

# UK VAT Risks for Charities

**V**AT risks potentially apply whether or not the organisation is already registered for VAT.

In particular, it should be considered whether a 'grant' is consideration for a supply of goods or services and potentially subject to VAT. Some clarification has been provided in this area by an update in January 2018 to HMRC's VAT Internal Guidance on grants.

## CHARITY INCOME – IS IT BUSINESS OR NON-BUSINESS?

For VAT purposes, a charity's income falls into one of the following two categories:

1. *Non-business* – where the charity is not required to provide any goods or services in return for the funding or the charity is not making a supply in the course or furtherance of business

*Examples include:* donations and grants (where monies are freely given with no expectation of anything in return other than accounting for use of the money)

2. *Business* – a charity will normally receive business income if it makes a supply of goods or services in return for income

*Examples include:* charity shop sales, supplies of education, welfare



**BY EDDIE BROOMFIELD**

*In this article on UK VAT, Eddie highlights some of the VAT risks for charities and not for profit organisations*

services, cultural admission charges, sports activities, sponsorship and income from the letting of property

## WHY IS THE BUSINESS STATUS OF CHARITY INCOME IMPORTANT?

Consideration of the business status of charity income is important for two reasons:

1. It is the first step in determining whether a charity may have an obligation to register for VAT and account for VAT on certain income. If a charity receives non business income, this income is not required to be taken into account when considering whether the charity has an obligation to register for VAT

2. It can impact upon a charity's entitlement to claim relief from VAT on certain types of expenditure such as the purchase/ construction of a building; relief from VAT on rent; and relief from VAT on gas/electricity.

### **Charity business income**

If a charity receives business income, the next step is to determine the VAT liability of such income, either taxable or exempt.

If a charity's business income does not fall within, or satisfy the conditions of, a VAT exemption (see below), such income shall be taxable for VAT purposes at the standard-rate (20%), reduced-rate (5%), or zero-rate (0%).

A requirement to register for VAT in the UK arises if either:

- a) At the end of any month the value of the charity's taxable income in the twelve months then ending exceeded the VAT registration threshold (£85k from 1 April 2017); or
- b) At any time there are reasonable grounds for believing the value of the charity's taxable income in the next thirty days alone will exceed the VAT registration threshold

If either of the above tests is breached, the charity must register for VAT and account for VAT

at the relevant rate on taxable business income. It should be noted that HMRC has the power to backdate VAT registration up to 20 years which could give rise to a substantial historic VAT liability particularly if the charity is not entitled to charge this VAT to its funder/customer.

It is therefore critical that a charity understands whether any of its sources of income are taxable for VAT purposes.

### ***VAT exemptions applicable to charity income***

If a VAT exemption applies to a source of business income such income is not required to be taken into account when considering whether a charity has an obligation to register for VAT.

VAT exemptions are potentially applicable to business income received by charities in a number of categories including:

- Education supplies
- Cultural admission charges
- Sporting activities
- Welfare services
- Fund raising events
- Certain income from letting/hiring of property

However, it should be noted that various conditions are attached to these VAT exemptions and a charity may need to take steps to bring itself within the conditions of the relevant VAT exemption for it to apply to a source of income.

## **WHAT ARE THE OTHER AREAS OF DIFFICULTY IN RELATION TO CHARITY INCOME?**

### **1. *Grants vs contracts for services***

A 'grant' received by a charity may be non business income or may in fact be a contract for services and accordingly business income for VAT purposes. This will depend on the terms but more importantly, the factual position. The VAT business status of each funding received by a charity must be considered individually.

If the funding is business income and taxable, say at the standard-rate of 20%, the charity may be required to register for VAT (under rules discussed above) by reason of that one funding alone. This could lead to a significant VAT liability for the charity if it is unable to pass on the VAT charge to the funder and must pay such VAT to HMRC out of its own reserves or finance the VAT payment. Additionally, HMRC may seek to levy penalties and interest in respect of the VAT liability.

VAT registration also has a wider impact on charity business income as VAT may also be due on other sources of taxable business income which a charity receives.

### ***In what circumstances is a 'grant' a contract for services and business income?***

For VAT purposes, a key principle when a charity receives funding is whether that funding is consideration for a supply of goods or services to the funder.

If the funding is made by the funder with no additional conditions

attached, other than say to report as to how funds are spent, then the funding will normally be non business income for VAT purposes.

If a grant is non business income, then it isn't required to be taken into account when considering whether a charity has an obligation to register for VAT.

Difficulties can arise where a charity is required to go beyond reporting on how funds are spent; if it is the case that there is a clear and direct link between the monies being paid and services provided in return; or where the funder is actually procuring services from a charity by, for example, effectively outsourcing an activity to a charity, then this could be a contract for services and business income.

In our experience there is an ever increasing trend for funders to use 'contracts' to provide funding to charities and consequently, a risk that charities are in fact providing services to the funder, or at least cause for HMRC to argue that such 'contracts' are business income.

### **2. Case law – Longridge on the Thames [2016] EWCA Civ 930**

Based on historic case law it has been a widely accepted principle that where a charity makes supplies that are below market value, such supplies are not 'economic' and are therefore non business for VAT purposes.

In the Court of Appeal decision in *Longridge on the Thames [2016] EWCA Civ 930*, a charity provided water sports activities and the fees charged were below cost. However, the Court decided that as there was a direct link between the water

sports activity provided and the fee paid, this was economic and a business activity for VAT purposes.

Where a charity receives income which is below market value, this decision may mean that the charity may have an obligation to register for VAT or is no longer entitled to obtain VAT relief on major capital expenditure such as the purchase/construction of a building; relief from VAT on rent; and relief from VAT on gas/electricity.

### ***3. VAT exemptions applicable to charity income***

As highlighted above, specific VAT exemptions can apply to various sources of income received by a charity.

However, the risk for a charity is that it did not historically, or does not currently, satisfy all the conditions of the relevant VAT exemption.

Some of the VAT exemptions require a charity to 'ring fence'

certain profits and apply them only for future use in the category to which the VAT exemption applies. For example, profits from supplies of education must be ring fenced for future supplies of education and can not be used to contribute towards other activities otherwise such income shall be taxable for VAT purposes.

This ring fencing of profits may not be being undertaken by a charity, especially if a charity is not aware of the requirement, meaning such income could be taxable for VAT purposes and the charity may accrue a historic VAT registration obligation, together with penalty and interest liabilities if not addressed early enough.

Conversely, a charity may not be in a position nor may not wish to utilise a VAT exemption if it means profits from a particular category of income must be ring fenced and can not be used to contribute to the charity's other activities.

## **CONCLUSION**

What should be taken away from this analysis is that the application of VAT rules to charities is complex. There isn't a general VAT exemption applicable to charities and VAT exemptions which are available to certain categories of income have very specific conditions to be satisfied.

This leaves considerable potential risk of an unexpected VAT liability if a charity's income does not fall to be non business or if a VAT exemption does not apply to its business income.

Charities can take steps to mitigate the VAT risk by identifying early whether funding is, or could be, subject to VAT. This leaves time to seek professional VAT advice and to liaise with funders where appropriate.

**Eddie Broomfield** is VAT Manager in GM<sup>c</sup>G Chartered Accountants' Charity Team

**Email:** broomfelde@gmcgca.com