

Building Schools for the Future

A guide to the potential VAT issues of community use and possible solutions

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1 Executive Summary

- 1.1 By understanding the issues at an early stage and appropriately managing the BSF programme, VAT does not necessarily have to be a problem. Conversely, failure to appropriately manage the programme could result in a significant VAT cost that would not just be limited to the VAT incurred on the BSF programme costs. The various models for delivering the BSF programme along with the associated VAT issues are considered in Sections 5-10.
- 1.2 In almost all cases, it is the introduction of community/commercial use that gives rise to a potential VAT issue whether this takes the form of a partial exemption restriction for the Local Authority, the inability to issue an appropriate zero rating certificate and/or irrecoverable VAT for VA schools/City academies – see Section 3.
- 1.3 For traditional LEA operated schools, the VAT problem arises specifically as a result of VAT exempt use as opposed to wider community/commercial use. Allowing free use or charging for taxable activities should not give rise to a problem. In many instances the problematic exempt use can be managed - see Section 12 and Case Study 1.
- 1.4 In respect of VA schools, under current HMRC policy, providing the LEA contracts for the supply and receives an invoice in its own name, it should be entitled to recover the VAT in full on the basis that it is providing the Governors of the VA school with services for nil consideration. It should be noted that HMRC recently took steps to tighten these rules, however, no changes have been implemented at this time and it is understood that any changes will be preceded by a transitional period. Any contribution by the VA school will be seen as consideration for the services provided. These services will typically be subject to VAT at the standard rate and the LEA will need to charge and account for VAT accordingly. However, there may be scope for the services to be zero rated for VAT purposes. Any VAT charged to the Governors of the VA School will generally be irrecoverable if no action is taken.
- 1.5 Directly funded VA schools and City academies will be unable to rely upon the favourable VAT rules applied to local authorities. The same position is likely if the LEA receives funding as agent of a VA school or City Academy; we understand that HMRC and the DfES are currently considering whether BSF funding is awarded to VA schools rather than the LEA. However scope exists to mitigate the VAT costs through a number of measures including the issue of an appropriate zero rating certificate and/or to maximising VAT recovery through appropriate structuring. These options are considered in Section 12 and Case Study 2.

2 Introduction

- 2.1 Building Schools for the Future (“BSF”) is the biggest single government investment in improving school buildings for over 50 years. The aim is to rebuild or renew every secondary school in England over a 10-15 year period that will involve early consultation, planning and ultimately the completion of new buildings at hundreds of school sites across England.
- 2.2 The BSF programme was officially launched in February 2004 with the announcement of a phase one comprising of 13 participating local authorities to complement the original 6 pathfinder authorities. Phases two and three have been announced and will add a further 9 and 10 local authorities respectively.
- 2.3 It is intention of the BSF programme to provide all secondary schools with 21st century facilities by 2020. The building needs of primary schools and secondary schools in areas not receiving early investment from BSF will continue to be met from existing successful capital programmes.
- 2.4 Clearly, this can only be achieved through considerable capital investment and local authorities need to recognise and be aware of the VAT issues that BSF brings, not only for themselves but for the additional legal entities that BSF involves.
- 2.5 PwC have been involved in advising various local authorities on the financial aspects of BSF and have been requested by Sport England to prepare a document outlining the generic VAT issues which arise as a result of PFI structures and design and build arrangements entered into as part of the BSF programme. The document deals with the various legal entities and also the particular issues that relate to Voluntary Aided (“VA”) schools and City Academies. This document is based upon the information contained within the standard documentation as available from the BSF/PfS web sites and discussions with a pathfinder local authority.
- 2.6 While the purpose of this document is to set out the likely key VAT issues arising from the BSF programme, it should not be taken as a substitute for obtaining VAT advice for local authorities who are embarking on the BSF programme. It is always recommended that specific advice should be sought, which should be based on the particular arrangements that the local authority is looking to undertake.

3 Overcoming the potential VAT issues of community/commercial use

- 3.1 In theory, VAT should not fall to be a significant burden in connection with a LEA procured BSF project, whether in the form of a conventional arrangement or a PFI structure. However, this is based upon one very impractical assumption – there is no/negligible community/commercial use. In short, there can often be a fundamental conflict between community/commercial use and VAT recovery.
- 3.2 The introduction of community/commercial use significantly complicates issues. For traditional LEA operated schools it introduces the scope for exempt income which then requires the Local Authority to include the VAT incurred on the development within its partial exemption calculation. For directly funded VA schools and City academies it limits the scope or prevents the issue of appropriate zero rating certificates.
- 3.3 Although this impacts upon the school and its sports facilities equally, it is the leisure side that tends to experience the most difficulties due to the greater scope for community/commercial use. Furthermore, many projects are reliant upon the generation of commercial income in order help cover the operating costs.
- 3.4 In some cases there will need to be a compromise regarding community/commercial use as the associated cost in irrecoverable VAT may be simply too great.
- 3.5 The following sections consider the VAT implications for all entities across the BSF programme. In considering the scope for community/commercial use it is essential that one eye is kept firmly on the bigger picture as what may seem to be relatively insignificant decisions can carry significant implications.

4 Basic principles for VAT recovery

Basic rules

4.1 General rules regarding the recoverability of VAT incurred on costs-

- VAT incurred on costs that are wholly attributable to taxable activities should be recoverable in full (subject to the normal rules).
- VAT incurred on costs that are wholly attributable to non-business activities will be irrecoverable.
- VAT incurred on costs that are wholly attributable to exempt activities are irrecoverable subject to partial exemption.
- VAT incurred on costs that are partly attributable to taxable activities and partly attributable to non-business activities should be recoverable to the extent that the costs relate to taxable activities. However also see Appendix H – Lennartz
- VAT incurred on costs that are partly attributable to taxable activities and partly attributable to exempt activities should be partly recoverable (but may be fully recoverable subject to partial exemption).
- VAT incurred on costs that are partly attributable to taxable activities, partly attributable to exempt activities and partly attributable to non business activities should be recoverable to the extent that the costs relate to taxable activities but may also be recoverable to the extent that the costs relate to exempt activities (subject to partial exemption). However, also see Appendix H - Lennartz

4.2 A brief summary of how partial exemption works can be found at Appendix A

Special Rules for Local Authorities

- 4.3 Local Authorities fall within the scope of the VAT Act 1994 Section 33 (3) and as such are entitled to recover VAT on costs that would typically not be recoverable for any other VAT registered entity.
- 4.4 Bodies that fall within the VAT Act 1994 Section 33 are entitled to recover any VAT that they incur in the furtherance of their non-business activities.
- 4.5 Furthermore, the standard de-minimis limit (See Appendix A – Partial Exemption) does not apply. The VAT Act 1994 Section 33 (2)(b) permits a Section 33 body to recover any VAT that it incurs on costs wholly or partly attributable to exempt activities as long as the exempt related VAT remains an insignificant proportion of the total VAT that the body incurs.
- 4.6 In this particular case, HMRC define insignificant as less than 5%. Therefore, as long as the total VAT on costs wholly or partly attributable to exempt activities remains below 5% of the total VAT incurred then the Local Authority will be entitled to recover all of the VAT it incurs.
- 4.7 However, while this may appear very generous, it makes managing the 5% limit absolutely critical. Because of the nature of the de-minimis test for Local Authorities, there is typically a significant liability for the Local Authority if it fails to remain below 5%. By definition, the least the liability can be is 5% of the total VAT incurred in the year. For most Local

Authorities undertaking a BSF programme, this could amount to a cost of between £1million and £3million in irrecoverable VAT depending on the size of the authority.

- 4.8 It is therefore essential that for Local Authorities, partial exemption is considered in respect of any projects that have the potential to result in additional exempt activities.

5 The legal entities involved

- 5.1 In any BSF programme, there will be a number of legal entities involved. Typically these will include a local authority (or more than one), Partnership for Schools Ltd (“PfS”), a Private sector Partner/s (“PSP”) and the creation of a new company in the form of the Local Education Partnership Ltd (“LEP”). However, additional legal entities may also be involved such as a special purpose company/vehicle (“SPV”), the governing body of a VA school or a Charitable company in the case of a City Academy.
- 5.2 It is understood that the use of a LEP is not compulsory. However, for the purposes of this guidance it has been assumed that a LEP will be created.

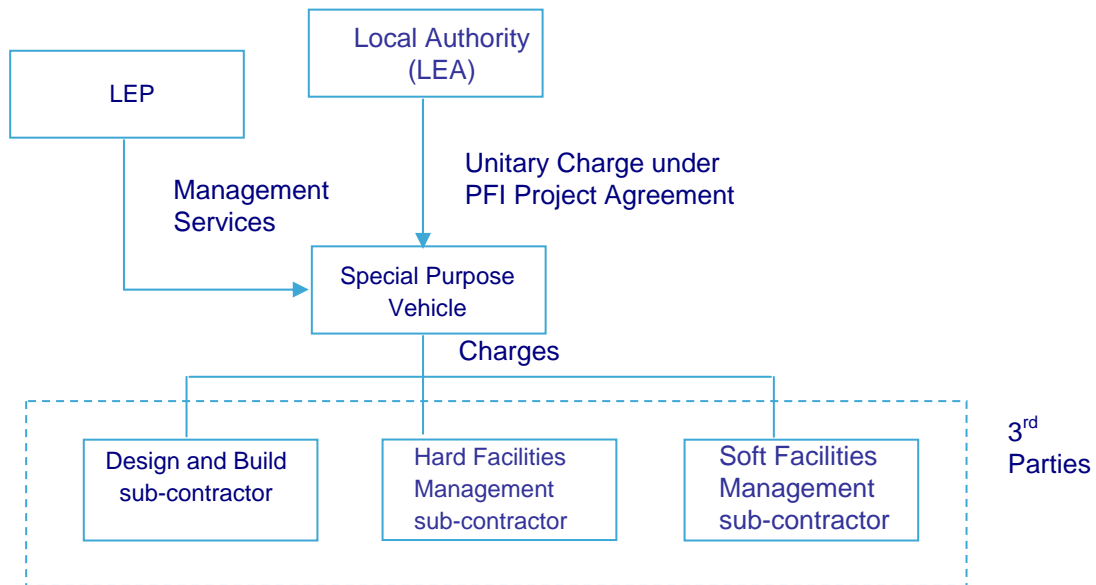
The concept of the LEP

- 5.3 In essence, the purpose of the LEP is to assist local authorities in delivering the BSF programme. It is intended that the LEP will be a legal entity in its own right, established as a public private partnership with three members, comprising:
- The Local Education Authority (“LEA”) - 10% shareholding
 - Private sector partners - 80% shareholding
 - Partnership for Schools (“PfS”) - 10% shareholding
- 5.4 It is hoped that the LEP, combining the skills of both private and public sector, will assist in managing the complexities that BSF creates.
- 5.5 The LEP will act as a single point of contact for procurement and delivery and will have an exclusive right to develop proposals for and deliver BSF schools. It is anticipated that the LEP will enter into design and build contracts, maintenance contracts and ICT contracts. In terms of PFI projects however, it is understood understand that the LEA will enter into the PFI agreement with the PFI special purpose vehicle directly (probably a subsidiary of the LEP).

6 PFI projects

6.1 The BSF standard documentation indicates the following contractual relationships.

The contractual structure for PFI contracts will in general reflect:



The LEP

6.2 In PFI project it is envisaged that the LEP will provide management services to the SPV.

Supplies by the LEP

6.3 The supply of management services by the LEP are likely to be subject to VAT at the standard rate.

Supplies to the LEP

6.4 The LEP will incur a variety of costs that relate to the provision of the management services. Some of these costs will carry VAT and some will not.

VAT recovery for the LEP

6.5 In accordance with the basic principles for VAT recovery the LEP should be entitled to recover any VAT that it incurs on costs that are wholly and exclusively attributable to the taxable management services.

6.6 The recoverability of any other VAT incurred by the LEP will be subject to the LEP's other activities and whether they are taxable, exempt or non-business.

The SPV

6.7 It is envisaged that the SPV will act in the same way as it would in any other PFI arrangement.

Supplies by the SPV

- 6.8 Any charges to the local authority are likely to be liable to VAT. This would include any one-off payments by the local authority to the SPV and the ongoing monthly unitary charge. There may be a challenge by Customs that the SPV is actually making two supplies - an exempt supply of an interest in land to the local authority and a taxable supply of facilities management. As discussed in Section 2, making exempt supplies would probably result in irrecoverable VAT in the hands of the SPV and depending on the contractual terms, could increase the on-going costs to the local authority.
- 6.9 To manage this issue, it is often recommend that local authorities seek to include an appropriate clause in their PFI agreement which obliges the SPV to opt to tax the development. An option to tax changes the VAT liability of the supply from exempt to taxable. However, it should be noted that an option to tax is not effective in all cases. Specific anti-avoidance legislation may disapply the option to tax in certain circumstances e.g. where the local authority has provided funding to the SPV and intends to use the facilities for exempt purposes.
- 6.10 Assuming the option to tax is not disappplied, this should ensure that all charges to the local authority are liable to VAT at the standard rate. The SPV's VAT recovery position should therefore be protected thus minimising the risk that irrecoverable VAT will become an additional cost that is ultimately recharged to the local authority.
- 6.11 It is understood that in some PFI agreements, the right to use the facilities outside of the agreed local authority school use will remain with the SPV. In these circumstances it will be the SPV that charges and retains the income for the use of the facilities and thus is responsible for accounting for VAT.
- 6.12 The letting of rooms and in certain circumstances, the letting of sports facilities to clubs and associations, is exempt from VAT (see Appendix B – liability of Sporting services). Therefore, if the SPV generates exempt income from the use of the facilities, it is likely to face a restriction in the amount of VAT that it can recover. This would apply equally to VAT incurred on operating costs as well as capital costs.
- 6.13 However, if the SPV has exercised the option to tax in respect of the facilities then, other than in a limited number of specific circumstances, all of the letting income should be subject to VAT at the standard rate.
- 6.14 Given that the SPV will be capable of distributing profits, it is unlikely to qualify for VAT exemption in respect of any supplies of either education or sporting services to individuals. Therefore, where supplied by the SPV, such supplies should be subject to VAT at the standard rate.

Supplies to the SPV

- 6.15 The SPV is likely to incur VAT on the cost of the Management Services provided by the LEP.
- 6.16 The supplies made under the Design and Build contract and the Hard and Soft Facilities Management Services will more than likely be subject to VAT at the standard rate.
- 6.17 It is also envisaged that the SPV will incur additional overhead costs which will be a mix of VATable and non-VATable items. These supplies may also include the licence granted by the local authority permitting the SPV to access the sites.

VAT recovery for the SPV

- 6.18 In accordance with the basic principles for VAT recovery the SPV should be entitled to recover any VAT that it incurs on costs that are wholly and exclusively attributable to its taxable activities.
- 6.19 If the SPV engages in non-business or exempt activities then some of the VAT that it incurs will be irrecoverable.
- 6.20 Exactly how the SPV will operate the facilities will clearly differ on a case by case basis. However, as long as the SPV only uses the facilities for taxable business purposes, then the SPV should be entitled to recover any VAT it incurs subject to the normal rules. Therefore, in a typical arrangement where the SPV simply makes a taxable unitary charge (and does not engage in supplies of lettings, education or sports facilities), then it should be entitled to recover all of the VAT that it incurs.

The local authority

- 6.21 The local authority will operate the facilities in the course and furtherance of the education of under 19 year old non-fee paying students. In most cases, the local authority will also have the opportunity to operate the facilities outside of normal school hours although there are a number of ways this may be achieved.

Supplies by the local authority

- 6.22 In order to give the SPV the ability to go onto the school sites, the local authority will often grant a licence over the sites. It is usual that the local authority does not specifically charge the SPV for this licence (any charges would have to be passed back onto the local authority through an increased unitary charge). Providing there is genuinely no consideration payable by the SPV (monetary or otherwise including barter arrangements) then it is likely that the granting of the licence would be seen to be a non-business activity for VAT purposes. However, where consideration is payable, the grant of the licence would be exempt from VAT or, where an option to tax has been exercised by the local authority, subject to VAT at the standard rate.
- 6.23 The primary purpose of the redeveloped site is the provision of education by the local authority to under 19 year old non-fee paying students. This is a non-business activity for the local authority.
- 6.24 However, there are a number of potential ways in which the local authority can use the facilities outside of normal school use. A summary of the typical envisaged use can be found at Appendix C.
- 6.25 The local authority will need to consider the VAT liability of the supplies that it makes and any resulting impact on VAT recovery.
- 6.26 Where the local authority makes exempt supplies by virtue of hiring or letting space/rooms or by supplying sports facilities to clubs associations etc... (see Appendix C) it may wish to consider exercising the option to tax in respect of the facilities thus making such supplies subject to VAT at the standard rate. It should be noted that the local authority would then be required to account for VAT on all such supplies including supplies to organisations that may not be in a position to recover the VAT charged.

- 6.27 Subject to the approach of the individual local authority, the operation of the facilities outside of normal school use may be the responsibility of the school fund and/or a Leisure Trust.
- 6.28 Where the local authority uses a specifically set up Leisure Trust to operate its facilities then consideration will need to be given as to how the interest in the facilities will be granted to the Leisure Trust. Typically this would be by way of a peppercorn lease which is generally accepted by HMRC as a non-business activity. However, where a commercial lease is used, the supply would be exempt unless an option to tax had been exercised. Again, the local authority may wish to consider exercising the option to tax in respect of the facilities thus making such supplies subject to VAT at the standard rate.

Supplies to the local authority

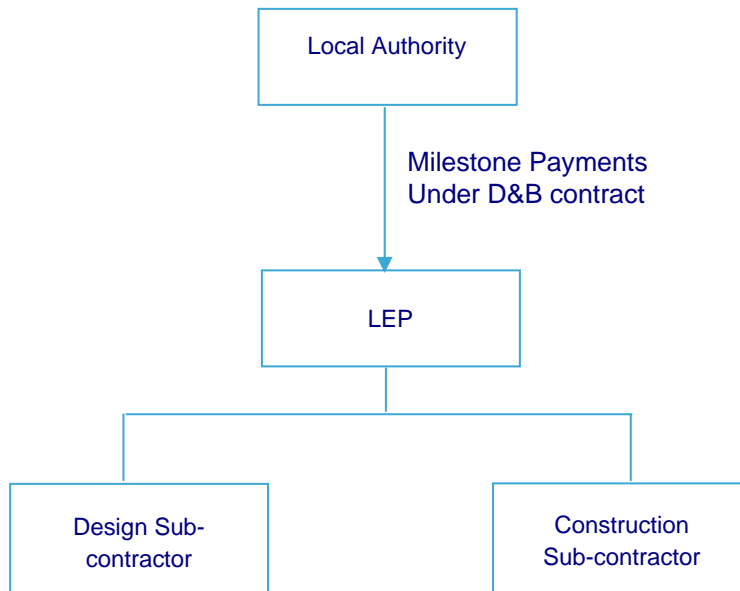
- 6.29 If the SPV has made an effective option to tax (not disapplied by virtue of the anti-avoidance rules) then the local authority will incur VAT on the full value of the unitary charge.
- 6.30 It is also envisaged that the local authority will incur a number of other costs which will be a mix of VATable and non-VATable items.
- 6.31 Additional supplies may take place if the SPV is responsible for providing catering in the schools. In respect of catering supplies, if the SPV operates as a principal for VAT purposes it will be supplying the meals direct to the pupils and staff in its own right. This will be a taxable supply and VAT will need to be added to the prices charged. This will mean that the prices to the pupils will increase by 17.5%.
- 6.32 If the SPV acts as an agent of the local authority, then the supply of the meals to the pupils will be a non-business activity since they will be seen as being provided by the authority in conjunction with non-business education. (Non-business treatment only applies to supplies of catering at or below cost when provided by the same person that supplies the education.)
- 6.33 Therefore, it is more VAT efficient if the SPV acts as the local authority's agent in providing the meals. However it should be noted that not all of the income collected from the catering service will be non-business. The supply of meals to staff and visitors will generally be standard rated since they cannot be incidental to education. Therefore, where the SPV act as agent for the local authority it will need to provide information relating to taxable sales to enable the local authority to account for the correct amount of VAT on catering to non-pupils.
- 6.34 Any separate agency charge by the SPV will typically be subject to VAT at the standard rate. However, a specific concession exists for institutions which use third party caterers to provide their catering facilities under agency arrangements. Under such arrangements, a caterer will typically incur costs for consumables which are subsequently recharged to the institution concerned. The caterer will also charge the institution for its staff costs, along with a management fee. Normally, a supply of staff would attract VAT, as would a management fee. However, in these circumstances, the recharge of staff costs can, by concession, be ignored for VAT purposes. This is on the basis that, if the institution provided the catering services from its in-house resources, it would not incur a VAT charge on the employment costs. As the caterer acts as agent for the institution, the staff costs are treated as though they are disbursements for the caterer.

VAT recovery for the local authority

- 6.35 As per the special rules discussed in Section 2, a local authority can recover any VAT that it incurs on costs attributable to its taxable and non-business activities.
- 6.36 The key is identifying the VAT to be incurred on costs that will be attributable to a local authority's exempt activities within the facilities. This can then be factored in to the local authority's partial exemption calculation to establish whether the local authority will be able to remain below the critical 5% de minimis limit and thus be entitled to full VAT recovery. Where the 5% limit is exceeded or is too close for comfort, the local authority can exercise the option to tax as necessary to reduce the exempt activities and thus reduce the overall amount of VAT incurred on costs associated with exempt activities.
- 6.37 Because of the unusual nature of a schools financial make up, it is not always straight forward to arrive at a method for determining what proportion of the VAT incurred relates to exempt activities. A simplified method has been agreed with HMRC in relation to schools and it is understood that this has also been accepted by HMRC (subject to minor changes) as applicable in BSF.
- 6.38 The method is reproduced at Appendix D and subject to how the individual local authority makes the facilities available for use outside of normal school use, may need slight amendment.
- 6.39 In principle, a schools PFI scheme should not lead to a change in the VAT status of a local authority. It is expected that, providing the scheme is effectively managed, there should not normally be any significant additional VAT exposure for the local authority. However, local authorities should be aware that PFI arrangements can give rise to increased exempt activity through the granting of interests in land and/or sports facilities (e.g. sales, leases and licences) and this exempt activity needs to be monitored so that if necessary, the authority can opt to tax in order to protect its partial exemption position.

7 Conventional projects

7.1 The BSF standard documentation indicates the following contractual relationships.



The LEP

7.2 On conventional projects it is envisaged that the LEP will provide the design and build services to the local authority.

Supplies by the LEP

7.3 The LEP will effectively assume the role of the main contractor in a standard design and build arrangement. The LEP will charge the local authority for the services supplied based upon pre agreed milestones.

7.4 The LEP's services are likely to be subject to VAT at the standard rate i.e. as the local authority is not itself a charity it is unlikely that any zero rating will be applicable.

Supplies to the LEP

7.5 The LEP will incur the costs of the design, and construction sub contractors. These services will more than likely be subject to VAT.

VAT recovery for the LEP

7.6 In accordance with the basic principles for VAT recovery the LEP should be entitled to recover any VAT that it incurs on costs that are wholly and exclusively attributable to the taxable services under the design and build contract.

7.7 The recoverability of any other VAT incurred by the LEP will be subject to the LEP's other activities and whether they are taxable, exempt or non-business.

The local authority

- 7.8 The local authority will operate the facilities in the course and furtherance of the education of under 19 year old non-fee paying students in the normal way. In most cases, the local authority will also have the opportunity to operate the facilities outside of normal school hours although there are a number of ways this may be achieved.

Supplies by the local authority

- 7.9 The primary purpose of the redeveloped site is the provision of education by the local authority to under 19 year old non-fee paying students. This is a non-business activity for the local authority.
- 7.10 However, there are a number of potential ways in which the local authority can use the facilities outside of normal school use. A summary of the typical envisaged use can be found at Appendix C.
- 7.11 The local authority will need to consider the VAT liability of the supplies that it makes and any resulting impact on VAT recovery.
- 7.12 Where the local authority makes exempt supplies by virtue of hiring or letting space/rooms or by supplying sports facilities to clubs associations etc... (see Appendix C) it may wish to consider exercising the option to tax in respect of the facilities thus making such supplies subject to VAT at the standard rate. It should be noted that the local authority would then be required to account for VAT on all such supplies including supplies to organisations that may not be in a position to recover the VAT charged.
- 7.13 Subject to the approach of the individual local authority, the operation of the facilities outside of normal school use may be the responsibility of the school fund and/or a Leisure Trust.
- 7.14 Where the local authority uses a specifically set up Leisure Trust to operate its facilities then consideration will need to be given as to how the interest in the facilities will be granted to the Leisure Trust. Typically this would be by way of a peppercorn lease which is generally accepted by HMRC as a non-business activity. However, where a commercial lease is used, the supply would be exempt unless an option to tax had been exercised. Again, the local authority may wish to consider exercising the option to tax in respect of the facilities thus making such supplies subject to VAT at the standard rate.

Supplies to the local authority

- 7.15 The local authority will more than likely incur VAT on the full value of the design and build services provided by the LEP.
- 7.16 It is also envisaged that the local authority will incur a number of other costs which will be a mix of VATable and non-VATable items.

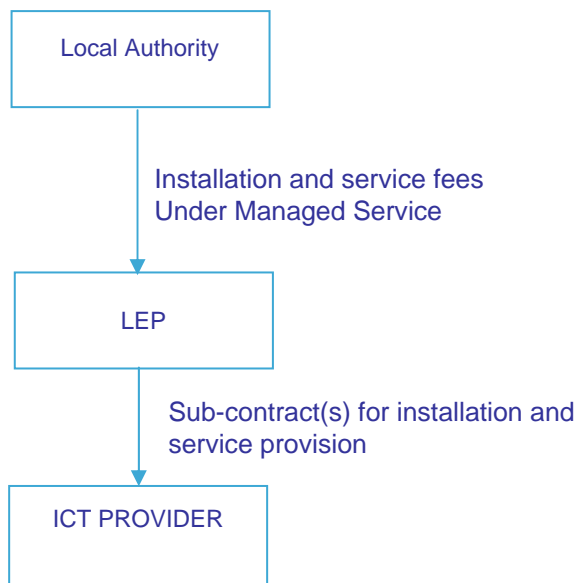
VAT recovery for the local authority

- 7.17 As per the special rules discussed in Section 2, a local authority can recover any VAT that it incurs on costs attributable to its taxable and non-business activities.

- 7.18 The key is in identifying the VAT to be incurred on costs that will be attributable to a local authority's exempt activities within the facilities. This can then be factored in to the local authority's partial exemption calculation to establish whether the local authority will be able to remain below the critical 5% de minimis limit and thus be entitled to full VAT recovery.
- 7.19 Where the 5% limit is likely to be exceeded or is too close for comfort, the local authority can exercise the option to tax as necessary to reduce the exempt activities and thus reduce the overall amount of VAT incurred on costs associated with exempt activities.
- 7.20 Because of the unusual nature of a school's financial make up, it is not always straightforward to arrive at a method for determining what proportion of the VAT incurred relates to exempt activities. A simplified method has been agreed with HMRC in relation to schools and it is understood that this has been also been accepted by HMRC (subject to minor changes) as applicable in BSF.
- 7.21 The method is reproduced at Appendix D and subject to how the individual local authority makes the facilities available for use outside of normal school use, may need slight tweaking.
- 7.22 From a VAT perspective there is no material difference between a BSF conventional project and historic school construction/renovation projects.
- 7.23 It is expected that, providing the project is effectively managed (options to tax exercised where appropriate), there should not be any significant additional VAT exposure for the local authority.

8 ICT services

8.1 The BSF standard documentation indicates the following contractual relationships.



The LEP

8.2 It is envisaged that the LEP act as the main contractor for the provision of ICT services and buy in the said services from a service provider.

Supplies by the LEP

8.3 The LEP will effectively assume the role of the main contractor for the provision of ICT services to the local authority. The LEP will charge the local authority installation and managed services fees.

8.4 The LEP's services will be subject to VAT at the standard rate.

Supplies to the LEP

8.5 The LEP will incur the costs of ICT service provider. These services will more than likely be subject to VAT.

VAT recovery for the LEP

8.6 In accordance with the basic principles for VAT recovery the LEP should be entitled to recover any VAT that it incurs on costs that are wholly and exclusively attributable to the taxable services under the contract for ICT services.

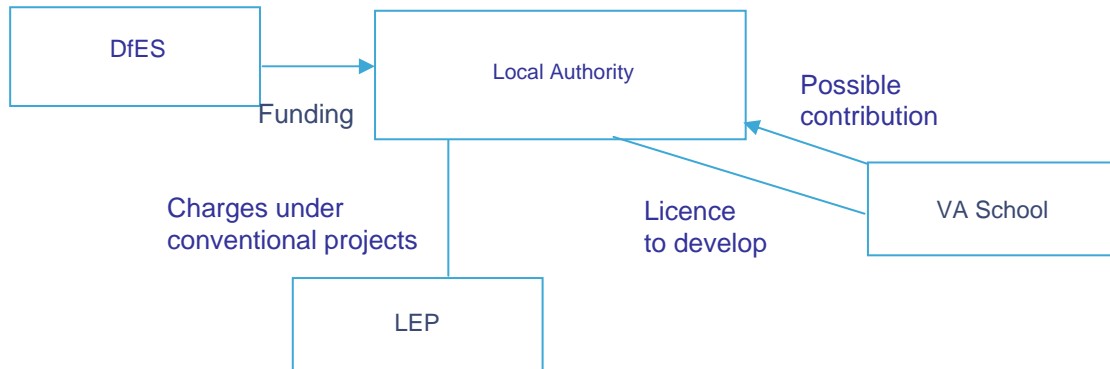
The recoverability of any other VAT incurred by the LEP will be subject to the LEP's other activities and whether they are taxable, exempt or non-business.

The local authority

- 8.7 For the local authority, the cost of the ICT services will form part of the overall cost of operating the school facilities.
- 8.8 The VAT incurred will therefore be recoverable to the extent that is attributable to taxable or non-business activities.
- 8.9 Assuming that the ICT services are not used exclusively for taxable or non-business activities, the VAT incurred will need to be included within the local authority's partial exemption calculation.

9 Voluntary Aided Schools

9.1 The BSF standard documentation indicates the following contractual relationships.



- 9.2 In many BSF projects, one or more of the schools being constructed may be voluntary aided schools ("VA schools"). In the case of VA schools, the governing body has an obligation to maintain the external fabric of their building and provide certain items of furniture and equipment. Normally, such expenses are funded by a direct grant from the DfES and where the Governors contract for works for which they are responsible, the VAT that they incur will generally be irrecoverable.
- 9.3 On the other hand, where the local authority (via the LEA) funds a project, wholly or in part, the local authority can currently recover the VAT incurred on this element, irrespective of who is actually responsible for carrying out the works. The local authority would need to contract for the works, receive an invoice in its own name and pay for the supply from its own resources.
- 9.4 Following in depth discussions between HMRC and the DfES it has been concluded that the LEA receives the funding only as agent on behalf of the Governors of a VA school. As such there will be no scope for VAT recovery via the LEA. If the Governors were to pass the funding to the local authority who in turn engage the contractors and carry out the project, HMRC would view the payment to the local authority as consideration upon which VAT would be due. Therefore, while the local authority could recover VAT on the costs associated with the project, it would need to charge and account for VAT on the onward supply to the Governors i.e. nil net benefit.
- 9.5 VA schools will need to consider the scope for mitigating irrecoverable VAT.
- 9.6 As a VA school is not part of the local authority, the favourable rules for VAT recovery do not apply and in principle a VA school cannot recover any VAT that it incurs on costs associated with its non business or exempt activities. Therefore, in most cases, the majority, if not all, of the VAT incurred by a VA school will fall to be irrecoverable and thus will be a cost to the project.
- 9.7 It is possible that the buildings being constructed will fall within the scope of the Capital Goods Scheme to the extent that they are used for business purposes and thus any VAT recovery will need to be monitored for a period of approximately 10 years (see Appendix A) and adjusted accordingly, if the level taxable/exempt use changes.

9.8 There are fundamentally only two ways to mitigate the cost of the VAT incurred on a VA school BSF project. These are considered in Section 12 of this report.

10 City Academies

- 10.1 City academies are generally developed outside of the local authority by a separate legal entity in the form of a company limited by guarantee (“the company”) which in most cases will also be a registered charity. As such the favourable VAT treatment which is afforded to local authorities is not available to the company and the normal VAT rules apply.
- 10.2 In respect of initial city academies, the DfES funded the respective company directly. Where this is the case, the company will face precisely the same fundamental VAT issues as a VA school. As such, any VAT incurred by the company will potentially be irrecoverable and thus fall as an additional cost to the project.
- 10.3 It is possible that the buildings being constructed will fall within the scope of the Capital Goods Scheme to the extent that they are used for business purposes and thus any VAT recovery will need to be monitored for a period of approximately 10 years (see Appendix A) and adjusted accordingly, if the level taxable/exempt use changes.
- 10.4 The scope for mitigating the VAT cost is considered in Section 12 of this report.
- 10.5 In the Budget 2007 the Chancellor intimated that measures would be brought in to assist city academies to address the conflict between managing VAT costs and allowing wider community use of their new facilities. The proposed measures involve the use of the Local Authority i.e. the DfES would directly fund the LEA to develop the facilities and make them available to the company. The LEA would contract for the necessary works, receive invoices in its own name and pay for the supplies from its own resources. Therefore, in theory, providing the LEA made the development available for nil consideration or for a peppercorn then it would be entitled to recover the VAT incurred in full.
- 10.6 The company therefore acquires the development without incurring VAT and without issuing any zero rating certificates (see Section 12). As such, there are no associated VAT recovery implications in connection with opening the development for community use.
- 10.7 However, although the theory behind this approach appears to work for new city academies (who will not be funded directly), it fails to address a number of questions regarding the reality of the arrangements.
- 10.8 For example,
- Contractually, who will be receiving the funding and in what capacity? Is it as with the VA schools and thus still problematic.
 - How will land/building transfers be dealt with?
 - How are contributions from commercial sponsors to be dealt with? If the LEA receives funding in return for constructing the development then this may be seen as consideration. If the LEA receives consideration, this could be subject to VAT at the appropriate rate or even worse could result create significant VAT recovery problem for the LEA.
- 10.9 Although a step in the right direction there are still a number of details to be ironed out before the proposed solution can be considered to work effectively.

11 Extended Schools

- 11.1 The issue of extended schools is still subject to ongoing discussions regarding which entity is actually considered to be making the supply.
- 11.2 This subject continues to be reported in the minutes of the CIPFA VAT Committee meetings. Although progress has been made considerable uncertainty still exists. Extracts of the various minutes are reproduced below.

June 2006

“It was noted that the DfES now appeared to recognise the delivery of services by schools as agents of the LEA as being a non business provision rather than being independently provided by the school outside of the S33 non business application. Non statutory services delivered outside of the jointly constructed strategic plan for a community would remain a provision under Section 27 powers in the Education Act 2002

Nick Williams (HMRC) agreed that it had been possible to identify the VAT flows in such arrangements and that a guidance note could now be prepared and issued via the CIPFA Technical information service.”

September 2006

“Steve Williams reported on a positive meeting with HMRC to prepare for a Guidance Note highlighting a number of key education related issues including ‘Extended Schools’. It was noted that the number of possible service delivery models relating to Extended Schools meant that a definitive note was unlikely; matters were further complicated by conflicting information emanating from the DfES which required clarification. Members also noted the Building Schools for the Future Programme, application of the 10% rule, and the subsequent fear of a contingent VAT liability on construction costs in the future.”

March 2007

Peter Gladdish queried whether where the governors of a school operate an extended school activity in their own name (i.e. not on behalf of the LEA), but the LEA makes a charge for the use of the facility, in the shape of a re-imbursment for premises expenditure, can this charge be treated as non-business if (a) it is childcare related or, (b) it is non-childcare related (e.g. leisure).

For HMRC, David Ogilvie observed that it would be necessary to review the provisions of the Schools Standards and Framework Act 1998 to establish whether a special legal regime was in place.

[Note: on 27 March 2007 HMRC replied: “ I am pleased to confirm that it can (ie be treated as non-business). Although the relevant education legislation could be clearer on the matter, it is clear from the DfES web site that in the context of the Childcare Act 2006, extended schools are seen as having an important role to play in the provision of childcare. Additionally, under the Education act 2002 there is an expectation that LEAs will have an advisory role in the context of extended schools. Following the judgment in Edinburgh Telford College, we consider that the LEA’s role in this matter is governed by an overarching special legal framework and that its charge to the governors for the use of the premises is not consideration for any supply to the governors.”]

June 2007

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“Steve Williams drew attention to what may prove to be the unanticipated effect of the clarification issued in April confirming the non-business status of recharges to school governors and other parties in respect of extended schools. Had HMRC intended that this would include such third party recharges as catering, furniture, stationery, non-teaching secondments etc? If there is to be a demarcation between recharges for education-related activities, and those for wider community use, there is an urgent need for specific guidance as to respective VAT liabilities.

For HMRC, David Ogilvie agreed that boundaries were being pushed further than envisaged and he would take this matter on board.”

20 Extended Schools – income from events

“Andy Stapley queried the liability of fees for events run at a school under the Extended Schools umbrella, for example a Family Health Club. Such events attract participation from the wider community.

If the LEA were making the charge this would fall to non-business under the social welfare provisions/Extended Schools initiative. If the school governors levy a charge, the normal rules would apply.

However, Steve Williams observed that under the latest DfES guidance the latter could include sports activities which should logically be non-business.”

12 Scope for mitigating the VAT cost

- 12.1 Subject to the specifics of the individual project, there are potentially a number of ways in which it may be possible to mitigate some, if not all of the irrecoverable VAT costs.

Traditional LEA operated school

- 12.2 Where the school is operated by the LEA, the VAT issues will revolve around the Local Authority's partial exemption position. In most cases, the cost to the Local Authority of being partially exempt will be significant.
- 12.3 In many cases it will be possible to manage the partial exemption position by opting to tax the facilities. This will ensure that, with potentially minor exceptions, all lettings of rooms and sports facilities (irrespective of the block booking criteria) will be subject to VAT at the standard rate. The net effect being to reduce the amount of VAT that is considered to be attributable to exempt activities within the partial exemption calculation. However, the down side is that VAT must then be accounted for in connection with the supplies and unless the proposed charges are increased accordingly, the net income will be reduced. It is likely that any VAT charged will not be recoverable by the users and thus represents an additional cost for them
- 12.4 Alternatively, making what would be exempt services available free of charge (non business) – for example not charging what may amount to a relatively small amount, may make a significant difference to the partial exemption calculation, while still permitting the facilities to be made available to the community. Again this would represent a commercial decision, balancing the loss of income against the impact on the partial exemption calculation.
- 12.5 In extreme circumstances it may be worth considering the use of a separate legal entity to deliver the leisure facilities within the Local Authority's region. For example, in cases where leisure services have been transferred to separate charitable Trusts, the Trusts are permitted to operate from the facilities under a management agreement which generally includes a peppercorn lease. In such cases there is unrestricted community use, the VAT sporting exemption applies to the Trust (see Appendix B) and the peppercorn lease is generally considered to be a non business activity for the local authority. As such the local authority will limit the exempt supplies that it makes and thus reduce the amount of VAT it incurs that is considered to be attributable to exempt activities within the partial exemption calculation.
- 12.6 Where the exempt use of the BSF facilities equates to less than 5% (see Appendices D and G) then the programme should not, in its own right, result in a partial exemption issue.

VA schools/City Academies

- 12.7 Where the Governors of a VA school ("Governors") are funded directly by the DfES (LEA only acting as agent) the issues are much the same as with directly funded City Academies ("Academies"). There are fundamentally only two ways to mitigate the cost of the VAT incurred on such projects.

Do not incur VAT on the costs in the first instance

- 12.8 UK VAT legislation currently zero rates services (excluding architectural, surveying, consultancy or supervisory services) when supplied to a charity in the course of construction of a building intended for use solely for a relevant charitable purpose. This only applies to new buildings and not to the conversion, adaptation or extension of existing

- buildings.
- 12.9 Relevant charitable purpose is defined as use by a charity in either or both of the following ways: -
- a) Otherwise than in the course or furtherance of a business; or.
 - b) As a village hall or similarly in providing social or recreational facilities for a local community.
- 12.10 It is unlikely that HMRC will accept that a BSF project will fall within the definition of a village hall or similar therefore, under UK VAT law, in order for the zero rating to apply, the VA school/Academy must be used solely for non-business purposes i.e. no charges made – e.g. education of non fee paying pupils.
- 12.11 However, by Extra Statutory Concession, HMRC allow zero rating where there is minimal (as opposed to no) business use. In principle, HMRC will allow zero rating where the building is to be used for a minimum of 90% (as opposed to solely) non-business use.
- 12.12 There are only a limited number of methods that can be used to determine the 90% use and these generally have to be agreed with HMRC in advance. The methods and their associated conditions are considered in more detail in Appendix E.
- 12.13 Due to the way in which some of the methods operate, the actual design of the school and its sports facilities can be an important factor. For example, the results of the floor space method would be significantly different if the sports facilities (which will invariably fail to qualify for non business use) formed part of the main school building as opposed to being a separate construction.
- 12.14 In order to allow the contractors to zero rate their supplies, the Governors/Academy will be required to issue an appropriate certificate confirming that they are a charity and intend to use the building/s for at least 90% non-business use.
- 12.15 Prior to the Budget 2007, the Governors/Academy were required to maintain the conditions necessary for zero rating (including the 90%+ non-business use) for a period of 10 years. If at any stage within this 10 year period, the conditions ceased to be met, a VAT liability would crystallise for the Governors/Academy (NOT the contractor).
- 12.16 However following the Budget 2007, with effect from 21 March 2007, HMRC will not enforce the self-supply charge when there has been a 'change of use' that was not anticipated at the time that zero-rating was obtained under the concession. This means that Governors/Academy using the concession to obtain zero-rating, and whose non-qualifying use subsequently exceeds 10 per cent within the 10-year adjustment period, will not now be required to account for a self-supply charge. However, if it is apparent that, at the time that zero-rating certificate was issued, it was intended or anticipated that the non-qualifying use would exceed 10 per cent within the 10-year adjustment period, HMRC will consider that the original supply should never have been zero-rated in the first place. In such circumstances HMRC would seek payment of the full amount of VAT not charged.
- 12.17 This, in effect makes it even more critical that zero rating certificates are only issued after due care and consideration has been give to the intended use of the buildings in question. In reality, there will still be buildings or parts of buildings where it is simply not possible to achieve zero rating.
- 12.18 The 90% non business test essentially limits the amount of commercial use. This is

particularly the case in respect of the sports facilities where there is greater scope for generating income from community use outside of school hours.

- 12.19 In theory, where the governing body/Academy is a registered charity, it should be possible to issue some form of zero rating certificate. Furthermore, through careful design and use of design/build contracts it may be possible to maximise the scope of the zero rating certificate to cover professional fees.
- 12.20 However, in practice, issuing a zero rating certificate can prove very difficult to support. Business use of the facilities is not always apparent at first sight. For example, admissions to school events/performances and sales of meals to staff and visitors all constitute business use.
- 12.21 It may be possible to tailor the physical design of the facilities and their intended use so as to maximise the availability of zero rating whilst still permitting some level of commercial use. In the majority of cases this would need to be considered very early in the process and may still result in a compromise.
- 12.22 The scope for zero rating can be further improved by limiting the charges that are made – for example not charging a particular user group several hundred pounds for what would be an exempt supply may result in the construction costs being zero rated and saving several thousand pounds in VAT.

Maximise the scope for recovering the VAT incurred

- 12.23 For most school buildings it should be possible to identify at least a part of the building that meets the 90% time test (see Appendix E). However, in the majority of cases it is unlikely that an appropriate zero rating certificate can be issued for the whole of the school building and perhaps even less likely that one can be issued for the sports facilities (assuming there is some level of commercial use).
- 12.24 Where VAT is incurred, the only possible mechanism for recovery is through the VAT registration of the governing body/Academy. As VAT registration applies to the entity as opposed to its activities, the governing body/Academy will need to consider the implications of VAT registration on their whole range of activities (including any existing ones).
- 12.25 As set out in Section 4, under the basic principles only the proportion of the VAT on the development costs that relates to taxable use of the buildings can typically be recovered. The VAT that relates to exempt use is not normally recoverable. The VAT that relates to the non-business use is either not recoverable or the equivalent of temporarily recoverable under the Lennartz mechanism (Appendix H).
- 12.26 It therefore follows that the more the school buildings and sports facilities are used for taxable purposes, the greater the degree of VAT that can be recovered on the development costs (and the ongoing running costs).
- 12.27 Although the core school use will be almost exclusively non-business, the Governors/Academy should consider the scope for introducing/increasing the taxable use by opting to tax and/or structuring the delivery of sporting services in alternative ways.
- 12.28 Opting to tax will ensure that, with potentially minor exceptions, all lettings of rooms and hire of sports facilities to clubs/associations etc... (irrespective of the block booking criteria) will be subject to VAT at the standard rate. The net effect of this will be to increase the level of VAT recovery in connection with the construction costs. However,

the down side is that VAT must then be accounted for in connection with the supplies and unless the proposed charges are increased accordingly, the net income will be reduced. It is likely that any VAT charged will not be recoverable by the users and thus represents an additional cost for them. This will be a commercial decision based upon the long term loss of income/need to increase charges balanced against the one off increase in VAT recovery in connection with the development costs/long term increase in VAT recovery in connection with operating costs.

- 12.29 Furthermore, supplies such as sporting services and coaching when supplied to individuals can also be made taxable if they are delivered by a trading company which does not itself qualify as an eligible body for the purposes of the sporting exemption (Appendix B). Again, this will be a commercial decision based upon the long term loss of income/need to increase charges balanced against the one off increase in VAT recovery in connection with the development costs/long term increase in VAT recovery in connection with operating costs. Further advice should be sought if this option is to be considered.
- 12.30 Unlike the traditional LEA schools, the issues for VA Schools/Academies are more of a compromise. The key is striking the correct balance between making certain supplies taxable to increase initial VAT recovery and the use of the Lennartz mechanism.
- 12.31 For VA Schools, the fact that the LEA is still responsible for the delivery of education (and is entitled to recover the VAT incurred on associated costs) provides an additional opportunity to maximise VAT recovery. If an appropriate agreement can be reached with the LEA, it may be possible to achieve full VAT recovery in connection with the sports facilities.

13 Summary of key points

- The LEP will be a separate legal entity and as a result, consideration should be given to VAT registration of the LEP.
- The LEP should also consider the VAT liability of the supplies it makes to other partners and third parties and its ability to recover VAT on its costs.
- The partners will need to consider if they are connected to the LEP; this could give rise to open market value issues for VAT purposes.
- The local authority should consider if the BSF programme gives rise to any additional exempt activity in order to assess the partial exemption implications.
- Both the SPV and the local authority should consider whether an option to tax over land and buildings is appropriate to protect their ability to recover VAT on costs attributable to supplies of those land and buildings.
- The catering arrangements of any PFI structure should be carefully considered to ensure that the arrangements do not create an additional VAT cost in the supply of meals and refreshments to pupils.
- The local authority may pass on a proportion of the costs incurred in relation to a PFI structure to the Governors of a VA school. Where the recharge represents the costs of ongoing external repairs and maintenance, the supply to the governing body will be standard rated and such VAT may fall as a cost to the Governors.
- Local authorities should be aware that HMRC are in the process of reviewing the rules around VAT recovery in relation to voluntary aided schools, although we would expect any changes to be preceded by a transitional period.
- A PFI structure should normally not have a detrimental impact on a local authority's VAT position, provided the arrangements are carefully considered and the partial exemption position is managed appropriately.
- VAT may fall as a cost to the governing body of a VA school and/or a City Academy. Consideration should therefore be given to the possibility of zero-rating supplies of construction services to minimise such additional costs.
- In the context of BSF, zero-rating is only available where services are supplied to the Governors of a Voluntary Aided school or a City Academy in the course of construction of a new building (not extension or renovation) to be used for a relevant charitable purpose.

14 Further advice

- 14.1 This guidance has been produced to assist BSF project teams in identifying the generic VAT issues inherent within the BSF programme and the various methods of delivery. It should not to be taken as a substitute for obtaining VAT advice in respect of a specific BSF project.
- 14.2 It is always recommended that specific advice should be sought, which should be based on the particular arrangements of that BSF project. If further advice or clarification is required please feel free to contact the author of this document, Mark Eastwood on 0113 2894556 (email mark.eastwood@uk.pwc.com), or your usual PwC Government and Public Sector team contact.

Partial Exemption

It should be noted that this Appendix is only a high level analysis of partial exemption and is intended simply to illustrate the mechanisms for identifying irrecoverable VAT.

Any VAT registered entity that makes both taxable and exempt supplies is described as being partially exempt. As discussed, VAT incurred on costs associated with exempt activities is not normally recoverable.

The process of determining to what extent the VAT incurred (on costs directly or indirectly associated with exempt activities) is recoverable is called partial exemption.

UK VAT legislation sets out what is referred to as the standard method for partial exemption which is as follows –

The Standard Method

The first stage is what is referred to as direct attribution and each cost (invoice) needs to be considered individually.

- VAT incurred on costs that are wholly and exclusively attributable to taxable activities is recoverable in full.
- VAT incurred on costs that are wholly and exclusively attributable to exempt activities will not be recoverable subject to the de-minimis limit (see below).

Any VAT incurred on costs that relate partly to taxable and partly to exempt activities will be recoverable in part but may be recoverable in full subject to the de-minimis limit.

VAT on costs which cannot be directly attributed is normally referred to as 'non-attributable' or 'residual' input tax. A partial exemption method must then be used to apportion this residual input VAT to determine how much of it is reclaimable. As the standard method for calculating recoverable VAT is an income based method, the percentage of residual input VAT which can be reclaimed is calculated as follows:

$$\frac{\text{Total value of taxable supplies}}{\text{Total value of supplies}} \times 100$$

If the resulting percentage is not a whole number (and the total residual input VAT is less than £400,000 per month on average), it should be rounded up to the next whole number.

In principle VAT that is recoverable is that amount that is directly attributable to taxable supplies plus the percentage of residual VAT arrived at by performing the calculation outlined above.

De minimis limit

Where the total non recoverable VAT (that which is directly attributable to exempt supplies or is not recoverable under the above calculation) in any VAT period is not more than:

1. £625 per month on average over the period, and
2. one half of the total input VAT for the period concerned,

then all such VAT in that period is treated as being attributable to taxable supplies i.e. it is recoverable in full.

Annual adjustment

The VAT recovery determined above is only a provisional recovery as there is also a requirement to carry out an annual adjustment. This is essentially the same calculation applied to the year as a whole. It is intended to balance out any seasonal trends.

The level of VAT recovery resulting from the annual calculation is compared to the actual VAT recovery throughout the year. Any difference is required to be adjusted accordingly.

Special Methods

If it can be demonstrated that the standard method does not produce a fair and reasonable result, then HMRC will consider proposals for use of a special method. An example of a special method would be a method based upon a combination of space and time that the facilities are used for taxable and exempt activities.

Capital Goods Scheme

The VAT capital goods scheme ("CGS") applies to certain items of computer equipment, land, buildings and civil engineering works.

With regards to buildings, generally speaking the CGS applies to a building constructed, extended or refurbished at a standard rate cost (costs subject to VAT at the standard rate i.e. ignore zero rate costs) of £250,000 (net of VAT) or more.

Although the VAT incurred on the cost of acquiring/constructing the capital item is recoverable (or not as the case may be) as normal, the VAT initially recovered must be monitored over a period of 10 years and adjusted annually should the level of taxable use change.

It is likely that the majority of facilities developed under a BSF programme will fall within the scope of the CGS.

Local Authorities

As with any other VAT registered entity, if a Local Authority makes exempt supplies then it is considered to be partially exempt. However, the de minimis limit that applies to Local Authorities is much more favourable as it is based upon a percentage (5%) of the total VAT that the Local Authority incurs in the year.

Therefore, a Local Authority is entitled to recover all of the VAT that it incurs on costs that are attributable to exempt activities as long as such VAT remains below 5% of the total VAT that the Local Authority incurs in the year.

As discussed, Local Authorities are entitled to recover VAT on costs that are attributable to non-business activities. Therefore, for many Local Authorities the VAT incurred on costs attributable to exempt activities will be less than 5% of the total VAT incurred and thus is recoverable in full.

However, the mechanics of this more favourable de minimis limit mean that exceeding it more than likely results in a significant cost. Based upon the amount of VAT that a typical Local Authority incurs in a year, exceeding the de minimis limit will generally result in a significant irrecoverable VAT cost. For example, engaging in £500,000 project that results in exempt activity may push a Local Authority over its de minimis limit and cost significantly more in irrecoverable VAT across the authority as a whole. For many Local Authorities, managing their partial exemption position is a high priority.

Every Local Authority has adopted a partial exemption method which it uses to determine the

recoverability of VAT that it incurs on costs associated with exempt activities. Such methods are often complicated, taking into account specific projects and recharges between different departments or committees within the authority. Although a Local Authority specific 'special method' has been agreed with HMRC, each Local Authority will operate its own version taking into account its own unique circumstances.

VAT liability of sporting services

This Appendix covers the VAT liability of sporting services for all legal entities other than local authorities – for local authorities see Appendix C.

Typically, a supply of services in connection with sport or physical recreation will be subject to VAT. However, UK VAT legislation provides exemption for certain types of services when supplied in specific circumstances.

Exemptions available to all entities

The hire of sports facilities by clubs, associations, schools or organisations representing affiliated clubs or constituent associations is exempt from VAT where –

- a) the supply is for a period of continuous use exceeding 24 hours; or
- b) (the supply is for a series of 10 or more periods where the following are satisfied –
 - (i) each period is for the same activity carried on at the same place;
 - (ii) the interval between each period is not less than 1 day but no more than 14 days;
 - (iii) the consideration is payable by reference to the whole series and is evidenced by a written agreement; and
 - (iv) the customer has the exclusive use of the facilities.

VAT Act 1994 Schedule 9, Group 1, Item 1 (m)

The fee for entering into a competition in sport or physical recreation is exempt where the fee is to be allocated wholly towards the provision of a prize or prizes awarded in the competition.

VAT Act 1994 Schedule 9, Group 10, Item 1

Further exemptions available to 'eligible bodies'

Until 31 December 1999, an 'eligible body' for the purposes of sporting services was simply a body which was precluded from and did not distribute any profit that it made i.e. Non Profit Distributing Organisations ("NPDO").

However, from 1 January 2000, HMRC introduced additional conditions in an attempt to prevent commercial organisations setting up in such a way as to benefit from the exemption by artificially qualifying as non profit distributing while still being able to extract profits through charges from associated business's.

Generally speaking, most genuine NPDOs will still qualify as an 'eligible body' for the purposes of the sporting exemptions. However, the additional conditions introduced from 1 January 2000 are quite complex and it is always recommended that appropriate advice is sought in order to be certain.

Where an entity qualifies as an 'eligible body' for the purposes of the sporting exemption the following supplies are exempt from VAT –

- Where the body is set up for the purposes of sport and physical recreation, the grant of a right to enter in to a competition in such activity.

- The supply to an individual of services closely linked with and essential to the sport or physical education in which the individual is taking part. Where the body operates a membership scheme, the exemption only applies to its members i.e. supplies to non members remain subject to VAT.

VAT Act 1994 Schedule 9, Group 10 Items 2 and 3.

Envisaged use by a local authority outside of normal school use

Education (free)

Where education is provided totally free of charge it is generally considered a non-business activity for the local authority. However, care should be taken when establishing whether fees exist but are simply met by a third party.

Education (fee paying)

The local authority is an eligible body for the purposes of the VAT Act 1994 Schedule 9 Group 6 and as such any education which is supplied for a fee is exempt from VAT.

Catering (provided to students)

Catering supplied to under 19 year old non-fee paying students is typically treated as a non-business activity itself providing it is supplied at or below cost. Catering supplied to fee paying students is exempt from VAT.

Catering (general)

Catering supplied to non-students will be subject to VAT at the standard rate although there may be some scope for zero rating certain cold take-away food.

Hire or letting of space/rooms (for a fee)

The hire or letting of space/rooms for a fee is normally exempt from VAT. However, if an option to tax is exercised by the local authority then the supply (subject to minor exceptions) becomes subject to VAT at the standard rate.

Hire or letting of space/rooms (no charge or a peppercorn)

The hire or letting of space/rooms, where no charge is made or where the charge is on a peppercorn basis, is a non business activity for the local authority

Provision of sports facilities for individuals

Local authorities are specifically excluded from the exemption under VAT Act 1994 Schedule 9 Group 10. As such, all supplies by local authorities to individuals of the provision of facilities for taking part in sport of physical recreation are subject to VAT at the standard rate.

Provision of sports facilities for clubs etc...

The supply of sports facilities is normally subject to VAT at the standard rate. However, when the supply is made to clubs, associations, schools or organisations representing affiliated clubs or constituent associations and

- a) the supply is for a period of continuous use exceeding 24 hours; or
- b) the supply is for a series of 10 or more periods where the following are satisfied
 - (i) each period is for the same activity carried on at the same place;
 - (ii) the interval between each period is not less than 1 day but no more than 14 days;
 - (iii) the consideration is payable by reference to the whole series and is evidenced by a written agreement; and
 - (iv) the customer has the exclusive use of the facilities

Then the supply becomes exempt from VAT.

It should be noted that where the local authority has exercised the option to tax in respect of the facilities in question, the exemption is no longer available and VAT should be charged accordingly.

Coaching

As the local authority is an eligible body for the purposes of the VAT Act 1994 Schedule 9 Group 6 coaching supplied for a fee is exempt from VAT. Coaching supplied free of charge is a non-business activity.

Simplified method for Local Authorities

Schools, by their very nature are engaged in non business activities which, in the main, generate little income. Furthermore, the limited income generating activities that a school does have may be subsidised e.g. trips and school meals.

Given that the income that a school generates across its range of business and non business activities is vastly disproportionate to the cost of providing the said activities, the standard method of determining the level of VAT recovery under partial exemption (income based) is considered inappropriate.

A simplified method has been agreed with HMRC which is considered to produce a more fair and reasonable result. Using this simplified method the VAT that is considered to relate to the exempt activities of a school (and thus needs to be incorporated into the partial exemption method) is determined as follows –

$$\frac{\text{Total value of exempt supplies}}{\text{Total school expenditure (exc VAT and capital)}} \times \text{VAT incurred by the school (inc capital)}$$

Non business use tests

The possible methods for determining the 90% plus, non-business use, are set out below and consider if and to what extent a zero rating certificate can be issued by a charity

The following extract from the Extra Statutory Concession describes the method that can be used to determine the 90% test and the associated conditions.

- 1 Time (whole building) - For the purposes of VATA 1994 Sch 8 Groups 5 and 6, Schedule 9 and 10 Group 1, and subject to the conditions set out below, the non-qualifying use of a building can be ignored if the entire building will be used solely for a qualifying purpose for more than 90 per cent of the total time the building is available for use.
- 2 Time (part building) - Alternatively, the non-qualifying use of an identifiable part of a building can be ignored if that part of the building will be used solely for a qualifying purpose for more than 90 per cent of the total time that part of the building is available for use.
- 3 Floor space - Alternatively, the non-qualifying use of a building can be ignored if 90 per cent or more of the floor space of the entire building will be used solely for a qualifying purpose.
- 4 Head count - Alternatively, the non-qualifying use of a building can be ignored if the entire building will be used solely for a qualifying purpose by 90 per cent or more of the people using the building (on a head count basis).

Conditions

- 1 For any one building only one of the four methods may be used.
- 2 The time based test for parts of a building, the floor space test and the head count test may only be used with the written agreement of HMRC.
- 3 The floor space and head count tests may not be applied to parts of a building.
- 4 The concession must be calculated and applied at the time a relevant supply is made. This is usually when the question arises of whether a building, or part of a building is used or will be used for a relevant charitable purpose.
- 5 The concession must be applied in a way which ensures a result which is fair and reasonable to both the taxpayer and HMRC.
- 6 This extra-statutory concession applies to supplies made on or after 1 June 2000.
- 7 It is a condition of the relief for charitable buildings that they continue to be used for the qualifying purpose for ten years after their completion. If during this ten-year period the building (or part of it) is put to a non-qualifying use that exceeds the terms of this concession, VAT must be accounted for on the deemed self supply that arises by virtue of VATA Sch 10 para 1.

Option to tax

A grant of a right over or interest in land is generally exempt from VAT. However, in certain circumstances the grantor can elect to waive the exemption or opt to tax the supply thus making it subject to VAT at the standard rate.

Anti-avoidance rules

Although introduced to combat what HMRC perceive as VAT avoidance, the anti-avoidance rules also inadvertently apply to many scenarios where HMRC accept that no VAT avoidance is taking place.

The anti-avoidance rules are complex but in principle they disapply the option to tax in relation to a grant of an interest in land/buildings in circumstances where –

- The grantor is the developer of the land/buildings and the grant involves a building or part of a building which is a capital item for the purposes of the VAT capital goods scheme i.e. cost in excess of £250,000 (exc VAT) to develop.
- The grant is made within the 10 year period of adjustment required by the VAT Capital Goods Scheme.
- At the time of the grant, it is intended that the grantor or a person responsible for funding (or part funding) the grantors development or a person connected with either, will during the 10 year period of adjustment, occupy the building otherwise than mainly for eligible purposes (at least 80% VATable business activity).

Example Case studies

These high level case studies are intended to illustrate the issues and potential solutions in a typical BSF programme. They are not intended to provide definitive advice.

Case study 1

Somewhereborough Council (“the Council”) is a Unitary authority delivering the usual range of services.

The Council typically incurs £24million of VAT per year of which approximately £1.1m (4.5%) relates to exempt activities. The Council is therefore below its 5% partial exemption de minimis limit and thus recovers the £24million in full

The Council has 15 LEA schools and 1 VA school. The Council is receiving £50million under BSF which it has allocated as follows –

<i>School</i>	<i>Cost</i>		<i>Works</i>
A1 secondary school	£10m	£1.75m VAT	New school
Conventional contract	£5m	£875k VAT	New sports facility
Other schools	£15m	£2.625m VAT	Refurbishment of schools
Conventional contracts	£5m	£875k VAT	Refurbishment of sports facilities
St John’s VA school	£10m	£1.75m VAT	New school
Conventional contract	£5m	£875k VAT	New sports facility
A2 secondary school	£4m	£700k VAT	Refurbishment
PFI contract	£4m	£700k VAT	New sports facility
£1m per annum unitary charge			

Once completed the Council intends to utilise the new facilities for community use outside of normal school hours. This will include adult education, lettings to third parties and hire of sports facilities. With the exception of the A1 and A2 secondary schools the Council estimates that the use of the school buildings will include fee paying adult education (1%) and room/facilities hire (1%).

The A1 and A2 secondary schools are much more community facing and the Council estimates the usage as follows.

A1/A2 secondary school building	
Core school use	90%
Adult education (fee paying) evenings, weekends and holidays	5%
Lettings of class rooms/hall to community groups etc...	5%
A1/A2 secondary sports facilities	
Core school use	50%
Club block bookings	35%
Private hire/individuals	5%
Coaching sessions/lessons (fee paying)	10%

For the purposes of this study it has been assumed that all of the costs are incurred in the same financial year.

VAT implications

All of the conventional contracts will be managed by the LEP under design and build contracts. The value of the contracts means that the LEP will be obliged to register for VAT. The design and construction sub contractors will charge VAT to the LEP on their respective services. The LEP will be entitled to recover the VAT that it incurs on the basis that it makes an onward taxable supply of services to the Council. The LEP will charge and account for VAT on its services to the Council. Therefore, VAT should not fall to be a cost for the LEP.

With regard to the PFI contract, the SPV incurs all of the construction costs along with the hard and soft facilities management charges and the LEP management charges (all subject to VAT). In order to recover the VAT that it incurs, the SPV must make only taxable supplies to the Council. Therefore, to avoid any potential challenge by HMRC that an element of the unitary charge relates to an interest in land and thus should be exempt, the SPV opts to tax its interest in the school/sports facilities. As with the LEP, VAT should not fall to be a cost for the SPV.

If managed correctly, all of the VAT and associated complications ultimately flow through the LEP and the SPV to the Council

In this scenario there are 2 key areas on which the Council must focus. The first is the capacity in which the Council receives the funding for the VA school. The second and always most significant, is the impact on the Council's partial exemption calculation.

Based upon current agreements with HMRC, the Council will be entitled to recover the VAT that it incurs on the costs of the VA school works providing it meets the conditions set out in Section 9 of this report.

However, if the Council is simply receiving the funding as agent of the VA school then the VAT will not be recoverable. Alternatively, the Council may be entitled to recover the VAT if it makes an onward charge (plus VAT as appropriate) to the VA school. Either way, the VAT then becomes an issue for the VA school. For the purposes of this particular study it is assumed that the Council is entitled to recover the VAT. However, Case study 2 looks at the issues faced by a City Academy which are almost identical to those faced by the VA school when the local authority only acts as its agent.

Turning to the second key issue, the Council must ascertain whether, having incurred all of the VAT on the costs of the BSF programme, it will remain below its partial exemption de minimis limit.

Based upon the level of VAT typically incurred in a year, plus the additional VAT resulting from the BSF programme, the Council can project what it believes will be its 5% de minimis limit for the year.

Typical VAT incurred	£24m
A1 secondary school	£2.625m
Other schools	£3.5m
St John's VA school	£2.625m
A2 secondary school	£0.175m – annual unitary charge only
Total	£32.925m
De minimis limit (5%)	£1.646m

Of the £24m VAT typically incurred, £1.1m is already identified as attributable to exempt activities. Therefore, providing that no more than an additional £546k of VAT is considered to relate to exempt activities then the Council will remain below its partial exemption de minimis

limit and all of the VAT will be recoverable.

The required level of analysis of the exempt use of the schools and their sports facilities will vary significantly from one local authority to another depending upon how easily it can be demonstrated that the partial exemption de minimis limit will not be exceeded.

For the purposes of this study each BSF funded development will be considered in turn.

*A1 secondary school - new build school and sports facility
VAT incurred - £1.75m school, £875k sports facility*

The exempt use of the school amounts to 10% overall i.e. the fee paying adult education and the room/hall lettings. Therefore in principle, the worst case scenario is that 10% of the VAT incurred on the cost of the school is attributable to exempt activities and needs to be included in the partial exemption calculation – 10% of £1.75m equals £175k.

The exempt use of the sports facility amounts to 45% overall i.e. the club block bookings and the coaching. Therefore in principle, the worst case scenario is that 45% of the VAT incurred on the cost of the sports facility is attributable to exempt activities and needs to be included in the partial exemption calculation – 45% of £875k equals £394k.

*A2 secondary school – PFI refurbished school and sports facility
VAT incurred on unitary charge (say split 50:50) - £87,500 school, £87,500 sports facility*

As above, the exempt use of the school amounts to 10% overall. Therefore in principle, the worst case scenario is that 10% of the VAT incurred on the cost of the school is attributable to exempt activities and needs to be included in the partial exemption calculation – 10% of £87,500 equals £8,750, say £9k.

The exempt use of the sports facility amounts to 45% overall. Therefore in principle, the worst case scenario is that 45% of the VAT incurred on the cost of the sports facility is attributable to exempt activities and needs to be included in the partial exemption calculation – 45% of £87,500k equals £40k.

*The St Johns VA school - new build school and sports facility
VAT incurred - £1.75m school, £875k sports facility*

As the VAT is attributable to the non-business transfer of the completed facilities to the Governors of the VA school, there is no exempt supply and thus no impact upon the partial exemption calculation.

*Remaining schools
VAT incurred - £3.5m*

The exempt use of the facilities amounts to 2% overall. Therefore in principle, the worst case scenario is that 2% of the VAT incurred on the costs is attributable to exempt activities and needs to be included in the partial exemption calculation – 2% of £3.5m equals £70k.

Summary

VAT on BSF costs associated with exempt activities - £688k (£175k+£394k+£9k+£40k+70k).

VAT on costs relating to wider exempt activities - £1.1m

Total VAT attributable to exempt activities - £1.788m

De minimis limit (5%) - £1.646m

The Council will therefore be partially exempt if it does not take steps to minimise exempt activity and will face an irrecoverable VAT cost of £1.788m.

Possible solutions

The Council must reduce the VAT attributable to exempt activities by at least £142k in order to avoid being partially exempt. There are potentially a number of steps that the Council can take.

1 Opt to tax the A1 Secondary school

Opting to tax the A1 Secondary school buildings will result in the following supplies becoming subject to VAT i.e. no longer exempt –

School building – lettings of class rooms/hall (5%)
Sports facilities – club block bookings (35%)

As a result, the partial exemption position for the A1 Secondary school would change as follows -

The exempt use of the school amounts to 5% overall i.e. the fee paying adult education. Therefore in principle, the worst case scenario is that 5% of the VAT incurred on the cost of the school is attributable to exempt activities and needs to be included in the partial exemption calculation – 5% of £1.75m equals £87,500, a reduction of £87,500.

The exempt use of the sports facility amounts to 10% overall i.e. coaching. Therefore in principle, the worst case scenario is that 10% of the VAT incurred on the cost of the sports facility is attributable to exempt activities and needs to be included in the partial exemption calculation – 10% of £875k equals £87,500, a reduction of £306,500

The total reduction in VAT that is attributable to exempt activities is £394k. Therefore, under this option the Council would avoid being partially exempt. Furthermore, it is evident that the Council could also avoid being partially exempt by option to tax only the Sports facilities. This would only be possible if the Sports facilities were not connected to the School buildings.

The impact of opting to tax means that the Council must charge VAT on services which otherwise would be exempt from VAT. Therefore, having opted to tax, the Council must either increase its charges to reflect the VAT charged or absorb the VAT itself. This is a commercial decision for the Council.

As previously stated it is unlikely that many of the users of the Sports facilities will be in a position to recover any VAT charged by the Council. Therefore the addition of VAT to the charges would represent a real cost to the users.

1a Adopt a specific booking policy at the A1 Secondary school Sports facilities

By adopting a booking policy that prevents any potential user qualifying for exemption under the block booking conditions it is possible to achieve the exact same result in respect of the Sports facilities in 1 above, without opting to tax.

This is particularly advantageous where the School buildings are connected to the Sports facilities as it does not impact upon the non sports lettings in the School building.

2 Opt to tax the A2 Secondary school

Opting to tax the A2 Secondary school buildings will result in the following supplies becoming subject to VAT i.e. no longer exempt –

School building – lettings of class rooms/hall (5%)
Sports facilities – club block bookings (35%)

As a result, the partial exemption position for the A2 Secondary school would change as follows -

The exempt use of the school amounts to 5% overall i.e. the fee paying adult education. Therefore in principle, the worst case scenario is that 5% of the VAT incurred on the cost of the school is attributable to exempt activities and needs to be included in the partial exemption calculation – 5% of £87,500 equals £4,375, a reduction of £4,375.

The exempt use of the sports facility amounts to 10% overall i.e. coaching. Therefore in principle, the worst case scenario is that 10% of the VAT incurred on the cost of the sports facility is attributable to exempt activities and needs to be included in the partial exemption calculation – 10% of £87,500 equals £8,750, a reduction of £8,750

The total reduction in VAT that is attributable to exempt activities is £13,125. Therefore, in isolation, this option would not avoid the Council being partially exempt.

As a PFI contract, the level of VAT incurred is considerably less as it relates to an annual unitary charge as opposed to a one off capital cost. The impact of the PFI project on the Council's partial exemption calculation is less significant. Therefore any option to tax will also have less impact on the partial exemption calculation but will still result in exactly the same issues regarding the commerciality of charging VAT to the users of the facilities.

2a Adopt a specific booking policy at the A2 Secondary school Sports facilities

As per 1a above an alternative is to adopt an appropriate booking policy to avoid the block bookings being exempt.

3 Opt to tax the remaining schools

Opting to tax the remaining school buildings will result in the following supplies becoming subject to VAT i.e. no longer exempt –

School building – lettings of class rooms/hall (1%)

As a result, the partial exemption position for the remaining schools would change as follows -

The exempt use of the school amounts to 1% overall i.e. the fee paying adult education. Therefore in principle, the worst case scenario is that 1% of the VAT incurred on the cost of the school is attributable to exempt activities and needs to be included in the partial exemption calculation – 1% of £3.5m equals £35k, a reduction of £35k.

Again, in isolation, this option would not avoid the Council being partially exempt.

4 If possible, cease charging for certain activities e.g. adult education and or coaching

By ceasing to charge, the supply of adult education and coaching become non-business activities. Although from a commercial perspective, not charging may seem like a bad idea, the impact of not charging what may be a relatively small amount could have a significant impact upon the partial exemption calculation. By not charging the VAT attributable to exempt activities would be reduced as follows -

A1 Secondary school

School building (£1.75m VAT) 5% adult education becomes non-business therefore the VAT attributable to exempt activities is reduced by £87,500

Sports facilities (£875,000 VAT) 10% coaching becomes non-business therefore the VAT attributable to exempt activities is reduced by £87,500

A2 Secondary school

School building (£87,500 VAT) - 5% adult education becomes non-business therefore the VAT attributable to exempt activities is reduced by £4375

Sports facilities (£87,500 VAT) - 10% coaching becomes non-business therefore the VAT attributable to exempt activities is reduced by £8750

Remaining schools

School building (£3.5m VAT) - 1% adult education becomes non-business therefore the VAT attributable to exempt activities is reduced by £35,000.

Conclusion

The partial exemption issues can be addressed by opting to tax the Sports facilities at A1 Secondary school or alternatively adopting a booking policy that prevents a block booking being made that qualifies as exempt.

Alternatively, a permutation of the other options will also ensure that the Council does not fall to be partially exempt.

Example Case studies

Case study 2

This case study examines the issues that are faced by City Academies and VA Schools (where the local authority only receives the funding as agent of the school). In doing so, the study focuses on a VA school scenario but it should be noted that the same issues also apply to City Academies. Unlike the first case study, the issues faced are wider ranging and result in compromises rather than definitive solutions.

As part of its BSF programme Somewhereborough Council ("the Council") received £15m funding as agent on behalf of the governing body of St John's VA school ("the Governors"). The funding is to be used to replace the existing school buildings/sports facilities, which are to be demolished. The funding has been allocated as follows -

£10m	£1.75m VAT	New school
£5m	£875k VAT	New sports facility

Once completed the Governors intend to utilise the new facilities for community use outside of normal school hours. This will include adult education, lettings to third parties and hire of sports facilities. An analysis of use is set out below –

School building

Under 19/non fee paying students (non-business)	1500
School building total floor space	15000m ²

It is expected that fee paying courses (exempt business activity) will attract approximately 200 individuals over the year who will use classrooms that amount to no more than 400m² for 3 hours on weekday evenings.

Approximately 1000m² relates to areas where there could be occasional business use. For example, admission charges to school productions and special events.

A further 600 m² will be available for casual hire by third parties (business use). The level of expected hires has proved impossible to gauge.

Sports facilities

Total envisaged opening	255 weekdays for 14 hours per day 102 weekend days for 9 hours per day
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Core school use (non-business)	190 days for 9 hours per day
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All parts of the Sports facilities will be used at some time by all 1500 pupils and commercial customers.

In principle, when the Sports facilities are not used for Core school purposes they will be available for commercial use.

Other than the hire of rooms in the school and the hire of sports facilities it is assumed that all other supplies are made by the LEA e.g. catering, concerts etc... and the VAT accounted for accordingly. It is acknowledged that this may differ from school to school.

VAT implications

Under the standard BSF contractual arrangements the Governors grant a licence to develop to the Council (typically for no consideration). The Council would then engage the LEP as with any other conventional contract.

The value of the contract means that the LEP will be obliged to register for VAT. The design and construction sub contractors will charge VAT to the LEP on their respective services. The LEP will be entitled to recover the VAT that it incurs on the basis that it makes an onward taxable supply of services to the Council. The LEP will charge and account for VAT on its services to the Council. Therefore, VAT should not fall to be a cost for the LEP.

The VAT incurred by the Council will be fully recoverable as it relates to an onward taxable supply to the Governors. However, unless any action is taken by the Governors, the Council will need to charge VAT to them in respect of the services supplied i.e. the construction services associated with building the new school and sports facilities. In theory, the VAT simply flows through the Council and thus is not an issue for them. However, in reality the available funding is finite and if the VAT is not managed efficiently it will have an adverse impact on the development and hence the LEA's ability to deliver education.

Generally speaking, the Governors will not be registered for VAT and unless the level of taxable activity exceeds the VAT registration threshold there will be no requirement to register. However, where VAT is incurred, the only mechanism through which recovery can be sought is VAT registration. That said the Governors will only be entitled to recover the VAT charged by the Council to the extent that it relates to their taxable business activities. In most cases this will not amount to a significant proportion.

Summary

The VAT on the costs associated with the construction of the new school building amounts to £1.75m VAT. The school building will be used predominantly for non-business activities although there will also be exempt use (room hire). It is assumed that the Governors will not make any other supplies i.e. adult education, catering etc.. will be supplied by the LEA. In this scenario, none of the £1.75m will be recoverable.

The VAT on the costs associated with the construction of the new sports facilities amounts to £875k VAT. The sports facilities will be used for non-business activities for a good proportion of the time although there will be a greater degree of business use. In contrast to the school building it is assumed that the business supplies will be made by the Governors. These will be a mix of exempt and taxable supplies. In this scenario, the proportion of the £875k VAT that relates to the provision of taxable supplies will be recoverable if the Governors register for VAT.

Mitigating the VAT cost

The Governors have a number of potential areas to consider. Some will be more appropriate than others but each is considered below.

Avoid VAT being charged by the Council

The most effective way to mitigate the cost of irrecoverable VAT is to avoid being charged VAT in the first instance. The Governors can consider the scope for issuing a zero rate certificate so as to make the supplies by the Council (all or in part) zero rated. As this does not result in exempt supplies being made by the Council it does not have an adverse effect on them.

The Governors can consider the various methods available to them to determine whether they can issue a certificate and also, just as importantly, if they can maintain the conditions attached to the certificate for the necessary 10 year period. Assuming that the school building and the sports facilities are separate unconnected constructions the business use tests apply as follows. In considering the tests, for the purposes of the zero rating certificate, all business activities that take place in the buildings must be taken into account, even if they are carried out by the LEA -

School building

Time based (whole of the building)	As various parts of the building will be used for business purposes, the building as a whole will not be used wholly for non-business purposes for at least 90% of the time. Also the level of business use is difficult to predict.
Time based (parts of the building)	Could be applied in respect of the areas used wholly (or at least 90% of the time) for non-business purposes i.e. 13,000m ² out of 15,000m ² and a zero rate certificate issued in respect of 13/15 th s of the cost.
Floor space	As 2,000m ² (13%) of space is used at least for part of the time for business purposes the method is not applicable in this case. If the business use space could be reduced to below 10% (e.g. by ceasing to charge for room hire or adult education), the method would permit a zero rate certificate to be issued for the full cost.
Head count	The total non-business headcount amounts to the 1500 pupils. The 200 fee paying students therefore equate to 12%. However, as the business use includes hiring rooms, the headcount of these bookings must also be taken into account – not an easy task. Therefore irrespective of the student analysis HMRC are unlikely to accept this method as fair and reasonable.

Sports facilities

Time based (whole of the building)	As above, the mix of use makes this method inappropriate.
Time based (parts of the building)	As there are no identifiable areas that would meet the criteria this is inappropriate.
Floor space	As there are no identifiable areas that would meet the criteria this is inappropriate.
Head count	The total non-business headcount amounts to 1500 pupils. In order for this method to be effective the actual total fee paying users of the facility would need to be kept below 166 – not practical.

Based upon the circumstances in this case study there is scope to issue a zero rate certificate in respect of 13/15ths of the school building under the time based (part building) method.

There is also potential to issue a zero rate certificate for the whole of the school building under the floor space method if the space used for business activities can be contained within the 10%. In considering this option, the conditions attached to the certificates must be born in mind.

Recovery of the VAT that is charged

Any VAT that is charged by the Council will be recoverable to the extent that it relates to taxable business activities. Therefore, in simple terms, the more taxable business use to which the development is put, the greater the recovery of VAT on the development costs.

In considering the position for the school building, the only business activity undertaken by the Governors is the letting of rooms. The letting of rooms is an exempt activity. Any VAT incurred on costs attributable to exempt activities is unlikely to be recoverable. However, if the Governors register for VAT and opt to tax the school buildings then the letting of rooms will become subject to VAT. While this results in VAT being due in respect of the letting income, it permits recovery of a proportion of the VAT incurred. Therefore the Governors would need to take a commercial decision based upon the scale of the lettings and the level of VAT recovery that they would permit.

Any VAT incurred on the school building that related to the non-business core school use should be temporarily recoverable under the Lennartz mechanism (Appendix F) providing the school building is also used for some level of taxable activity

A similar position exists in respect of the sports facilities. The first issue, however, is determining the level of business and non-business use.

NB the following analysis is for illustration purposes and any method would need to be agreed with HMRC as being fair and reasonable.

Based upon the projected opening hours it can be estimated that the level of non-business use is approximately 37%. Therefore, £323,700 (37% of the £875k) should fall to be temporarily recoverable under the Lennartz mechanism (Appendix F).

The business supplies that will be made by the Governors are typically –

Sporting services supplied to individuals	Exempt	20%
Coaching	Exempt	5%
Block bookings	Exempt	40%
Supplies to clubs/associations etc...	Taxable	35%

Therefore, the remaining £551,300 will be recoverable to the extent that it relates to taxable business activities i.e. £192,955 (35% of £551,300). The balance being irrecoverable.

By opting to tax the sports facility the block bookings would become taxable. Therefore, the level of VAT recovery would increase to £413,475 (75% of £551,300). However, this would result in the VA School/Academy either increasing its prices or accepting a reduction in net income.

Furthermore, by using a trading company to deliver the coaching and supplies to individuals, it should be possible to ensure that the supplies become taxable (Further advice may be necessary if this option is pursued). Therefore, the level of VAT recovery would increase to 100% of £551,300. Again, this would result in the VA School/Academy either increasing its prices or accepting a reduction in net income.

Conclusion

It should be possible to issue a zero rating certificate in connection with 13/15ths of the VAT

on the costs of constructing the school building. It may even be possible to extend this to cover the whole of the building if the business use can be contained within 10% of the total floor area.

Any VAT attributable to non-business use may be temporarily recoverable under the Lennartz mechanism providing there is at least some level of taxable use.

It is possible to increase the level of taxable use of the buildings by opting to tax and/or using a trading company to deliver some of the services thus making them taxable (as opposed to exempt). This in turn can significantly increase the level of VAT that falls to be recoverable.

In the case of a VA School, where an appropriate agreement can be reached with the LEA, there may be scope to structure the delivery of the facilities in such a way as to achieve full VAT recovery (including the proportion that relates to the LEA use for core school use) in connection with the sports facilities – Further advice should be sought.

Lennartz

The following extracts from HMRC's Business Brief 15/05 sum up the Lennartz mechanism and in simple terms how it works. A full copy of the Business Brief is available on the HMRC web site (www.hmrc.gov.uk).

It should be noted that the application of the Lennartz mechanism is not necessarily straight forward especially where the business use of the asset includes exempt use.

Background

In 1991, the ECJ decided in the case of Lennartz (C-97/90) that taxpayers making business and private use of goods had, in principle, a right to full and immediate deduction of VAT on their purchase. The private use of goods forming part of the assets of a business is treated as a taxable supply of services (under Article 6(2) of the Sixth VAT Directive) and so liable to output tax. In short, therefore, a business can reclaim the VAT in full "up front" and then account for the private use of the goods over their economic life (as opposed to apportioning the VAT incurred between business and private use). This is known as the "Lennartz mechanism".

Summary of HMRC's New Policy

The Lennartz mechanism is now available for the purchase of land, buildings and civil engineering works with mixed business and non-business use where those goods are allocated wholly to the business. It can also be used for certain construction services on buildings or civil engineering works. The services concerned are those, which result in, or will result in, the construction of a new building or civil engineering work, or a major refurbishment or extension of an existing building. HMRC will require the output tax charge under the Lennartz mechanism to be calculated over a maximum 10 year period.

The Lennartz mechanism also continues to apply in respect of purchases of services where those services are incorporated into goods used in the business and significantly increase the value of the goods to the business.

VAT on services that are consumed in relation to day-to-day activity, such as repair and maintenance, must continue to be apportioned.

Calculation of output tax charge under the Lennartz mechanism on land, buildings, and civil engineering works

The calculation of the output tax charge for non-business or private use of a building poses particular problems in arriving at a reasonable value for the annual cost of that use. In the Seeling case, reference was made to "the duration of the economic life" of immovable property such as land and buildings. HMRC considers that the 10-year period referred to in this context is a fair time frame over which the private/non-business use of immovable property should be measured. Therefore, HMRC have decided that, when applying the Lennartz mechanism to immovable property, the output tax charge should be calculated over a maximum 10-year period based on straight line depreciation, unless a shorter period is indicated (e.g. where a taxpayer's leasehold interest in the building has under 10 years to run).