

CONTRACTS,
SERVICE LEVEL AGREEMENTS
AND GRANTS:
UNDERSTANDING
THE DIFFERENCES

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INTRODUCTION AND EXECUTIVE SUMMARY

This briefing note has been commissioned by Highlands and Islands Enterprise (HIE) to clarify the definitions of contracts, service level agreements and grants by public sector organisations in funding social enterprises to deliver or provide services and to look at the legal and other implications of using the different types of financial arrangements. It has been prepared by Senscot with support from the law firm MacRoberts LLP and the Pool, DTA Scotland's consultancy service.

There is currently a wide range of terms used to describe the financial arrangements between public authorities and social enterprises. The most common terms are 'grants', 'contracts' and 'service level agreements' (often abbreviated to SLAs). Others include 'performance grants', 'management contracts', 'management fee contracts', and 'service contracts'.

There is also a wide range of understanding, especially amongst social enterprises, of the differences between various types of financial arrangements and the practical implications these differences have in legal, financial and other terms.

These implications can be significant. For example:

- The legal liabilities for each party will vary considerably depending on whether the financial arrangement is a contract or a grant. For example, a contract for delivery of a service by a social enterprise may include clauses which could allow a public sector organisation to seek damages over and above the value of the contract if the social enterprise fails to meet its contractual obligations (and similarly a social enterprise might be able to seek compensation if the public authority fails to meet its obligations).
- The tax position and liability of a social enterprise in respect of VAT and corporation tax will be affected by whether income is grant income or income earned under a contract.
- Similarly, income from a grant and from a contract may or will generally be treated differently in a social enterprise's accounts. In turn this could affect whether a social enterprise is regarded as being a trading organisation, a "going concern" and a suitable enterprise for investment, support and so on.

In view of these implications, it is very important that social enterprises and public authorities both understand the real nature of the financial arrangement they are entering into and also choose the most appropriate form.

As different names can be applied by different organisations to describe the same arrangements, it is often sensible for social enterprises and public authorities not to focus on what they call an arrangement but rather put aside the various names and focus on:

- whether they are entering into a grant or a contract (which may sometime be called an SLA or be accompanied by an SLA) and
- the legal and other implications of the provisions of that grant or contract.

This will both clarify the legal status of the arrangement and also, more broadly, assist in establishing whether income associated with it should be regarded as trading income for different purposes.

There is no one factor which determines whether funding is being provided under a grant or under a contract. It is important to analyse the arrangement as a collective whole and social enterprises should be doing this as a matter of course, in any case, in order to determine risks and liabilities. There are a number of features which can be assessed and these are described in detail in the briefing note which contains sections on contracts, SLAs and grants.

In conclusion, in order for social enterprises and public authorities to minimise the risks arising from the financial relationships they enter into together, it is important for each entity to obtain clarity about the nature of that relationship from the outset.

WHY DOES IT MATTER?

1. A public authority may provide funding to a social enterprise in return for that social enterprise providing services under a contract. Alternatively, a public authority may award funding through a grant to a social enterprise which has satisfied various grant conditions.
2. Over the last few years, a number of public sector organisations, particularly in England & Wales, have created, and attributed the label 'Service Level Agreement' to contracts which often contain less onerous contractual provisions than other contracts for services. These are often used when a public authority enters into a contract with third sector organisations, including social enterprises.
3. The fact that a set of conditions is titled 'grant conditions', 'Service Level Agreement', 'contract for services' or otherwise, does not necessarily mean that this label will be correct. Determining whether a particular source of funding from a public authority is in fact a 'grant' or a 'contract' is important for a number of reasons, including:
 - Service delivery risk (i.e. the extent of each party's liability for performance). Each party to a funding relationship needs to be completely clear about the status of the relationship so that they understand their obligations, liabilities, and so on;
 - Public bodies need to be clear to ensure that they comply with EU procurement law;
 - Social enterprises need to be confident that they are treating funds paid by the public authority properly for tax purposes, especially VAT;
 - As a measure of a social enterprise's "financial sustainability", trading income under contracts can be important as it is used by a number of public sector bodies as a measure of the financial sustainability of external organisations;
 - As the social enterprise community in Scotland matures, it is looking to demonstrate an increasing level of trading. The current uncertainty over the status of some SLA's makes this more difficult. With the roll-out of the social enterprise Mark across the UK in February 2010, a key criterion for eligibility is trading levels as a percentage of turnover. The current lack of clarity surrounding financial management could inhibit the ability of many Scottish social enterprises to access such an award.

WHAT IS CURRENT PRACTICE?

4. A number of public sector organisations have been interviewed regarding how financial arrangements are currently dealt with. In addition, a range of social enterprises were invited to complete an online survey and a number of those were then interviewed to explore the issues in slightly more detail.

5. Public sector organisations overall probably had a clearer view of the difference between a service contract, a SLA and a grant than social enterprises. Contracts were seen as a legally binding document for the provision of service or goods which are generally used where the public authority had tendered for the delivery of a service or goods. By contrast, Public sector organisations confided that SLAs and grants were more likely to be used where a social enterprise had approached a public authority to fund a service or activity. SLAs were most specifically used to define the level and quality of activity to be delivered under a grant, and in one authority, all grants above £10,000 had to be accompanied by a SLA. It was recognised by those specialising in procurement, that under SLAs and grant, the public authority had more limited redress in terms of recovering money if performance fell below the agreed standard. However, it is evident that even within a single organisation policy and practice could vary between different parts of it and it was not uncommon for 'contract' and 'SLA' to be used interchangeably. There was some preference expressed for using contracts more than SLAs as they were considered to give both the public authority and the social enterprises greater clarity and protection although it was recognised that SLAs were appropriate in some circumstances.

6. Amongst social enterprises, there seemed to be a wider range of understanding of the differences between contracts, SLAs and grant. There was also a wide range of views about the significance of the differences and their relative merits. Many social enterprises either did not perceive or believe that there were significant differences between a contract and a SLA as they had experienced them, although there was recognition that contracts were normally tendered and were more specific than SLAs. It was also recognised by some social enterprises that SLAs could be used to define the conditions attaching to a grant more precisely. Many social enterprises did not express a preference between working under a contract or under a SLA providing it was possible to determine what constituted trading income as opposed to grant income. Social enterprises did not generally have any control over or choice of whether they worked under a contract, SLA or grant. Of those that did perceive differences, the majority saw contracts as being more tightly defined than SLAs and preferable to them. In their view, contracts provided greater clarity and security against changes in funding, and in comparison, SLAs tended to be vulnerable to change and to making full cost recovery

more difficult. However, there was a minority view that SLA's enabled social enterprises and public authorities to have a more partnership based relationship with greater dialogue and flexibility in designing and delivering services.

WHAT IS THE LEGAL POSITION?

CONTRACTS

So what is a contract?

7. A contract for services between a public authority and a social enterprise is essentially ***a legally enforceable agreement between those parties under which the social enterprise provides services in return for payment.***

8. It might be the case that the services are provided to the public authority. For example, a social enterprise involved in recycling waste might provide such services directly to a public authority under a service contract in return for payment by the public authority. Equally, it might be the case that the services are provided to third parties. For example, a social enterprise involved in social care might provide such services, on a public authority's behalf, to individuals in return for payment by the public authority.

9. In short, where a public authority pays money to a social enterprise in return for that social enterprise providing services to that public authority and for that public authority's benefit, the link between the social enterprise and the public authority will generally be a contract.

Risk and liability

10. In addition to stating which services require to be delivered, a service contract might require the services to meet specific quality standards or to be delivered in accordance with a particular timetable.

11. Importantly, if a social enterprise, operating under a service contract, either fails to meet the required quality standards, does not deliver on time or is unable to deliver the services at all, a service contract will generally include provisions that enable the public authority to raise court proceedings against the social enterprise for "breach of contract" and to seek payment of damages by the social enterprise. Such damages can, in some cases, exceed the amount of money which would otherwise have been payable to the social enterprise under the service contract.

12. Similarly, if a party fails to comply with the terms of a service contract (by terminating without a contractual right to do so or failing to pay, for example) then a service contract will generally enable the other party to take legal action against the party in breach, for example by seeking recompense for a social enterprise's loss.

Identifying a service contract:

A service contract will generally contain:

- *an obligation requiring the social enterprise to provide services;*
- *an obligation requiring the public authority to pay for that service provision;*
- *provisions dealing with rights to terminate the contract;*
- *provisions relating to breach of contract and liabilities; and*
- *'boilerplate' contract provisions dealing with matters such as variation of terms, waiver of rights, subcontracting, law governing the contract and the forum for disputes.*

SERVICE LEVEL AGREEMENTS

And what is a "Service Level Agreement"?

14. There are two main circumstances in which a social enterprise is likely to come into contact with a document titled 'Service Level Agreement'.

15. Firstly, 'Service Level Agreement' (frequently abbreviated to 'SLA') is generally used as a legal term to describe a contract which sits alongside a contract for services and which sets out particular quality standards which require to be met when delivering services under that contract. The contents and bearing of a SLA can vary considerably. In some cases, failure to meet service levels specified in a SLA may mean that the social enterprise is required to pay 'service credits' which the public authority can set-off against the social enterprise's future invoices, or in some cases, it may allow the public authority to terminate the contract. On the other hand, some SLAs may not be legally binding at all – they may simply be a set of targets which the parties aspire to meet. Indeed, the latter can be relatively common where arrangements with public authorities are concerned.

Identifying a SLA:

- *The social enterprise may be presented with a contract for services and an accompanying SLA;*
- *A SLA may make reference to an accompanying contract;*
- *A SLA's provisions may relate only to required service quality standards and key performance indicators;*
- *A SLA may set out 'service credits' applicable to each service level; and*
- *A SLA may not have any provisions relating to a payment mechanism or contract 'boilerplate' provisions such as waiver of rights, subcontracting, law governing the contract and the forum for disputes.*

13. Secondly, 'Service Level Agreement' is sometimes used to describe a contract in which a public authority may have amended certain provisions so as to make risk or obligation owed to the social enterprise less onerous. For example, when compared with a more standard contract for services, a Service Level Agreement might make clear that the public authority's liability to a social enterprise in the event of breach of contract or termination will be restricted to the payments due under the contract. Another example relatively common in Service Level Agreements is for payment to be structured as a 'Management Fee'. In addition, Service Level Agreements can include provision for the public authority to "claw back" money not spent on providing the services. These are examples of provisions that can often be included in this second form of 'Service Level Agreement' with social enterprises.

Identifying a "Service Level Agreement"

This type of arrangement will be a 'service contract' and the identifying factors which should confirm this are those noted in the section on contracts.

14. A SLA and a contract for services might both be contained in a single document. This might be called a 'Service Contract' or a 'Service Level Agreement'.

15. It is important to carefully consider the content of a document that states it is a 'Service Level Agreement' to determine whether it is a form of contract for services, a set of quality standards accompanying such a contract, or even whether it might in fact be an incorrectly labelled grant.

GRANTS

And what is a grant?

16. A grant, in the context of a social enterprise receiving a grant from a public authority, can be described as a payment made by a public authority in exercise of a statutory power. The grant award is often conditional on the social enterprise spending the funding awarded in a particular manner (generally referred to as "Conditions of Grant"). For example, Conditions of Grant may require the social enterprise to account for spend and repay the grant if the Conditions of Grant are not met. Such conditions are often found in grants involving European Structural Funds.

17. The Conditions of Grant frequently require a social enterprise to carry out activities which provide benefit to someone other than the public authority. For example, a grant may be provided to assist a social enterprise in growing its activities. Equally, a grant may be provided so that a social enterprise can, in turn, assist a particular body of individuals. This is one of the key factors in identifying a grant - a grant will generally be provided to a social enterprise in order to undertake activities that are for the benefit of third parties (as opposed to the public authority).

Liability under a grant

18. If a social enterprise fails to comply with Conditions of Grant, its financial obligations are limited to paying back all or some of the money actually awarded. This generally exposes a social enterprise to less risk than would be the case under a contract, where the social enterprise may also have to compensate a public authority for losses as a result of the social enterprise's breach of contract (see section on contracts above).

19. In terms of identifying whether a particular arrangement is a grant or not, if the arrangement between the social enterprise and the public authority would, without risk of enforcement action, allow the social enterprise to hand back the grant and refuse to carry out activities, the arrangement is likely to be a grant rather than a contract.

Legal rights

20. A public authority has a public duty to make or refuse grants according to any specific statutory criteria set out in the applicable legislation (which will differ, depending on which public authority is making the award).

21. If a public authority makes a "non-compliant" grant to a social enterprise, it is possible that the public authority might be required to withdraw that grant. If a public authority withdraws or does

not pay a grant to a social enterprise, it would not be open to that social enterprise to sue the public authority for damages. This could be an issue if, for example, the social enterprise had incurred costs in expectation of receiving grant funding. In such circumstances, the social enterprise could seek 'judicial review'.

Trading income and representation in accounts

23. Many public sector bodies will look at the proportion of funds that an organisation generates through trading, i.e. an organisation's 'trading income', in order to assess its financial sustainability and /or its eligibility for programmes of support, both financial and non-financial. An organisation with a poor financial sustainability rating or a lower level of apparent trading income may find that it is disadvantaged.

24. Generally speaking, payments under a contract will amount to trading income but payments under a grant will not.

25. An additional consideration for social enterprises with charitable status is that, payment made under a grant for a specific purpose will invariably have to be treated as 'restricted funds' and represented as such in the organisation's accounts. Where payments constitute 'restricted funds' they must be used for a specific purpose, generally the purpose set out in the grant. On the other hand, there will generally be greater freedom over use of surplus income from payments received under a contract.

Identifying a grant

Funding is likely to be a grant and not a contract where:

- *the money is to be used to undertake activities (which can include providing goods or services to a third party) that are not being undertaken for the benefit of the public authority;*
- *the money is being given to further a public authority's statutory duty;*
- *the social enterprise has the choice of either performing or else handing back the money without potentially incurring further costs;*
- *a social enterprise with charitable status requires to treat the funding, and present the funding in its accounts as 'restricted funds'; and*
- *the only obligation on the public authority under the grant is to comply with the applicable statutory and other processes in awarding the grant.*

CAN'T WE JUST LOOK AT THE NAME?

26. Confusion as to whether a social enterprise is being awarded a grant or entering into a contract often stems from the fact that either form of arrangement can often be used between a public authority and a social enterprise in relation to funding a social enterprise's activities with, or services to, third parties.

27. The title of a document does not on its own determine the legal status of the arrangement and it is, to some extent, "going by the name" that has led to some confusion in the public sector to third sector arrangements.

28. For example, sometimes what is actually a contract might be labelled as a grant (with the contract terms referred to as Conditions of Grant) and vice versa. A document that is incorrectly labelled can lead to unexpected issues for a social enterprise in terms of tax treatment and procurement law (**see sections below**). In addition, where the conditions or provisions have not been checked by the social enterprise, a social enterprise might find that it is exposed to liability and risk under a contract that it had believed was a grant.

29. It is for the above reasons that it is important to go beyond the name and ascertain whether funding is being given as a grant or a contract (including a 'Service Level Agreement'). We have identified above some factors that should assist social enterprises in identifying the type of document that they are entering into and the principal legal issues associated with each. To determine whether funding is being provided under a grant or under a service contract, no single factor can be used (particularly not the name of the document) – it is important to analyse the arrangement as a collective whole and social enterprises should be doing this as a matter of course to determine risks and liabilities.

HOW DOES EU PROCUREMENT LAW APPLY?

30. Whether an agreement entered into between a public authority and a social enterprise is a "contract" in terms of the EU procurement rules is also of importance in relation to arrangements between public authorities and social enterprises. A public authority, in particular, is obliged to follow the procurement rules where they apply. It is however, also important that social enterprises understand when the EU procurement rules apply. For example, changes introduced in December 2009 can, in certain circumstances, result in contracts being "ineffective" where they are entered into in breach of the procurement rules. If a contract entered into by a public authority and a social enterprise was rendered ineffective under EU procurement rules, contractual obligations might cease, including payment by the public authority. As a result, a social enterprise might face a situation where it was unexpectedly out of pocket.

31. The EU procurement rules must be followed, and a tendering process followed, by a public authority where particular thresholds are met and a contract for "works", "goods" or "services", as defined under the EU procurement rules, is to be entered into. Broadly speaking, the key question that the public authority requires to consider is whether its proposed arrangement involves the engaging of a person or entity to provide works, goods or services.

32. A genuine grant would not require to be tendered on account of there being no engagement to provide services. On the other hand, there would be a requirement to tender genuine contracts (including "Service Level Agreements").

33. Public policy has been shifting from using grants to using contracts with the result that social enterprises are increasingly required to take part in competitive tender processes in relation to arrangements to be entered into with public authorities.

34. Factors likely to be considered by the public authority in considering whether an arrangement would amount to a contract under the procurement rules will generally include those set out in the section on contracts in this note. A further "identifier" for procurement purposes is whether the proposed arrangement would be subject to the payment of VAT by the public authority (see below).

35. Of course, many public authorities will now also hold "competitions" for grant funding and may opt to follow procurement processes, in terms of the EU procurement rules or otherwise, in circumstances in which there is not necessarily a requirement for them to do so under the EU procurement rules.

WHAT ARE THE TAX CONSIDERATIONS FOR SOCIAL ENTERPRISES RELEVANT TO WHETHER THE ARRANGEMENTS ARE A GRANT OR A CONTRACT?

General Position

36. The tax treatment of income received by a social enterprise from a public authority will depend on whether the income is grant income or a payment for services under a contract (or a contract described as a "Service Level Agreement" as set out above).

37. There is no statutory definition of grant in the tax legislation and it is a matter of fact whether a payment will amount to a grant or a payment for services. Clearly the factors set out earlier in this note are likely to be of some relevance and there will be circumstances, such as grants provided under a specific piece of legislation, where income will be easily identifiable as grant income. HM Revenue & Customs ("HMRC") recognise that grant providers often impose conditions on how a grant may be spent and can require detailed receipts to be kept. HMRC accept that such conditions do not necessarily turn a grant into a payment for the provision of services.

VAT treatment of grants and contracts

38. In general, if a payment received by a social enterprise is a genuine grant, as may be broadly identifiable by a social enterprise using the information above, then a social enterprise will not have to account for VAT as the grant does not amount to a payment for services. The VAT treatment of grant income must always be considered in detail with full knowledge of all facts surrounding the award of the grant and the way in which the grant funding is to be applied.

39. If the payment received by a social enterprise is a payment for services under a contract, then the amount received will be taxable in full in the hands of the social enterprise and VAT may be chargeable by the social enterprise depending on whether the social enterprise is, or is required to be registered for VAT and the nature of the service provided.

Different types of grant income

40. There are two types of grant income for tax purposes; revenue grants and capital grants.

Revenue grants

If the grant is a revenue grant which is used to pay for revenue expenditure incurred in the course of the trade of a social enterprise, then the grant income will be taxable as trading income. An

example of such a revenue grant might be a grant towards the cost of a social enterprise providing business support services to third sector organisations.

If the grant income is in respect of revenue expenditure relating to activities that would be treated as non-trading activities by HMRC, for example a grant applied in the course of the primary purpose trading¹ of a social enterprise with charitable status, then the grant will not be taxable income. This is only likely to apply to social enterprises with charitable status.

Capital grants

A capital grant must be applied in the acquisition of a capital item. A capital grant is not taxable when received by a social enterprise, but will impact on the social enterprise's ability to claim capital allowances.

41. The tax and VAT treatment of grant income is not straightforward and it is advised that social enterprises should seek appropriate tax advice in relation to any grant income received.

¹ 'Primary purpose trading' is trading which contributes directly to one or more of the objects of a charity as set out in its governing document. By way of example, a charity whose charitable objects are to provide public benefit to those in need through the operation of care homes would likely be carrying out primary purpose trading if it entered into a contract with a local authority to operate care homes.

CONCLUSION

42. This briefing note has sought to identify some factors that social enterprises need to be aware of when identifying the type of financial arrangement that they are entering into with public agencies and the principal legal and other issues associated with each. To determine whether funding is being provided under a grant or under a contract, it is important to note that no single factor can be used (*particularly not the name of the document*). It is also important to analyse the arrangement as a collective whole and social enterprises should be doing this as a matter of course to determine risks and liabilities.

It is clear that there are varying levels of understanding amongst social enterprises of the differences between various types of financial arrangements and the practical implications these differences have in legal, financial and other terms.

It is also clear that there is a wide range of terms used to describe the financial arrangements between public authorities and social enterprises. The most common terms are grants, contracts and service level agreements (SLAs). But other terms are frequently used as well i.e. performance grants, management contracts, management fee contracts, and service contracts.

Social enterprises and public authorities both have to understand the real nature of the financial arrangement they are entering into and to choose the most appropriate form.

This will require them to focus on:

- whether they are entering into a grant or a contract (which may sometime be called a SLA or be accompanied by a SLA) and
- the legal and other implications of the provisions of that grant or contract.

This will both clarify the legal status of the arrangement and also, more broadly, whether income associated with it should be regarded as trading income for different purposes.

A lack of clarity gives rise to a number of additional risks - legal, financial, tax-related, and reputational – which could have considerable adverse impacts.