Charity Tax Commission Call for Evidence

RESPONSE FROM ICAS TO NCVO

5 July 2018

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Background

ICAS is a professional body for more than 21,000 world class business men and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business and in the not for profit sector; many leading some of the UK's and the world's great organisations. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have around 3,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

Introduction

The ICAS Charities Panel and the ICAS Tax Board welcome the opportunity to respond to the NCVO Charity Tax Commission's Call for Evidence.

We believe that it is appropriate to review charity tax reliefs given that 20 years have passed since the previous review.

While we understand that the Commission is keen for any recommendations arising from its eventual findings and conclusions to be fiscally neutral, we believe that this should not be the only measure used to prioritise areas for reform. The bigger role charities now play in the delivery of public services and the shift from grant funding to commissioning, has brought into focus the VAT status of charities relative to other entities, where the current arrangements are, in themselves, not fiscally neutral.

Our more detailed comments are set out overleaf.

Any enquiries should be addressed to Christine Scott, Head of Charities and Pensions, at cscott@icas.com

Scope of the review

While the scope of the review sets out some of the main areas where tax relief is available to charities and some more minor ones, there are some notable gaps. This illustrates that it may not be possible to quantify in full the overall value to the UK charity sector of charity tax reliefs or, conversely, the tax burden on charities.

Charities are normally exempt from income tax and corporation tax (and benefit from 'corporate Gift Aid'), but these are not mentioned in the call for evidence. These reliefs are not formally applied for by charities and charities are not routinely required to submit a self-assessment form or CT600, therefore, assessing their value would probably produce a rough estimate at best. Conversely, this means that any losses are not tax relieved.

We believe it is worth highlighting that charities pay employers' National Insurance as any employer must do. We are not recommending the introduction of a concession here but in terms of giving a full picture of charities and tax, this is an important element. Also, while not a tax, some larger charities are required to pay the apprenticeship levy which is re-distributed across employers to fund apprenticeship schemes. We would be keen to understand the extent to which the charity sector has benefited from the re-distribution of apprenticeship levy monies and if the benefit is equivalent to the amount raised from the sector. While the apprenticeship levy is a UK-wide levy, its distribution is devolved to the Scottish Government. Anecdotally we are aware that there have been short-comings in the mechanism for distributing apprenticeship levy money in Scotland.

It is questionable whether the apprenticeship levy is a charge it is reasonable to place on charities. For charities subject to the levy which are largely donor funded, donors may reasonably expect that their contribution is applied to the charity's purposes. For those charities providing public services, the levy is effectively being recycled back to the public purse. It would be useful to know the cost of the apprenticeship levy to the UK charity sector, compared to the amount received by the sector to fund apprenticeships.

The review is also silent on the impact of tax devolution on charity tax and charity tax reliefs; the impact of tax devolution is relevant when considering Gift Aid, business rates relief and stamp duty land tax (SDLT). Land and buildings transaction tax (LBTT) is the tax which replaced SDLT in Scotland.

Balance of tax reliefs between donors and charities

While we are fully supportive of the principle of tax incentives to encourage giving to charity, we feel there is a case for a review of the balance of tax reliefs to donors on the one hand and charities on the other.

Gift Aid is particularly complex in this respect with the basic rate relief provided to the charity and any higher rate relief available to the donor through self-assessment. This is further complicated for Scottish donors (as noted below), as fewer Scottish taxpayers now have a marginal tax rate which is the same as the UK basic rate. Research has shown that the higher rate relief to donors does not deliver additional charitable giving commensurate with the cost to the Exchequer: the Commission should consider the implications of this in its final report and recommendations. We set out more details about the research under the heading 'Gift Aid'.

Payroll giving is straightforward in that the tax relief is entirely to the donor, but this needs better explanation in order to encourage donors (especially taxpayers above the basic rate) to understand that they are only pledging a gross amount to the charity and the net cost to the donor will be considerably less. We suggest consideration of changes to allow payroll-giving donors to pledge the net amount they wish to give to charity (which would then be grossed up as part of the payroll giving computations).

In the case of Inheritance Tax (IHT) relief on charitable bequests, we note that recent changes to the IHT regime have led to some increases in charitable legacies – which we welcome. However, there may be scope for further targeted measures to encourage those with estates below the IHT threshold (soon to be £1 million for some couples where RNRB is available) to leave a legacy to charity.

Strictly speaking any further measures would not be tax reliefs, but there are situations where the Exchequer subsidises certain behaviours which are socially desirable by granting something similar to tax relief even for non-taxpayers. The Gift Aid small donations scheme (GASDS) is an example of this. This scheme is funded through Grant in Aid i.e. public expenditure rather than the traditional Gift Aid.

We recognise that ultimately the Government will need to decide if it wishes to provide further incentives for legacy giving; this would need to be weighed against the cost of establishing and running a system for administering a new scheme.

VAT

We are surprised that the estimated cost to the sector in irrecoverable VAT is as low as £1.5 billion and believe that it may be higher. We question whether the information collated by HMRC to produce this estimate is sufficiently complete.

We believe the Government should undertake a fundamental review of the current VAT regime for the public and charity sectors. We set out our justification for this and other recommendations in a Budget representation made by the ICAS Tax Board to HM Treasury entitled 'Reforms to VAT and the Public Sector' on 20 January 2017. A copy of the representation is included in Annex 1.

Gift Aid

The devolution of income tax powers
The partial devolution of income tax to Scotland through the ability of the Scottish Parliament to set income tax rates and bands, means that there is a weakening of the link between the donation and the tax forgone for Scottish taxpayers, whether they are donating to a Scottish charity or a charity based in another part of the UK.

The current position of the UK Government is that charities can continue to reclaim Gift Aid on donations at the UK basic rate: this position was confirmed following the Scottish Government's 2017 Budget, where a proposal to vary Scottish income tax rates and bands from those in the rest of the UK was made for the first time. The Budget was subsequently approved by the Scottish Parliament.

The ICAS Charities Panel (formerly the ICAS Charities Committee) responded to a consultation on this topic back in 2011. This is attached in Annex 2. This response pre-dates the additional tax powers devolved by the Scotland Act 2016 and sets out the pros and cons of the pragmatic approach currently being followed. However, the response illustrates the length of time that this has been an issue and there is a question mark over how sustainable this approach will be if income tax rates and bands diverge more substantially in future.

Cost of higher rate tax relief
Research has found that for every £1 spent on tax relief to higher rate taxpayers, only 35p was generated for charities. The main evidence base is the research conducted by Professors Kimberley Scharf and Sarah Smith for HMRC. It can be accessed directly at
https://warwick.ac.uk/fac/soc/economics/staff/kascharf/itax-scharf-smith.pdf

A more detailed report on the study by Kimberley Scharf and Sarah Smith is also available as a report from the Institute of Fiscal Studies:
https://www.ifs.org.uk/wps/wp1007.pdf

These findings were supplemented by more recent work by the same authors, supported by National Audit Office analysis of tax returns which was reported in a Civil Society news item:
https://www.civilsociety.co.uk/news/tax-reliefs-for-rich-increase-charitable-giving-study-says.html

Without drawing any conclusions on the implications of this key finding at the present time, the research should at least be considered by the Charity Tax Commission when it considers any recommendations to Government on the reform of Gift Aid.

Gift Aid small donations scheme

With relief of only £29 million arising from the GASDS, we feel there is scope to extend the scheme further. The current limits are extremely low and do little to address the intended purpose of GASDS, which was to offer some support from the Exchequer for charities receiving significant amounts of income through cash donations in circumstances where it is not practical to seek Gift Aid declarations.

The current rules are complex and still present significant challenges, in spite of the changes made in 2016 and 2017. We therefore suggest that further simplification could increase the uptake of the scheme, provided this could be achieved without increasing the risk of fraudulent claims.

Business rates relief

We believe that business rates relief is vital to the sector and we would not support any further steps to restrict its availability, should these be proposed.

In Scotland, the Barclay Review made several recommendations to restrict the availability of business rates relief to certain types of charity. The Scottish Government has set out its response to the review. A significant number of the Review's recommendations were rejected but changes are planned to the availability of business rates relief to independent schools. These are set out in more detail in a recently published consultation by the Scottish Government available at: http://www.gov.scot/Publications/2018/06/2880.

The Barclay Review found it to be unfair that independent schools receive rates relief at 80% when compared to state schools, which do not qualify for rates relief. Therefore, the review report recommended that rates relief be removed from independent schools to end this inequality.

At the time of its December 2017 budget, the Scottish Government announced that it accepted this recommendation. Only specialist schools dealing with particular support needs will continue to receive rates relief (although the recent consultation noted above invites views on the treatment of independent schools with exceptional circumstances, such as specialist music schools).

The charitable status of independent schools was outside the scope of the review and there is no change in this regard, although the imposition of full business rates has been seen by some as an attack on their charitable status. There are also concerns about the impact increased costs could have on the public benefit obligation of independent schools. This is met currently by the provision of bursaries or other forms of financial assistance (for example, sponsored places), access programmes and the community use of school facilities outside school hours.

Stamp duty land tax

We are not aware of any difference in the availability of relief from LBTT on transactions undertaken by charities in Scotland compared to SDLT. However, should the Charity Tax Commission make any comments in its final report and any recommendations about relief from SDLT, it should recognise that this no longer applies UK-wide.

ANNEX 1

Budget Representation:
Reforms to VAT and the Public Sector

20 January 2017

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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[1]. 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[2] 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.

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

[2] 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 NPDBs. 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.

ANNEX 2

THE
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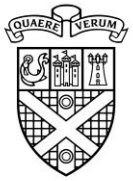
OF SCOTLAND



Response from
The Institute of Chartered Accountants of Scotland
to the Calman Charities Technical Sub-Group

Implications for charity tax reliefs arising from a Scottish rate of income tax

1 April 2011

INTRODUCTION

The Charities Committee of The Institute of Chartered Accountants of Scotland (ICAS) welcomes the opportunity to comment on the Calman Charities Technical Sub-Group discussion paper on the implications for charity tax reliefs which could arise following the introduction of a Scottish rate of income tax.

The Institute's Charter requires its Committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Our comments on the consultation questions are set out below.

CONSULTATION QUESTIONS

Question 1

Gift Aid. Would you prefer the UK basic rate or the Scottish basic rate to apply to donations made by Scottish taxpayers? Can you give some reasoning for your choice?

Response

On balance we believe that the UK basic rate of income tax should continue to apply to Gift Aid claimed by charities, even if a Scottish basic rate of income tax were to differ slightly from the UK rate. We support this approach on the grounds of administrative simplicity from the perspective of charities and HMRC. Applying the UK basic rate will address any difficulties which may arise from the definition of a Scottish taxpayer in the draft Scotland Bill, as under the proposed definition not all individual taxpayers will know whether they are a Scottish taxpayer until after the year-end.

However, not all members of the Charities Committee agree and the Committee as a whole is mindful that this approach represents a departure from the underlying social policy intention that a taxpayer can choose to make a donation to a charity in lieu of receiving the gross income. A taxpayer makes a donation to charity from his or her net income but the charity receiving the donation benefits from the gross position in relation to the basic rate of tax. This link will be broken if the UK basic rate is applied to all donations, in the event that a Scottish basic rate of income tax varies from the UK basic rate.

The reason for giving this choice to taxpayers is that the state values the contribution made through charitable works to the purposes of the state sufficiently to agree to the tax, which would be due on the gross income, being forgone by the state in favour of charitable works. Taxpayers can choose whether to receive the income and suffer tax on it or they can choose to allocate the entire gross income (and capital gains) to charity. This is what Gift Aid achieves and a correct understanding of why it exists should be the starting point for any review of policy, even one which results in a departure from the underlying social policy intention.

Question 2

If the UK basic rate applied to Gift Aid reclaimed by the charity, do you think that the higher and additional rates should apply to higher rate and additional rate relief claimed by a Scottish donor, or the Scottish rates?

Response

We understand that claims for tax relief by higher rate taxpayers will continue to be dealt with through the self-assessment process and therefore relief can be claimed at whatever rate is appropriate to the individual, whether it is a UK rate or a Scottish rate.

Self-assessment arrangements, both legal and procedural, should also be reviewed so that any changes necessary are made to enable Scottish taxpayers to continue to claim tax relief on capital gains where they would currently be entitled.

Question 3

Are there any problems HMRC has not identified?

Response

Definition of a Scottish taxpayer

The definition of a Scottish taxpayer is not yet settled which makes it difficult to comment definitively on how the Gift Aid system should adapt to the income tax reforms proposed within the Scotland Bill.

Variations in the rate of income tax

We also believe that should the UK basic rate of income tax and the Scottish rate vary significantly in future, any decision to apply the basic UK rate to donations should be reviewed.

The public may view the application of the UK rate negatively, particularly if the UK rate and the Scottish rate vary significantly. This is demonstrated by the following circumstances: if the Scottish basic rate was lower than the UK basic rate and Gift Aid was applied at the UK basic rate, a donation under Gift Aid by a Scottish taxpayer to a Scottish (or English charity) would result in a repayment to that charity of an amount of the state's resources in excess of the amount of tax deducted from the taxpayer: In this example other taxpayers would be subsidising the charity from taxes paid. The opposite applies in the case of the Scottish basic rate being higher than the UK wide rate: the outcome would be that a Scottish taxpayer would not obtain the full benefit of the social policy intention behind Gift Aid and neither would the charity supported by the Scottish taxpayer.