Local authorities: VAT on income generating activities

Indirect Tax

20 March 2024

We consider how the ‘special legal regime test’ and the ‘significant distortion of competition test’ apply to take local authorities’ income generating activities outside the scope of VAT.

Key Points

What is the issue?

The decision in the joined cases of *Chelmsford*, *Midlothian* and *Mid-Ulster*, and ensuing policy updates by HMRC, are significant developments in defining the scope of VAT for local authorities.

What does it mean for me?

The cases clarify how both the 'special legal regime test' and the 'significant distortion of competition' test apply to take local authorities' income-generating activities outside the scope of VAT.

What can I take away?

Although concerned with local authority sports provision, the outcome could have much wider implications wherever a special legal regime exists and there is an already significantly distorted market.

In 2020, the First-tier Tribunal handed down its initial decisions in three linked appeals: *Chelmsford City Council* (2020) UKFTT 433 (TC); *Midlothian Council* (2020) UKFTT 434(TC); and *Mid-Ulster District Council* (2020) UKFTT 432 (TC). The three local authorities argued that their provision of sports services should fall outside the scope of VAT under Article 13(1) of the EU Principal VAT Directive (now transposed into the VAT Act 1994 s 41A).

These represent the most important cases on Article 13(1) and the VAT liability of local authorities' services since the Court of Appeal's judgment in *Isle of Wight Council* (2015) EWCA (Civ) 1303, in which the Court of Appeal upheld the Upper Tribunal's finding that non-taxation of local authorities' provision of off-street car parking would lead to significant distortion of competition.

Article 13(1) lays down three tests. The activity must be:

- delivered by a body governed by public law (this is taken as read for a local authority);
- subject to a special legal regime only applicable to bodies governed by public law; and
- such that non-VATable treatment would not cause significant distortion of competition.

Although the ultimate outcome of the litigation post-dates the UK's departure from the EU, the outcome is equally applicable under s 41A.

HMRC rejected the local authorities' arguments and the three appeals proceeded to the First-tier Tribunal as 'test cases' covering the three jurisdictions of the UK: *Chelmsford* for England and Wales; *Midlothian* for Scotland; and *Mid-Ulster* for Northern Ireland.

The First-tier Tribunal

The local authorities proffered three arguments as to why their sports services should fall outside the scope of VAT under Article 13(1):

1. Their provision does not constitute an economic activity within the meaning of Article 9. The tribunal rejected this argument.
2. If an economic activity, provision is made under a special legal regime and non-VATable treatment would not cause significant distortion of competition. This was upheld by the tribunal subject to hearing further evidence, if necessary, on significant distortion of competition.
3. The tribunal was not persuaded by the third argument, relating to the discretion afforded member states by Article 13(2) to treat such services as outside the scope of VAT, which is beyond the scope of this article.

The tribunal first concluded that three factors are irrelevant to determining whether local authorities' activities are subject to a special legal regime: the subject matter of the activity; the purpose of the activity; and the fact that private providers are capable of carrying out similar activities.

In essence, the dispute over the 'special legal regime test' distilled to HMRC's assertion that whilst a mandatory obligation placed upon local authorities requiring them to carry out a specified activity does amount to a special legal regime (and that there can then be no significant distortion of competition if simply fulfilling their statutory obligations), a discretionary power enabling local authorities to carry out an activity is not enough unless accompanied by further prescriptions, proscriptions and constraints laid down by accompanying statutory or regulatory provisions.

The existence of mandatory obligations on local authorities to provide sports services in Scotland and Northern Ireland made the outcome in *Midlothian* and *Mid-Ulster* almost a foregone conclusion. However, in England and Wales, the Local Government (Miscellaneous Provisions) Act 1976 s 19 provides that 'a local authority may provide … such recreational facilities as it thinks fit'.

The tribunal nevertheless concluded that a special legal regime does exist governing local authorities' provision of sports services in England and Wales, and that there are clear differences between the legal conditions under which local authorities do so compared to private sector suppliers of sports services.

The tribunal thus concluded that in all three jurisdictions local authorities provide sports services under a special legal regime and that consequently their provision of sports facilities falls outside the scope of VAT, providing that would not cause significant distortion of competition.

Whilst accepting the decisions on the existence of a special legal regime in Scotland and Northern Ireland, the finding in England and Wales reportedly caused alarm in HMRC at the apparently wide interpretation of the 'special legal regime test'. If left undisturbed, it was felt that it could lead local authorities to argue that all their activities are subject to a special legal regime. HMRC therefore appealed *Chelmsford* to the Upper Tribunal.

Chelmsford at the Upper Tribunal

In June 2022 the Upper Tribunal (2022) UKUT 149 (TCC) dismissed HMRC's appeal on the 'special legal regime test' and upheld the First-tier Tribunal's decision that local authorities in England and Wales provide sports services under a special legal regime. HMRC had appealed on the ground that the First-Tier Tribunal had erred in law by failing to draw a distinction between 'sovereign powers', which are needed to exercise certain specified activities, and 'statutory powers', which merely authorise the carrying out of such an activity. HMRC's argument was that Article 13(1) only applies to public bodies acting under 'sovereign powers'. The Upper Tribunal, however, could find nothing in the case law to support such a distinction.

Ultimately, the Upper Tribunal accepted that the Local Government (Miscellaneous Provisions) Act 1976 s 19 does amount to a special legal regime when taken together with the multitude of other statutory and regulatory prescriptions, proscriptions and constraints with which local authorities in England and Wales must comply when delivering sports services.

These include requirements for local authorities to prepare strategies for promoting or improving the economic, social and environmental wellbeing of their area (under the Local Government Act 2000 s 4); and an obligation to ensure that their functions are discharged having regard to the need to safeguard and promote the welfare of children (under the Children Act 2004 s 11). Clearly, no private sector supplier of sports services is required to comply with these constraints and hence they must contribute to the existence of a special legal regime.

The 'significant distortion of competition test'

Although HMRC appealed the First-tier Tribunal's decision in *Mid-Ulster*, the Upper Tribunal remitted the case back to the First-tier Tribunal on the grounds that its previous decision had conflated the 'significant distortion of competition test' with the 'special legal regime test', holding that the statutory obligations placed on Northern Irish local authorities mean that in practice there can be no competition, as no private sector provider would be required to comply with the same obligations.

It thus seemed that the First-tier Tribunal would be required to rule on the 'significant distortion of competition test' in all three cases.

The onus would then fall on HMRC to prove that there would be significant distortion of competition by reference to an economic analysis of the market to demonstrate that: there would be competition; that competition would be distorted; and that distortion would be significant (i.e. more than negligible when judged on a nationwide basis). However, HMRC's economic analysis, somewhat surprisingly, concluded that no significant distortion of competition would be caused by treating local authorities' provision of sports services as falling outside the scope of VAT. HMRC confirmed this in Brief 3(2023) 'Changes to VAT Treatment of Local Authority Leisure Services'.

The outcome of HMRC's economic analysis is probably the most important development on Article 13(1) since the *Isle of Wight* judgment, laying down a fundamental caveat to the 'significant distortion of competition test'.

The nationwide market for sports services is already significantly distorted, as sports services are provided by:

- local authorities able to treat their provision as exempt from VAT but still fully recover associated input VAT incurred under their advantageous partial exemption regime;
- trusts and charities able to treat their provision as exempt from VAT but unable to recover associated input VAT incurred due to the private sector partial exemption rules; and
- commercial providers whose supply is subject to VAT and so who can fully recover associated input VAT incurred.

The conclusion reached by HMRC's economic analysis was that where the market is already significantly distorted, treating local authorities' provision within that market as outside the scope of VAT with full VAT recovery under Section 33, rather than exempt from VAT but still with full VAT recovery, would not further significantly distort competition.

The agreed position

The agreed position on local authority sports provision therefore is that to be treated as a non-business activity outside the scope of VAT, the activity must:

- be the subject of a special legal regime; specifically that the statutory provision, as a discretionary power, is underpinned by other statutory or regulatory constraints that impinge upon how the activity is performed, with which the local authority must comply and which do not apply to private sector providers; and
- have previously been treated (or should have been treated) as a VAT-exempt supply: while this explicitly includes the sports services held to be exempt from VAT when delivered by a local authority in *London Borough of Ealing* (Case C-633/15), other statutory exemptions relating to sports and leisure services may be acceptable, such as sporting tuition and sports-related education.

To be treated as a non-business activity outside the scope of VAT does not require the sports services in question to have previously been treated as exempt; rather that they could have been, even if the authority chose not to for other reasons, notably due to adverse partial exemption implications.

Updated guidance

HMRC has now confirmed in updated guidance at VATGPB8410 that the following sports activities are accepted as being non-business and so outside the scope of VAT:

- sports lettings: the hire of a sports facility for sports use, including under a recurring series of lets;
- lettings of sports facilities by a business such as an aerobics instructor or a five-a-side football league, providing the business uses the facility for the benefit of individuals taking part in sport;
- lettings of non-sports facilities for sports use such as a community centre or school assembly hall, providing the local authority has set up the space for use as a sports facility prior to the hire;
- ‘long-term leases’ of sports facilities such as by a football or cricket club where the venue is a local authority maintained and managed sports facility (though this does not include the simple lease of a sports facility under which the tenant club takes responsibility for its maintenance and management);
- letting a park for a sports event, providing it is set up for such use by the local authority;
- sports tuition such as swimming lessons and sports coaching courses;
- ‘sporting goods’: the hire by a local authority of appropriate sports equipment such as badminton rackets and floatation aids (though not where a local authority sells ‘sporting goods’ such as tennis balls and swimming goggles); and
- outdoor pursuits centres where the supply is of expressly sports and leisure activities, such as canoeing and climbing, with instruction and/or equipment provided.

Wider implications

Whilst HMRC expressed concern that local authorities would try to apply more widely the decision on the ‘special legal regime test’ in *Chelmsford* unless ‘constrained’, in fact its conclusion in Brief 3(2023) (and confirmed in VATGPB8410) and its rationale on the ‘significant distortion of competition test’ seems to be of even more wide-reaching consequence.

If an already significantly distorted nationwide market cannot be further significantly distorted by treating local authorities' provision in that market as falling outside the scope of VAT, what other such markets do local authorities participate in where they are currently required to treat their supplies as within the scope of VAT?

One that is immediately apparent is cultural activities, such as theatres and concert halls.

It seems clear that non-business treatment should now apply to local authorities' provision of cultural activities in Scotland and Northern Ireland, given that their respective special legal regimes encompass the mandatory provision of both sports and cultural activities.

In England and Wales, however, the position is less clear. The primary law governing cultural activities in England and Wales is the Local Government Act 1972 s 145(1)(b). This is directly analogous to that governing sports services in being merely an enabling power. Arguably there are equivalent additional statutory and regulatory constraints, such as were agreed in *Chelmsford*, which constitute a special legal regime.

HMRC has generally always accepted that treating local authorities' cultural activities as VAT-exempt does not cause a distortion of competition.

However, it would still require a further economic analysis to address the 'significant distortion of competition test'. This is because the provision of sports services is a relatively easily defined market for which the VAT treatment of the various participants is clear. This is not the case with cultural activities, which is a more diverse market, including both cultural performances and admission to museums and galleries (and in respect of the latter is further complicated by VAT recovery permitted to certain 'national museums' under Section 33A).

Furthermore, the 'significant distortion of competition test' is a different and wider test than that applicable to public bodies' treatment of cultural activities as exempt from VAT, which is directed at the local market and commercial providers required to charge VAT. Rather, it requires a more than negligible distortion of the overall market that is sufficient to be felt nationwide, as held in *Isle of Wight*.

Postcript: On 27 February 2024, the Court of Appeal handed down judgment in *Northumbria Healthcare NHS Foundation Trust* [2024] EWCA CIV 177. HMRC had been assuaged over the potentially wide definition of special legal regime when the Upper Tribunal [2022] UKUT 267 TCC) agreed with the decision in *Chelmsford* that the additional constraints necessary to constitute a special legal regime must be in statutory or regulatory provisions. The Court of Appeal, however, has held that Northumbria Healthcare's provision of hospital parking subject to a special legal regime as binding guidance, with which a public body must comply, meets that criterion. The implications of this could be profound.