charity tax group

CHARITIES AND VAT:
an evaluation

December 2020

Introduction

Since its introduction in the 1970s, VAT has always been a problem for charities, not just because of the large amounts of irrecoverable VAT that they have to pay, but also because of the complexity of the VAT regime as it affects them. Successive Governments have acknowledged that charities face significant problems with VAT and have introduced a number of targeted reliefs to reduce the scale of the problem, but they have been constrained by EU law from doing anything more radical.

Following the UK's withdrawal from the EU, one of the major obstacles to radical reform of the system is removed. Furthermore, the VAT system is already under review: the Office of Tax Simplification [OTS] has called for a review of UK VAT rates, reliefs and exemptions and the House of Commons Treasury Select Committee is reviewing the scope and effectiveness of tax reliefs after COVID-19.

As the main representative body for the sector on tax issues, the Charity Tax Group [CTG] wants to ensure that any review of the VAT system fully recognises the position of charities. We therefore commissioned a report from London Economics[1] to update the information that we hold on the value of the VAT reliefs that have been introduced for charities, the remaining irrecoverable VAT burden and, for the first time, an analysis of the amount of output VAT that charities pay to HMRC/Treasury.

The research is particularly timely given the current financial crisis facing many charities as a result of the COVID-19 pandemic. The Chief Economist at the Bank of England, Andy Haldane, in a keynote speech[2] on 23 November 2020 pointed out that ***"around three-quarters of charities have experienced a rise in demand for their services with a third having seen demand increase by over 25%".***

He went on to say that ***"the sector (is) in a fragile financial state. In Pro Bono Economics' [PBE] November survey, over 80% of charities expected their income to decline over the next year, with around a third expecting a decline of 25% or more, largely from earned and fundraising sources. ... This difficult financial backdrop is already causing some charities to scale back their activities, others to lay off staff and others still to shut their doors. Research by PBE puts the funding gap for the sector this year at around £10 billion. ... At just the time demands on the sector are greatest, their services are at risk of being squeezed, with the costs felt by those least able to bear them."***

The findings quoted in this speech demonstrate just how vital it is to solve the charity VAT problem once and for all.

This research together with our new modelling tool, which has been developed as part of the London Economics research, has enabled CTG to assess the most effective way of providing a solution to this long-standing problem and will enable us to assess the impact of any proposed changes to the VAT regime or reliefs. This tool will be an invaluable resource in future discussions with policymakers.

1 *The value of VAT reliefs for the charity sector,* London Economics, 2020
2 *The Role of Charities in an Era of Anxiety,* Pro Bono Economics, 2020
3 *UK Charity Tax Relief Statistics Supporting documentation* (page 3), HMRC, 2019

Scope of research

While the Government regularly publishes statistics on the value of Gift Aid and business rates reliefs, HMRC has confirmed[3] that it holds insufficient data to quantify accurately the value of VAT reliefs to charities.

In 2010, a CTG report[4] estimated that charities incurred irrecoverable VAT amounting to £1billion per annum. This estimate was updated in 2011 to £1.1-1.4billion after the increase in VAT from 17.5% to 20%[5].

CTG commissioned London Economics to conduct a survey to gather an up-to-date comprehensive set of data from charities on VAT, which not only evaluates the level of irrecoverable VAT incurred by charities but, for the first time, quantifies the value of existing VAT reliefs and exemptions. These reliefs are vital to the financial sustainability of many charities, enabling them to continue to provide essential services to the benefit of the wider economy. Full details of the methodology are outlined in the research report.

The case for reform

CTG recognises that seeking new tax reliefs against a background of wider tax increases is unlikely to be successful unless charities can demonstrate the overall financial benefit of their work. As the Chief Economist at the Bank of England recognises, the Government's support for the sector in response to the COVID-19 pandemic has only touched the surface at a time when charities have been under increasing pressure to do even more.

But the problems that VAT causes for the sector have not just arisen in relation to the pandemic: the VAT system has always been a significant obstacle to charities doing more even though demand for their services has increased dramatically over many years.

In short, the key point is that charities only incur irrecoverable VAT when they are engaged in charitable activities and the amount of irrecoverable VAT paid or absorbed by the sector is a significant obstacle to their ability to increase their contribution to the economy.

4 *Irrecoverable VAT and its impact on charities*, Charity Tax Group, 2010
5 *Charity Tax Map: First Edition*, Charity Tax Group, 2011

Key findings

VAT

Irrecoverable VAT

The research identified that when charities purchase goods and services they pay around £3.1 billion in VAT (input VAT) a year – of which £1.8 billion (57%) is irrecoverable – a notable increase on our earlier calculations of £1-£1.4 billion[6]. Irrecoverable VAT arises on non-business expenditure and expenditure incurred in the performance of VAT exempt supplies.

Reliefs on purchases

The research found that VAT reliefs on purchases by charities are estimated to be worth £0.8 billion for the charity sector as a whole, providing the first clear evidence of their value.

The survey indicated that just over half of the reliefs are applied to high-value infrastructure/capital expenditure such as ambulances, adapted vehicles for people with disabilities, construction of buildings qualifying for zero rate relief and lifeboats. These reliefs provide a significant long-term benefit for those charities that incur such expenditure but, unfortunately, the majority of charities are not in a position to take advantage of such reliefs as their expenditure is on to day-to-day running costs that do not benefit from similar VAT relief.

Relief on sales

The research found that zero and reduced rated VAT relief on sales, such as the sale of donated goods, together with not being required to charge VAT on specified sales exempted from VAT is worth £3.2 billion to the sector.

VAT charged on sales

The research also quantified, for the first time, the VAT charged on supplies of goods and services by charities (output VAT) which amounts to £1.7 billion per year. There is strong evidence to suggest that because charities are providing services to people who cannot recover the VAT charged and are often those who are least able to pay, charities subsidise the true cost of providing the services by absorbing the VAT instead of adding it – thereby increasing the overall VAT burden on the sector.

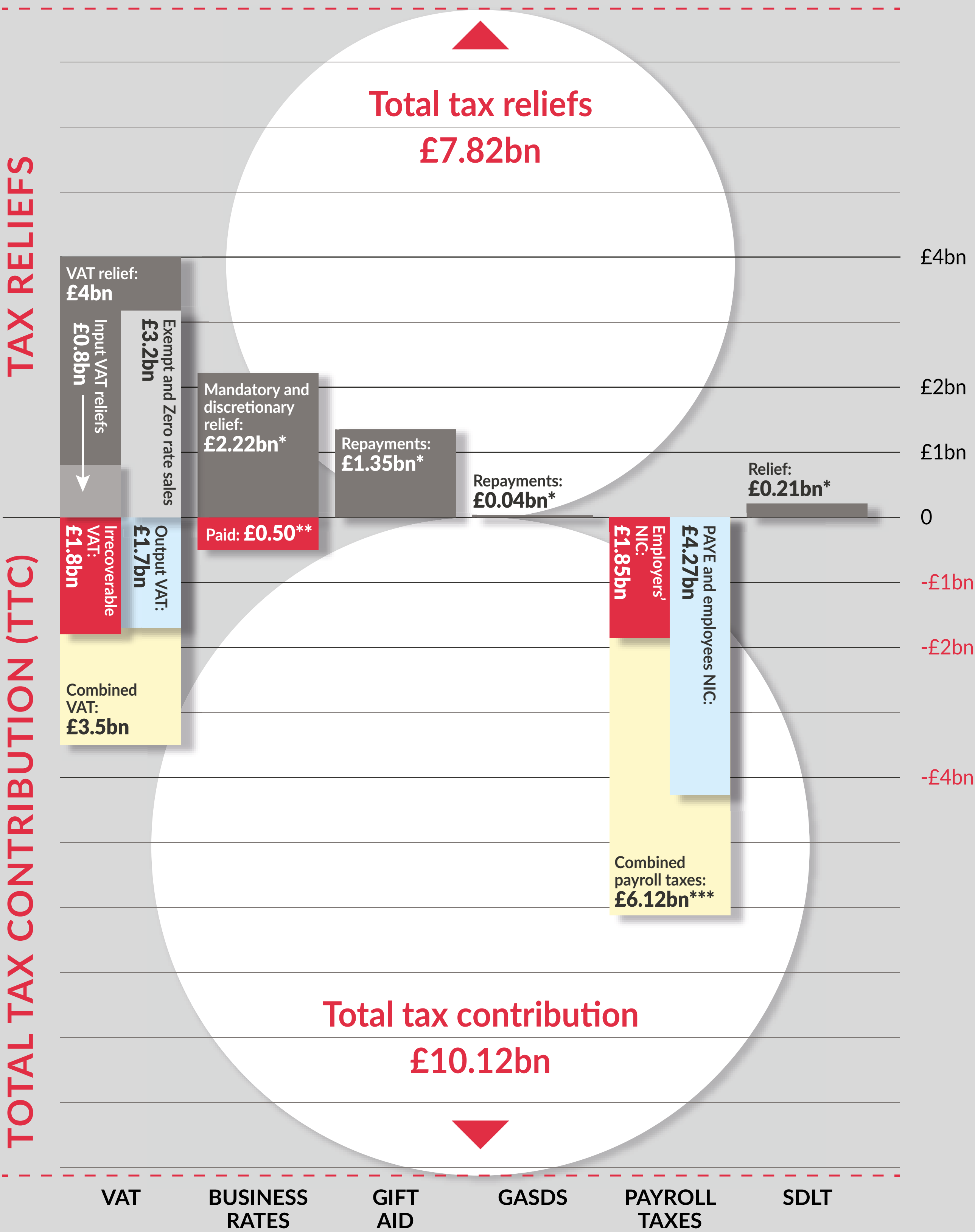
Other taxes

The contribution to GDP made by the charity sector is assessed as being £18.2 billion, with the value for formal volunteering calculated as being £23.9 billion[7]. In order to calculate the overall tax position of charities, including the total tax contribution [TTC] of the sector, the participants in the survey were also asked to provide data on the amount of employment tax paid and collected, as well as data on other tax reliefs claimed. When combined with published Government statistics, the data provides an important overview of the overall tax burden facing charities, which is demonstrated in the graph below.

The voluntary sector employs 910,000 people (excluding educational charities). It therefore pays Employer NICs of at least £1.85 billion[8] and, because of the extent of the activity generated by charities, they collect a further £5 billion in taxes which are generated by the operations of the charity (PAYE and Employee NICs etc). Although these are not a tax liability of charities, they are collected and administered on behalf of HMRC as a result of the activities that are undertaken by charities and it is clear that any reduction in charitable activity would have a significant impact on the total tax contribution made by the sector.

6 *Charity Tax Map: First Edition*, Charity Tax Group, 2011
7 *UK Civil Society Almanac 2020*, NCVO, 2020
8 *UK Civil Society Almanac 2020*, NCVO, 2020

Comparison of Tax Reliefs received vs Tax Contribution



In addition to the taxes outlined in the graph, charities pay other taxes including Excise Duty, Apprenticeship Levy, and Insurance Premium Tax and benefit from reliefs on taxes on income and gains. Data on these taxes and reliefs is not currently available.

All figures are based on analysis of data received in the London Economics research survey unless otherwise specified.
*Source: HMRC Charity Tax Statistics 2018/19
**Source: CTG analysis based on statistics published by HMRC and MHCLG
***This figure is based on voluntary sector employee numbers and therefore excludes Education Charities

VAT reform recommendations

The piecemeal, incremental VAT improvements that have been introduced over the last 30 years have been very welcome for those parts of the sector that have benefited from them but they have done little to help the majority of charities providing services: we argue that radical reform is needed.

The new data that is now available gives the Government the information it needs to address the underlying structural distortions in the VAT system that adversely affect charities. In the light of this data, CTG has considered a range of options that would effect the sort of change that the sector needs to resolve this issue. These include:

- **Replacing exemptions with a super-reduced rate:** When VAT was introduced, a range of important public interest exemptions were introduced to ensure that certain supplies of ***social value*** could be provided without the extra burden of VAT being added to charges made to consumers. They are absolutely vital and much appreciated but they do cause significant problems for the charities supplying those services because such charities cannot recover the VAT incurred on their purchases adding to their overall irrecoverable VAT bill.

  CTG is not arguing for an abolition of the exemptions because, as the research shows, the loss of exemptions for the education, culture and welfare sectors would have a detrimental impact of £2.38bn per annum on the overall finances of these parts of the sector. We have, however, looked at whether the replacement of the exemptions with a super-reduced rate would be an effective way of reducing the amount of irrecoverable VAT incurred.

  The research by London Economics indicates that replacing exemptions with a super-reduced VAT rate would certainly help some charities but would also create losers. Our modelling tool indicates that a 2.5% VAT rate would approximate to a breakeven position for those parts of the sector that supply exempt services. A very low replacement VAT rate would provide a major fiscal benefit to those charities with high input tax figures but for many others even a rate of 2.5% would be likely to give rise to a loss as the input tax they incur is minimal (e.g. when salaries represent the majority of a charity's costs). The only way of avoiding this would be to introduce an option to tax for those organisations that found it helpful to them. This would simplify the system for those who calculate that opting to tax would be beneficial but would leave the others having to operate under the current system

- **A special charity VAT rate for purchases:** The idea of VAT reliefs on inputs is not unprecedented. When VAT was enshrined in UK law, certain derogations were allowed by Brussels, including a number of zero and reduced VAT rates. Zero rated supplies include printed and electronic books, sale of donated goods by a charity, supplies of most charity advertising, and some capital expenditure; while there is a reduced 5% VAT rate on fuel and power.

  One of the simplest, easiest to administer and most effective ways of resolving the charity VAT problem would be to build on the well-established charity-specific zero rates that already exist by introducing a supplementary special charity VAT rate on other purchases, which ideally would be set at 0% but could be adjusted according to economic circumstances. The proposal would not override the important current zero and reduced rate VAT reliefs (unless the rate chosen was less that the reduced rate), which would remain on the statute book. A reduction in the cost of input VAT to charities would ensure that the cost savings would be spread across the whole sector and not just limited to those that are VAT-registered and make taxable supplies. **Crucially, a lower rate of VAT on purchases would allow charities to spend more in support of their charitable aims of providing much needed services – something that would be particularly helpful as part of the recovery from the COVID-19 pandemic.**

  A key benefit of this proposal is that it would be extremely simple to introduce as it would just involve introducing another schedule to the VAT Act 1994 that specifies all supplies to a charity should have a specific rate (other than those listed in Schedules 7A, 8, and 9), and a section in the Act denoting the rate applicable to that schedule from time to time. It could therefore be introduced very quickly. The rate could also be changed by Government to respond to crises and help to stimulate charity activity.

The proposal would be simple for the Government to control and require only simple certification and a basic checking approach between charities and suppliers to ensure compliance, a procedure already in place for other charity VAT reliefs. It does of course create a procedure for both supplier and charity to follow, but this is effectively very little burden per transaction. A supplier need only hold a certificate from a charity which could be checked in a straightforward way (such as by checking their details with the relevant regulator). A charity need only issue a pre-drafted certificate to all suppliers. Furthermore, there cannot be any "grey area" analysis issues. All supplies to charities will be at the charity rate (apart from those that are already zero-rated rates) so there cannot really be any doubt as to the status of the supply.

Conclusion and next steps

The new research by London Economics, commissioned by CTG, makes an important contribution to our understanding of the impact of VAT on charities. The results of the study highlight the importance of existing VAT reliefs and exemptions for the charity sector. However, it also provides strong evidence that VAT continues to place a significant burden on UK charities which has a detrimental impact on their ability to provide services to those who require them.

In the light of the research findings and mindful of the current economic uncertainty, CTG has reviewed various options for VAT reform and concluded that **the most effective solution would be in the introduction of a new special charity VAT rate on purchases,** to complement existing reduced and zero rates and the social exemptions. The proposal is simple, benefits all charities, and can be introduced and managed easily.

In proposing this reform, CTG is mindful of the need to ensure the solution is palatable and practical for the Exchequer and HMRC officials both in cost and administrative terms. It would require limited additional administration from HMRC and it is difficult to discern any unintended consequences, or scope for abuse. Given the financial pressure charities are facing it is also likely to be well received and understood by the public, without impacting them directly. The proposal demonstrates a clear break from existing rules, framed by the EU, without completely overhauling the VAT system.

CTG will be submitting this proposal to the Treasury Select Committee Inquiry on Tax after Coronavirus and as part of its next Budget Submission.

For too long, VAT has created an obstacle to charitable activity. We now have a clear and practical solution to address this problem and support the valuable work UK charities are doing on behalf of us all.

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For further information:
info@charitytaxgroup.org.uk
Tel: **020 7222 1265**

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