

# VAT and Leisure Management Options: Has the Game Changed?

By David Rushton, Director



SLC's David Rushton considers the impact of the 2017 European Court of Justice's Ealing Case, Carillion's collapse and an increasing political lobby to bring services back in house.

Will this reverse the trend in leisure management outsourcing and result in more local authorities bringing services back in-house?

In 2017 the European Court of Justice handed down a judgement that effectively settled one of the leisure industry's longest standing arguments. By finding in favour of the London Borough of Ealing in its suit against HMRC, this has made in-house run sport and leisure services eligible for the same level of VAT exemption on income as Not for Profit Distributing Organisations (NPDO) and trusts.

It was undoubtedly a ground-breaking decision that potentially involves a significant amount of money. An NPDO trust operating a leisure centre with a £1 million turnover is able to recover VAT worth in the region of £150,000 per annum or more. For a leisure operation with a turnover of £5m or £10m, this equates to a significant business advantage over non-exempt competitors and explains why so many local authorities have in the past established charitable trusts to manage their leisure operations. It also explains why VAT exemption had been a major debating point within the leisure industry for the last 20 years.

Some engaged in this debate had cast VAT exemption as a genuine game-changer in the field of leisure contracting. The playing field would be levelled, the competitive advantage of businesses established as an NPDO trusts would be eroded, and in-house contracts would once again be viable. Along with the 2015 Public Procurement Regulations, the failure of some major outsourcing businesses, such as Carillion, and the re-emergence of public ownership on the national political agenda, it seemed that the time for change had arrived.

However, a couple of years on from the ECJ ruling this shift in approach has yet to appear. Those local authorities politically inclined to keep services in-house might have been able to strengthen their case. Indeed, some authorities may be considering their options rather more carefully than before, but none has yet undertaken what we might term a 'reverse procurement', taking the contract back in-house from an outsourced contract. Some are exploring this but at the time of writing this article, no local authority has actually done it.

*'The new in-house model comes with new risks and challenges'*

Many in the sector held on to the expectation that the erosion of this VAT advantage would make everyone rethink their approach to leisure procurement. However, when the time came, the new contracting landscape was not quite as simple as some might have hoped. The new in-house model comes with new risks and challenges.

Most obviously, VAT exemption is far from straight forward. Obligations for VAT rest with the whole local authority rather than any specific service under its control. For a leisure trust, VAT and exemption is based on the income and expenditure of the leisure contract. For a local authority, it is based on the income and expenditure of the whole organisation. This is a complex area but essentially it involves the relationship between the VAT exemption claimed on income and the VAT claimed on expenditure. A local authority could find itself worse off if its leisure operation affected its de minimis position, which is the maximum amount of VAT an authority can recover. Most authorities already operate quite close to their de minimis limit. This makes it quite difficult for them to adopt VAT exemption on leisure services if they might be considering expenditure, perhaps housing or other capital projects, that might otherwise be eligible for VAT exemption.



In contrast, leisure operators, particularly those set up as hybrid trusts, which have elements of the business established as private companies and other elements as an NPDO trust, are able to focus on the delivery of a single service and maximise their VAT recovery without the concerns of capital programmes elsewhere in the organisation. If a local authority puts its leisure services out to tender, a private operator or a hybrid trust will be able to offer a fixed price that will include its VAT exposure over the period of the contract. If a local authority decides to run that service in-house, the overall cost of the service will be much more uncertain. This is because so much will depend on what the authority does over the next 10 years in terms of VAT recovery across the rest of its services.

The collapse of Carillion in 2018 has led some lobbyists in the sector to suggest that many multi-site operators may be close to following in Carillion's demise. They point to over trading and operators being encumbered with too many unsustainable contracts. There has historically been evidence of over bidding (often for strategic reasons to secure market share and /or unsophisticated approaches to procurement with too heavy a focus on contract price rather than quality). This has now slowed significantly. Why? Better, more balanced approaches to leisure procurement where quality is weighted higher than price. Additionally, some operators have recognised they are not structured to be competitive enough and are withdrawing from the market or focusing purely on contract extensions rather than new business. As yet there has not been a collapse of any multi-site leisure operators many of which have been in existence for over 25 years.

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Another major issue that emerges when exploring any in-house option is that of operational costs, in particular staffing. Bringing staff back in-house raises the prospect of employing staff on local authority terms and conditions, including the associated pension requirements. For any local authority that has been working with a private contractor for any length of time, this could result in an increase of staff costs of some 15-20%. When staff costs can account for 50-60% of the total cost of an operation, this represents a significant hurdle.

Management infrastructure is another potential challenge. Any leisure operation requires significant resources to deal with all aspects of running a service, functions such as payroll, health and safety, and finance. A multi-site leisure service is likely to need an experienced contracts manager, plus marketing and business support staff. If you are working with a contractor, these items are accounted for within the management fee. If you are bringing services back in-house, these back-office functions will need to be properly costed and carefully considered.



Those authorities which have multi-site operators running their facilities are likely to be benefiting from economies of scale. These operators can essentially buy equipment, materials and in some cases utilities at much lower rates than smaller operators. Authorities considering bringing services back in-house need to factor this in.

So, while the ECJ decision might have been a game-changer for some, the benefits have not been quite as clear-cut as many might have hoped. If local authorities are operating below de minimis they can reclaim VAT and the ruling may have added weight to the argument for keeping a service in-house if that is the local political preference. However, the financial case for bringing services back in-house has not been radically altered.

Many political administrations will continue to seek reassurances on protecting worker's pay and conditions (e.g. Living Wage) and control over the delivery of services linked to effective measures to support equality of access.



Leisure service delivery is now a very sophisticated market with a number of highly experienced and successful multi-site operators able to offer significant efficiencies and economies of scale. In many cases, outsourcing leisure services linked to investment in modern leisure assets can generate a significant financial return to the authority. This can also be achieved incorporating the requirements on pay and conditions, control and equality of access. In times of austerity this can be hard for any local authority to ignore.

These surpluses can be reinvested back into addressing issues of affordability for target groups on low incomes and supporting targeted outreach. For example, the surplus could be used to meet the recreational needs of young people at risk of anti-social behaviour, poor educational attainment and ultimately lower quality of life opportunities.

As the sector considers the shape of leisure service provision over the next decade, whilst the ECJ Ealing Case has provided many local authorities with food for thought, the real issue to be addressed is optimising future investment in leisure facilities. This will ensure authorities have the widest range of policy levers and essentially sustainable resources available to them to address local priority issues in a sustainable way.

**Let's start a conversation.**

If you would like to discuss your leisure management options and have an informal chat with one of SLC's experts, please give us a call on **01444 459927** or email us at **[info@slc.uk.com](mailto:info@slc.uk.com)**