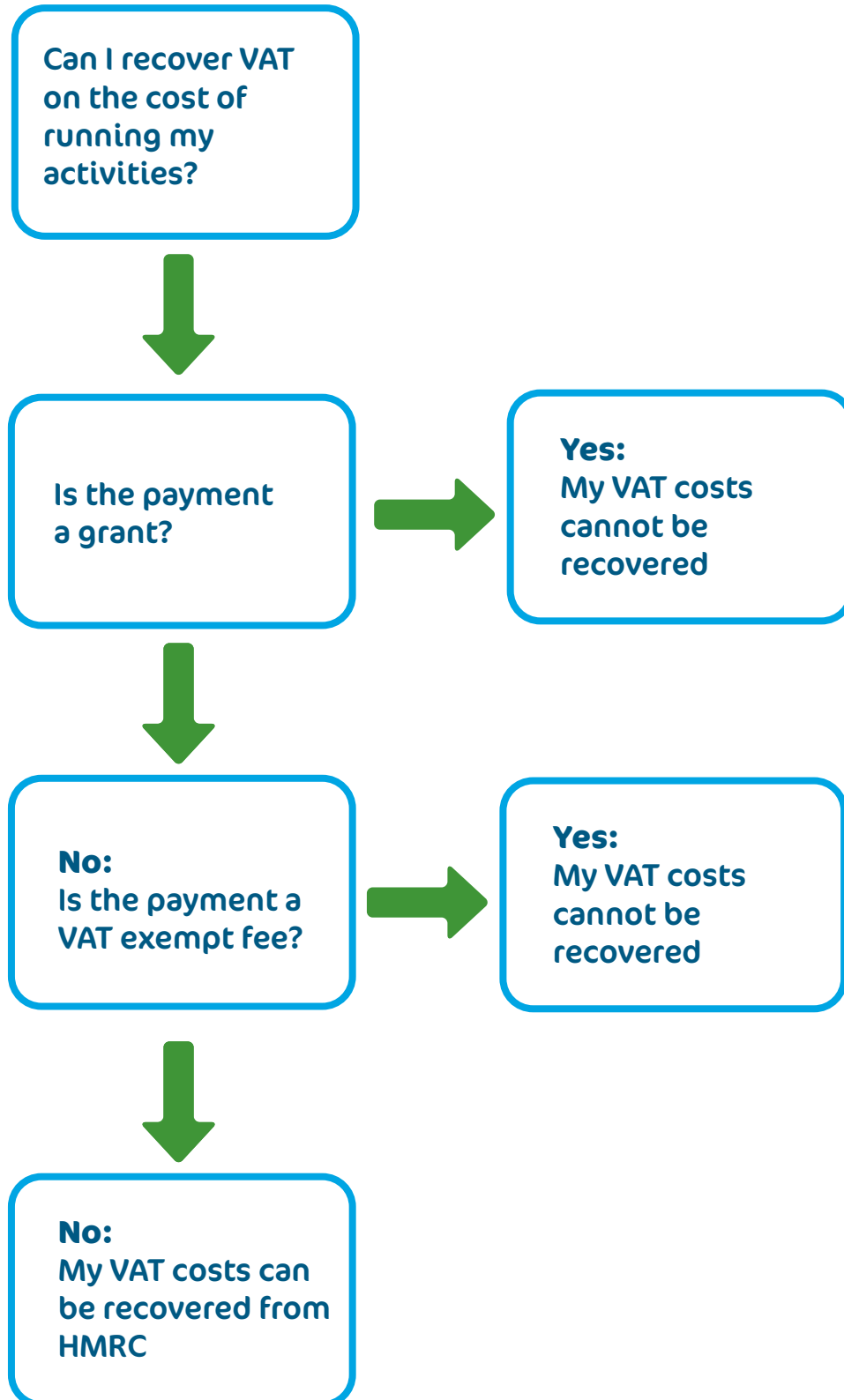
N.B. Local authorities and other government organisations are often keen to structure agreements as grants instead of as contracts for services. This is because they do not have to follow complex and restrictive procurement rules when making grants.

This can cause problems for the sector. Whether or not a payment is a grant or a fee for services depends on the circumstances under which the payment is made, and not on how it is referred to. Calling a fee a grant does not make it a grant for VAT purposes.

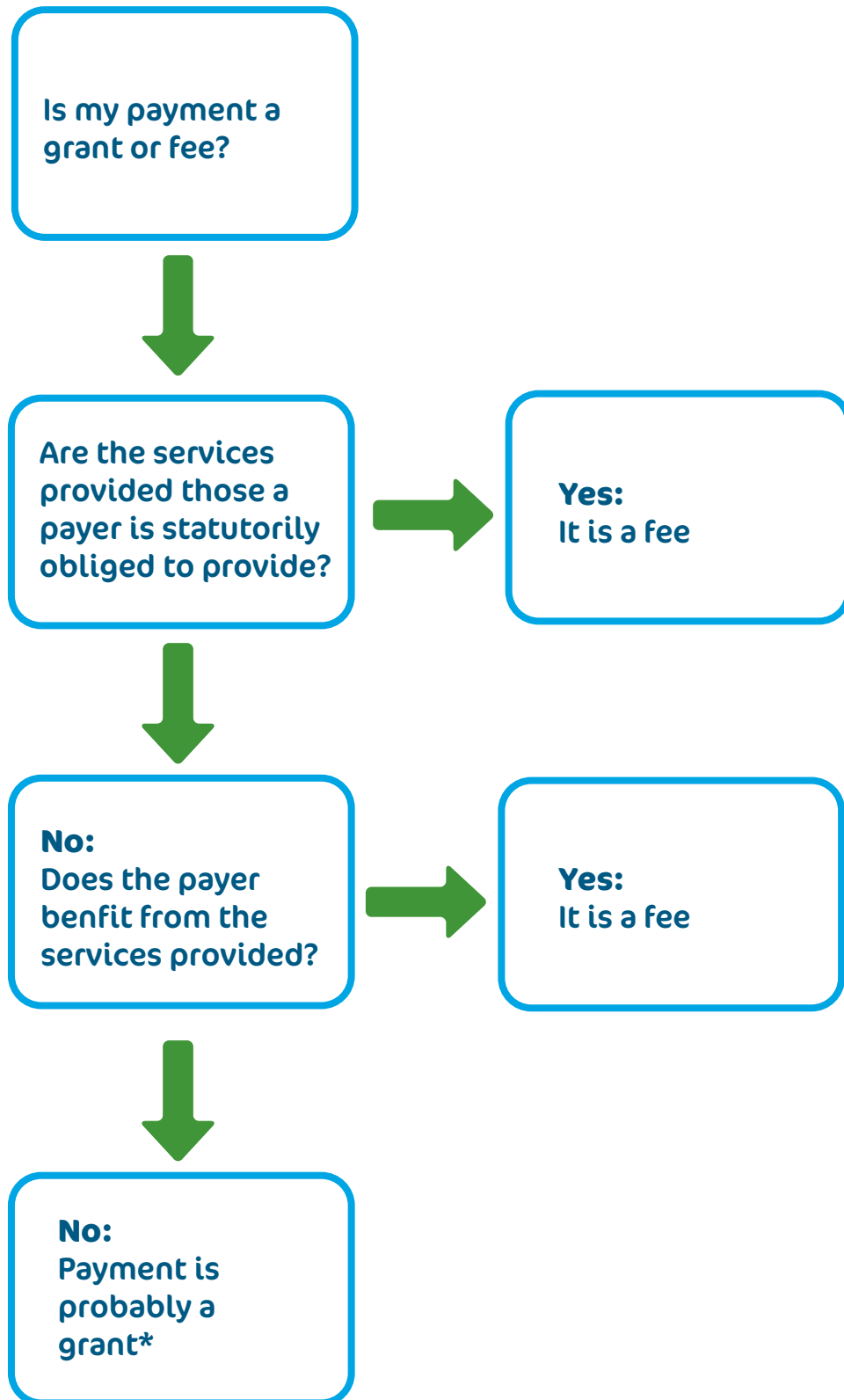
Flow Chart 1 - VAT treatment of payments received



Flow chart 2 - Can I recover VAT on my costs?



Flow chart 3 - Grant or fee?



*Always seek advice

VAT and charges between third sector organisations

VAT charges between third sector organisations can be a real issue when working together on grant funded projects or on delivering contracts for services that are VAT exempt. Two organisations working in partnership often assume that VAT is ignored when they work together. This misunderstanding arises because the activity is grant funded; because the partners think charities are generally exempt from VAT, or because a contract for services is VAT exempt (for example, it is an “education” or “welfare” service).

However, the third sector organisations need to stand back and consider the nature of the services they provide each other. Sadly, the VAT status of the work carried out by the partnership is usually irrelevant. Their recharges are usually seen as separate supplies, which are subject to VAT. The VAT usually cannot be recovered because their income is either exempt from VAT or a grant.

So, for example, if a charity is contracted to provide welfare services to a local authority, but subcontracts work out to another charity, that subcontracted work will probably fall within the VAT exemption.

On the other hand, imagine the same two charities contract directly with the local authority to deliver the same service. One charity agrees to deal with the administration side of the work and charges the second charity for the cost of the administration service. This administration service is not covered by any of the VAT exemptions and so is subject to VAT.

VAT zero rates

VAT zero rates are available for a number of different supplies. They are still within the scheme of VAT, but the rate of VAT is zero. Zero rate supplies include printed reading materials, public transport, sale of donated goods in charity shops, and food.

The zero rate for food is an example of the complexities of VAT. Most foods are zero rated but confectionary, crisps, ice cream and many other ‘snack’ foods are subject to 17.5% VAT. Yet caviar is zero rated!

Chocolate biscuits are subject to VAT. Chocolate cakes are not. The courts, after much deliberation, decided that Jaffa Cakes are in fact a chocolate cake rather than a chocolate biscuit!

Suggestions for reducing the VAT pain

The following suggestions will help to reduce the burden of irrecoverable VAT for your charity:

- When bidding for grant funding, ensure that your budgets include the VAT payable on your costs, because you will not be able to recover this VAT from H M Revenue and Customs.
- Likewise, when bidding for contracts for the provision of VAT exempt education or welfare services, ensure that budgets include the VAT payable on your costs because you will not be able to recover this VAT from H M Revenue and Customs. Unlike charities, local authorities have special rules which enable them to recover VAT on their costs.
- Consider the secondment of shared staff. If the agreement is for grant funding, the VAT impact of recharges can be reduced by seconding staff between the two charities. Such secondments are ignored for VAT, and so no VAT is due on salary etc recharges. This does not apply to central administration staff and does not apply where the charities are funded through fees instead of grants or other donations. This is a complex area, where specialist advice is required.
- If advice is sought from H M Revenue and Customs – ensure you get it confirmed in writing. This is partly to ensure you understand the position correctly, and partly to ensure the tax authorities do not later deny or back track on verbal advice given!
- Ensure the agreement/contract is written using the correct terms and language. Funders often have scarce in house legal resources and so use “off the shelf” contracts for services when they should use a grant agreement. Using the wrong agreement containing the wrong terminology will confuse the VAT treatment.
 - If it is for grant funding – the term “grant” should be used throughout
 - If it is a contract for services – the term should be used throughout.
 - Grants are not fees and *vice versa*.
 - If a grant funder wishes to impose conditions to their funding under a service level agreement this should be detailed in an appendix to the grant agreement.

Third sector views on the VAT regime

The opinion of most charities and umbrella organisations is that the VAT charges that arise from charities working together are artificial and only arise because of the narrowness of the law. They provide an unwelcome reason why charities should not work together.

Many charities and umbrella organisations have asked HM Revenue and Customs to make a concession for inter-charity recharges where they are working together jointly on projects. Sadly, thus far HM Revenue and Customs has not been willing to make any such concessions.

Case Study 1: Dickens and Trollope's training manual

This case study shows how supplies between charities may attract VAT, even where they are related to grant income that is outside the scope of VAT. Sadly, this VAT cannot be recovered.

Two charities, Dickens and Trollope, apply for and receive grant funding from the Learning and Skills Council to set up and run adult literacy classes in London.

Neither charity could deliver the whole service by itself. They decide to make a joint application for the funding and agree to carry out the project in partnership. They are each paid grant funding of £500,000.

Dickens is a large, well established charity with substantial in-house administrative support. However, it does not have enough trainers free and available for the project. Trollope is a smaller charity and while it does not have the internal resource to administer the

project, it has a large bank of trainers it can call upon to deliver the classes.

Dickens agrees to write a training manual for the programme, provided Trollope pays £10,000 towards the cost of this. Dickens and Trollope will use the manual to deliver the training.

The grant funding is VAT free, as it is outside the scope of VAT. However, the charge to Trollope for its share of writing the training manual is subject to VAT of £1,750.

Trollope cannot reclaim the VAT charged from H M Revenue and Customs, because its income from the project is outside the scope of VAT. This creates an irrecoverable VAT charge of £1,750 in the hands of Trollope.

If Dickens and Trollope had been a single charity, no VAT would have been charged.

Case Study 2: Community and Spirit's contract administration

This case study shows how supplies between charities may attract VAT, even where they are related to a contract for services that are exempt from VAT. Sadly, this VAT cannot be recovered.

Two Charities, Community and Spirit, specialise in providing home care services to the elderly and disabled.

They jointly contract with their local authority for the provision of care services in their area. They each receive £400,000.

Community agrees to deal with all the administration and financial issues surrounding the contract and charges Spirit £15,000 for its share of these administration costs.

The contract is for the provision of VAT exempt welfare services. However, the administration services provided by Community to Spirit are not covered by the VAT exemption and so are subject to VAT of £2,625.

Spirit cannot reclaim the VAT charged from H M Revenue and Customs, because the contract is VAT exempt. This creates an irrecoverable VAT charge of £2,625 in the hands of Spirit.

If Community and Spirit had been a single charity, no VAT would have been charged.

Case Study 3: Canova's grants programme

This case study shows how no VAT is chargeable within a grants programme, where a charity makes further grants to other charities. This is still true when the charity retains some of the grant funding to cover its administration costs.

Canova is a charity that receives a grant from an arts body, with the intention that it administers the grant and makes further grants to arts charities to fund their work.

The arts body will receive no benefit from the grant-funded work, so it is outside the scope of VAT.

Canova makes grants down to the arts charities Reubens, Turner, and Stubbs. Canova retains 10% of the total grant funding received to cover its administration costs.

Grant funding is simply passing through Canova to other beneficiary charities. There is no supply for VAT purposes, so no VAT is chargeable.

Case Study 4: Iowa's work with a local authority

This case study shows how payments can be a combination of grants and fees, and the effect of this on subcontracts down to other charities.

Iowa provides care and learning activities to a mixture of disabled people on behalf of a local authority. Some of their clients are severely disabled and the local authority has a statutory responsibility to fund their care. Others are less disabled but the local authority wishes to be a good citizen and still fund the cost of care and activities.

Payments made to Iowa for the severely disabled are fees (albeit exempt from VAT) while payments made to Iowa for the less disabled are grants outside the scope of VAT.

Iowa subcontracts part of the work to Missouri, New Jersey, and Wisconsin. The subcontracts will either be VAT exempt fees or outside the scope of VAT grants depending on the nature of the disabled people being cared for.

None of the charities can recover VAT incurred on related costs. However, if the local authority carried out the work itself then under special rules it probably could recover the VAT incurred on its costs.

Further Reading

There are various HMRC publications which can be downloaded from their website, www.hmrc.gov.uk

The author suggests the following VAT Public Notices which can be found on the above website using the search facility:

- 701/1 – Charities
- 701/30 – Education and Vocational Training
- 700/1 – Should I Be Registered For VAT?
- 749 – Local Authorities and Similar Bodies
- 700 – The VAT Guide (a general guide to VAT)

To access the above Public Notices follow the instructions below:

- Go to www.hmrc.gov.uk,
- Click on the “business and corporations” section, click “VAT”,
- Then click on “VAT information sheets”,
- Then click on “public notices (numerical order)”,
- You will find all of the Public Notices listed above and more there.

A Practical Guide to VAT – for Charities and Voluntary Organisations

Directory of Social Change Second Edition (2001) Kate Sayer ISBN 1 900 360 624

Charity Finance Yearbook 2008 CFDG 2008 ISBN 0 952 160 81

A number of VAT related reports can be found on NCVO’s website:
www.ncvo-vol.org.uk

More guides on VAT for third sector organisations can be found on the Finance Hub website www.financehub.org.uk

About the author

Bill Lewis is Tax Consultant to Charity Solicitors Bates Wells and Braithwaite. He has over 20 years experience in providing taxation advice to clients in a career which has spanned working for H M Revenue and Customs, Pricewaterhousecoopers, commerce, and the social enterprise sector. He frequently lectures and writes on taxation issues affecting charities and has contributed to the writing of guidance on H M Revenue and Customs website and their VAT notices.

Disclaimer

The information in this article is believed to be correct at the time of publication. It is general in nature and is not intended to be exhaustive nor to provide legal advice in relation to any particular situation, and should not be acted or relied upon without taking specific advice.



financehub

St Andrew's House
18-20 St Andrew's Street
London EC4A 3AY
tel 020 7832 3016

financehub@cafonline.org
www.financehub.org.uk

