Dacorum Borough Council

VAT Partial Exemption Review

Final Report

Distribution list:

Key dates:

Contents

1. Executive summary

1.1. Background

Section 33 of the VAT Act 1994 allows local authorities to recover the VAT they incur on their non-business activities. Local authorities can also recover VAT incurred on business activities including VAT exempt business activity, even though other organisations cannot do so.

To reclaim the VAT incurred on exempt activity, that VAT can be no more than a de minimis limit of 5% of the total VAT expenditure in a financial year. If the 5% limit is exceeded then the authority must repay to HM Revenue and Customs (HMRC) the entire amount of VAT recovered on exempt activity. In the case of Dacorum Borough Council ("DBC"), we understand that this would amount to approximately £244,000.

In 2009/10, following a two year moratorium, HMRC brought back the requirement for local authorities to monitor their exempt input tax and undertake an annual Partial Exemption ("PE") calculation. Councils are required to calculate their PE position by October following the end of each financial year.

1.2. Objectives and Scope

The overall objective of this review was to undertake a risk assessment of DBC's PE methodology, to assess its currency, practicality, accuracy and to identify any areas in which improvements might be made.

In summary, the scope covered the PE methodology and Internal Guidance provided to the members of staff with responsibility for making VAT determination decisions.

1.3. Summary assessment

Our review found that, overall, the VAT accounting arrangements at DBC appear to be adequate with regard to the partial exemption ("PE") and monthly VAT return process.

However, to ensure that exposure to PE costs and other VAT risks is mitigated effectively, the VAT function should take a more pro-active role in identifying potential VAT risk issues (including PE and VAT liability questions) and manage those issues by communicating actively with the directorates within the Council.

The Council should undertake the following steps:

1. **Calculation Methodology:** Update and amend its PE methodology and obtain agreement from HMRC – The key elements of this being:
   - remove overhead from the PE calculation,
   - pro-rata those areas where there are mixed supplies.

2. **Forecasting/Monitoring:** Increase officer awareness of the possible VAT implications of future capital projects, the financial impact of exempt input tax on the year end PE figure, and the need to review VAT impact at the start of the project.

3. **Directorate Awareness:** Delivery of directorate focused VAT training to ensure awareness of VAT issues and the appropriate responses to them.

4. **Finance Guidance:** Provide VAT guidance notes to staff so that they will be able to correctly identify if the expenditure or income is standard rated or not, minimising potential financial loss or exposure to assessment from HMRC.

We would like to take this opportunity to thank all staff involved for their time and co-operation during the course of this review.

2. Scope of assignment

2.1 Objective

The overall objective of this review was to undertake a risk assessment of DBC's PE methodology, to assess its currency, practicality, accuracy and to identify any areas in which improvements might be made.

2.2 Approach and methodology

The following activities were undertaken during the course of our review:

- discussions with key members of staff to determine the procedures and methodology adopted to deal with PE;
- evaluation of the current PE methodology;
- review of DBC's procedures to deal with questions of VAT liability; and
- preparation of a draft report.

3. Partial Exemption and Capital Expenditure

The Current PE Method

Most local authorities will have a methodology for calculating their PE position which has been agreed with HMRC, except where the method adopted is the 'standard method' published by HMRC. DBC has adopted a version of the 'standard method' and must continue using this method until it is either withdrawn by HMRC or a new method is agreed.

Evidence of HMRC review or agreement to DBC's specific method was not available.

The Calculation

DBC's PE calculation follows a standard process. Our review looked at data for 2009/10 but we understand that there have been no changes to the method or processes in 2010/11 and have therefore updated the report with current information. The first stage, identifies spend across revenue cost centres and capital projects which is subject to VAT. The second stage is then to identify the VAT liability of supplies which are made by those revenue cost centres or in relation to the capital projects – and to categorise those supplies as one of standard rated, zero rated, non-business or exempt.

Where there is any level of exempt activity within a revenue cost centre or against a capital project, the full amount of VAT incurred is attributed to that VAT exempt activity. This is known informally as the 'first cut' methodology.

For example, in 2009/10, income from Bennet's Gate shopping centre was £300,500, of which £93,500 (31%) related to VAT exempt supplies (e.g. exempt lets of land). VAT expenditure incurred by the Council on works or activities related to the Bennet's Gate cost centre was £5,200. The whole £5,200 was identified (and attributed) as VAT on exempt activities, whereas the amount attributable to exempt supplies could have been reduced to £1,612 (31%) with further scrutiny. Whilst this approach is in line with HMRC guidance and the Council is currently below the 5% de minimis threshold, an alternative, more detailed PE method may be of benefit to the Council at a later date if the Council's expenditure relating to VAT exempt activities was to rise.

Recharges

VAT is incurred on costs which relate to recharges of supplies where the original supply was exempt from VAT. We understand that in 2009/10, this amounted to £78,420 and is also identified and included in the total level of exempt input tax.

Final Percentage

DBC's total expenditure on VAT in 2009/10 was £4,843,450 (2010/11 = £3,955,723) of which £180,685 (2010/11 = £136,916) was incurred on revenue and capital areas in which there is some VAT exempt activity. This means that the Council's input tax relating to VAT exempt supplies (according to the method used) for 2009/10 is 3.73% (2010/11 = £2.45%). The Council would need to have incurred an additional amount of input tax relating to exempt activities of £61,000 (2010/11 = £142,000) in order to breach the 5% de minimis threshold.

Based on the Council's current PE method, if the 5% threshold had been breached in 2009/10, DBC would have had to repay, to HMRC, approximately £244,000 (2010/11 = £279,000)

Action Required: Forecasting the PE position

DBC does not currently undertake a rolling forecast of its PE position for the current year and the two years ahead as is standard practice in many local authorities.

Forecasting requires that the Assistant Accountant has knowledge of the capital programme and/or that project owners are aware of the need to consider VAT implications when discussing the roll out of a capital project. This does not happen at present.

A forecast of the PE position would enable the identification of potential issues arising from planned spending in areas of activity that generate VAT exempt income for the Council and that may cause the Council to exceed its 5% de minimis threshold.

Undertaking a regular forecast would forewarn DBC and allow it time to investigate the situation well in advance in order to consider alternatives.

It is also important that the forecasting is supported by an ongoing monitoring process to ensure that the forecasts are consistent with the actual activity. For example, as the planned spending for capital projects can often slip across financial years, there is an ongoing risk of exposure. In order to manage this potential exposure the Assistant Accountant or the Capital Accountant should be made aware of the need to notify the VAT manager of any potential slippage, in order to allow action to minimise any potential impact.

For example, the Council has recently incurred significant costs in relation to the Maylands business centre and has acquired investment properties that also require expenditure. How the Council intends to make supplies from these premises, and other premises that may be purchased, significantly impacts on how the input tax should be treated. If the Council chooses to generate rental income, for example, this could have a direct impact on the its ability to recover all of its VAT that relates to making exempt supplies.

To ensure that forecasting and monitoring is performed effectively, it is vital that staff in directorates with responsibility for planning new capital projects, are aware of VAT as a potential issue/cost for DBC. It is therefore important to ensure that awareness is raised through training, guidance and regular communication.

In addition, it should be an integral part of the finance team's responsibilities, to identify the capital projects within the Council and seek advice on their impact on the Council's VAT position, where required.

Action Required: Update the Current PE Methodology

Whilst the current PE methodology demonstrates that the VAT incurred by the Council which relates to its VAT exempt income, is less than 5% of the total VAT incurred, there is scope to amend the method to allow a more detailed analysis to take place. The advantage of a more detailed calculation is that the Council would have greater 'headroom' in assessing whether or not it will exceed the 5% de minimis threshold. The following suggestions could be adopted in a revised PE methodology. The first would not need to be agreed by HMRC, but the second would:

1. Since the end of the PE moratorium and the re-introduction of the need for a PE calculation, HMRC have accepted that the exempt input tax which relates to overhead recharges may be excluded from the PE calculation.
2. In addition, the current method adopted assumes 100% VAT exempt activity in a revenue cost centre or where a capital item is used, even when there are both taxable and VAT exempt supplies. A more detailed calculation could be agreed with HMRC which apportions the input tax between the activity with the cost centre (rather than just allocating all input tax to exempt activity).

4. VAT Coding of Income and Expenditure

As part of our review of the PE position for the Council, we also reviewed the VAT coding in the Council's accounting system.

DBC's accounting system is set up with cost centre codes being allocated a particular VAT code, which determines the default VAT treatment of any transactions posted against those codes. The VAT codes are as follows:

0	NO VAT CODED
EX	Exempt Income
LC	Leased Cars Tax (Expenditure)
NB	Non-Business Income
NN	No VAT on Purchases
OT	Outside the Scope Income
SF	Standard Output Tax (Extract VAT from Income)
SI	Standard Input Tax (Expenditure)
SO	Standard Output Tax (Add VAT to Income)
ZR	Zero-Rated Income

Whilst we did not identify any specific issues with respect to the VAT codes attributed to particular cost centres, there can be an inherent weakness in systems such as this, where the VAT determination for a particular purchase ledger or sales ledger transaction is pre-set or reverts to a default position.

This weakness may mean that, for example, a VAT purchase invoice on which no VAT was charged (for example, because the supplier was not registered for VAT), when coded to a cost centre which is pre-set to VAT code SI, may result in VAT being recovered even though the Council was not charged any VAT.

Action Required: Directorate Awareness

In order to avoid the potential under-declaration of output tax or overclaim of VAT, the Council relies on the staff processing the invoices and payments, to review the VAT treatment. We understand that queries from the accounts payable staff are directed to the VAT accountant as and when they arise, and that a similar arrangement is in place for those staff dealing with sale invoices (referring to the head of section).

It is important that personnel responsible for coding income and expenditure for VAT purposes have regular and up to date training on VAT to ensure that they understand the approaches to take and can seek guidance and input from central resources.

5. Recommendations

Recommendation 1: Changes to the PE methodology

Recommendations

- That the Council bring its PE methodology up to date by no longer including VAT incurred on overhead recharges in the calculation.
- That the PE calculation is monitored on a more frequent basis, to ensure that the Council has notice of any potential breach of the 5% de minimis threshold
- That a review of the planned capital programme is initiated as part of the PE methodology, to identify any future capital projects that may cause the 5% threshold to be breached.
- That a programme is developed to ensure that staff in directorates with responsibility for planning new capital projects receive training, guidance and regular communication.

Observation

Taking out the overhead recharges VAT from the calculation will save officer time, provide increased 'headroom' in the PE de minimis limit (the 5% threshold) and demonstrate to HMRC that the Council is up to date with current practice. The recharges are costs that have been incurred in relation to exempt supplies but the VAT will already have been factored in to the PE calculation on the original purchase.

In the absence of any evidence of the current method having been agreed with HMRC, it would be prudent to notify and obtain the agreement of HMRC that the method is acceptable. We would not expect that HMRC's agreement would be withheld.

In the event that the more frequent monitoring and the review of the capital programme identifies that the Council may breach the 5% threshold, further steps may be taken to mitigate. Either by undertaking a more detailed analysis of income and expenditure as part of a revised methodology, including a more detailed approach to identifying VAT on exempt supplies (which for completeness, would need to be agreed with HMRC) or by approaching HMRC in advance of an expected breach and discussing matters with them in advance.

Responsibility

Richard Baker, Regulatory & Financial Accounting Team Leader

Management response / deadline

Major projects are subject to review by finance officers. All capital projects are reviewed by CSSG and VAT implications can be identified at this stage. The finance team has access to help desk advice and regular training through the CIPFA/Deloitte VAT advice line and a separately agreed contract.

Further improvements are planned. At the completion of the 2011/12 partial exemption calculation in September 2012 the current methodology was appraised. Subsequently, a review of options for forecasting VAT on future projects will be undertaken and a forward projection will be completed during budgeting for 2013/14. At the point we will agree the method with HMRC.

Recommendation 2: VAT Coding of Income and Expenditure

Recommendation
• That the Council initiates a programme of VAT training for those officers responsible for determining the VAT treatment of transactions (accounts payable and accounts receivable at the least). • That the Council prepares and maintains access to guidance on the VAT liability of supplies for members of staff responsible as above.
Observation
In 2009, HMRC's new VAT penalty regime came into force. The new regime relies heavily on the concept of taxpayers (such as the Council) being able to demonstrate that they have taken reasonable care in order to prevent errors arising. In view of this, it is recommended that guidance on the VAT liability to be applied to invoices is produced as well as providing training for staff processing invoices, in order to mitigate the risk that DBC under declares VAT due on sales or over claims VAT recoverable on purchases. Where an error in posting does arise in the future, DBC will be able to provide HMRC with evidence of measures having been taken by the Council to minimise the possibility of errors, in other words that it has taken reasonable care.
Responsibility
Richard Baker, Regulatory & Financial Accounting Team Leader
Management response / deadline
All officers who deal with VAT codes do receive training. Manual errors will occur from time to time but there is a low risk of failure. However, steps have been taken to reduce further risk of error. The Regulatory and Financial Accounting Team Leader has introduced a data checking process to identify areas where coding errors are regularly occurring and is exploring the option of implementing an automated checking facility to ensure that the correct VAT code is raised. A decision on this will be made by 31 March 2013.

Appendix A – Staff interviewed

The following personnel were consulted:

Richard Baker	-	Regulatory & Financial Accounting Team Leader
Yamini Krishnan	-	Assistant Accountant (Regulatory & Financial Accounting)

We would like to thank the staff involved for their co-operation during the review.