Revenue & Customs Brief 28/07

VAT treatment of contracted out local authority leisure services

The **memorandum of understanding** that was jointly agreed by Customs and Excise and the Chartered Institute of Public Finance and Accountancy (CIPFA) in 1991 was reviewed in 2006 and this Business Brief contains the revised version, which supersedes the earlier version (published in Business Brief 11/99). The revisions have been agreed with CIPFA.

1. Introduction

1.1 This memorandum of understanding sets out how VAT is to be applied to the various supplies that can arise in the provision of local authority leisure services. The contents have been jointly agreed by HM Revenue & Customs and CIPFA. The primary purpose is to identify the types of supply that will normally be encountered and to confirm their correct VAT treatment. It should be noted, however, that the contents will be subject to review from time to time to reflect changing commercial practice and any VAT Tribunal or Court decisions in this area of the tax.

2. Background

2.1 Local authorities may be involved in the provision of leisure services in a number of ways:

- by a direct service organisation (DSO) within the local authority's own leisure services department;
- through a non-profit distributing organisation (NPDO), eg a charitable trust or industrial and provident society, in which the authority may have a degree of representation;
- through a wholly commercial independently owned "for profit" leisure management contractor.

2.2 In the case of a DSO, all supplies continue to be made by the local authority and the VAT accounting position is as described at paragraph 5.1 below. However, where the leisure facilities have been developed, owned and operated by the local authority, and the authority then agrees with an NPDO or commercial operator that it will take over the operation of the leisure facilities subject to the authority's conditions, this process is known as "contracting out". The various arrangements that flow from the contracting out process can give rise to a number of potential supplies for VAT purposes.

3. Who is making the supply of the leisure facilities?

3.1 Deciding who is actually making the supplies to the users of the leisure facilities is perhaps the single most important aspect to be established, as the appropriate VAT treatment is dependent on this factor. To answer this question, all the relevant documentation e.g. the invitation to tender, the final contract/agreements, back letters and leases or licences and the operational arrangements that are adopted should be considered, to determine the intentions of the parties.

NPDO contractors

3.2 Where operation of the leisure facilities is to be taken over by an NPDO contractor, it is common practice for the relevant premises to be leased to it by the local authority in return for the payment of a peppercorn rent. Thereafter, the NPDO will act as a principal in making supplies to users of the facilities.

Independent contractors

3.3 An independent contractor will, in most cases, be engaged to run the leisure facilities as a principal. However, there can be instances where the contractor will agree to act as an agent of the authority in running certain facilities. In the past, ambiguous written agreements led to uncertainty over the status of some independent contractors. In many cases, the agreements failed to make clear that it was always intended by both parties for the contractor to act as a principal in making supplies to the general public and other users. To avoid such problems, current agreements should make clear the status of the contractor and fully reflect the arrangements under which the parties are to operate.

4. VAT treatment of payments between parties

4.1 Local authorities may make payments to operators of leisure facilities. However, the nature of these payments can vary and their VAT treatment depends on the circumstances in which they are paid. In some cases they are simply a grant and are therefore outside the scope of VAT. In other cases, such amounts can represent consideration for a supply or third party consideration. Each case needs to be decided on its own facts.

4.2 Distinguishing between grants and payments can be difficult, especially when interchangeable terms are used, such as “deficit funding”. Where funding is freely given, with nothing supplied in return, then the payment is not consideration for any supply. This is normally the case with grants paid by public bodies. Conversely, where funding is given in return for specific goods or services, then that payment is consideration for a supply.

4.3 In recent years it has become increasingly common for grant monies to be awarded on condition that the recipient enters into a service level agreement and agrees to meet targets set out in that document. The funding body may even be entitled to quarterly progress reports. This does not of itself mean that a supply is being made in return for the funding. These agreements are often drawn up purely to ensure that the funds are used for the intended purpose, or “good housekeeping”.

4.4 To decide whether funding is a grant or consideration for a supply the following questions must be asked.

- Does the donor receive anything in return for the funding?
- If the donor does not benefit, does a third party benefit instead? And if so, is there a direct link between the money paid by the funder and the supply received by the third party?
- Are there any conditions attached to the funding, which go beyond setting out the terms under which the funds are allocated and the requirement to account for how the funds are used (commonly referred to as ‘good housekeeping’)?

In the case of leisure centres, it is important to consider issues such as the historical provision of the facilities and the relationship between the parties. The answer to these questions will often indicate the nature of the payment.

4.5 For example, where leisure facilities are developed and owned by an operator who merely seeks financial support from the local authority for what has always been the operator’s own facilities, then this support is likely to be grant funding which is outside the scope of VAT.

4.6 Where, however, leisure facilities have been developed, owned and operated by the local authority, and the authority then contracts out the operation of those facilities – imposing conditions upon the contractor - any payments made by the authority to the contractor are more likely to be consideration for the contractor’s supply of agreeing to take over the provision of leisure services under the conditions imposed by the authority.

4.7 Such arrangements, where payments are found to be consideration, can give rise to various supplies depending upon whether the contractor is acting as an agent of the local authority or as a principal. Some VAT consequences of these are described below.

4.7.1 Principal agreements i.e. where the NPDO or independent contractor supplies the facilities to the user

a) Contractors' responsibilities

- The payments made by the local authority to the contractor are usually in the form of an annual management fee and/or a variable "contractor's deficit", normally intended to make good any overall shortfall between the takings and operating costs. Under the circumstances described in para 4.6 above, this may represent the consideration for a standard-rated supply by the contractor of agreeing to operate the leisure facilities subject to the authority's conditions.
- In some circumstances a contractor may be obliged to repay some of the gross/net profits to the local authority if, for example, they exceed an agreed level over a period of time (a "contractor's surplus"). These payments normally represent a reduction in the management fee payable by the local authority and VAT credit note procedures will apply.
- Where any monies paid over by the local authority to the contractor are directly linked to prices charged to users, then such payments may represent third party consideration for use of the facilities. The contractor is therefore obliged to account for VAT on the same basis as the normal takings and this cannot be recovered as input tax by the local authority.

b) Local authorities' responsibilities

- With the exception of where payments represent third party consideration as described above, any VAT charged to the local authority by a contractor acting as principal in respect of the management fee or deficit funding will be recoverable in full by the authority subject to the normal rules. VAT charged by the contractor in these circumstances is not attributable to any lease or licence to occupy granted by the local authority to the contractor.
- There will be a liability on the part of the authority to account for output tax (subject to an option to tax having been exercised), on any amounts received in respect of the grant to the contractor of a tenancy or a license to occupy the leisure facilities. However, where there is no rent or a peppercorn rent payable by the contractor, the grant of the tenancy or licence to occupy will normally represent a supply for no consideration.
- Where there is neither monetary payment nor non-monetary consideration from the contractor to the local authority for a lease or licence to occupy, this is seen as a non-business transaction for the local authority. Any VAT which the authority incurs on costs attributable to the premises will be recoverable under section 33 of the VAT Act 1994 subject to the normal rules.
- Under some arrangements the contractor is obliged, as a condition of taking over the running of the leisure facilities as a principal, to periodically pay an agreed fee to the local authority. Provided this is not rent payable in connection with the granting of a tenancy or licence to occupy the leisure facilities, it will normally represent consideration for a standard-rated supply of the granting of the right to operate the facilities by the local authority to the contractor.

4.7.2 Agency agreements

- The contractor is liable to account for VAT on its supply of agency services to the local authority. Consideration for this supply will comprise any amounts paid to the contractor by the local authority and any amounts retained by the contractor from the takings.
- The VAT charged by the contractor to the local authority will be attributable to the supplies which the authority makes from that facility. It must be apportioned between taxable and exempt supplies in accordance with the authority's section 33 refund

method (i.e. its partial exemption method), and will be recoverable subject to the authority's partial exemption position.

- Any amounts paid over by the contractor to the local authority in respect of the takings collected on behalf of the local authority, will be outside the scope of VAT so far as the contractor is concerned. The liability to account for VAT on the takings remains with the local authority (see paragraph 5.1).
- In some cases the contractor may incur operating expenses as agent for the local authority. Where the supplies are subject to VAT, any entitlement to input tax deduction rests with the local authority. However, if the contractor acts in its own name in relation to the expenses there is a requirement under section 47(2A) VATA 1994 in the case of goods, for the supply to be treated as being made to and by the agent. Where this applies the contractor may recover the VAT involved as input tax (subject to the normal rules) and is required to account for output tax on the onward supply to the authority. Supplies of services may (if the parties wish) be treated in the same way under section 47(3). There is a requirement to account for the tax on the onward supply in the same tax period as it was recovered.

5. Liability of supplies to users of the leisure facilities

Where supplies are made by a local authority

5.1 The supply of leisure activities will continue to be made by the local authority in circumstances where a DSO is set up or where a contractor is brought in to run the facilities as an agent of the authority. In these circumstances the local authority is liable to account for VAT on the takings at the standard rate for all supplies other than those that may be exempt under the VAT Act 1994, schedule 9, group 1(m) (note 16) (Single lets for over 24 hours and a series of single lets to the same person) – see Notice 742 Land & Property– and group 6 (education) – see Notice 701/30 Education & Vocational Training.

Where supplies are made by a NPDO contractor

5.2 The liability to account for VAT on the takings rests with the NPDO. Some supplies may be taxable and others eligible for exemption under the VAT Act 1994, schedule 9, group 1(m) (note 16) and group 6 (see paragraph 5.1 above), or group 10 (sporting services supplied by non-profit making organisations and competition entry fees - see Notice 701/45 Sport).

Where supplies are made by an independent contractor

5.3 Where the contractor acts as a principal any supplies made to the users of the leisure facilities will be liable to VAT at the standard rate unless exempt under the VAT Act 1994, schedule 9, group 1(m) (note 16) (see paragraph 5.1 above) and group 10 (Item 1) (competition entry fees - see para 5.2 above).

Further supplies made by either contractor to users

5.4 There may be further supplies made in the course of operating leisure facilities such as room hire, crèche facilities and catering franchises. The liability of these will vary and may include additional exempt supplies.

6. Further advice

6.1 This memorandum covers only the basic arrangements that can apply to the operation of contracted-out local authority leisure services. Those involved should consult the HMRC National Advice Service on 0845 010 9000 if they require further guidance on any of these aspects, or if there is anything not covered specifically.

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