

Newsletter

VAT – Welfare Services

You will see from the attached letter that Customs have given further details of the change in VAT treatment of certain welfare services. You will also have seen our e-mail with an overview of these proposals. This newsletter expands on those views.

The legal basis for the proposed changes is Article 4(5), EC 6th Directive which is the provision which allows local authorities and other bodies governed by public law to treat certain activities outside the scope of VAT, primarily those performed under what is known as a “special legal regime”. The final sub-paragraph of this Article states that:

“Member states may consider activities of these bodies which are exempt under article 13 or 28 as activities which they engage in as public authorities.”

What this means is that a national government may authorise local authorities etc to treat exempt supplies as non-business. Hence, it is within the Chancellor’s powers to designate, let us say, child care services as non-business when supplied by a local authority, although there are qualifiers to that in that this cannot be the case where distortions of competition arise.

Paragraph 4 of Customs’ letter indicates which areas will be covered. These are self-explanatory and appear to be chosen with Sure Start and other early years initiatives in mind. However, one of the most significant statements in this letter relates to grants of leases, lettings and licences, which Customs believe will not be included in the services switching from exempt to non-business. Thus, the adverse effect of granting leases to other bodies may well remain, whereas if local authorities elect to provide services themselves (rather than constructing buildings and leasing to external organisations), the VAT obstacles will disappear.

The danger here is that, by leaving this major area unresolved, these initiatives will continue to be VAT-led rather than organised on best practice lines.

Customs have, however, proposed that the effects of granting exempt leases etc can be mitigated by alterations to the way that local authorities carry out their partial exemption calculation. This matter has been kicking about for several years – ever since the Haringey case – but this appears to be the first time that alternatives have been put forward by Customs for public debate. Some of the options, though, are frightening, albeit that they are published as discussion points.

Option 1

Option 1 proposes that local authorities be sectorised for the purposes of the partial exemption calculation, and the 5% test applied to each sector. There are further calculations which separate capital and revenue and appear to be aimed at keeping revenue expenditure deductible (if it is below 5%) whilst potentially limiting recovery in respect of capital expenditure if its use is more than 5% exempt. These calculations are not explained in any detail and it is difficult, based on the brief outline in the letter, to understand exactly what is trying to be achieved. More worrying, though, (particularly to those authorities currently within the 5% limit) is the concept of sectorisation.

Let us imagine a district council with a total input tax of £2m per year, and exempt input tax of £80,000, most of which is in the leisure services sector. Under a global calculation, the authority remains comfortably below the 5% limit. Under a sectorised calculation, the leisure services sector may be at about 30% exempt, whilst all other sectors remain at about zero exempt input tax. Is the proposal that leisure services should lose £80,000 year on year? And what about the VAT within the central recharges calculation? Will that be deductible as relating to central services, or partly irrecoverable as relating to the element recharged to leisure services?

On the other hand, it might give the flexibility for exempt activities to take place in one sector without affecting other sectors of the authority where exempt supplies are made if the authority might have otherwise exceeded the 5% limit under a global calculation.

Option 2

Option 2 involves using the Capital Goods Scheme to distribute exempt input tax over a longer period. For instance, let us take the example of a local authority refurbishing a building for lease to a charity (the lease may be one where an option to tax would not be valid) where the input tax would, under the present system, push the authority over its 5% limit. Using the Option 2 method the VAT would be split over the 10 years of the Capital Goods Scheme, so 1/10th of the input tax would be counted as exempt input tax in the current calculation, another 1/10th in next year's calculation, and so on.

This seems to be a practical solution to the problem of taking the VAT hit all at the time of construction, however it does mean that the local authority will have fixed amounts of exempt input tax hitting the calculation for the next 10 years, so what if you want to do a similar thing in 5 year's time? Might you lose some VAT on that project, and also some VAT off the current year project, and some from the project from 2 years ago.....? It will certainly take VAT planning in local authorities to new heights and, as Customs have warned, might have an element of retrospection if you have to include that leisure centre you built three years ago and thought you had protected your input tax recovery at the time!

Option 3

Option 3 involves treating funding by central government grants as being non-business use of a building. It would be interesting to see how central government funding is defined, as much funding comes from “agencies” rather than directly. Would, for instance, a contribution from a health trust – which is funded entirely by central government – toward a new community centre which they plan to share with the local authority constitute central government funding? If a grant is awarded for a project which results in an authority making entirely exempt supplies, can the input VAT legitimately be reclaimed under section 33, VAT Act 1994 which requires that the VAT is “not for the purpose of any business carried on by the body”? This option raises more questions than it answers.

Looking to the future

It is not absolutely clear from paragraph 9 of Customs’ letter whether they are proposing that one of these options (or maintaining the status quo) will be applied to *all* local authorities, or whether each local authority must choose the option *it* prefers (and stick to it!). If the former is the case, could an individual authority not be allowed to adopt the latter through modification of its Special Method? In other words, the option chosen by Customs becomes a local authority standard method, but individual authorities may deviate from that through a special method. This would seem to offer the chance of at least giving every authority the opportunity to minimise its exposure to partial exemption losses.

Have your say

A debate on easing the VAT burden for local authorities is always welcomed, but we at Elysian believe it should be an informed debate, with as many local authorities as possible being given the opportunity to put forward their views. If you have any views on this issue you would like to be passed on to Customs, please put them through your usual communication channels or let us know and we will put them forward for you, as we have done on many occasions in the past.

If you would like to discuss any of the issues above, please write, e-mail or call us. Our contact details are below.

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