BRIEFING

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The Implications of LB Ealing v HMRC (Case C-633/15)

The Background

As many may be aware, sporting services provided by an eligible not-for-profit body are treated as VAT exempt. Whilst exempt bodies usually lose entitlement to reclaim their own VAT costs, more often than not, there's a net commercial and financial benefit from not applying VAT to the supply. Conversely, for-profit providers must charge and account for VAT on their equivalent activities.

Interestingly, and back in the early 1990's when the sporting exemption was overhauled, specific legislative reference was incorporated to exclude all public authorities from eligible body status. Therefore, sporting services income received by councils remained subject to VAT at the standard-rate.

Whilst local authorities clearly do not operate for profit, and VAT exemption would normally be a benefit, they were motivated to tax their supplies and had pressed HMRC on the matter. Their objective was to preserve the insignificant (de minimis) level of their VAT exempt activities to continue to benefit from reclaiming all their VAT costs under their unique VAT refund rules.

Local authority representatives, having previously persuaded HMRC to adopt this position, might give one a clue as to whether the enacted legislation was suitably neutral.

Over the years, one significant consequence of the differing VAT treatment has been to encourage authorities to contract out services to other providers (including controlled companies and sports and leisure trusts). In a potential case of 'cake and eat it', and with a suitably structured arrangement, it is often the case that the main infrastructure VAT costs are still borne and recovered by the local authority, whereas the VAT exempt sporting income is collected by the trust.

Outcome of the Ealing Council Case

Under Article 133(d) of the European Principal VAT Directive ('PVD') all EU member states have the discretion to apply a 'distortion of competition' criterion to specified VAT exemptions.

For example, should VAT exemption of an operator's sporting services put other commercial operators at a disadvantage then their own services should, in principle, also be subject to VAT. Of course, application of this condition must not be discriminatory and needs to be looked at on a local case-by-case basis. HMRC maintains that it does in fact apply this condition to all public bodies and this is in place by way of the legislative exclusion to the eligible body status. The same legislative condition is not however applied to all other non-profit providers.

In 2013, the London Borough of Ealing ('LBE') submitted a VAT refund claim to HMRC arguing its supplies were exempt from VAT. The claim, not surprisingly, was rejected by HMRC, but was escalated up to the UK's First Tier Tax tribunal. Whilst LBE was undoubtedly excluded

from exemption under UK law, it argued the UK's application of the non-distortion of competition condition was fundamentally incorrect and that it had the right to rely on the direct effect of the European Directive.
The case was duly referred by the UK courts to the highest authority, Court of Justice of the European Union (CJEU), which largely agreed with LBE. Broadly speaking, the Court's conclusion (C-633/15) is that the UK cannot apply the condition to only public authorities without also applying the same test to all non-profit providers. This would appear a just outcome.

In summary, if the UK wants to apply the distortion of competition test to non-profit-making bodies governed by public law (local authorities), it must also apply the same distortion of competition test to services supplied by other non-profit-making bodies. So far, HMRC has failed to issue a formal public response to the CJEU findings.

Ultimately, the UK must adhere to the Court's decision and choose whether to change the law to apply the distortion of competition condition more equitably, or remove it entirely.

Implication for Local Authorities

The past

Options for local authorities

Many local authorities with in-house operations may now consider submitting a protective claim to HMRC for a reimbursement of overpaid VAT. The success of such claims may be dependent on HMRC's response to the LBE case, whether qualifying conditions were met and evidenced, and whether HMRC will argue that 'unjust enrichment provisions' would apply.

However, before eagerly submitting a large VAT claim, great care should be taken to assess the wider impact of changing taxable income into exempt income. For example, what effect would increased costs attributable to exempt activities have on the authority's partial exemption position?

Local authorities have also, over the years, transferred the management of their leisure centres to newly created or existing charitable entities, with a view to saving VAT arising from the status of the manager and to benefit from mandatory business rates relief.

The LBE case may now negate the VAT advantage, and there are also uncertainties on the long-term business rate savings, especially if incomes transfer to local government.

The future

Handling future charging policy

So far as VAT is concerned, once HMRC has clarified its position, local authorities could either reduce the charge on sporting services (which is unlikely) or retain the existing charge and keep the difference. There is also the possibility of charges being raised to account for those instances where associated VAT recovery will be lost.

Implications for existing outsourced management contracts

HMRC will undoubtedly be considering a range of VAT related issues associated with the outsourcing of leisure management contracts, particularly as many such contracts involve payments by the contractor against an element of operating surplus. as opposed to payment of a management fee or subsidy by the local authority.

Historically, payment of any management fee has included VAT and, in most cases, the lease of the leisure sites has been on the basis of a peppercorn non-business rental lease. Local authorities and contractors alike will need to consider the implications of any impending HMRC policy changes.

Whilst it is unlikely that a local authority would wish to terminate any management contract (assuming it had the power to do so) because the VAT changes, the standard Sport England contract already contains provisions on business rates and the prospective regime changes which could be extended to

incorporate the implications of the LBE VAT case.

Increasingly, contracts are now incorporating no fault termination provisions which mitigate against establishing a long-term relationship between the parties, including expectation of capital investments and increased income.

Conclusion

The leisure contract management regime has changed and continues to change with both the LBE VAT case and the impact of the business rate changes, such that local authorities may now remove VAT applicable to sporting charges, but may find that they pay the total cost of both mandatory or discretionary relief. The promise in the Culture White Paper to maintain the 50% subsidy may well come into play, but until decisions are made by the Department for Communities and Local Government, the position lacks clarity.

Whilst it may be desirable to permit local authorities to retain 100% of their business rates, they have no option to permit the 80% mandatory business rates for charitable entities, and may well be paying 100% of that relief.

Many operators may now be reviewing their business plans and projections in light of the above and it is anticipated that negotiations with local authorities to become quite fraught.

More than ever it will be instrumental to keep appraised of these key issues, to proactively protect your interests (e.g. contractually) and understand what financial impact this may all have.

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Simon has had many years of local government experience, both as an elected member and advising local authorities on outsourcing sporting, leisure and heritage facilities, including the creation of charitable entities to take advantage of their favourable fiscal treatment.

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Scott has 15 years' VAT experience and works across the not-for-profit sectors including local and central government, the NHS, emergency services, education and charities. He has provided indirect tax advice to some of the UK's largest organisations including many well-known public bodies, commercial firms working in the sector plus many state funded entities.

Scott has also enthusiastically supported various industry groups helping their cause to reform the VAT system by highlighting inequities in tax regulations and helping to push for new VAT refund schemes for non-profit organisations.