

NORTH WEST LEICESTERSHIRE DISTRICT COUNCIL

POLICY DEVELOPMENT GROUP - WEDNESDAY, 27 JUNE 2018

Report Title	LEISURE VAT IMPLICATIONS
Contacts	<p>Councillor Nick Rushton 01530 412059 nicholas.rushton@nwleicestershire.gov.uk</p> <p>Strategic Director of Housing and Customer Services 01530 454819 glyn.jones@nwleicestershire.gov.uk</p> <p>Head of Finance and S151 Officer 01530 454707 tracy.bingham@nwleicestershire.gov.uk</p>
Purpose of report	To provide information to Policy Development Group views on the issue of VAT exemption on sporting services and to seek comments of the group before the matter is presented to Cabinet and Council for decision.
Council priorities	Value for Money
Implications:	
Financial/Staff	There is a financial benefit to the council in making a claim, as detailed within the report.
Link to relevant CAT	No direct implications.
Risk Management	If exemption status is claimed, but the council's leisure centres are not outsourced, payments to HMRC will be required and further significant sums payable should the council undertake any capital improvement works to its centres. Full details regarding this risk are included in the report.
Equalities Impact Screening	No direct implications.
Human Rights	No direct implications.
Transformational Government	No direct implications.
Comments of Head of Paid Service	Report is satisfactory
Comments of Section 151 Officer	As report author, the report is satisfactory.

Comments of Monitoring Officer	Report is satisfactory
Consultees	None
Background papers	None
Recommendations	THAT POLICY DEVELOPMENT GROUP NOTE THE REPORT REGARDING THE ISSUE OF VAT EXEMPTION ON SPORTING SERVICES AND PROVIDE COMMENTS TO CABINET AND COUNCIL

1.0 BACKGROUND

- 1.1 Members will be aware that the financial modelling work in respect of the decision to outsource the council's leisure centres has to date has considered the implications of VAT in terms of the likely saving that an operator can achieve which in turn flow back to the council. This VAT saving is based on the different VAT status of non-profit making organisations providing sports and leisure services. Local Authorities have in the past been required to charge VAT, resulting in a lower amount retained in respect of the provision of those services when compared to non-profit making organisations for whom there is no requirement to charge VAT, meaning that prices can be maintained and the difference between what the market will pay and what would otherwise be transferred as VAT withheld.
- 1.2 Last July, a Court of Justice for the European Union (CJEU) ruling introduced doubt in respect of this element of the future outsourcing saving, when considering a case between London Borough of Ealing and HMRC. The ruling determined that Local Authorities should not be treated differently from non-profit making organisations in respect of the charging of VAT on sports and leisure services.
- 1.3 HM Revenue and Customs (HMRC) have since accepted that certain supplies of sporting services made by local authorities can be treated as exempt from VAT. On 29 December 2017, HMRC issued guidance detailing how Local Authorities may make a claim for exemption relating to VAT incorrectly charged on supplies of sports and leisure services.
- 1.4 HMRC has acknowledged that councils may continue to rely on the UK law and account for VAT on income received from supplies of leisure services, until that law is changed. This does mean that the council could continue as it has done, accounting for VAT on leisure income, recovering all VAT incurred on related costs. If the council chose to maintain the status quo, it could not make a claim for overpaid VAT in prior years.

2.0 VAT EXEMPTION

- 1.5 A claim in respect of the past 4 years can be made to reclaim VAT paid under the existing VAT treatment method. Where a council opts to make a claim for exemption in respect of past periods, they'll be expected to continue to exempt supplies in subsequent periods.
- 1.6 However, VAT on related costs must then also be treated as attributable to the council's VAT exempt supplies and considered in the "test of insignificance".

1.7 This test of insignificance considers that the level of VAT incurred in relation to all VAT exempt business supplies is no more than 5% of the total level of VAT incurred on all goods and services. Where a “one-off” breach of the 5% test arises, it is possible to look at over a 7 year average. If the partial exemption test is breached, the local authority must repay all the VAT it has recovered in relation to all of its exempt supplies during the financial year.

3.0 REVIEW OF NWLDC OUTSOURCING BUSINESS CASE

1.8 The council has a potential claim for the past 4 years of historically overpaid VAT of approximately £1m and the ability to retain all income raised moving forward. This approach may have been taken irrespective of whether the outsource option had been pursued by the council.

1.9 However, as in 2.2 above, VAT incurred on costs would also need to be treated as attributable to VAT exempt supplies under the test of insignificance. This would include capital expenditure under the business as usual case (but not under the outsourced case, since the expenditure would be incurred in relation a “non-business activity of the council – see Table 1 below).

1.10 As a result, the most economically advantageous option to the council remains outsourcing, but with the claim for historic VAT and VAT exemption for the remaining period of time that the council delivers leisure services pursued. The table below summarises the financial position of the council, assuming exemption status is obtained.

Table 1 – Conclusion of review of outsourcing business case and business as usual position under VAT exemption

Business as usual case	<p>Assuming no significant capital expenditure, the business as usual case would breach the test of insignificance in the 4 years from 2016/17 to 2019/20, taking the 7 year average above 5% and a payment required to HMRC.</p> <p>Any additional capital expenditure would further exaggerate this breach and the resultant financial payment to HMRC. If the council were to continue with the build of the new facility at a cost of £20m between 2019/20 and 2020/21, this breach would reach a significant level.</p> <p>Despite the ability to then retain all income, a reduction in income can be assumed as customers would favour modernised facilities elsewhere in/outside of the district.</p> <p>If lower levels of capital investment are considered in the form of redevelopment of the Hermitage site, consideration would need to be given to the relationship between investment and the ability of the council to generate income growth.</p>
Outsourced case	<p>Under the outsourcing option, and assuming the claim for historic VAT and VAT exemption before transfer is pursued, the 7 year average test of insignificance should not be breached and there is no resultant payment to HMRC.</p> <p>Despite the significant £20m capital investment in the new facility, for the purposes of VAT, the council no longer makes the supply of leisure services. Typically an operator would occupy the new facility under a “peppercorn</p>

	<p>lease” arrangement, which would allow the council to recover VAT incurred on the capital investment.</p> <p>This “peppercorn lease” arrangement is common in similar circumstances and has HMRC’s approval (subject to conditions). In practice, this arrangement will mean that the council will need to grant a peppercorn lease in the new facility, once it has been constructed. Care will need to be taken to ensure that the council does not receive any consideration by way of rent. Typically the council would receive any “surplus share” in the increased use of the facilities through a payment from the operator for the right to operate the leisure facilities. This charge made by the council to the operator would be subject to VAT, and that VAT may not be recoverable in full by the operator. It is expected that during the procurement of the operator, operating models such as this will be proposed.</p> <p>Due to the committed capital investment, the outsourced option will deliver a more advantageous position in respect of income growth which will flow back to the council in the form of a committed annual “management fee and surplus share”, which will be a payment by the operator for the right to operate the facility.</p>
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1.11 In summary, the business as usual case remains non-financially viable compared to outsourcing and this position is exaggerated further when significant capital expenditure is considered. This is because, compared to business as usual the outsourced option delivers the following:

- Ability to generate income growth through sector experience,
- Ability to deliver cost efficiencies
- Ability to deliver savings through reduced NNDR costs
- Modernised (£20m +) facilities with a substantially lower risk of a detrimental VAT impact to the council and the ability to generate further growth as a result of this

4.0 RISK MANAGEMENT

1.12 Once the alternative treatment has been adopted it cannot be reversed. There is therefore the risk that if for any reason the outsourcing does not go ahead and a successful exemption claim is made, the council is locked in to this decision which will put the council in a unfavourable position in respect of undertaking any required capital investment under an in-house service (as illustrated in Table 1 above). This is because, under in-house services and the alternative VAT treatment, the partial exemption limit is triggered and sums are payable to HMRC when significant capital investment is undertaken.

1.13 In mitigation of this risk, the following has been acknowledged:

1.13.1 The council is well underway with the competitive dialogue process and have no indications at this stage that a contract will not be awarded.

1.13.2 The deadline for bidders to submit Detailed Solutions is 20 July 2018, meaning that officers will have an understanding of the level of quality of bids pre the final decision being made by Council on 11 September 2018.

1.13.3 The application to HMRC will take some time to complete before it is submitted, meaning that there is still time for the decision to proceed with the alternative VAT treatment to be reversed if necessary and before the application to HMRC is submitted.

1.14 Given the above, a recommendation will be made to Cabinet and Council to proceed with the VAT claim and ongoing alternative VAT treatment.

5.0 NEXT STEPS

1.15 The application process to make an exemption claim to HMRC requires for a number of steps to be undertaken and evidence prepared. As a result, VAT specialists from Ernst and Young, who are engaged to support the council in respect of the leisure project, will continue to assist the Head of Finance and her team in preparing a claim. The anticipated cost of preparing the claim and associated evidence is approximately £15k and will be absorbed within existing budgetary provision and off-set against the VAT reclaimed. Should there be additional support required in the event HMRC wish to further interrogate the claim, this will be called off on a day rate basis.

1.16 The decision to proceed with the claim for exemption will be presented to Cabinet on 24 July 2018 and finally to Council on 11 September 2018.

1.17 Proposals regarding use of the £1m reclaimed VAT will be subject to a future Cabinet decision, noting the intention to offset the costs of support required to make a successful claim as outlined in 5.1 above.