VAT cost sharing groups

Introduction

For the first time in the UK charities have the possibility of buying in services or outsourcing without having to pay VAT on them under the “cost sharing exemption”. This makes a supply of services by a cost sharing group (“CSG”) to any of its members exempt from VAT provided various conditions are met. The measure is mainly of benefit to sectors that carry out VAT exempt activities such as health, care, education, culture, sports, housing and financial services, and this includes those charities with exempt activities and also those funded by grants and donations.

These organisations will be able join together to set up a membership entity that will supply its members with services exempt from VAT. For example:

- A group of care charities might set up a CSG to provide themselves with agency care staff for a wholly VAT exempt agency fee
- A group of education charities might set up a CSG to help them identify grant funding opportunities and to assist them in applying
- A group of sports centres might set up a CSG to provide cover staff or admin support services to its members
- A group of housing associations might set up a CSG to supply property maintenance services to its members

The idea is that it provides smaller entities in these sectors with access to the same economies of scale as larger groups of companies without suffering a VAT penalty. However, a distortion of competition clause does apply.

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Legislative implementation

The implementing legislation (Finance Act 2012) only states the basic conditions for the VAT exemption to apply. The legislation then gives the Treasury the power to make regulations imposing conditions on the exemption, but the Treasury has not yet exercised those powers. Instead, HMRC has produced detailed guidance on the scheme (see Further Information section below). This is because there are still uncertainties at the EU level about how the cost sharing exemption operates. Once these are ironed out the Treasury will presumably implement conditions via regulations rather than HMRC guidance.

This injects an unfortunate degree of uncertainty into the exemption which may act as a disincentive to setting up CSGs before the legal position is settled, especially given one of the key uncertainties relates to how CSGs can supply core services such as shared premises, admin and finance which will often be potential areas for achieving economies of scale.

CSG conditions

For a supply to be VAT exempt under the cost sharing exemption it must meet all of the following conditions:

1. It must be a supply of services (as opposed to a supply of goods)
2. The supplier must be an independent membership entity (the "CSG")
3. The supply must be from that entity (the CSG) to one of its members
4. The members of the entity must all carry out VAT exempt or non-business activities
5. The supply must be directly necessary for the exercise of the member's VAT exempt or non-business activities
6. The CSG must merely claim from the member exact reimbursement of its share of the joint expenses
7. The exemption of the supply must not be likely to cause distortion of competition

Going through each of these conditions:

1. **Supply of services**
   The services can be of any type – for example, supplies of staff, advice or management services. However, the exemption excludes supplies of goods. But HMRC accepts that a supply of goods that is ancillary to a qualifying supply of services is also covered by the exemption – for example, the provision of food under a catering contract.

2. **Independent membership entity**
   The body making the supply (the "cost sharing group" or "CSG") must be an independent membership entity, for example (and probably most likely) a share or guarantee limited company with the members as shareholders or guarantors. The CSG must be separate from its members in order to be able to make VAT exempt supplies to its members.

A CSG must have at least two members. If membership of the CSG drops to one, then supplies from the CSG to its sole member cannot qualify for the cost sharing exemption.

Potential structures for the CSG include share or guarantee limited companies, CICs, co-operative societies and unincorporated associations. Partnerships and LLPs have to be 'for profit' so a CSG set up to just serve its members could not be a partnership or LLP. However, HMRC accepts that a partnership or LLP that also charges non-members at a profit could be a CSG.

HMRC requires that all members either receive qualifying supplies from the CSG or have a genuine and realistic intention of receiving qualifying supplies. If an existing member ceases to receive qualifying supplies for any period of 12 months following their membership of a CSG then HMRC will presume that an intention to receive such supplies has ceased and that the member will therefore cease to be eligible for membership of the CSG going forward. However, if the member can show that the intention to receive qualifying supplies in the near future still exists then HMRC will accept membership of the CSG can continue.

HMRC accepts that a member can be a member of more than one CSG and that neither the CSG nor its members need be VAT registered. HMRC also accepts that a CSG can be controlled by one of its members (see below for more on control of a CSG).

3 **The supply must be from that entity to one of its members**

The exemption only covers supplies from the CSG to its members and not the other way around. This means that members will have to be careful if they wish to put their own resources into the CSG. For example, if a member wishes to provide staff for use by the CSG, simply supplying the staff for a fee is likely to attract a VAT charge that will be irrecoverable for the CSG. However, employing the staff on joint contracts of employment, seconding staff (using the HMRC secondment concession in VAT Notice 700/34) or VAT grouping with the CSG are all possible options for avoiding this irrecoverable VAT cost in the CSG. See below for more comments on the VAT grouping option.

Supplies by the CSG to non-members are also excluded from the exemption as are supplies from one member to another. HMRC accepts that a CSG can make for-profit or not-for-profit supplies to non-members but these will not benefit from the special CSG exemption.

4 **The members of the entity must carry out VAT exempt or non-business activities**
Each member must carry on one or more VAT exempt or non-business activities. HMRC will impose a 5% entry criteria for membership – i.e. a prospective member must have at least 5% exempt plus non-business activity as determined by its normal business/non-business and partial exemption methodologies.

HMRC will accept a member can join on the basis of an intention to carry out 5% or more non-business plus VAT exempt activities. However, if it does join on such a basis then HMRC will insist that it does actually commence such a level of non-business plus VAT exempt activity within 12 months of joining or it must leave the CSG.

5 **The supply must be directly necessary for the exercise of the member's VAT exempt or non-business activities**
HMRC interprets directly necessary as meaning directly attributable, so a supply will be directly necessary for the exercise of the member's VAT exempt or non-business activities if and only if the supply is directly attributable to those activities in accordance with the normal VAT meaning of the term. However, HMRC will also accept that where a member of a CSG has exempt and/or non-business activities that form 85% or more of their total activities, all the supplies of services they receive from the CSG can be regarded as meeting the 'directly necessary' condition. The 85% level can be determined in accordance with the member's normal partial exemption and business / non-business methodologies but HMRC imposes conditions on when the test is applied.

This allows entities with a low level of taxable activity to receive exempt CSG supplies of core services such as admin, finance and HR even if a some of those services will be used for the charity's taxable activities (up to 15%). However, this is considered controversial and is one of the reasons the Treasury has not implemented any regulations yet. The European Commission has taken Luxembourg to the Court of Justice over a similar clause in its legislation, though that is a much higher 30% – 45% threshold below which taxable activity is ignored.

The 85% test can be met in either of two ways:

- The forward looking test: the member has an intention in the 12 months immediately following joining a CSG to make 85% or more exempt and/or non-business supplies
- The backward looking test: the member has made 85% or more exempt and/or non-business supplies in the immediately preceding 12 months or in the immediately preceding completed partial exemption year

The forward looking test only applies once, on joining the CSG. The backward looking test can be applied at any time. If a member initially meets either the forward or backward looking test but the proportion of taxable activity increases so the 85% test is no longer met, HMRC does not accept that all CSG supplies to that member can be

VAT exempt. But HMRC will accept VAT exemption of supplies from the CSG which are directly attributable to that member's exempt and/or non-business activities.

Once a member has failed the 85% test it can only re-meet it by fulfilling the backward looking test. If a member hovers around the 85% level, so they are likely to go in and out of meeting this test, then the responsibility for ensuring the correct VAT treatment is applied rests on the CSG. So the CSG may have to impose certification requirements and conditions. For example, a requirement that at the end of each VAT year the member certifies to the CSG that its level of VAT exempt plus non-business activity was 85% or more. If the member cannot certify this, then the CSG will retrospectively amend its invoices as required. Until such time as appropriate policy and practice in this area become clear, it may be best to get HMRC approval of such arrangements in advance.

6 The CSG merely claims from its members exact reimbursement of their share of the joint expenses

The CSG must charge the members for the services on a non-profit basis and in proportion to the level of use of its services by each of the members concerned. The fee can include apportioned overheads, depreciation etc. in the price calculation and can allow for a surplus to build up designated reserves for the benefit of members but the deliberate accumulation of profits for distribution is prohibited. However, HMRC does accept that the CSG can make for-profit supplies to non-members (which attract their normal VAT treatment).

The exact reimbursement of cost condition was examined in the 2014 tax tribunal case West of Scotland Colleges Partnership. The partnership (a company limited by guarantee) was set up to assist the colleges in identifying and applying for grant funding. The Partnership initially charged its members a flat fee which was then adjusted to take account of the size of the college. The Tribunal held that the exact reimbursement condition is a strict requirement and it is for the CSG to prove it is met. It must provide suitable evidence of how the fees charged achieve this. The Partnership could not provide this and so lost its appeal.

The CSG will have to have some mechanism for identifying how costs are driven, how the driver is consumed by its members, recording this and charging members as appropriate. For example, a CSG providing agency staff could charge per staff hours worked, with overheads absorbed into an hourly charge rate. Timesheets would have to be able to identify which member the work was carried out for. Members could then be invoiced listing staff, tasks hours worked, charge-out rates and fees falling due in the charging period.

HMRC accepts that the 'exact reimbursement' rule can be met over a reasonable period of time given the nature and context of the supplies being made, and this can allow for building up surpluses in order to cover costs in another. HMRC also accepts it can be demonstrated by using normal accounting techniques.

7 **The exemption of the supply must not be likely to cause distortion of competition**
The distortion has to be caused by the exemption itself and excludes any distortion caused by the entities achieving economies of scale or the presence of a not-for-profit membership controlled operator in the market. The conditions under which this condition will block exemption are therefore not clear.

HMRC sees the main risk as being from commercial operators claiming to be CSGs. HMRC's view is that, as the CSG must be owned and controlled by its members, this precludes private concerns from operating as a CSG. However, a CSG can of course contract with a private service provider to provide it with services. HMRC also states that if supplies from a member to a CSG are used as a mechanism to artificially inflate costs to extract a profit from the supplies made by the CSG, then they will fail to meet the 'exact reimbursement' condition and will fall to be treated as fully taxable.

Particular issues

Control of a CSG

HMRC accepts that one member may control a CSG, for example by owning more than 50% of the share capital, but the CSG must have other members as well and HMRC requires that if the CSG is a share limited company then all of the shareholders are members.

VAT groups

A member can be a member of a VAT group and a CSG at the same time. However, it is the member itself that must meet the CSG conditions, not the VAT group's representative member or the VAT group as a whole.

A CSG can also be a member of a VAT group – for example, if the CSG is a corporate body that is controlled by a corporate member, the CSG can join that corporate member's VAT group. However, in this situation supplies from the CSG to its controlling member (and any other members that are in the same VAT group) are outside the scope of VAT as intra-group supplies rather than VAT exempt as CSG supplies. Similarly, any supplies from members who are in the VAT group to the CSG itself are outside the scope as intra-group supplies.

This is therefore one way for a member to put resources into a CSG without generating irrecoverable VAT in the CSG. For example, if a member controls the CSG and brings it into a VAT group, then that member can supply staff and other resources to the CSG and the fee for that supply will be outside the scope of VAT.

Sectorised methods and the 85% test

HMRC will, in certain circumstances, accept the 85% test being applied to particular parts of a member's business provided the test can be reasonably applied. For example, if the member has a sectorised partial exemption and business/non-business method they can apply the test on a sector basis. If a particular sector qualifies, the member can receive all supplies from their CSG that are attributable to that sector on a VAT exempt basis.

The test could also be applied on the same basis if, for example, a member can identify specific account codes in its accounting system; if the test is satisfied on that basis a member can receive all supplies from their CSG that are directly attributable to that account code on an exempt basis.

Cross border cost sharing groups

HMRC accepts that a UK established CSG can include members established in other EU member states and that a UK established entity can be a member of a CSG established in another EU member state. Providing the UK cost sharing rules are met, HMRC will accept that a cross border CSG to member supply is VAT exempt and no UK output VAT need be charged or accounted for under the reverse charge. However, the cost sharing rules differ between EU member states so the same may not apply in the other EU state. Cross border CSGs will therefore need to consider the rules applicable in all of the member states concerned.

Further information

Contact Sayer Vincent on svinfo@sayervincent.co.uk or call us on 020 7841 6360 to discuss your plans.

HMRC cost sharing exemption guidance:
http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ShowContent&propertyType=document&id=HMCE_PROD1_032269