

Capital Projects – The Tax & Legal Elements

A Legal Overview of Capital Projects

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Introduction

For many charities, embarking on a capital project is not an everyday issue. Generally speaking charities embark on capital projects because they are essential to the achievement of the charity's objects.

Arts charities need to develop performance spaces or at the very least an operating base. Welfare charities may need to develop treatment or residential centres. Educational charities need teaching facilities. Some charities, such as those that offer facilities for use by the community such as playing field or village hall charities, essentially exist to hold and manage a capital asset.

Later in this session we are going to explore in greater detail two particular aspects of capital projects that often prove troublesome namely tax issues, especially VAT and property issues.

My role is to offer a broader overview, from a lawyer's perspective of issues that will challenge a charity in carrying out a capital project. I am a public and planning lawyer by specialisation but I have been closely involved as lead partner in several charitable capital schemes and this overview draws on that experience.

As every Welsh nonconformist knows a good sermon has three points, so I shall be approaching this subject under the broad headings of (i) Preparation (ii) Delivery and (iii) Post opening.

Preparation

Capital projects come into being for a number of reasons.

The realisation of the project and its subsequent operation may be the purpose of your charity. At one extreme this encompasses a single scheme of national significance such as the Wales Millennium Centre. At a more local level was the "Cynnal – 21st Century Village Halls" scheme promoted by the WCVA with funds from the Millennium Commission to refurbish village halls throughout Wales to celebrate the year 2000, where the individual projects were quite small in

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capital terms but significant and important for the village hall charities that were carrying them out. In many instances these charities start off a building project and only at a later stage do they become living, functioning organisations delivering their charitable objects for the public benefit.

Alternatively, the charity is already operational and is either expanding its capital assets or refurbishing them.

Unless the charity has a substantial built estate, such as Amgueddfa Cymru/National Museum Wales, it is unlikely to have a dedicated estate management or building organisation in house.

The first stage in preparing for a capital project is to address the two fundamental questions of how to organise the planning and supervision of the works and secondly how the works are to be funded.

An important first step is to ensure that the trustees are organised in a way that ensures that the trustee body as a whole is "fit for purpose" to carry out such a project.

This will entail looking at three issues:

- (i) Does the charity have the right blend of skills and experience among the trustees so they can consider critically the advice they receive from their own staff and from external advisers? The range of skills will be wider the larger the project, but the areas that may need to be covered are:
 - a. Building/construction experience e.g. a builder, quantity surveyor or architect.
 - b. Property/valuation experience e.g. a chartered surveyor.
 - c. Financial e.g. an accountant or banker
 - d. Project management/consultancy
 - e. Legal

By recruiting trustees with the needs of a specific project in view you may well be able to find trustees who are willing to make a contribution that is mainly devoted to the project who may not otherwise feel they have a contribution in terms of the day to day activities of the charity.

- (ii) Is the charity's constitution appropriate to carrying out the project? Does it have the necessary borrowing powers? If it is an unincorporated trust the Trustees should consider the advantages of incorporation in terms of corporate governance, execution of documents and the additional (limited) layer of protection from personal liability that a company structure provides. Also the Trustees should check their insurance

position to ensure you have powers to take out directors' and officers' liability insurance and ensure that the level of cover is reviewed in the light of the size of the project. Finally, unless you have recently purchased the site the title should be checked to ensure that there are no matters or defects that will impede the project. If there are, address them now, not when a funder asks for evidence of title.

- (iii) Is the corporate governance structure appropriate to manage the project? As a matter of charity law it the trustees corporately who must take the major decisions on a capital project in terms of the decision to proceed and whether the charity has the resources and the capacity to proceed. However, before these major decisions can be taken, there should be much detailed work in preparing to present details of the project, its procurement and the associated legal documentation to the Trustees as a whole. A charity embarking on a project should therefore consider carefully establishing a committee of trustees, with the requisite skills and backgrounds, to manage the project and to give preliminary consideration and formulate recommendations to the full trustee body in respect of those key decisions that require approval of all the Trustees. This should form part of a wider consideration of the governance arrangements for the project and should include:
- a. Formulating the terms of reference of the "Project Committee", including the arrangements for it to report back to the full Trustee body.
 - b. Arranging the financial delegation and authorities for the project. This will involve considering the levels of expenditure and variations that can be authorised by the Chief Executive or Project Manager, those that must go to the building committee and those that must go to the full Trustee body. Particular consideration should be given to the authority to make payments from the project contingency fund.

Operating a Project Committee on this basis requires self discipline on the part of the Trustees a whole. In any significant decisions there are myriad design and construction decisions to be taken in any significant project as it proceeds. Questions of finishes and design can provoke strong opinions, but time spent agonising over these will probably be paid for through variations to the project. Having set up a Project Committee a wise body of trustees will focus on ensuring that the governance of the project is proceeding according to the approved arrangements and charity good practice and not on intervening in the management of the project.

Top Tip 1 Make sure charity's Trustee Body and constitution are "fit for purpose".

Top Tip 2 Consider a dedicated committee to run the project with well written terms of reference and let them get on with it, while the rest of the Trustees get on with running the day to day life of the charity.

However, to an extent, this is to jump ahead of ourselves. The other aspect of a capital project to consider at this stage is assembling the team of advisers to the project. You will need to consider the technical advice you will need in relation to architecture, engineering, project management and quantity surveying, as well as property, financial and legal advice. You may also need to decide what advice and assistance you need in fund raising or applying for finance – the writing of grant applications or running fund raising campaigns are disciplines in their own right. It is at this stage that the skills of the Trustees with specialist knowledge will come to the fore in identifying and recommending advisers who may be suitable for the project.

In terms of legal advice a major project needs advisers who can call on a range of legal specialisations. Typically these will be: charity law, corporate finance, real estate and planning, tax and, possibly, public law and commercial law.

If the capital project is part of the start up process for the charity, or the charity needs to get some initial funding in place for the planning of the project it is not unusual to ask professional advisers if they are prepared to work "at risk" until funding was secured. This was a particular feature of the way that Millennium Commission funded projects were put together. Clearly, professional advisers all take their own views on how to respond to such invitations. If the charity follows down this route, however, the following should be borne in mind:

- (i) An element of competition or tendering is desirable however small the project and enables the charity to demonstrate its awareness of value for money from the outset.
- (ii) If the charity is expecting consultants to work "at risk" the charity should make sure that their engagement is properly documented, including the "at risk" element and the point at which they will be paid. You may also get consultants to work "pro bono" or at a discounted rate to their normal fees. Make sure this is recorded – it may be possible to use it as match funding.

- (iii) If the project is going to be funded from public funds and it is expected that funding in total will exceed 50% of the value of the project then it will be necessary to follow the Public Procurement Regulations. These are a subject in themselves. However, the point to bear in mind is that if the funding is based on this assumption the charity would be well advised to follow the rules from the outset – even before funding is confirmed – if it is expected that the cost of the works could exceed £5,000,000 (approximately). Most consultancy services (although not legal services) are also subject to the tendering regulations if the cost is likely to exceed £150,000 (approximately). If the charity does not do so then advisers who may have seen the project through its difficult formative stages can find themselves expected to re-tender. This is unsatisfactory for them and also for their competitors, because of the incumbent advisors' knowledge of the project.

Top Tip 3 Have clear terms of appointment with professional advisers from the very start, and cover "at risk" and discounted work.

Top Tip 4 If you have large project with over 50% funding you should follow the Public Procurement Regulations from the outset.

The final point to highlight on preparation is the need to ensure that you have addressed the taxation issues that arise from the nature of the project and your proposed funding sources. Alan Matthias will cover these in his contribution.

Delivery

In order to deliver the project the charity needs to have its funding in place and it needs to have its contractors in place. Putting them in place requires legal advice and this is the basis on which the whole project will proceed. This is a critical time for the Trustees and the Project Committee. I will consider each in turn:

- (i) Selecting the contractor and the type of procurement strategy to be followed is the province of the construction lawyers. It is fair to say that a construction management route is now the one most favoured for large capital schemes with a major element of public funding. This involves the appointment of a single lead contractor who will organise the construction and who will divide the work into various "packages" to be sub contracted. The client's sole contractual relationship is with the main contractor and the appointments of key advisers such as the architects are novated or

transferred to the main contractor at the point the contractor is appointed. This is a difficult point in a project because a consultant with whom the Trustees will have worked closely in getting the project through the approval process is now put at one remove.

In adopting this procurement route it is not unusual to adopt a two stage process for appointing the contractor. At the first stage the contractor is given an agreed fee to work up its costing of the scheme and on the basis of that work is expected to offer the client a guaranteed maximum price. The funding that has been offered and the client's own design and costing work will have set the budget and the two stage process provides an opportunity to bring the project to an end or for redesign/renegotiation before the project is committed on site.

Smaller projects may adopt a more traditional technique with an architect directly employed architect as a consultant by the charity throughout and the charity employing the contractor separately. However, although the value of a project may be relatively small it may still be a huge undertaking for the charity in question. Funders are increasingly unwilling to fund cost overruns and unless the charity has significant other resources cost certainty is probably the most important consideration in procuring a capital scheme.

Building contracts are a subject in their own right and the only other thing I would mention is the importance of the charity having in place its own representative to deal with the main contractor and to analyse and process payments. On a small project this will probably mean a "clerk of works" appointed by the charity. On a large project it will mean a directly employed project manager with commercial and construction specialists to assist him. It also needs to be remembered that this team will be concerned not only to check and report on the stage payments to the contractor, but will also be responsible for the draw down applications for the project funding.

In deciding to proceed with the project the Trustees will have to decide whether the project and the terms on offer are in the best interest of the charity and they must be satisfied that they can fund the work they are about to commission.

Top Tip 5 Different types of building contracts achieve different elements of certainty. Charity trustees need very good reasons for not having cost certainty as their primary objective in entering into a building contract.

- (ii) After the euphoria of securing the funding package, the arrival of the funding agreement is usually a sobering experience for the Trustees. If the charity is borrowing funds commercially then most charities expect the formalities of bank loan and mortgage documentation.

What sometimes comes as a surprise is that funding from lottery and public sources is now subject to similar funding agreements and security arrangements. My colleague Caroline Campbell will cover the formalities that this entails in respect of the charity's land.

The important point to remember is that funding terms are offered very much on a "standard form" basis. The funder may be willing to show a degree of flexibility in the negotiation of terms and conditions that are specific to the project.

In broad terms the Trustees will be expected to provide the following in the agreement:

- a. A detailed description of the project to be annexed.
- b. Make representations that they have the powers to enter into the agreement, that they can validly execute all the documents needed to proceed with the project, that the information provided in the grant application is accurate and not misleading and that they do not know of any factors that will prevent successful completion of the project.
- c. Undertakings not, without the funder's approval, to alter the details of the project, to use the grant only for the approved purpose, not to incur further borrowings, not to grant any further security, not to alter the charity's constitution, not to dispose of any of the assets being created with the funds and to secure the other sources of funding required for the project.

The Agreement will specify the events that will constitute a default entitling the funder to seek repayment covering matters such as failure to complete the project, breaches of obligations, misuse of funds or losses through fraud or negligence and insolvency.

Terms of this nature can and do appear daunting to Trustees, who generally at this stage (if they have not already done so) turn to their legal advisers and ask about personal liabilities of trustees.

Of course, things do go wrong with projects, but if the worst happens it is important that the Trustees can demonstrate that they have brought their own knowledge and skills to bear, that they

have taken appropriate professional advice and that they have acted prudently in concluding that if they accept the funding and other funding that they have been offered, that they will be able to complete the project within the funding available.

Top Tip 6 The Trustees should be prepared to consider carefully and in detail the funding terms and whether they would be acting prudently in the best interested of the charity if they accepted them.

Frequently the most difficult issues that arise in relation to funding relate to the pre-conditions of funding and the matters that must be achieved before funds flow in full or at all. These can cover all manner of things specific to the project. Here are some examples:

- (i) planning permission
- (ii) approval of a business plan
- (iii) approval of the terms of other funding
- (iv) matched funding in place
- (v) securing highway closures
- (vi) approval of the professional team
- (vii) approval of the construction contract and contractor
- (viii) conclusion of satisfactory arrangements with "joint venture" partners and settling operating arrangements

In some cases, usually involving European funds, the charity may be set a particular milestone date, such as a date by which a building contract must be signed, or the funding is lost.

Another area of occasional difficulty and complexity is if another organisation is a partner in your funding bid, or their presence was an essential factor in your proposal. In such cases the funders will generally expect "Heads of terms" to be in place when funding agreements are signed and may well require the other body to be legally committed to the project as a pre-condition of funding. If this is the case, allow time for negotiations with these other bodies – they may be in a strong bargaining position.

Top Tip 7 In negotiations with funders, focus on getting reasonable and achievable conditions precedent, rather than arguing about standard form clauses that a funder is not going to change.

It is also very important to remember that all the funding and construction documents are living instruments. In particular a charity must expect to obtain the consents required of funders. If the charity does not want to risk having grant claims rejected or held up with consequent cash flow problems for the charity and the prospect of late payment penalties until matter are rectified it also need to remember the wide ranging nature of the conditions as any trustees will tell you who have had grant withheld because a press release wasn't cleared or the incorrect logo was used on signs.

A prudent step is to include these requirements in the risk register for the project.

Top Tip 8 Keep the conditions of funding in mind throughout the project – not in the bottom drawer.

Post Opening

Plaques have been unveiled, dignitaries entertained and funders thanked – what was a building site has become a living entity in the service of the charity's objects. There still remain a few issues to bear in mind:

- (i) Much of the funding may have been in the form of grants, but the terms and conditions of funding and the security you may have given remain in place to ensure that the purposes for which the funding was given are maintained. You may find you need funders' consent whenever you change your constitution or when you wish to put in place overdraft or working capital arrangements with your bank.
- (ii) Public funders will have ensured that they have the right to audit the final accounts of the project.
- (iii) It may be the time to look again at the fitness for purpose of your Board to make sure that you have the skills to manage the transition from a capital project to an operational organisation.

Top Tip 9 The conditions of funding will bind the charity throughout the life of the asset.

This briefing note is intended solely as an overview of the law. It was last updated on 27 April 2006. No responsibility can be accepted for the completeness or accuracy of this briefing note and professional advice should be taken in relation to any specific problems.

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