

Cherwell District Council

Report For: Assistant Director of Finance and Section 151 Officer

Date of Report: 14 September 2023

Report Title: Partial Exemption and Option to Tax

Report of: Head of Finance and Deputy Section 151 Officer

This report is public

Purpose of report

The purpose of this paper is to look at opting to tax properties following our review and advice from PSTax.

During the past twelve months many conversations have been had with PSTax, our VAT consultants as it became apparent that the council is getting close to its 5% de minimis limit. Following decoupling the Council has taken the opportunity to review its approach to VAT. After receiving advice from PSTax and reviewing the capital programme it became apparent that opting to tax all viable properties owned or purchased in the future was the only way to mitigate the council's risk to the partial exemption calculation. This practice is common in councils around the country and is particularly important for smaller councils who have a lower de minimis but high expenditure on their property portfolio.

1.0 Recommendations

The Assistant Director of Finance (S151 Officer) is recommended:

- 1.1 To adopt a policy of opting to tax council owned properties where VAT reclaimed on spend on these properties would otherwise contribute to the council's partial exemption calculation.

2.0 Introduction

- 2.1 A partial exemption calculation is required each year by law. This calculation requires the council to prove that it has not recovered more than 5% of VAT in relation to exempt income activities. If the Council exceeds the 5% limit, then it may have to repay to HMRC all the VAT it has reclaimed from exempt activities. The best way to protect our position is to opt to tax properties that provide exempt supplies.
- 2.2 Opting to tax means that we charge tenants/service users VAT on our invoices. This has no impact on anyone unless the tenant does not reclaim VAT. In these instances, if the charge is nominal, we could reduce our income by 20% to mitigate the risk.

3.0 Report Details

- 3.1 The council is facing increased risk of breaching the 5% de minimis. If this is the case, we can calculate a 7-year average, and if that is under 5% the council do not need to repay HMRC. Should there be a breach of the 5% de minimis and the 7-year average the council would need to repay HMRC all the VAT reclaimed in the current financial year on exempt income activities. This is estimated to be more than £300k for 2022/23 and will have ongoing financial impacts.
- 3.2 Following decoupling from Oxfordshire County Council, Cherwell District Council has taken the opportunity to review its policies. The Council has considered its partial exemption position and now considers that introducing an option to tax would be the most appropriate course of action. The Council has taken advice from its VAT adviser PSTax who have said that this is the most tax effective course of action to protect the Council. In addition, this is the same course of action that many other local authorities take.

Peppercorn Rents

- 3.3 Peppercorns are a rental charge of £1 per annum and allow the council to account for any expenditure as “non-business”. This has been used to avoid breaching our PE, however, there are risks involved as new grant schemes become more complicated.

PSDS Schemes (Public Sector Decarbonisation Scheme)

- 3.4 One of the reasons for a potential breach in 2022/23 is the decarbonisation works that were due to be carried out. In order to mitigate the council’s risk of exceeding the partial exemption threshold the council has had to postpone decarbonisation works on Drayton Pavilion and Stratfield Brake sports ground as there is not an option to tax on these sites.
- 3.5 To receive the decarbonisation grant, the council needs to be the beneficiary of the grant and therefore the bill payer for utilities. This presented the council with 3 options,
1) Take responsibility for the utilities and recharge the cost of them to the organisations, this would not breach the peppercorn rent and hence VAT status where there was a meter that could directly identify the amount of the utilities used,
2) Take responsibility for the utilities and find room in the budget – this was not acceptable
3) Opt to tax the property.
- 3.6 Doing the work would put the council at risk of incurring PE impacts.

Option to Tax

- 3.7 Placing an “option to tax” on a property the Council owns means that the Council will have to charge VAT on services it provides to tenants, but also means that the Council can reclaim any VAT it incurs on maintaining/repairing the property without there being an impact on the Partial Exemption calculation.

- 3.8 The council owns several properties that pose a high-risk to the partial exemption calculation, if any capital works need to be carried out, and the best way to mitigate this is to opt to tax the property. Opting to tax a property means that we can still charge a peppercorn (£1 rent), but any other income i.e., recharging utilities, insurance, service charges etc. would be subject to 20% VAT. All the expenditure incurred by the Council on the property however would not feed into the partial exemption calculation as it is seen as a business transaction.
- 3.9 The implications of opting to tax the properties is that all recharges and income, raised by the council, would be subject to 20% VAT, and some of the council's buildings are used by charities and businesses who are not VAT registered or, provide exempt supplies themselves and cannot recover any VAT they incur. This would mean that the rent paid by businesses that cannot reclaim VAT, e.g. a betting agency, would have a 20% increase with no means of reclaiming the VAT. However, without including a option to tax on buildings that the Council owns means any capital work that needs to be carried out will impact on the PE calculation. This would also be the case for any properties in which the council recharges utilities and insurance. It also means that if the council were to sell any of these properties it would need to include VAT.
- 3.10 Community centres are currently posing a risk due to being eligible for decarbonisation works and other works such as solar power installation that are funded by PSDS grants. As the community centres may be run by charities, they will have the option to disapply the option to tax if the building is used for a "relevant charitable purpose". As this is a delicate area, the council would need staff to talk to each of the community centres and make sure that they won't disapply and are aware of what we are doing and why. If the charity were to disapply the council's option to tax would be void. But then the Council would have to explain to the Charity that it would have to consider very carefully when it would be able to carry out any necessary works to the building.
- 3.11 As the council also owns residential properties these also contribute heavily to the exempt supplies we provide, however, it is not possible to opt to tax residential dwellings. Works such as those required for health and safety need to be completed but contribute significantly to our partial exemption calculation. The only way to alleviate some of the pressure is to opt to tax the properties we can.
- 3.12 The option to tax does not guarantee that the council will not breach its partial exemption, but by opting to tax the council reduces the risk of future breaches and keeps the 7-year average lower thus reducing what, if any, repayments they need to make to HMRC.
- 3.13 This is a long-term decision that effects the property for 20 years (unless it is sold) and cannot be revoked after the 6-month cooling off period. This decision would only affect the supplies made by the council and not the supplies of the tenant.

4.0 Conclusion and Reasons for Recommendations

- 4.1 In conclusion it is recommended that the council opts to tax as many properties as it can to mitigate the risk to partial exemption. In the future, putting in place an "option to tax" should be the standard approach adopted by the Council unless there is a clear reason not to.

5.0 Consultation

N/A

6.0 Alternative Options and Reasons for Rejection

- 6.1 The following alternative options have been identified and rejected for the reasons as set out below.

Option 1: Don't opt to tax – rejected due to risk of breaching 5% de minimis and repaying HMRC reclaimed VAT approx. £300k+

Option 2: Take responsibility for utilities and insurance – rejected due to financial constraints.

7.0 Implications

Financial and Resource Implications

- 7.1 If the council does not opt to tax then it is at increased risk of exceeding the Partial Exemption threshold and faces repaying HMRC £300k+. In addition, the Council may have to pass on grants received (e.g. PSDS as it is not able to mitigate the VAT implications).

Comments checked by:

Joanne Kaye, Head of Finance (D151), joanne.kaye@cherwell-dc.gov.uk

Legal Implications

- 7.2 We need to ensure we are complying with the legislation duties. The Council will need to comply with Section 33 of the Value Added Tax Act 1994 and associated guidance. The Council's Finance team has obtained detailed advice on this from PS Tax which provides advice on the Options to Tax. An equalities and impact assessment may need to be undertaken as this change is likely to affect low-income organisations such as charities who may be providing vital services in the community. New leases will need to be written to ensure there is an option to tax. All leases currently running will need to be checked to ensure they contain provisions that allow for the option to tax before the option is exercised.

Comments checked by:

Alison Coles, Legal Services Operations Manager, alison.coles@cherwell-dc.gov.uk

Risk Implications

- 7.3 Breaching 5% de minimis
Community centres disapplying option to tax
Any arising risk will be managed through the service operational risk and escalated to the Leadership Risk Register as and when necessary.

Comments checked by:

Celia Prado-Teeling, Performance & Insight Team Leader,

Celia.Prado-Teeling@Cherwell-dc.gov.uk

Equalities and Inclusion Implications

7.4 There are no equality implications arising from accepting the recommendation.

Comments checked by:

Celia Prado-Teeling, Performance & Insight Team Leader,
Celia.Prado-Teeling@Cherwell-dc.gov.uk

Sustainability Implications

7.5 There are no environmental sustainability implications from this proposal

Comments checked by:

Jo Miskin, Climate Action Manager,
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8.0 Decision Information

Key Decision (N/A)

Financial Threshold Met: N/A

Community Impact Threshold Met: N/A

Wards Affected

All

Links to Corporate Plan and Policy Framework

All

Lead Councillor

N/A

Document Information

Appendix number and title

- Appendix 1 - CDC Assets - VAT Risk Tables
- Appendix 2 – PSTax Helpline – PE and Option to Tax

Report Author and contact details

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