

# **FUTURE IMPACT OF LEISURE INVESTMENT AND ADOPTION OF THE EALING RULING ON THE AUTHORITY'S PARTIAL EXEMPTION CALCULATION.**

## **PURPOSE**

The report's remit is to determine the impact planned investment at the authority's leisure facilities will have when combined with the decision for the Council to adopt the Ealing VAT ruling on the overall right to recover VAT on all Council costs. This review models the potential level – currently advised – of VAT likely to be incurred on the proposed leisure redevelopments in the context of other known or budgeted VAT spending to support the delivery of current service plans across the Council.

The mechanism used to model the levels of VAT on costs which relate to potential areas of VAT Exempt income areas is the existing partial exemption method as set out in agreement with HMRC.

## **BACKGROUND**

All councils have areas of their activity which generate income which is treated as VAT Exempt. These income areas could be from the rent of offices or market pitches, burial & cremation income areas or tenancies on farms. Each council has to identify the VAT on its costs which are seen to support these Exempt income areas and then measure that level of Exempt VAT costs against a set measure to establish that these VAT costs can still be recovered from HMRC.

To date there has yet to be an instance where a council has been blocked from being allowed to recover these amounts of Exempt VAT costs as the set measure has not been breached.

### **What has changed?**

**Ealing Ruling** - Following the decision of the Court of Justice for the European Union (CJEU) in London Borough of Ealing, HMRC accepts that certain supplies of sporting services made by local authorities can be treated as exempt from VAT. The sporting exemption only covers supplies made to individuals participating in a sporting activity.

**Advantages of Ealing** – Any council which chooses to adopt this ECJ ruling can effectively enable the leisure services pricing structure to remain the same to the service user but the value within that charge that would have been treated as VAT payable to HMRC is no longer passed over to the tax authority.

HMRC accept that it is a decision for each council as to whether they choose to apply the VAT Exemption treatment available as a result of this case. In income terms it would put the council in the same position as charitable trusts that have been established to run leisure services.

In addition to this increase in retained income from leisure services going forward the ruling also gives the opportunity for the authority to submit retrospective claims for reimbursement of significant historical VAT overpayments – the VAT that it has already passed across on its leisure services income.

**Disadvantage of Ealing** – The adoption of Ealing will have the potential to increase the amounts of VAT on costs that will be related to VAT Exempt income areas. As the VAT treatment of the income changes from Standard rated to VAT Exempt then the proportion of exempt income over total income will significantly increase and in most cases double. The modelling suggests that, at most centres, the exempt income percentage will increase from 35% to 75%.

In such cases, any input tax (expenditure VAT) incurred on costs that are directly and immediately linked to the generation of exempt income streams (i.e. the Sporting Income areas) will similarly increase. This level of Exempt VAT cost would rise even further with capital expenditure on the leisure asset in addition to normal revenue spend in that sector.

### **Why would an increase in the level of Exempt VAT costs be a concern to the Council?**

The key concern for the council is that to safeguard our continuing ability to recover all the VAT we incur on our costs we need to ensure that the level of Input Tax we incur in relation to our VAT exempt supplies remains under a figure of 5% of ALL the Input Tax we incur in the year.

This 5% figure is the set VAT measure that is applied by HMRC – it is called the “de minimis” level.

If our Exempt VAT costs value in each year remains under 5% of all the VAT we incur on costs, we can still reclaim it from HMRC.

It is not just therefore the level of VAT exempt income that we generate that creates the issue but the level of Input VAT on costs which can be shown to support those VAT exempt income areas that creates the concern.

If we exceed the 5% Input VAT figure, we would potentially lose all that value in VAT recovery not just the VAT value over the 5% figure.

The most damaging effect would therefore be present where, having adopted the Ealing ruling to treat the leisure income as VAT Exempt, significant capital investment at these sports centres was then undertaken. For example; capital spend of £5 million net of VAT at a centre where 75% of income generated is VAT Exempt, will contribute 750k of Exempt VAT costs to add to the calculation an addition of approx. 5.5 % points.

Future planned capital programmes have been established from the capital plans and from discussions with related teams to inform this paper. These spending plans could create spikes in VAT costs within the VAT years which can be viewed in Appendix 1

## What can councils do to help manage spikes in spending in relation to VAT Exempt income areas?

### Seven Year Averaging Calculation

This calculation is allowed by HMRC to assist a Local Authority to manage breaches when they occur in a particular year respect of its partial exemption 5% calculation.

HMRC will allow that IF, despite detailed analysis of the amount of expenditure that you put to exempt use, the VAT you have identified still exceeds the 'insignificant' limit (5%) during the financial year, you may reconsider the position over a longer period of 7 years. Effectively flattening out the "spike" in the VAT Exempt costs value over this longer period.

At this moment in time HMRC do apply strict conditions when using the 7-year averaging.

- You must keep details of the calculation with your VAT records.
- HMRC reserves the right to revisit the question of whether a breach is **occasional** and **insignificant** if it subsequently turns out that a local authority miscalculated its percentage in any given year. The same applies where there's evidence of manipulation of figures.
- Any 7 consecutive years may be used as long as no more than 2 forecast years are included.

### What is the effect of choosing to apply the Ealing Ruling retrospectively?

As already noted, this potential change in the VAT treatment applied to leisure services income springs from a ruling obtained at the Court of Justice of the European Union by the London Borough of Ealing (Case C 633/15).

The decision, which has been accepted by HMRC is that the UK had incorrectly excluded local authorities from the exemption of charging VAT for the provision of sporting facilities. Local authorities had been excluded from the exemption to ensure that there was no distortion of competition. However, the court decided that any restriction on those grounds had to be applied to both public bodies as well as private non-profit-making bodies providing sporting facilities. It followed that the local authorities were entitled to claim direct effect and therefore to treat those supplies as exempt from VAT provided that they did so on a **consistent** basis.

The use of the phrase "consistent" is an important one to consider.

The ruling means that local authorities are entitled to recover any net over-declarations of VAT they have made as a result of having treated the supplies as taxable rather than exempt.

The net over-declarations are calculated **after** deducting from the over-declared output tax any input tax wrongly claimed in the prescribed accounting period (VAT return) on the assumption that the supplies in question were taxable and not exempt, unless that input tax is treated as insignificant. By “insignificant” this means that as long as the Exempt VAT costs were under the 5% de minimis level in that year or under the longer 7-year averaging calculation.

Should a council choose to apply the VAT change to their leisure income retrospectively then they may find that even when treating the income as now VAT exempt the level of VAT on costs that were linked to this exempt income would still remain under this 5% level. Therefore, the council would benefit from the refund of the overpaid VAT without having to repay any VAT on costs it had originally recovered.

Councils across the UK are able to access this option to change the treatment of leisure services income.

The “consistent” basis means that HMRC will expect any local authority which chooses to apply the Ealing ruling on a retrospective basis to benefit from the “windfall” of VAT overpaid MUST also continue to apply the VAT Exempt treatment on the leisure income on a going forward basis.

Protective appeals have already been submitted to HMRC by accountancy firm KMPG under instruction from the Council, in respect of the VAT amounts that would be due back to the Council from the retrospective application of the VAT Exempt treatment on affected leisure income with approximately nine months still to be submitted. The Council still needs to confirm with HMRC that they will be applying the change retrospectively in order for HMRC to consider the values included on the claims.

The estimated value of the above retrospective claims amount to potentially £2.2 million.

HMRC would undertake the due diligence in respect of the claims. Clearly the additional funding that this would create would be welcomed by the Council to support the Council’s current financial position and current and future challenges.

## **MODELLING METHODOLOGY**

A number of scenarios were modelled in respect of the Partial Exemption calculations going forward to identify potential areas of breaches of the 5% level and whether these breaches could be resolved to ensure the Council did not risk HMRC blocking the right to recover all our VAT on costs of providing our services.

These options included reviewing seven-year averages, sensitivity analysis and using a third party to complete the build and lease back of leisure centres to the authority.

The basis of each model is outlined below. All versions cover the periods 2012-13 to 2023-24 which is the known extent of budgeted capital plans.

- 1. Adoption of Ealing from April 2019** – This assumes Ealing to be adopted from April 1<sup>st</sup> 2019 and not applied retrospectively which would result in non-submission of claims for a VAT “windfall”.
- 2. Non-Adoption of Ealing** - Sporting services remain being charged at standard rated VAT - in effect retain the status quo.
- 3. Adoption of Ealing to allow submission of retrospective claims** – Relevant Sporting income would be treated as VAT Exempt historically and therefore an over claim of VAT paid would be made. Future leisure income would also have to be treated as VAT Exempt.
- 4. Outsourcing any Caldicot Leisure Centre Investment in isolation** – Adopting Ealing and submitting retrospective claims.
- 5. Outsourcing any Abergavenny Leisure Centre Investment in isolation** – Adopting Ealing and submitting retrospective claims
- 6. Outsourcing any Abergavenny and Caldicot Leisure Centre Investment** – Adopting Ealing and submitting retrospective claims
- 7. Bringing forward any Abergavenny Leisure Centre investment to commence in 2020-21 in line with the Caldicot Leisure Centre Investment.**- Adopting Ealing and submitting retrospective claims

## **ANALYSIS OF INITIAL MODELLING SCENARIO'S**

The initial modelling was completed on the three scenarios' below where comments on the impact of each approach have been included.

**Adoption of Ealing from April 2019** – This assumes Ealing to be adopted from April 1<sup>st</sup> 2019 and not applied retrospectively which would result in non-submission of the claims referred to above.

The model is not favoured by the authority as the potential benefit from submitting retrospective claims will not come to fruition. For obvious reasons and current financial constraints the importance of taking the opportunity to secure additional income where possible cannot be ignored.

**Non-Adoption of Ealing** - Sporting services remain being charged at standard rated VAT - in effect retain the status quo.

The authority would give up the opportunity to submit retrospective claims and also the non-adoption of Ealing would result in the authority losing the potential to increase revenue by 20% on their net position for sporting

services which are currently being charged with standard rated VAT rather than treated as VAT exempt.

### **Adoption of Ealing to allow submission of retrospective claims –**

Allows the benefits from the retrospective claims and exemption of the sporting services going forward to be obtained.

The risk that the Council has had to consider is whether this approach would expose the Council to losing the right to recover VAT on its costs in future years. Depending on planned spending levels coming to fruition it may arise that the partial exemption 5% limit could be breached in 2018-19, 2020-21 and 2021-22 with only the 2018-19 breach being able to be overcome by using the seven year average method.

All potential breaches are directly attributable to the leisure centre capital investments undertaken or proposed in these years.

2018-19 - Monmouth Centre and Pool  
2020-21 – Caldicot Leisure Investment  
2021-22 – Abergavenny Investment

After appraisal and discussion of the models by the project team, the decision was made to consider the adoption of the Ealing ruling retrospectively, submit retrospective claims and treat future leisure income as VAT Exempt. It would be essential to closely monitor VAT costs spent in these VAT exempt income areas and therefore as a matter of prudence the Council has undertaken a “look forward” approach at this current point.

A second stage of modelling was undertaken.

### **ANALYSIS SECOND STAGE OF MODELLING SCENARIO'S**

Due to the authority's preferred position of adopting Ealing retrospectively and submitting the claims which could result in triggering breaches of the 5% VAT limit, an adjustment to the model was needed to identify options which may reduce the risk of breaches.

It was decided to appraise the effect of outsourcing the build of the major leisure investments at Abergavenny and Caldicot in tandem or in isolation.

### **Mechanics of Outsourcing the construction and provision of the Leisure Centres to Alliance Leisure**

The spikes in the VAT costs being incurred by the Council are created by the fact that the Council is currently considering undertaking the construction of each centre themselves and therefore would incur the VAT on the build costs over a relatively short period of time – 18 months – 2 years in the case of each build. If the two

planned builds were to overlap then clearly this could increase the VAT spike for that year.

Therefore, from the VAT perspective, as the Council has the desire to operate the leisure services in-house and be accountable for the income streams this service will generate, we looked at mechanisms that would flatten those VAT costs spikes by spreading the costs over a longer period of time.

This could be achieved by contracting with an unconnected third party who would undertake to build the new centre and then lease that centre to the Council over a longer time period – 10/15/20 years.

The third party – in this instance we have used financial modelling on costs provided by a third party – would incur the VAT on the build costs and would be able to recover this VAT as they would be granting a lease to the Council on which they would charge VAT. The Council would then establish whether it would be able to recover this VAT as it would still relate to a VAT Exempt income area. The impact of a third party undertaking the new leisure builds and then leasing the assets to the Council are reflected below.

**1. Outsourcing the Abergavenny and Caldicot Investment – Adopting Ealing and submitting retrospective claims**

This option did resolve the potential of early partial exemption breaches but by committing to the outsourcing of both schemes this would put significant pressure on the partial exemption calculation for the next 25 years.

This approach could leave little contingency in terms of headroom for unforeseen events that could impact adversely on the partial exemption calculation. Under this model there is still a breach of the 5% limit in 20-21 and 23-24.

Any number of variable factors may have come into play by that date – an increase in the 5% limit for example – but these are unknown factors at this point.

This option would also severely restrict the flexibility of the capital programme in terms of investing monies in other exempt income generating projects e.g. County Farms, other Leisure Centres.

**Abergavenny/Caldicot Outsource**

Year	Type of Calculation	Exempt Input Tax	P/E	Best possible
		Potential Loss to the authority	Percentage 5% Ceiling	Seven Year Average
2019-20	Forecast	397,534.19	4.21%	

2020-21	Forecast		406,567.66	4.08%	
<b>2021-22</b>	Forecast		699,617.26	<b>5.04%</b>	4.45%
2022-23	Forecast		558,596.06	4.70%	
2023-24	Forecast		558,757.34	<b>5.02%</b>	4.91%

2. **Bringing forward the Abergavenny investment to commence in 2020-21 in line with the Caldicot Investment.** - Adopting Ealing and submitting retrospective claims.

The option was appraised using the both the outsourcing scenarios and both schemes remaining in house. The movement of the Abergavenny build forward by a year had little impact on the overall partial exemption position of the authority.

There were reservations on the mechanics of undertaking two major leisure investments in tandem and the impact this would have on Leisure Services across the authority.

3. **Outsourcing the Abergavenny Investment in isolation** – Adopting Ealing and submitting retrospective claims.

The approach produced positive results from a partial exemption perspective with a small breach in 20-21 due to the Caldicot build which if spending levels remain as budgeted, might not be managed by the seven-year average but would likely to be overcome by robust VAT management of the capital programme.

The negatives were the headroom for future partial exemption breaches due to the repayments being based on a 25-year term.

Year	Type of Calculation		Exempt Input Tax Potential Loss to the authority	P/E Percentage 5% Ceiling	Best possible Seven Year Average
2019-20	Forecast		397,534.19	4.21%	
2020-21	Forecast		<b>1,181,702.38</b>	10.74%	<b>5.21%</b>
<b>2021-22</b>	Forecast		645,495.53	4.68%	
2022-23	Forecast		504,474.33	4.27%	
2023-24	Forecast		504,635.61	4.57%	



**4. Outsourcing the Caldicot Investment in isolation – Adopting Ealing and submitting retrospective claims.**

This approach also produced positive results from a partial exemption perspective with a small breach in 21-22 due to the Abergavenny build which could not be managed by the seven year average but would likely to be able to overcome by robust VAT management of the capital programme.

It also provided a greater contingency in terms of headroom for future partial exemption breaches in comparison to the other outsourcing models.

Year	Type of Calculation	Exempt Input Tax	P/E	Best possible
		Potential Loss to the authority	Percentage 5% Ceiling	Seven Year Average
2019-20	Forecast	397,534.19	4.48%	
2020-21	Forecast	406,567.66	4.08%	
<b>2021-22</b>	Forecast	<b>1,544,439.26</b>	10.29%	<b>5.24%</b>
2022-23	Forecast	487,294.25	4.14%	
2023-24	Forecast	487,455.53	4.42%	

**SENSITIVITY ANALYSIS CALDICOT OUTSOURCE MODEL**

Further analysis was undertaken in respect of the Caldicot model in terms of projecting the increased level of exempt input tax which would cause a partial exemption breach to occur.

The results identified there was headroom for increased level of exempt input tax but this contingency would be significantly impact upon by which service incurred the additional expenditure e.g 250 k additional spend in a leisure centre environment would attribute 36k to the partial exemption calculation approx. 0.3% points the same spend at a school would only allocate £500

The reduction of capital net spends was also modelled to identify when a breach would occur. As with the above headroom was present for capital expenditure to decrease and directly impact adversely on the level input tax the authority recovers as a whole which is the denominator for the partial exemption calculation.

**OTHER IMPACT FACTORS /ASSUMPTIONS**

The Council has had to consider the longer term impact of the adoption of the Ealing ruling as well as the current budgeted levels for capital spending on leisure sites

going forward. There are a range of factors that will influence the reality in each year of the levels in VAT exempt costs that will be identified. These factors are considered below.

### **HMRC Negotiation.**

The claims will be submitted to HMRC by the Council's advisers, KPMG once the decision is made to retrospectively apply the Ealing ruling. The authority's VAT accountant will need confirmation from the authority's section 151 officer once a decision has been made on how the authority wishes to proceed.

The claims will be subjected to compliance checks by HMRC officers. Timelines for this review of a claim can vary and will depend on issues raised. Six months from submission date to payment would be a fair estimate.

### **Capital Programme Calculations – Impact factors/assumptions**

- The accuracy of the capital programme in terms of costs and profiling are key when forecasting the potential impact on the partial exemption calculations to highlight potential years when a breach of the 5% limit will arise.

At present the key projects are the leisure investments at Caldicot and Abergavenny where increased costs would have a negative impact and vice versa for decreased costs.

Year 20-21 – Caldicot Investment Potential Outsourcing

Year 21-22 – Abergavenny Investment £6.5.million

- Projects where significant VAT costs would be incurred but these are in areas where there is little or no VAT exempt income generation - such as the Abergavenny Band B School development would have a significant positive impact on the partial exemption calculation. These type of projects would increase the total value of input tax over which the Exempt VAT cost value is placed thus reducing the Exempt Input Tax % in that period.

Year 20-21 to 23-24 – Approx. £42 million investment Abergavenny Band B

It has been assumed the Asset Investment fund will continue to purchase property letting businesses under the VAT arrangements known as "Transfers of a Going Concern". Meeting the conditions of a "going concern" from the VAT perspective can mean that no VAT is charged on the acquisition of those property letting businesses.

It would be a consideration in future to not use this "going concern" VAT route to purchase business ventures where possible if this would boost the denominator VAT value in the partial exemption calculation. This would assist with the 5% VAT calculation.

- The capital programme for 23-24 is estimated to incur a minimum £20 million net spend. This assumes other grant funded or authority funded capital

schemes will be present in addition to the core capital programme currently modelled over the medium term.

### **Ealing Adoption.**

- The 01/04/2019 date has been used for the modelling. It is now estimated Ealing will be implemented from 01/11/2019 with previous periods subject to retrospective claims

### **Unplanned Aspects.**

- Whilst actual capital expenditure could fall below those modelled in these calculations there is also the risk of overspend.
- Other areas could generate exempt Input Tax on an unplanned basis as seen with the major works incurred on Small Holdings insurance claim recently.

### **Summary of Mitigating options if the Council chooses to apply Ealing on a Going Forward Basis:**

- Flatten the level of VAT spikes in capital spend in-house by using third parties to develop the assets which would be leased into the council to run.
- Schedule in-house delivery of leisure capital projects over a longer time period to reduce the seven-year average impact
- Review the TOGC options to identify if investment purchases need to follow this path, this would allow the authority to boost Input VAT into the partial exemption calculation but application of this is unknown at present.
- Robust VAT management specifically in respect of the capital programme and potential exempt income generating schemes. Including early intervention and appraisal of the VAT implications of future schemes before commitment to those schemes can be given.

None of these mitigating options represent anything more than prudent planning considerations to safe guard the overall ability of the Council to recover VAT on its costs which in the absence of that VAT recover would create an additional cost burden.

The Council has a good working relationship with HMRC and is consistent in its approach to take all reasonable care in ensuring it achieves a complaint VAT management position which would not risk challenge by HMRC.

