



## Budget Representation: Reforms to VAT and the Public Sector

20 January 2017

## About ICAS

1. The following representation has been prepared by the ICAS Tax Board. The Board, with its five technical Committees, is responsible for putting forward the views of the ICAS tax community, which consists of Chartered Accountants and ICAS Tax Professionals working across the UK and beyond, and it does this with the active input and support of over 60 committee members. The Institute of Chartered Accountants of Scotland ('ICAS') is the world's oldest professional body of accountants and we represent over 21,000 members working across the UK and internationally. Our members work in all fields, predominantly across the private and not for profit sectors.
2. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. From a public interest perspective, our role is to share insights from ICAS members into the many complex issues and decisions involved in tax and financial system design, and to point out operational practicalities.

## What is the public sector?

3. For the purposes of this representation the term is used to cover all not for profit organisations, including:
  - Central Government
  - Local Government
  - The public health sector – the NHS.
  - The public education sector, and
  - Charities.

## VAT treatment of the public sector: distortions and complexities

4. In the past, many services were delivered by local authorities, government bodies or the NHS, ie bodies within the provisions of sections 33 and 41 of the VAT Act allowing VAT to be recovered in certain circumstances. Due to constraints on public spending and pressure to achieve efficiencies it is increasingly common for the provision of the same services to be transferred to other not-for-profit entities, including charities, that do not fall within sections 33 or 41.
5. The UK VAT regime for the public sector is not fiscally neutral because the different VAT status applicable to different parts of the public sector provides a VAT recovery shelter for some organisations but not others – even though they are delivering the same services to the same end users.
6. VAT cost sharing was introduced in the UK in July 2012 to allow independent groups of persons to form cost-sharing groups to provide shared services without charging VAT. This does not address the limited scope of sections 33 and 41 but should have helped not-for-profit organisations to minimise irrecoverable VAT. However, take up has been low because of the onerous nature of some of the conditions and uncertainty around EU infraction proceedings against other jurisdictions. There have also been problems for some not-for-profit entities trying to use cost sharing, due to the complexity of the regime which concentrates on anti-avoidance rather than helping organisations to cost share.
7. ICAS produced a detailed paper on VAT and the Public Sector in 2014. This included a detailed analysis of the distortions and problems arising from the UK approach to VAT and the Public Sector. A substantial extract from this paper appears in the Appendix to this representation and includes detailed examples of the VAT problems and additional costs caused by the current UK rules applying to different public sector bodies.

## **Costs and value for money**

8. Taxpayers' money is being used to provide public services. Where the provision of services is transferred from a body within s33 or s41 to another not-for-profit entity outside these provisions and so unable to benefit from the VAT recovery, it will increase the cost of providing the service by up to 20%. Increasing the cost of providing a public service is not a desirable outcome; increased VAT receipts for the Treasury will be offset by increased costs for other government departments/local authorities - or service levels will be reduced.
9. It may be possible to put in place arrangements to mitigate the VAT impact of the provision of services by a different body (see Categorisation examples 1 and 2 in the paper contained in the Appendix), but this in itself costs money for advice, implementation and agreeing the tax treatment with HMRC. In some cases, there will also be ongoing costs of operating what can be complex arrangements. It is not a good use of taxpayers' money for HMRC and bodies providing public services to be devoting time and incurring costs trying to get round problems caused by the fact that the underlying VAT regime for the public sector is not fit for purpose.
10. The use of arrangements to mitigate the VAT impact may also give rise to disputes between HMRC and public sector bodies. Both parties then incur additional costs (paid for by taxpayers) and may become involved in litigation – leading to publicity and giving a poor impression to taxpayers. In view of the public sector procurement rules there may also be issues for entities who use complex VAT arrangements to get the best possible return for public expenditure.
11. The differences in VAT recovery act as a disincentive to implementing new and innovative service delivery models across the public sector.

## **Actions the government could take**

12. Undertake a fundamental review of the current VAT regime for the public sector to address complexity and provide a level playing field for all organisations in the sector. The wider VAT reforms likely to arise from Brexit offer a good opportunity to consider a new approach.
13. Introduction of additional targeted refund schemes as a short term interim measure. Various targeted refund schemes have been introduced, for example, for UK search and rescue and air ambulance charities and for hospices. Whilst this piecemeal approach is ultimately unsatisfactory because it fails to address the underlying problems, additional targeted schemes would be useful in the short term.
14. Improve the cost sharing regime by relaxing the onerous conditions for not-for-profit entities and charities - and changing the focus for these bodies to provide help rather than concentrating on anti-avoidance. Currently, this would be subject to the constraints of EU law but post-Brexit there would be scope to go further.
15. Mandate HMRC to set up a specialist team to administer VAT in the public sector. There is a very strong argument for HMRC to treat the public sector as a special sector administratively and to have dedicated resources for dealing with its issues. A dedicated HMRC team open to discussion with public sector bodies and their external advisers would help to address issues consistently and to minimise expenditure of public money on disputes around complex VAT queries.

## **Appendix: Extract from the ICAS 2014 Paper: VAT and the Public Sector**

### **1. BACKGROUND**

In April 2014 ICAS responded to a consultation issued by the European Commission on the impact of the current VAT system on public sector organisations<sup>1</sup>. This project identified a number of areas in the UK's system where the current rules give rise to distortions in the way that different parts of the public sector are subject to VAT on essentially the same transaction. ICAS has been asked by its members to look in more detail at the position and identify areas where the UK Government should focus its attention on ensuring a level playing field across the public sector.

Our focus in this area has also been informed by the public sector procurement rules. These rules were changed from 1 April 2013 for central government contracts of more than £5 million and require bidders for these contracts to self-certify their tax compliance as part of the tender process. The introduction of these rules has had an impact across the public sector and many organisations find themselves in the position of needing to include information on tax compliance on tenders to national governments. This is against a background where there may be strategies adopted by public sector organisations to maximise VAT recovery that appear to be in contravention of this rule, even where these are treated as acceptable tax planning by HMRC.

#### **Definition of public sector**

The term “public sector” needs to be clarified. We are using this term in this paper to cover all not for profit organisations as the VAT issues are common across the sector. We have used the term to include:

- Central Government.
- Local Government.
- The public health sector – the NHS.
- The public education sector.
- The charitable sector.

### **2. UK LEGISLATION – CATEGORISATION OF VAT ENTITIES**

The UK has applied article 13 of the European Directive<sup>2</sup> by implementing specific rules regarding the VAT treatment of public sector organisations which splits these organisations into four types:

- Local Authorities and similar organisations (including the BBC) – section 33 VATA 1994 allows these organisations to recover all VAT incurred on activities related to the non-business functions of the organisation. There can be issues where the organisation receives non-statutory sources of income where these new activities are outside the scope of section 33.
- Government departments and the NHS and associated organisations – Section 41 VATA 1994 allows these organisations to recover input VAT in certain circumstances but they cannot recover VAT on non-business activities. The Treasury lists the services on which these departments are able to receive funding to compensate for irrecoverable VAT in the London, Edinburgh and Belfast Gazette.

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<sup>1</sup> A copy can be found at <http://icas.org.uk/Technical-Knowledge/Tax/Consultations-and-Submissions/>

<sup>2</sup> The text of the Article is as follows:

“States, regional and local government authorities and other bodies governed by public law shall not be regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with those activities or transactions.

However, when they engage in such activities or transactions, they shall be regarded as taxable persons in respect of those activities or transactions where their treatment as non-taxable persons would lead to significant distortions of competition.

In any event, bodies governed by public law shall be regarded as taxable persons in respect of the activities listed in Annex 1, provided that those activities are not carried out on such a small scale as to be negligible”.

- Other public sector organisations – these are organisations that do not have any specific provisions that allow them to recover VAT on their activities which are for the public good. These organisations use the standard income method to split their activities between business and non-business, and operate an appropriate partial exemption method to determine what input tax can be recovered. In the UK organisations dealt with under these arrangements are mainly charities, housing associations, universities. In effect, these public sector bodies are not treated under article 13 as they are not “bodies governed by public law” as defined by the Principal VAT Directive.
- Non-Departmental Public Bodies (NDPBs) which are effectively a separate category for VAT purposes. These are organisations which have a role in the processes of government, but are not a Government Department or part of one, and which accordingly operate to a greater or lesser extent at arm’s length from Ministers. As these organisations are separate from central government they do not benefit from the section 41 treatment unless they are Crown NDPBs. An NDPB is only able to register for VAT where it makes taxable supplies and can only recover VAT in connection with those supplies and its residual input tax allocated to those supplies under the partial exemption method adopted. This can be a very complex area as the funding of NDPBs relies on grants from Government and often this funding is calculated on the basis that VAT can be recovered in line with section 41 VAT 1994. It is only once plans to transfer services to the NDPB are advanced that VAT is considered and there can be significant issues to overcome in this area.

### 3. IMPACT OF UK LEGISLATION ON CATEGORISATION

To demonstrate how these regimes would work in practice, consider the example of an organisation in each category incurs £1,000,000 input tax on implementing a new payroll solution across the organisation where the work was outsourced to an external contractor. The VAT recovery position would be:

- Local authority – would be able to recover the £1,000,000 in full under the terms of section 33.
- Central government, NHS – would be able to recover the £1,000,000 in full under the terms of section 41 provided the services were covered by the Treasury List.
- Other public sector organisations – universities, charities etc – if the organisation was able to be VAT registered the £1,000,000 input VAT would be treated as belonging in the partial exemption “pot”. Partial exemption is the method used to allocate input tax incurred on general activities in proportion to an organisations ratio of taxable supplies to total supplies. These types of organisations will have predominantly exempt supplies so full recovery is not possible. Assuming a recovery rate of 15% (this figure is illustrative of the VAT recovery rate for the sector) would mean that the organisation would only be able to recover £150,000 of the VAT incurred, leaving it with a balance of £850,000 to cover with funding from other sources.
- NDPBs - if the organisation was able to be VAT registered the £1,000,000 input VAT would be treated as belonging in the partial exemption “pot” with similar issues as above. The partial exemption rules would apply to these organisations but as they carry out government functions which are non-business for VAT, they are unlikely to have very significant levels of taxable supplies. Assuming a recovery rate of 5% (this figure is illustrative of the VAT recovery rate for the sector) would mean that the organisation would only be able to recover £50,000 of the VAT incurred, leaving it with a balance of £950,000 to cover with funding from other sources.

This example demonstrates the wide variation across the public sector and the value to the organisations of the statutory shelters in sections 33 and 41. It also illustrate the issues associated with transferring responsibilities from within government to new organisations – either NDPBs or other types of organisations – and the impact on funding for the new organisations.

The VAT cost is a significant burden, and at the moment these rules act as a disincentive to implementing new strategies for delivering public services. There is not a level playing field across the public sector and we believe it is time to address this issue within the UK.

To try and illustrate how this affects the running of the public sector we have looked at two scenarios where the same transaction carried on by bodies with differing status has a very different tax impact.

## **1. Categorisation example 1 – social housing**

The first example is the provision of social housing which is exempt from VAT in the UK. Where the housing is provided by a local authority they are able to recover the VAT incurred on repairs and maintenance under the generous partial exemption de minimis rules available to local authorities. If the same housing is provided to the same tenant by a Housing Association they are not able to recover these amounts of VAT. A Housing Association is generally a not-for-profit body which may have charitable status and is likely to receive public money; many evolved from the outsourcing of social housing provision in the UK.

The VAT anomaly can lead to issues when there are transfers of social housing stock from the local authority sector and where the successor landlord does not benefit from the local authorities' VAT shelter outlined above. This can result in convoluted structures to allow the repair and maintenance obligations to remain with the local authority so that VAT can be recovered as the cost of making a complete transfer of all obligations is the 20% of VAT incurred on repairs and maintenance. There are significant professional and legal costs associated with structuring the transaction in this way. The bulk of these costs are on the initial transaction but there are on-going compliance costs.

To give some idea of the financial impact of the VAT in these cases we have looked at the VAT costs of refurbishment programmes under housing stock transfers from Glasgow City Council. The technical issue concerned the recovery of VAT on future refurbishment costs associated with the social housing. As noted, housing associations do not fall into the section 33 shelter available to local authorities and cannot recover VAT incurred on refurbishment work. The additional cost of this VAT threatened the financial viability of the transfer of social housing stock and the third party funders pushed for action to mitigate this cost so the transfer could proceed. A structure was designed, with HMRC consent, to effectively allow the cost of refurbishment to remain with the local authority.

Glasgow Housing Association acquired the social housing stock of Glasgow City Council in 2003 with an intended budget of £1.47 billion for refurbishment costs. The level of future costs anticipated on refurbishments where Glasgow Housing Association includes both the debtor due from Glasgow City Council and the creditor for future upgrades disclosed at 2012 is £250 million.

As indicated by the example above, it is possible to enter into contractual arrangements which benefit from the VAT recovery position of the local authorities. However, without detailed approval from HMRC this type of tax planning could be seen as falling foul of the guidelines included in the Treasury document "Managing Public Money" issued in April 2013 which states at paragraph 5.6.1:

"Public sector organisations should not engage in, or connive at, tax evasion, tax avoidance or tax planning..... artificial avoidance schemes should normally be rejected".

The guidance notes that tax advisers can be used for normal compliance activity but it casts doubt on the ability of Government bodies, including NDPBs, to adopt planning strategies which are justifiable in terms of deliverables and governance if one of the aims is also to maximise the VAT recovery on their activities. There is a tension between this requirement and the need to use public money effectively. Paying more tax than is required could be the result of this tension.

## **2. Categorisation example 2 – "relevant residential purpose" or "relevant charitable purpose"**

The other example to consider is the provision of accommodation for "relevant residential purposes" or "relevant charitable purposes". Where the developments falls within either of these categories the construction work will be zero-rated with no VAT cost charged on construction costs from the main contractor. This zero-rating covers most work on student accommodation for Universities and work for charities on providing premises to be used for the non-business activities of the charity.

On substantial capital projects of this nature there are normally significant costs from architects, surveyors and other consultants which cannot be treated as part of the construction and are subject to VAT at 20%. If these costs are incurred by either a university or charity the VAT incurred would not be recoverable.

The approach to this that has been used is for the university/charity to set up a separate subsidiary to act as the main contractor on a design and build contract for the organisation. This structure allows the subsidiary to use the composite supply rules to zero-rate the whole supply it makes to the organisation – so it is able to recover all the VAT incurred on associated architects, surveyors' etc. costs. Using a separate subsidiary is the method used to ring-fence the property activity and make sure that the VAT can be recovered while giving the organisation the control over the appointment of main contractors on the project and apply for funding for the project while under the control of the organisation.

This is a normal planning strategy, and has been accepted by HMRC. HMRC reviewed the position in 2011 as a result of the Talacre case at the European Court of Justice (C-251/05) and after discussion with the Charity Tax Group decided that the treatment as a composite supply would be available for zero-rated construction services in Group 5 Schedule 8 VATA 1994. The Charity Tax Group took Counsel's opinion on the issue as part of their discussions on the issue and HMRC accepted that the Talacre judgement.

### **3. PUBLIC SECTOR PROCUREMENT RULES**

As the planning for transfer of housing stock outlined above demonstrates, this is tax planning by the public sector to enhance VAT recovery. The procurement rules across the whole public sector will require organisations to consider whether they can justify the use of this type of planning to eliminate VAT costs on property transactions. To the man in street, the use of a single purpose vehicle property development company can look like part of an avoidance scheme and using this type of structure does not add to overall transparency. There is now a tension between planning for financial viability and the need to be seen to be tax compliant even if this would mean a higher tax bill for the organisation.

### **4. ADMINISTRATIVE COMPLEXITIES**

#### **4.1 Business and non-business activities**

There are further layers of complexity in VAT recovery for public sector organisations in dealing with VAT. The first step is that these organisations will be involved in splitting their activities between business activities and non-business activities. This is a complex area in itself and there is a wealth of case law that covers the issue, along with a full manual of guidance for HMRC staff at <http://www.hmrc.gov.uk/manuals/vbnbmanual/index.htm>.

#### **4.2 Partial exemption**

Once this has been calculated the organisation then has to consider its partial exemption position applicable to its business supplies. A large number of public sector organisations are partially exempt – their supplies for VAT purposes include both taxable supplies and exempt supplies – and they are required to agree a formula with HMRC for apportioning the input VAT that is incurred across the business activities of the organisation between its taxable activities and its exempt activities.

This can be a very complex process and involves work to ensure that the accounting system and the staff who operate the system can distinguish between taxable and exempt supplies and purchases. For example, it becomes important that income from car parking activities is allocated to either taxable or exempt for some organisations. The operation of the partial exemption scheme is dependent on this level of detail being available to complete the calculation for all public sector bodies.

### **5. ADMINISTRATIVE COMPLEXITY PARTICULAR TO THE PUBLIC SECTOR**

There are a number of areas where there are particular problems for public sector bodies as a result of the complexity of UK VAT regulations and this paper will now go on to consider these in more detail to give a flavour of the types of issues that these organisations have to deal with in practice. The examples to be covered are:

- Issues around prescribing within the NHS.
- Issues around cost sharing across the public sector.

## **Administrative complexity example 1 - prescribing within the NHS**

The NHS is treated in a very complex way by the VAT rules and their interpretation by HMRC. We are focusing on the issue of prescribing within the NHS as a discrete issue but in the bigger picture the rules around partial exemption calculations and the interaction with contracted out services cause significant practical issues for the day to day running of the NHS. The HMRC guidance on this issue is here <http://www.hmrc.gov.uk/menus/frame-nhs.pdf> and gives some flavour of the issues and problems associated with this area

As noted above the NHS is a section 41 organisation and is able to recover input VAT in certain circumstances. For most of the organisations covered by section 41 the supplies they make are outside the scope of VAT or exempt so there is no requirement to account for VAT.

Prescription services offered by the NHS are zero-rated for VAT in certain circumstances under Group 12 of Schedule VATA 1994. This means that the VAT incurred in purchasing the medicine can be recovered while there is no VAT to be accounted for on any prescription charges.

The UK legislation in this area applies the zero-rating as follows:

“1) the supply of any qualifying goods dispensed to an individual for that individual's personal use on the prescription of an appropriate practitioner where the dispensing is:

- a) By a registered pharmacist; or
- b) In accordance with a requirement or other authorisation under a relevant provision”.

There is HMRC guidance which defines the terms used in the legislation so that most prescriptions issued under the NHS prescribing guidelines fall into this zero-rating. It is worth noting that drugs and medicines supplied in hospital are treated as part of a supply of healthcare to the patient which is outside the scope of VAT and the VAT incurred by the hospital on these drugs and medicines cannot be recovered by the NHS.

However, there are developments in the ways that prescriptions are issued by the NHS in line with policies to try and reduce the pressure on general practitioner workloads. One of the areas that is causing difficulties from a VAT perspective is prescribing by local clinics for medicines to be used by non-named individuals, and thus outside condition one. This occurs for many emergency prescriptions such as for drug treatment where the clinic is not able to get a suitable prescription for the individual. If the conditions cannot be met, the supply is treated as standard-rated so that the clinic is required to account for VAT on the cost of the drugs or medicine and this can create significant problems.

There are plans to expand the powers of local clinics in this area, and it is likely that they will be able to issue emergency prescriptions for a wider range of drugs and medicines, including expensive cancer treatment drugs. This additional VAT cost will have significant impact on funding for the NHS and it is vital that HMRC adapt their guidance to ensure that it reflects an up to date approach to prescribing within the NHS.

## **Administrative complexity example 2 - cost sharing across the public sector**

In July 2012 legislation was passed that allows an independent group of persons to form cost-sharing groups to provide shared services without charging VAT in line with Article 132.1(F) of the Principal VAT Directive. Until this legislation was introduced, organisations were able to set up cost-sharing groups but the services provided by the cost-sharing group were subject to VAT which is a disincentive where organisations are not able to fully recover VAT. The legislation is intended to combat this position and allows the cost-sharing group to treat its services as exempt from VAT. This VAT exemption gives the group the scope to realise the savings of shared services without the additional VAT costs.

The UK legislation is rules based and is included in Group 16 Schedule 9 VATA 1994. The primary conditions are as follows:

- There must be an independent group of persons supplying services to persons who are its members.
- All the members must carry on VAT exempt and non-business activity.

- The services supplied by the cost-sharing group must be directly necessary for a member's exempt and/or non-business activity.
- The Cost-sharing group must only recover the member's individual share of the expenses incurred by the cost-sharing group in making supplies to its members.
- The application of the exemption to the supplies made by the cost-sharing group must not likely to cause a distortion of competition.

As with most rules-based tax legislation the terms used are further defined, and these impose additional conditions for organisations who are considering whether a cost-sharing group would be appropriate to their circumstances. The conditions outlined above include a requirement that the services supplied are "directly necessary" to a members exempt and/or non-business. HMRC interpret this as requiring that the organisation has exempt/non-business activity which represents at least 85% of the total activities.

For many Higher Education Institutions and charities, this limit is very problematic as they are actively involved in trying to generate more business income to address funding concerns – through business partnerships, holiday rentals, consultancy work etc. The conflicting demands of funding issues for the organisation may mean that it cannot satisfy this test and it cannot be involved in cost-sharing groups. The 85% threshold is not included in the Principal VAT Directive and was included by HMRC primarily to prevent organisations with higher levels of taxable activity using this as an opportunity to manage their VAT position.

The conditions outlined also illustrate the complexity of the legislation for the public sector. To be able to determine if they are within the conditions the organisation must undertake a number of calculations using accurate and reliable information and understand all the strands of its activities. This ought to be straightforward – but as recent Tribunal cases such as Brockenhurst College TC02569 demonstrate, this is still an area where organisations need to keep up to date with developments.

This rules based interpretation of the Principal VAT Directive into UK legislation illustrates some of the major issues for the public sector. The UK legislation is driven by rules rather than principles and these particular rules narrow down at each stage of the process the organisations that are eligible for the shelter provided. The legislation does not focus on helping organisations to cost-share and includes anti-avoidance rules within the relief granted – the 85% test and the requirement that this exemption does not distort competition. The underlying attitude which appears to be evidenced by the legislation is that organisations are trying to take advantage of the VAT system, when in fact most organisations are trying to understand and comply with their responsibilities under the UK's tax laws.