VAT Treatment of Charities and Public Bodies
In the United Kingdom
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This essay considers the VAT treatment of charities and public bodies in the United Kingdom. In general, the same legal principles apply to charities and public bodies as to commercial enterprises. But unlike with VAT-registered businesses, the purpose of charities and public bodies is not to make a profit or engage in commercial activities. Nevertheless, there is no general exemption from VAT for those entities. Sometimes VAT concepts are more difficult to apply to those groups than to businesses, for which VAT is already sufficiently complex.

The concept of a supply made in the course or furtherance of a business\(^1\) is usually straightforward in the case of most businesses, but it can be awkward when considering charities and public bodies and it has given rise to complex case law. VAT compliance is a considerable administrative burden for both charities and public-sector bodies, with each obliged to take steps to minimize VAT liabilities as much as possible. Consequently, both public bodies and charities usually have complex VAT accounting systems.

Charities
Many charities pay no VAT because they do not make supplies of goods or services, because they are not in business, or because their turnover is below the limit for registration.\(^2\) In the U.K., a body must register for VAT if it makes taxable supplies that exceed the annual VAT registration threshold — currently £70,000 — or if it is likely to do so within the next 30 days.\(^3\)

\(^1\)Value Added Tax Act 1994, s. 4.
\(^2\)See, in general, HM Revenue & Customs Notice 701/1 (May 2004) on charities for guidance on VAT and charities.
\(^3\)See Value Added Tax Act 1994, Sched. 1, para. 1.
A charity will have its primary activity set out in its statement of aims and objectives. Because those activities are often of a nonbusiness nature, they may well be outside the scope of VAT. If they fall within the definition of a business, some portion of a charity’s supplies may be either exempt from VAT, zero rated in accordance with Schedule 8 of the Value Added Tax Act 1994 (the act), or taxed at the reduced VAT rate of 5 percent.

Voluntary VAT registration can be beneficial in some cases, particularly when a charity receives zero rated revenues (for example, sales of donated goods). This allows VAT recovery on costs without any VAT being payable on revenues. Once registered, a charity must charge output VAT on the taxable supplies of goods and services and can recover the input VAT incurred on purchases relating to taxable (standard, reduced, or zero rated) supplies, but not exempt supplies. Charities are also unable to recover the VAT that they incur on purchases necessary to carry out their nonbusiness activities.

**Business Activity**

Business activities mainly take place when making supplies to other persons for any form of payment or consideration, cash or otherwise, that have a degree of frequency and scale and continue over a period of time. Many gray areas have arisen in determining what constitutes a business activity under the VAT regime.

For example, there may well be a business activity when charities receive funding (for example, from a local authority or other government body) and are required to perform services in return. A careful examination of the arrangements is required to

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5 See Value Added Tax Act 1994, Sched. 7A. The reduced rate applies to children’s car seats; contraceptive products; domestic fuel and power; installation of energy-saving materials; grant-funded installation or connection of heating equipment, security goods, and gas supplies; installation of mobility aids for the elderly; renovation and alteration of empty dwellings; smoking cessation products; residential conversions; welfare advice or information; and women’s sanitary products.
7 17.5 percent; Value Added Tax Act 1994, s. 2. This is due to rise to 20 percent in January 2011; Finance (No. 2) Act 2010, s. 3.
8 5 percent; Value Added Tax Act 1994, s. 29A.
determine whether VAT is chargeable on the value of the services. If it is, VAT recovery on the costs will also be possible if the supplies aren’t exempt. There is much case law dealing with whether a business activity has been undertaken for VAT purposes.

**Exempt Supplies**

Once the business activities of a charity are identified, it is necessary to establish whether any of its supplies fall within the exempt category. Those are services that are deemed necessary supplies so that it is considered in the public interest not to charge VAT. For those supplies, no VAT is chargeable, and they do not count toward the turnover threshold. Many charities are involved in these areas of work. If they are only making exempt supplies, there will be no requirement to register for VAT, no matter the turnover.

The public interest exemptions most likely to affect charities are set out in Schedule 9 of the act and are as follows:

- education;
- health and welfare;
- membership subscriptions to trade unions and professional and other public interest bodies;
- sports, sports competitions, and physical education services;
- fundraising events by charities and other qualifying bodies; and
- cultural services.

There are more exemptions for specific activities. The exemptions for education, sport, and cultural services apply when the supplier is an eligible body, the requirements of which differ from group to group and have been the subject of considerable litigation.9

**Zero Rated Supplies**

For zero rated supplies, VAT will not be added to the cost to the charity. Similarly, a charity making zero rated supplies will

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9See, for example, regarding the supply of education, research, or vocational training, the definition of an eligible body in Value Added Tax Act 1994, Sched. 9, group 6, para. 1, note 1.
not need to charge VAT on those supplies. However, it may recover input tax in relation to zero rated supplies. The zero rated supplies most likely to affect charities are set out in Schedule 8 of the act and include the following:

- talking books for the blind and handicapped and wireless sets for the blind;
- the construction of annexes used for a charitable purpose;
- alterations to protected buildings used by charities;
- the sale of goods donated to a charity;
- the donation of any goods for sale or export by a charity;
- the supply of any relevant goods to an eligible body\(^{10}\) that pays for them with funds provided by a charity or from voluntary contributions; and
- the supply to a charity providing care or medical or surgical treatment for human beings or animals, or engaging in medical or veterinary research, of a medicinal product or veterinary medicinal product when the supply is solely for use by the charity in that care, treatment, or research.

**Irrecoverable VAT**

U.K. charities complain bitterly about their VAT treatment, in particular the burden of irrecoverable VAT. They have managed to obtain only minor concessions\(^{11}\) to the VAT regime since its introduction in 1973. VAT rules, as they affect charities, are complex and cause many problems. According to the Charity Tax Group (CTG), the irrecoverable VAT burden for charities is estimated at £1 billion a year.\(^{12}\) The CTG campaigns on behalf of charities to seek changes in tax legislation and administration.

Studies in Denmark, Ireland, and the U.K. indicate that charities are paying around 4 percent of total expenditure on VAT.\(^{13}\) The burden is not spread evenly across the charitable sector. For example, Action for Blind People pays 5.8 percent of its total

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\(^{10}\)Defined in Value Added Tax Act 1994, Sched. 8, group 15, note 4.

\(^{11}\)For example, in 2002 a package of VAT relief for charity buildings, including residential communal homes, was introduced.

\(^{12}\)See http://www.ctrg.org.uk/home.

\(^{13}\)See http://www.ctrg.org.uk/campaigns/VAT/.
expenditure on VAT. The increase in the standard VAT rate to 20 percent, effective from January 2011, will increase that burden by at least £150 million per year.\textsuperscript{14}

CTG is campaigning for a rebate to match the irrecoverable VAT incurred when the expenditure relates to charitable activities. The problem of irrecoverable VAT has become more severe in recent years as charities seek to widen their funding base to include more earned income and provide more services under contract. The move away from donations and grants to earned income has increased the circumstances in which charities incur VAT.

**Public Bodies**

Several different categories of public bodies are subject to VAT, and their ability to recover input VAT will be determined by reference to the category into which they fall. However, all public bodies must charge VAT on their business supplies.\textsuperscript{15} The public bodies that are affected by VAT include:

- government departments;
- local authorities and other “section 33” bodies;
- health authorities;
- nondepartmental public bodies;
- executive agencies and trading funds; and
- police authorities.

The normal VAT registration requirements apply to public bodies other than local authorities. With a local authority, if taxable supplies in the course or furtherance of a business are made, the local authority must register for and charge VAT, regardless of whether the value of the supplies reaches the normal VAT registration threshold.\textsuperscript{16}

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\textsuperscript{14}Charity Tax Group press release, June 22, 2010.
\textsuperscript{15}See, in general, HM Revenue & Customs Notice 749 (April 2002) on local authorities and similar bodies for guidance on VAT and public bodies.
\textsuperscript{16}Value Added Tax Act 1994, s. 42.
While the act is domestic U.K. legislation, much of its scope is determined by EU VAT directives. Under European law:

States, regional and local government authorities and other bodies governed by public law shall not be regarded as taxable persons [that is, they do not have to charge VAT] in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with those activities or transactions.

Consequently, when public bodies carry out statutory functions, which are considered nonbusiness activities, they do not have to charge VAT. Case law has confirmed that those public bodies engage as public authorities when they undertake their duties under a special legal regime that applies to them and not to other bodies. HM Revenue & Customs recently reconsidered its interpretation of the phrases “bodies governed by public law” and “special legal regime” in light of recent case law. HMRC considers that a body will satisfy this criterion only if it is a public-sector body that forms a part of the U.K.’s public administration, such as a governmental department, a local authority, or a nondepartmental public body. Article 13(1) of the directive is not intended to enable other bodies to claim special treatment merely because they have delegated powers, are regulated in some way by the state, are funded by public money, or are subject to specific rules in the pursuit of their activities.

Several activities are also excluded from the scope of article 13(1). That article removes some activities from its application unless they are carried out on such a scale as to be negligible. Those are:

- telecommunications services;
- the supply of water, gas, electricity, and thermal energy;
- the transportation of goods;

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port and airport services;
- passenger transport;
- the supply of new goods manufactured for sale;
- some activities of agricultural intervention agencies;
- the operation of trade fairs and exhibitions;
- warehousing;
- activities of travel agents;
- activities of commercial publicity bodies;
- the operation of staff shops, cooperatives, and industrial canteens and the like; and
- some commercial activities of radio and television bodies.20

Guidance known as Treasury directions,21 published in 2002, provides a list of additional supplies that, when made by government departments, are deemed to be made in the course or furtherance of a business.

Also, under article 13, supplies will not be treated as being nonbusiness when it would lead to significant distortions of competition. The issue of public bodies and distortions of competition has recently been considered both in the U.K. courts and the European Court of Justice,22 in a test case that concerned local-authority-operated car parks. Car parking charges were imposed by the local authorities, but private-sector providers also supplied parking services.

The private-sector providers had to account for VAT, potentially putting them at a commercial disadvantage to the local authority providing the same service. The ECJ believed that the rule includes both actual and potential competition with an existing or would-be private trader, provided the possibility of a private trader entering the market is real. The ECJ ruled that for there to be significant distortions of competition, the effect must be “more than negligible.”

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21Made under Value Added Tax Act 1994, s. 42(2).
22Revenue and Customs Commissioners v. Isle of Wight Council (C-288/07) [2009] 1 CMLR 4. The litigation, which is ongoing, has a long procedural history, dating back to 2000 and involving several decisions of the tribunal, the High Court, and, on reference to it by the High Court of questions of EU law, the ECJ.
The example of car parking illustrates the complexities in this area. When a public authority imposes charges for parking at meter bays on the public highway, including excess parking charges, it does so under statutory powers that only a public authority can exercise. This activity is nonbusiness. However, in providing off-street parking in garages, buildings, and open spaces, the authority is not acting under any special legal provisions that give it powers beyond those available to the private traders with which it is in direct competition, meaning that activity is business.

Recovery of Input Tax

While ordinarily no VAT is due on income received from exempt supplies or nonbusiness activity, no VAT recovery is possible on the expenditure incurred. Without special provisions, this could be problematic for public bodies, because they may make significant nonbusiness supplies. Public bodies, including local authorities, are therefore subject to a special regime that entitles them to recover VAT incurred when engaged in nonbusiness activities. It relates back to an original commitment that VAT would not be a burden on local authorities pursuing their statutory functions.

Under this special regime, while local authorities do not charge VAT on income received from nonbusiness activities, they can still recover all VAT incurred on expenditures in pursuing those activities. Local authorities can normally recover all the VAT that they incur under the special partial exemption regime for section 33 bodies. That is on condition that VAT on costs relating to exempt business supplies is not more than 5 percent of all VAT incurred. If that limit is exceeded, none of the VAT is recoverable. This 5 percent test is therefore very important for local authorities.

A separate, less extensive recovery mechanism exists for other public bodies that do not fall within the section 33 regime. It

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23 See HM Revenue & Customs Notice 749, para. 5.8.7
24 Under Value Added Tax Act 1994, s. 33.
25 This 5 percent limit was removed in tax years 2008 and 2009 but is now fully implemented, requiring careful monitoring by local authorities.
enables government departments and health service bodies\textsuperscript{26} to recover some input tax attributable to supplies they receive for nonbusiness activities.

The application of the VAT rules to public bodies is complicated, as evidenced by the amount of case law in the area. Careful consideration is required in all transactions to determine whether VAT is chargeable and recoverable.

**Conclusion**

This short essay cannot do justice to the complexities that arise for both charities and public bodies when considering the application of VAT to their activities. The area is governed by extensive legislation, case law, and HMRC guidance, which interested readers are invited to examine. The lesson for Americans considering a VAT regime is that careful thought must be given to the treatment of charities and public bodies, and the issues are likely to be far more complex than one might imagine.

\textsuperscript{26}Defined in Value Added Tax Act 1994, s. 41.