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GRANT VS. CONTRACT

GRANT VS. CONTRACT-WHAT IS THE DIFFERENCE AND WHY DOES IT MATTER?

It is important for organizations to correctly classify agreements both for disclosure purposes and for accurate reporting of expenses and revenues.

Author: MELANIE BARTLETT

MELANIE BARTLETT is the owner of M Bartlett Law LLC in Avon, CO. She can be reached at mbartlett@mbartlettlaw.com.

More and more nonprofit organizations are struggling with a decision-grant or contract? In many situations there is no clear answer to this question. There are, however, certain hallmarks of the two types of agreements that have been identified by the IRS, accounting standards, and practitioners to guide organizations in classifying both incoming and outgoing agreements. Many nonprofit organizations have developed internal checklists to document essential questions that are raised and to make certain agreements are treated consistently. Understanding the qualities of each type of agreement will help an organization structure arrangements based on the applicable disclosures and the timing of the recognition of revenue requirements. If an organization is concerned about either of these factors and appreciates the difference between the two types of agreements, it can negotiate the terms of the arrangement to produce the most favorable treatment.

Besides the classification of an agreement as a grant or a contract and the results of the categorization, exempt organizations must deal with concerns involving (1) publicly supported organizations under **Section 170(b)(1)(A)(vi)** ; (2) broadly publicly supported organizations under **Section 509(a)(2)** ; and (3) private non-operating foundations.

This article assumes that the agreement under consideration is related to the organization's charitable purpose and not in connection with an unrelated trade or business.

The importance of correct classification

It is important for nonprofit organizations to correctly classify incoming and outgoing agreements not only to accurately reflect their financials to the IRS and the public, but to also structure relationships in a way that best benefit the organization. The treatment of an agreement will affect the category of expense or revenue under which the payment appears, the timing of the recognition of the revenue, and an organization's operations and monitoring procedures. Whether an agreement is considered a grant or a contract will trigger varying concerns based on an organization's tax status. Among other considerations, the classification of incoming funds is important in calculating the level of public support for the two types of what are generally referred to as "public charities" (i.e., [Section 501\(c\)\(3\)](#) organizations other than private foundations). The classification of outgoing funds is essential for private foundations to determine whether certain procedures must be followed, such as including legally required terms and conditions in the underlying agreement.

The main interest of each type of organization discussed in this article is addressed in more detail below.

Publicly supported organizations.

A publicly supported organization is one that normally receives a substantial part of its support from a governmental unit or from the general public. [1](#) This support can take the form of either (1) normally receiving at least 33-1/3% of its support from governmental units or from the general public or (2) normally receiving at least 10% of its support from governmental units or from the general public and also meeting certain other tests of public support. [2](#) An agreement that is considered a grant will count towards the organization's public support percentage, while an amount received from an arrangement classified as a contract will not be included in this calculation. In addition, if the organization receives an overwhelming amount of gross receipts through related activities in comparison to its public support, such that almost all of its support is from gross receipts from related activities and an insignificant amount of support comes from contributions, the organization will be in danger of losing its tax-exempt status. A publicly supported organization may also be concerned with the public disclosure of organizations to which it gives grants.

Broadly publicly supported organizations.

A broadly publicly supported organization is an organization that normally receives (1) more than 33-1/3% of its support from contributions, membership fees, and gross receipts from activities related to its exempt functions, with certain exceptions, and (2) no more than 33-1/3% of support from gross

investment income and unrelated business taxable income. **3** This type of organization must also be careful to properly classify arrangements for the public support test and to consider the disclosure requirements of Form 990. Amounts received under an agreement considered a grant count in full towards the organization's public support percentage, while revenue received from contracts, or revenues from gross receipts, may be limited to the greater of \$5,000 or 1% of the amount of the organization's total support for such year. The organization also is required to keep an internal list showing, for each year, certain details about revenues limited under the public support test. Thus, although revenues received from certain contracts only partially count towards an organization's public support percentage, these agreements generally require a higher amount of internal documentation.

Private foundations.

Private foundations must be concerned with the classification of agreements as grants or contracts in order to avoid classifying payments under agreements as taxable expenditures. Grants to certain organizations will be considered taxable expenditures unless the private foundation follows applicable IRS rules, so it is essential for an organization to understand the difference between a grant and a contract and to also understand how to properly structure a grant to meet the guidelines under the Code and regulations to avoid classifying payments under the grant as taxable expenditures.

When a private foundation makes a grant to an organization that is not recognized by the IRS as a public charity, such as a foreign organization, or makes a program related investment, the private foundation can follow certain rules to avoid classifying the agreement as a taxable expenditure. These rules, known as the expenditure responsibility rules, require that the foundation exert all reasonable efforts and establish adequate procedures to (1) see that the grant is spent solely for the purpose for which it is made, (2) obtain full and complete reports from the grantee on how the funds are spent, and (3) make full and detailed reports to the IRS. **4** A private foundation may avoid exerting expenditure responsibility on a foreign grantee and avoid classifying the agreement as a taxable expenditure if it obtains an equivalency determination that the grantee is the equivalent of a U.S. public charity. If the private foundation does not want to impose expenditure responsibility or obtain an equivalency determination for an organization, it may structure the agreement as a contract. The private foundation may also want to consider the disclosure requirements of Form 990-PF when structuring arrangements.

Defining the difference

Agreements arise in a myriad of forms, some easy to classify for tax and accounting purposes and others that seem to fit into either category. It is therefore necessary for nonprofit organizations to understand the difference between a grant and a contract from an accounting standpoint and under IRS rules.

For expense purposes, the tax law does not distinguish between grants and contracts. Rather, the Form

990 instructions state that organizations may report expenses in accordance with financial accounting standards. For revenue purposes, however, the regulations distinguish "gifts and contributions" from "grants" from "gross receipts from the performance of services." **5** A streamlined definition of a gift or contribution is the payment of money or transfer of property without adequate consideration. A simple definition of a contract or fee for service is the payment of money or transfer of property as consideration for services. Agreements entered into by nonprofit organizations are normally not so cut and dry, however, and often fall somewhere between the two concepts.

The general hallmark of a contract is that goods and services are provided to the purchaser organization with the purchaser having the right to considerable control of the project. Contracts are often referred to as "fee for service" arrangements because of this characteristic. The usual trait of a grant is that it is made primarily to support the recipient's mission with the recipient having substantial control of the project. The handling of intellectual property can be a fairly strong indication, though it is not always definitive. One hallmark of a grant is the recipient's retention of control of any intellectual property developed under the agreement. By contrast, the purchaser will generally have the rights to intellectual property under a contract.

The regulations acknowledge the tension between the two categories of revenue. Regulations governing broadly publicly supported organizations provide guidance for recipient organizations in classifying funds as grants or gross receipts. These regulations can be used as guidelines for other organizations in determining whether funds are related to a grant or contract. Grants are normally given to a grantee organization to encourage the carrying on of certain activities in furtherance of its exempt purposes. **6** The fact that an agreement is titled a contract or grant does not control its classification. **7** Likewise, the wording of any solicitation by the recipient is a factor in determining its classification, but this is only a minor and not controlling factor.

In distinguishing the term "gross receipts" from the term "grants," the regulations provide that "gross receipts" means amounts received from an activity to serve the direct and immediate needs of the funder, rather than primarily to confer a direct benefit upon the general public. **8** In general, payments made primarily to enable the funder to realize or receive some economic or physical benefit as a result of the service will be treated as gross receipts with respect to the recipient. **9** The regulations also recognize that the terms and conditions in an agreement, the common occurrence that the purposes of the grantor and grantee are similar, and the likelihood that an agreement will benefit the grantor makes it difficult to distinguish between funds received as gross receipts *from* the carrying on of exempt activities as opposed to those funds received as grants *for* the carrying on of exempt activities. **10**

Regulations governing private foundations provide insight into the definition of a grant as well. They provide that "grant" includes, but is not limited to, such expenditures as scholarships, fellowships, internships, prizes and awards, loans for purposes described in **Section 170(c)(2)(B)**, and program-related investments. **11** In addition, a grant includes an expenditure as a payment to an exempt organization to be used in furtherance of that organization's exempt purposes whether or not it has solicited such payments. **12**

The financial accounting standards make the distinction between contributions and exchange transactions for financial reporting. These categories are akin to grants and contracts and are helpful in correctly classifying agreements. They provide that a contribution is an unconditional transfer to an organization made or received voluntarily, while an exchange transaction involves a transfer in which each party receives and gives items of commensurate value. **13** One key difference between these two categories is that in an exchange transaction, the possible public benefits are only secondary to the possible benefits to the funder, whereas under a contribution, the benefits to the funder are only incidental to the possible public benefits. **14** A contribution involves a transfer to increase a recipient's ability to carry on its charitable purposes while an exchange transaction likely involves payment for services to be rendered in exchange. A contribution also creates fiduciary liability on the part of the recipient while an exchange transaction generates contractual obligations and a creditor or debtor relationship. Agreements can be partially contributions and partially exchange transactions, but that situation is beyond the scope of this article.

Although parties may negotiate the terms of an agreement to contain hallmarks of either a grant or a contract, there is no requirement that a recipient of an amount under an agreement classify incoming funds in a manner that parallels the funder's classification of the outgoing funds.

The IRS offers several examples to distinguish between the two types of agreements, two of which are summarized below.

Example. A nonprofit research organization engages in contract research and receives funds from the government to develop a specific electronic device needed to perfect articles of space equipment. The initiative for the project came solely from the government and the government could have contracted with for-profit research organizations that carry on similar activities. The funds received from the government for this project are gross receipts and do not constitute grants. The organization provided a specific product at the government's request and thus was serving the direct and immediate needs of the payor. **15**

Example. A government agency makes a community action program grant to a nonprofit organization. As part of this program, the organization signs an agreement with an educational organization to carry out a housing program for the benefit of poor families. Pursuant to this agreement, funds provided by the government agency are provided by the nonprofit to the educational organization to build or rehabilitate low-income housing and to provide advisory services to other nonprofit organizations in order for them to meet similar housing objectives, all on a nonprofit basis. The payments under this agreement constitute grants because the program is carried on primarily for the direct benefit of the community. **16**

Factors in classifying an agreement

There is no magic formula to decide the proper classification of an agreement. The following questions, however, are critical when deciding whether to classify an agreement as a contract or a grant. There is a

substantial ambiguous area between contracts and grants, and the answers to the questions should be evaluated as a whole to determine an agreement's classification. Certain factors are more important than others and there is often no bright line between a grant and a contract. If an organization is consistent in answering questions along the lines of the following and classifying the agreements according to the answers, it will establish a good practice in following such procedures for its records.

- *What type of work is being funded?* A grant generally benefits the recipient directly while a contract mainly benefits the funder directly. If the type of work being funded is similar to the kind of work that the recipient would perform absent the agreement, this is an indicator of a grant. The work does not have to be identical to the activities of the recipient to be a trait of a grant, just similar to its existing or planned activities. One sign of the arrangement being a contract is that the work under the agreement is not similar to the kind of work that the recipient would perform without the funds.
- *Is the service or product under the agreement normally provided to others for a fee in the recipient's regular course of business?* A contract usually has a specific work product or service expected at the end of the term and the payment is normally based on market price. It is an indicator of the arrangement being a contract that the recipient normally performs the service or produces the product in its regular course of business for a fee.
- *What type of entity is the recipient?* If the recipient is a for-profit entity, the agreement will typically be classified as a contract. There are a few circumstances under which an agreement with a for-profit entity is properly classified as a grant, but these are fairly uncommon. Thus, the fact that the recipient is a **Section 501(c)(3)** entity, a public university, a governmental unit, or a foreign organization equivalent to a U.S. non-profit organization is a general indication that the agreement is a grant, although this is not a factor that would outweigh other considerations.
- *If the recipient entity is a nonprofit organization, does the work under the agreement support the recipient's mission or exempt purpose?* A grant's purpose is normally in furtherance of both the funder's and the recipient's missions. The alignment of the purposes of the agreement with the recipient's goals is a quality of a grant. The purpose of the agreement merely supporting the funder's goals is a hallmark of a contract.
- *Who will own the work product?* The recipient's ownership of the work product created under the agreement is an indication of a grant. The funder having ownership rights to the work product developed under the agreement is a sign that the agreement is a contract. Joint ownership of intellectual property developed under an agreement is a signal that the agreement is a grant, although this is not a factor that would outweigh other considerations.
- *Will the recipient conduct activities in its own name or as an agent for the funder?* The recipient's conduct of the activities in its own name is a feature of a grant. The recipient's performing the activities as the funder's agent or in the funder's name is a hallmark of a contract.
- *How much control will the funder have over the recipient in performing the deliverables under the agreement?* Under a grant, the funder's role is similar to that of a general monitor or

administrator rather than as an overseer, which is generally a characteristic of a contract. The recipient's ultimate control over the deliverables under the agreement is an indicator of a grant. The funder's control of the deliverables under the agreement is a sign of a contract. Control can include the approval by the funder of milestones under the agreement to proceed to the next milestone, regular check-ins with the funder to make certain the recipient is on track under the agreement, and other language in the agreement to the effect that the funder controls the actions of the recipient or that the recipient is under the direction of the funder. Note that the expenditure responsibility rules require the funder to make certain that charitable funds are spent in furtherance of exempt purposes. Such control of the funds, however, does not constitute control of the recipient's performance under the agreement, which is the object of this question.

- *What happens if the recipient does not meet the deliverables?* A grant recipient is generally expected to attain certain performance objectives, but these frequently are not met, or the result of the project is not as anticipated in the agreement. Both parties to a grant generally recognize that this may happen, and the failure to produce certain deliverables outlined in the agreement does not create a breach. When a grant is involved and the recipient fails to perform under the agreement, the recipient commonly is not penalized for nonperformance but is expected to return any unspent funds and any work product developed under the agreement. Under a contract, however, the recipient is expected to deliver certain products or services to the funder and the failure to do so will result in a breach of the agreement and possibly a penalty.
- *What is the method of delivery of the final work product?* The time and place for delivery of the work product to third-party recipients is usually determined at the discretion of the recipient under a grant. In a contract, the method of delivery to the end recipients is usually determined by the funder.
- *What is the method of determining the amount of payment?* The amount of a grant usually is ultimately determined by the funder in response to a request by the organization for funding. The amount exchanged under a contract is normally equal to the value of the services or work product being provided under the agreement and may be negotiated between the parties.
- *What are the terms relating to the delivery of the work product?* The work product under a contract is normally delivered to the funder whereas delivery under a grant is usually to individuals or organizations other than or in addition to the funder.

On Form 990

Once the organization has made a determination as to the classification of an agreement, the funds will show up in the appropriate areas of the Form 990 and financial statements. As alluded to above, the accounting rules for grants and contracts are different. As a grant, the total amount of the agreement is recorded when the grant is signed (unless all or a portion of the grant is conditional) by both the funder and the recipient. The accounting rules for contracts are more complicated but, roughly speaking, the

expenses and revenue are recognized as work is performed, rather than when the contract is signed. The results of classifying an agreement as a funder and a recipient are discussed below.

Funder.

Despite the disclosure difference, grants and contracts both are functional expenses for purposes of Form 990 and financial statements. Part IX of IRS Form 990 breaks expenditures into (1) grants and other assistance to governments, organizations, and individuals in the U.S. and outside of the U.S. on Lines 1 through 3, and (2) fees for service by non-employees on Line 11. The total amount that an organization provides as grants in a fiscal year will show up in Lines 1 through 3 according to the location (domestic or foreign) and nature (an individual or an organization or government) of the recipient. The total amount of applicable fee for service, or contract, expenses will generally show up in the various sublines of Line 11.

If a grant to an organization or governmental unit is more than \$5,000, it must be separately disclosed and accounted for in either Schedule I or Schedule F of the Form 990, depending upon the location and nature of the recipient. The disclosure of the name, address, EIN, Code section (if applicable), amount of the grant, and purpose of the grant is required on Schedule I for any U.S. recipient organization or government. If the funding organization makes aggregate grants to individuals in the U.S. in the amount of more than \$5,000, the organization must disclose the type of grants, number of recipients, and amount of the grants on Schedule I but not the actual name of the recipients.

If an organization makes a grant to a non-U.S. recipient, the grant may appear on Form 990, Schedule F. The name of a foreign recipient organization that receives more than \$5,000 in grant funds is not disclosed on this Schedule but for each disclosable grant, Schedule F requires the funding organization to include the region of the world in which the grantee is located, the purpose of the grant, the amount of cash granted, and the manner of cash disbursement. For grants to individuals outside of the U.S., Schedule F requires the organization to disclose more than \$5,000 of aggregate grants and other assistance to foreign individuals, the type of grant, region, the number of recipients, and the manner of cash disbursement. An organization must also describe its procedures for monitoring the use of its grants and other assistance in the U.S. and outside the U.S.

Individual grants to organizations and governmental units and aggregate grants to individuals at or below \$5,000 are not separately disclosed for the purpose of Form 990. They are grouped together by whether or not they are made to domestic organizations or governments, domestic individuals, or foreign recipients, and will appear in the total number for such applicable grant expense.

Part I of Form 990-PF requires an organization to break operating and administrative expenses between (1) contributions, gifts, grants paid, and (2) total operating and administrative expenses. For each grant paid during the year or approved for future payment, regardless of the amount, the private foundation must list the recipient, the foundation status of the recipient, the purpose of the grant, and the amount of

the grant on Part XV, Line 3 of Form 990-PF. The organization must also provide details on Part VII-B, Line 5c of each grant over which it exerts expenditure responsibility.

If an agreement is properly classifiable as a contract and is under \$100,000, then it is not separately disclosed on Form 990, but it is included as an expense under the appropriate fee for services category on Part IX, Line 11 or possibly on Line 24 as an "other" expense. If the contract is over \$100,000 and is with one of the five highest-paid independent contractors, the details of the contractor, services provided, and amount of compensation will be disclosed on the Form 990 as a highest-paid independent contractor on Part VII, Section B, Line 1. If the contract is over \$100,000 and it is not with one of the five highest-paid independent contractors, it will show up as a highest-paid independent contract on Part VII, Section B, Line 2, but the amount and details will not be disclosed. However, if the contract is with a foreign person and the organization had expenses of more than \$10,000 in the aggregate attributable to business or programs services outside of the U.S., certain details of the agreement, but not the name of the recipient, will be combined with other expenses in the region in question on Schedule F of Form 990.

Expenses from agreements considered contracts are treated similarly on Form 990-PF, Part VIII, Line 3, but the threshold is \$50,000 instead of \$100,000. Amounts paid under contracts for the accomplishment of a private foundation's charitable mission are considered qualifying distributions.

Recipient.

When an organization receives a grant totaling \$5,000 or more from any one source, it must separately list the grant on Form 990, Schedule B. The organization must include the name and address of the grantee along with the amount of the grant. Although this information must be submitted to the IRS, if the recipient organization files a Form 990, the name and address of the grantor, and in some cases the amount of the grant, may be redacted for public purposes. A private foundation is also required to file Schedule B with Form 990-PF, but this information may not be redacted for public purposes.

The aggregate amount of grant revenue will appear on the appropriate subline of Part VIII, Line 1 of Form 990, which includes the total amount from governmental and other sources. As discussed above, grants will count toward the public support test for publicly supported and broadly publicly supported organizations. They will be part of the public support percentage calculation on Schedule A of the Form 990. Private foundations receiving revenue from grants will report this information in Part I, Line 1 of Form 990-PF.

Revenues received from contract agreements generally appear either as program service revenue, a miscellaneous revenue item, or other amounts reported as related revenue on Part VIII of Form 990. This revenue may also appear on Schedule A of a broadly publicly supported organization's Form 990 as gross receipts from a related activity. It also will count towards its public support percentage, subject to the restrictions discussed above. Moreover, aggregate revenues of more than \$10,000 from or attributable to business or program services outside the United States must be disclosed in general on

Schedule F.

Private foundations receiving revenue from contracts will include the overall amount on Part 1, Line 11 of Form 990-PF. A detailed analysis of income-producing activities must be disclosed by the organization on Part XVI-A along with an explanation of how each activity contributed importantly to the accomplishment of the foundation's exempt purposes. This means that the organization may explain the activity under the contract but it is not required to include the funder of the contract.

Conclusion

It is important for organizations to correctly classify agreements both for disclosure purposes and for accurate reporting of expenses and revenues. When drafting agreements, organizations should also keep in mind the differing levels of disclosure between grants and contracts, especially when dealing with a sensitive arrangement or a public relations concern. For example, if a funder wants to give money to an organization for lobbying activities and it does not want the name of the organization to appear on its list of grantees, this payment should be structured as a contract in order to avoid the item being separately disclosed.

Understanding the accounting treatment of grants and contracts also will allow an organization to structure a relationship to recognize funds in a particular fiscal year, whether the agreement is structured as an unconditional grant to recognize the public support upon execution of the agreement or as a contract with the income recognized as the payments are received. With the tools and analysis discussed in this article, organizations should be able to structure arrangements in a manner that meets their needs and complies with the law.

1 Sections 509(a)(2) , 170(b)(1)(A)(vi) .

2 Reg. 1.170A-9(f) .

3 Section 509(a)(2) .

4 Section 4945(h) .

5 Regs. 1.509(a)-3(f) , 1.509(a)-3(g) .

6 Reg. 1.509(a)-3(g)(1) .

7 *Id.*

8 Reg. 1.509(a)-3(g)(2) .

9 *Id.*

10 Reg. 1.509(a)-3(g)(1) .

11 Reg. 53.4945-4(a)(2) .

12 *Id.*

13 FAS 116; ASC 958-605-20; ASC 958-605-15-6.

14 ASC 958-605-20.

15 Reg. 1.509(a)-3(g)(3), Example 1 .

16 Reg. 1.509(a)-3(g)(3), Example 3 .