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PSTAX Insight

HMRC revises treatment of VAT on in house leisure services – welcome news for many local authorities

This timely bulletin outlines the changes and how agency arrangements might pass this benefit on to outsourced leisure services.

In March this year, HMRC announced a significant change to the VAT treatment of local authority leisure services that could add hundreds of thousands of pounds onto revenue lines.

Prior to March 2023, local authorities managing in-house leisure centres were required to treat services such as gym memberships and other facility visits as business activities for VAT purposes and pay VAT to HMRC from the income. Now, a revised treatment of VAT states these services are classified as non-business supplies for VAT purposes. This means local authorities pay no VAT on their income, as well as reclaiming all the VAT they incur on the related costs (revenue and capital) unconditionally.

Currently more than 20% of leisure facilities are owned and managed in-house by local authorities across the UK. Qualifying local authorities do not need to take any action; the transfer of VAT payments is automatic, resulting in an immediate financial uplift.

It is estimated there are 2,700 leisure centres in the UK, so roughly 500 are still managed in-house. The potential VAT benefit for each centre (given type of facilities) is in the region of £100,000 – £150,000, so across the sector the savings would be £54 million – £81 million per annum.

In consideration of this change, several operators who manage centres on behalf of local authorities are considering how this VAT ruling could also improve the VAT position between themselves and their local authority clients.

Many are not for profit and therefore gain no further benefit on income, as they account for no VAT on activity income, however, they must pay corresponding irrecoverable VAT on expenditure. Some are considering a new ‘agency’ model, whereby they collect income on behalf of the local authority so income remains ‘non-business’, which would mean they too would not have to pay irrecoverable VAT on expenditure.

The sector impact of this would also be significant; it is estimated that circa 780 leisure centres are managed by not-for-profit organisations, (members of Community Leisure UK). If all benefited from an agency agreement model with their local authority client, the financial benefit could be in the region of £50,000 – £100,000 per centre, that equates to circa £39 million – £78 million per annum.

In total, the VAT ruling could improve the public sector leisure centre finances by circa £100 million – £150 million per annum.

Given the sizable financial benefits of this VAT ruling, Max Associates have posed the question to leading tax advisors and local government lawyers to assess, whether it is likely that these financial benefits can be realised and how an 'agency' agreement would impact a typical leisure management contract held between operators and local authorities?

VAT analysis

When a local authority carries out a non-business activity, it does not account for VAT on its income and can reclaim all the related VAT costs.

Following the conclusion of long-running litigation, HMRC's March 2023 announcement and subsequent discussions, we understand HMRC now might accept non-business treatment applies to:

- Memberships;
- facility visits (for sport or recreation purposes, e.g., not to visit a catering facility);
- letting of sports facilities;
- lettings of non-sports facilities for sports, such as a community centre in some cases;
- leases of local authority-run sports facilities;
- letting local authority recreation grounds (such as parks) for sports events;
- sports tuition and education.

Agency model

The concept of principal and agent in VAT is that where an organisation acts as the agent of a principal, the principal is still making and receiving the supplies of goods and services, with the agent arranging them.

For outsourced leisure services, an agency model would mean that as the supplies of the leisure services would still be made by the local authority (as principal), the local authority's favourable VAT status would apply both in terms of the non-business treatment of the income and the ability to recover VAT on the related expenditure.

There are well-established VAT rules determining whether an agency/principal relationship exists. For services, HMRC will start with these tests:

- **Identity** – the services bought or sold by the agent on behalf of the principal must be identifiable.
- **Value** – the principal must know the exact value at which goods or services have been bought or sold on its behalf.
- **Separation** – the value of the agent's service must be separately identifiable from the main supply and should generally be known to the principal
- **No change** – the agent's intervention cannot alter or change the direction of the main supply between buyer and seller.
- **Nature and value** – agents generally cannot alter the nature or value of supplies which they arrange for their principal.

HMRC will look at the written contracts between the parties. However, even after considering these tests, the position can be inconclusive. Here, HMRC will look at the substance and reality of the overall position.

This type of HMRC-sanctioned arrangement for non-business supplies already exists in local authorities. One example is outsourced school catering contracts.

The supply of education is non-business in a local authority school, and the supply of catering to students will also be non-business if it's made at or below cost. Many local authorities outsource their school catering to contractors in arrangements where they act as the school's agent in providing catering.

Simplistically, the contractors provide the catering and collect the income, offsetting the collected income against the charges for their catering services. There are two supplies. First, the local authority's supply of catering to its students, which is non-business. Secondly, the contractor's supply to the local authority of running the catering service, which would be standard rated for VAT.

Significant structural differences might exist between an agent/principal for school catering and leisure services. However, clearly it is feasible that a local authority could appoint a provider to run its leisure centres as its agent.

Therefore, an agent/principal arrangement could maximise the benefits of a local authority's favourable VAT status, i.e., VAT-free income and the full recovery of related VAT costs.

Implementing an agency model carries risks that HMRC does not accept the agent/principal arrangement. However, with careful planning and advice, the agency model can provide significant VAT benefits for a local authority and the providers.

Contract issues

The local authority leisure sector has developed a well understood outsourcing model where an Operator provides leisure services to the Authority usually under a Sport England template contract. If an agency model were to apply, the agent would provide services on behalf of the Authority. The local authority leisure sector has become accustomed to this concept for carrying out capital works at the local authority's centres in a VAT-efficient manner.

The Sport England template suite of contracts needs fairly extensive additions to be acceptable to HMRC as a legitimate agency arrangement. This would usually include introducing an Agency Agreement setting out the scope of the agent's role (including what the agent can do in the name of the principal), what the agent will do on the principal's behalf including service standards and an agency fee (including how it is calculated), along with other common risk allocation. If a provider was essentially to provide the full (or majority of the) leisure service specification as an agent, this would require a much broader scope of the agent's role and therefore likely more focus on the Agency Agreement.

In order for an agent to take the benefit of the recent VAT ruling, the local authority would need to be VAT principal for the purpose of providing leisure services. In order to demonstrate that relationship, the main Sport England agreement would reserve that the local authority is responsible for the leisure services.

If the agency arrangement is proven to be an accepted model by HMRC for the broad set of leisure services set out in the VAT-ruling then the contractual arrangements would have to be carefully crafted to ensure a lawful agent/principal relationship is established whilst at the same time importing the right level of risk transfer to the operator (acting as agent).

Procurement issues

Some leisure operators are already proposing this agency model and local authorities who have run, are running or planning to run procurements for leisure services will be considering whether to accept the model following this VAT ruling. There will also be issues to work through to ensure bidders are being evaluated on a like for like basis where some operators propose an income agency approach and others don't.

If approached by an incumbent leisure operator wishing to switch from their current contractual arrangement to an income agency model, the authority will need to be satisfied that the requirements of Regulation 72 of the Public Contracts Regulations regarding modifications of contracts during their term are complied with. Regulation 72 provides a number of safe harbours for modifications of existing contracts, and these would need to be worked through to ensure a compliant change to current arrangements.

Conclusion

An agent/principal arrangement could maximise the benefits of a local authority’s favourable VAT status, i.e. VAT-free income and the full recovery of related VAT costs.

Authorities can now expect queries at an early stage of procurements about whether an agency model will be accepted. With that being said, procurement decisions are better made up front rather than in response to a specific bidder's request (to avoid complaints of bias) so the authority's position is best considered and communicated from the outset.

If the agency model proves financially attractive, then ensuring the risk position is not jeopardised by the agency agreement would be well be worth the time and resource investment during the procurement.

Local authorities will also carefully need to consider how to respond to incumbents' requests to change existing arrangements to an income agency one or indeed whether the authority might introduce the potential change itself having regard to the financial benefits of doing so in a procurement-compliant way.

The authors of this article are working with operators and local authorities, on individual cases to assess whether an application of an agency agreement could bring savings to the partners in a way which could satisfy HMRC and legal and procurement requirements.

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