Strategy and Resources Committee
28 November 2017

VAT Partial Exemption Mitigation Options Report

Report of the:	Acting Director of Finance and Resources
Contact:	Teresa Wingfield
Urgent Decision?(yes/no)	No
If yes, reason urgent decision required:	N/A
Annexes/Appendices (attached):	None
Other available papers (not attached):	None

Report Summary

This report sets out the Council's current VAT position and suggests how to mitigate the risk of having to repay to HMRC VAT recovered on expenditure relating to exempt income.

Recommendation (s)

(1) That the Committee notes the implications of the Council's limited VAT recovery position.

(2) That the Committee agrees to the recommendations 1-3 at paragraph 4.9 of this report to mitigate the risk of having to repay in excess of £176,468 of recovered VAT to HMRC.

(3) That the Committee notes that officers will investigate and report back on further actions that may be required at other buildings to improve the Council's VAT position and mitigate the risk of future repayments.

1 Implications for the Council's Key Priorities, Service Plans and Sustainable Community Strategy

1.1 The Medium Term Financial Strategy and Efficiency Plan aims to maintain the financial health of the Council whilst delivering the priorities in the Corporate Plan.

2 Background

2.1 In the U.K. VAT is applicable to most income and expenditure transactions at either zero, lower or standard rate. This means that we charge VAT on income as applicable, which we then pay over to HMRC. We pay VAT at the appropriate rate on expenditure incurred, which we recover from HMRC via our monthly VAT return.

2.2 Under S33 of the VAT Act 1994, activities undertaken by a local authority which are part of its statutory duties are treated for VAT purposes as non-business transactions, which fall outside the scope of VAT. Whilst this means that VAT is not charged by the Council on these transactions, S33 permits recovery of VAT on related expenditure.

2.3 All VAT registered bodies are subject to different rules relating to exempt supplies. These include land and building transactions, insurance, postal services, education, health & welfare, sports and sports competitions, works of art and cultural services. Exempt supplies are not classed as taxable; no VAT is chargeable on the supply and VAT cannot ordinarily be reclaimed on related costs.

2.4 The most significant exempt supplies made by the Council are rents and lettings.

2.5 Less stringent rules apply to exempt supplies made by local authorities. We are permitted to recover VAT on expenditure related to exempt income, provided that the amount does not exceed 5% of total VAT recovered from HMRC in any one year.

2.6 If the 5% limit is breached then the whole amount of VAT recovered relating to exempt income becomes payable to HMRC, not just the amount in excess of the 5% limit.

3 VAT recovery by the Council

3.1 Officers complete an annual partial exemption calculation to determine whether VAT recovered on expenditure relating to exempt income is in excess of 5% of all VAT recovered. The Council has been close to this 5% limit on a number of occasions over the past six or seven years. If the limit is breached then the Council could be required to pay back all of the exempt VAT recovered, not just the amount by which the 5% limit was breached.

3.2 To mitigate the risk of breaching the limit we have elected to opt properties to tax where appropriate. When a property is opted to tax standard rated VAT is applicable to income from lettings and hires. As the property no longer generates exempt income VAT recovered on related expenditure is omitted from the partial exemption calculation.

3.3 Hirers and lessees registered for VAT, and using the property for taxable business purposes, can recover the VAT charged. Charities using he property for certain charitable purposes can submit a charitable exemption certificate so that their charges remain exempt.

3.4 Residential property cannot be opted to tax, so that where anything other than a peppercorn rent is received all VAT recovered on expenditure has to be included in the partial exemption calculation.

3.5 In 2013/14 recovery of VAT on the repair works at Ewell Court House, following a fire there, resulted in a breach. VAT recovered on these works had to be included in the calculation as the related income was from letting fees, which are an exempt supply.

3.6 HMRC agreed that we could apply a seven year averaging method. This involves averaging the percentages over the previous four years, the current year and the forecast for the following two years. Our average percentage across the seven year period was 4.8%.

3.7 In 2016/17 the Council recovered from HMRC a total of £176,468 VAT relating to exempt supplies, which was £77,169 over our 5% limit for the year. The amount recovered included £108,800 VAT on 'one-off' works at Blenheim Road to bring nine units of temporary accommodation back into use.

3.8 When the works were completed the Council entered into a lease with a local housing association so that they would take over the units for use as temporary accommodation. As the units are used for residential purposes the income from the lease is exempt from VAT, resulting in the £108,800 VAT recovered having to be included in our partial exemption calculation. This exceeded the 5% limit for 2016/17.

3.9 Use of the seven year average is permitted by HMRC for "occasional" breaches, and so we can ask permission to use it again. If permitted we may avoid a repayment of £176,468 to HMRC. To apply we will have to submit figures for the full seven years to HMRC, including the forecasts for 2017/18 and 2018/19 to demonstrate that the average over the period is expected to fall below 5%.

3.10 If we are not able to use the seven year average method, or we reach a point where we are over the 5% limit even across seven years, we will not only be required to pay back our exempt input tax but will also be within the scope of the "Capital Goods Scheme" (CGS). This involves examining all of the capital goods created in the last ten years (relevant capital goods for us are buildings where we have spent more than £250,000) and monitoring the use of the asset over a ten year period. If VAT was recovered at the time of creating the asset (either because it was within the 5% de minimis, or because it was used for non business purposes) and the asset is now used for exempt purposes we would be required to adjust for a proportion of the VAT initially recovered. So, as well as the cost of lost VAT, a breach of the seven year average would bring with it a lot of additional work in creating and maintaining a capital goods register.

3.11 On calculating the forward forecasts it is clear that during 2017/18 and 2018/19 the Council will need to significantly reduce expenditure on any properties generating exempt income, in order to average below 5% and thereby avoid the £176k repayment.

3.12 Assuming the Council's current levels of total VAT recovered continue in 2017/18 and 2018/19, we would need to restrict recovered exempt VAT to £90k for 2017/18 and £74k for 2018/19. Our lowest recovered figure in the last nine years was in 2014/15 at £74k.

4 Proposals

4.1 The figures at paragraph 3.12 indicate the extent of the actions required to avoid a breach across the seven years. These will need to include:

4.2 Postponement of all non-essential work on the properties set out in the table below, at least until the end of the forecast period, i.e. March 2019. Where work is unavoidable, e.g., for health and safety reasons, the tax recovered will have to be factored into the final forecasts.

4.3 Under VAT rules peppercorn rents are not classed as exempt income. This means that where work is undertaken to bring a property into residential use, offering the property for management at a peppercorn rent would allow expenditure on the works to be omitted from the calculation. Alternatively, we should negotiate a management agreement, any income would then be outside the scope of VAT.

4.4 Where no preliminary expenditure is necessary, exempt rental income could be received without any VAT impact by issuing a full repairing lease. The Council would then receive an income but as lessees would be responsible for ongoing building repairs and maintenance there would be no related expenditure to be included in the Council's partial exemption calculation.

4.5 Elections to opt to tax so that VAT becomes chargeable are not permissible on residential buildings. However, opting to tax non-residential buildings where appropriate would reduce receipt of exempt income. Users not registered for VAT would not be able to recover the VAT incurred, though the effect of the higher charges could be mitigated by passing on the additional costs incrementally, with the income to the service being subsidised by contributions from the Council's earmarked VAT reserve.

4.6 The Council could decide to cease charging for lettings at buildings where there is negligible income against expenditure, or where exempt income is generated. It is the level of expenditure that affects the calculation; it has to be included, irrespective of the income received. Currently exempt income from hirers at the Wells Centre is around £3k-£4k per annum. VAT recovered on expenditure is around £6k, which has to be included in the 5% limit. If no income were received from lettings at the Wells Centre the forecasts for 2017/18 and 2018/19 would reduce by approximately £6k per annum.

4.7 The application of charitable exemptions creates exempt income even where the building is opted to tax. The Council could elect not to accept further exemption certificates and, where considered appropriate, offer a discount on the standard rated charges instead.

4.8 Acceleration of intended disposals would reduce the Council's exposure to ongoing expenditure. The forecast for 2018/19 assumes disposal of the Ebbisham Centre by March 2018. If this is not achieved then forecast will increase by approximately £14,000, which is likely to breach the seven year average.

4.9 Table 1 below sets out the actions necessary to mitigate a breach of the 5% limit across the seven years 2012/13 to 2018/19. If no further unanticipated costs occur during this year or next, the Council may be able to avoid a breach and thereby having to repay VAT recovered from HMRC in 2016/17 totalling £176,468, plus any Capital Goods Scheme adjustments that may be required.

TABLE 1

	Building	Essential Action/s	Effect on calculation
1.	**South Street** £400k estimated cost of renovation works proposed on two residential flats. This would increase exempt VAT recovered by £80k.	Postpone works until after March 2019 and seek expert VAT advice. Whenever this work is undertaken an additional £80k into the annual calculation is likely to result in a breach of the 5% limit. Specialist advice on self-management, management agreements and peppercorn rents will be required before work is started. Depending on advice on management agreements officers could investigate implications of transferring property to EEPIC.	Undertaking the works before March 2019 would result in an immediate breach of the seven year average. EEPIC would not be able to recover VAT.
2.	**Ebbisham Centre** The forecast calculation for 2018/19 assumes that this building will be disposed of by March 2018. If the disposal is not achieved the forecast for 2018/19 will increase by £14k plus VAT recovered on any remedial or capital works.	Dispose of building by March 2018 without any interim non-essential works.	If disposal is delayed a further £14k minimum will be added to the average, creating significant risk of breach.

	Building	Essential Action/s	Effect on calculation
3.	**Private Sector Leasing Scheme & EEBC owned temporary accommodation** Initiatives relating to reducing temporary accommodation costs generally relate to residential properties.	Review schemes to ensure that exempt income is avoided. Self-manage properties or agree management contracts with agents if necessary.	Exempt income from residential properties increases the risk of future breaches. Each case will need to be considered individually to avoid this.

4.10 Proposals set out at paragraph 4 are applicable to other buildings where action is required to reduce the risk of breaching the 5% limit. These properties include:

4.10.1 Bourne Hall

4.10.2 Wells Centre

4.10.3 Cox Lane Centre

4.10.4 Longmead Centre

4.10.5 Playhouse

4.10.6 Staff Properties

4.10.7 Parks Pavilions

4.11 All expenditure at these properties impact on the VAT position. This includes utilities, cleaning, ad hoc repairs and maintenance as well as larger capital projects.

4.12 The Council also includes in its calculation 50% of VAT recovered on expenditure relating to Nonsuch House. This reflects the 50/50 split with London Borough of Sutton of the costs and income of the Nonsuch Joint Management Committee. The JMC are considering applying for a Heritage Bid to undertake works at the Park/Mansion House. If this bid were successful VAT recovered on the works would affect the Council's VAT position. Subject to expert VAT advice, a potential solution might be to approach LBS to determine whether they would be agreeable to an application to opt to tax the site.

5 Financial and Manpower Implications

5.1 The Council is at risk of breaching the seven year average which could result in having to make a repayment of £176,468 in previously recovered VAT to HMRC.

5.2 HMRC would have to give permission for use of the seven year method. The current forecasts for 2017/18 and 2018/19, particularly the latter, anticipate lower VAT recoveries than previous actuals.

5.3 When calculating the seven year average the final two years are based on forecasts. Unanticipated expenditure or reduced total VAT recovery figures will affect these, so there can be no guarantee that a breach can actually be avoided.

5.4 Implementing some or all of the proposals set out in this report would demonstrate to HMRC the Council's commitment to achieve the forecast percentages and stay within 5% recovery over the seven year period.

5.5 ***Chief Finance Officer's comments:*** *as set out in the body of this report*.

6 Legal Implications (including implications for matters relating to equality)

6.1 The Council will continue to fulfil its statutory obligations on all services provided.

6.2 ***Monitoring Officer's comments:*** *It is important that maintenance activities are planned and undertaken in such a way so as to ensure compliance with the Council's statutory duties in respect of, for example, health and safety. It is also important to ensure that we meet our legal obligations to our landlords (where applicable), and to our tenants. Proposals to defer works to another year need to make sure that these issues have been considered.*

7 Partnerships

7.1 Implementation of some of the proposed actions will involve careful management of partnerships with Housing Associations, hirers and tenants.

8 Risk Assessment

8.1 The risk of breaching the 5% limit can be mitigated by these actions but unexpected and unavoidable expenditure would affect the calculation.

8.2 Given the Council's previous years' percentages HMRC may ask for evidence of how we propose to comply with the limit and may take approval of the proposals in this report as evidence of the Council's commitment to the achieving this.

9 Conclusion and Recommendations

9.1 That the actions set out at paragraph 4 be undertaken where possible.

9.2 That the timing, location and extent of proposed capital projects and revenue works are carefully considered, having regard to VAT implications.

Ward(s) Affected: (All Wards);