

# *VAT Considerations For District Heating*

*Scottish Futures  
Trust*

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# *Executive summary*

- Public Sector budgets remain under considerable pressure and the ability of local authorities, NHS Boards, and other publicly funded and/or publicly run bodies to improve energy efficiency and provide or source low carbon electricity and heating is becoming harder than ever to realise.
- The long-term benefits from reducing energy bills for the public estate, local residents, and businesses means that the search for cost-effective opportunities is likely to be given an ever increasing priority in years to come.
- Additionally, the Scottish Government has committed to generating an equivalent of 100% of electricity demand from renewable sources by 2020, along with at least 11% renewable heat. Combined Heat and Power (“CHP”) is considered to be a highly efficient way to use both fossil and renewable fuels to produce electricity and heat. CHP solutions seem likely to be increasingly suited to public sector buildings given their ability to provide low carbon heat, cooling and electricity, and with a payback which in some cases has been calculated at less than five years.
- CHP is therefore expected to play an important role in meeting the Scottish Government’s targets, and Scottish Future’s Trust (“SFT”) is considering the benefits of CHP & District Heating (“DH”).
- When appraising public sector procurements, there is often considerable uncertainty over the burden of VAT, as the application and administration of VAT in the public sector is always complicated, often inconsistent and occasionally governed by rules which do not apply in the private sector.
- The evaluation of VAT costs incurred by public bodies is therefore not straightforward. Particular care must be taken to ensure that costs savings that might be achieved in implementing CHP & DH are not lost as a result of creating additional irrecoverable VAT within a supply chain.
- SFT has engaged PwC (“us”) to provide a summary paper to highlight relevant VAT considerations and set out potential VAT efficient structures for the Relevant Organisations within the Scottish Public Sector (as defined in the next section) that will be involved as a supplier and/or purchaser of the heat and/or power that is generated.
- The construction of a CHP facility will be subject to standard rate VAT. The Relevant Organisation that incurs the VAT cost may or may not be entitled to recover the VAT on the costs incurred, depending on their activity.
- Consequently we have suggested a structure where the CHP is leased by the Relevant Organisation that constructs the CHP facility to another Relevant Organisation that will operate the CHP. This may realise a VAT cost spread over a long term period, but would result in immediate recovery of the VAT incurred on the construction cost.
- Climate Change Levy (CCL) must be considered, as depending on how efficient the CHP is, a tax may be due. Regardless of liability to the exemption or exceptions, CCL will result in an administrative burden.
- For the onward supplies of the heat and power which are created by a CHP facility or DH scheme, we have considered whether VAT savings can be achieved by the application of the Cost Sharing Group Exemption, or by having a VAT Group registration.
- The Cost Sharing Group VAT Exemption would be helpful in removing VAT on supplies of heat and power by the Cost Sharing Group to Relevant Organisations who were members of the Cost Sharing Group. However, the VAT legislation only applies Cost Sharing Group Exemption to the supply of services (and goods which are ancillary to those services). UK VAT legislation defines heat and power as “goods”, the provision of which would not be ancillary to a separate service and therefore without changes to both EU and UK VAT legislation, the Cost Sharing Group Exemption cannot be utilised.
- VAT Group registration was also considered, as organisations that are registered for VAT within a VAT Group can (and must) disregard supplies to/from other organisations within the VAT group. However, we anticipate the VAT group conditions cannot be satisfied by the Relevant Organisations, and therefore VAT grouping cannot be utilised.

- Relevant organisations selling heat and power must therefore charge standard rate VAT at 20% or reduced rate VAT at 5% on their supplies. Reduced rate VAT applies in restricted circumstances (primarily on supplies of energy for domestic use, or by a charity for its charitable non-business purposes), so in practice we anticipate standard rate VAT is likely to be applicable.
- Relevant Organisations purchasing heat and power will therefore incur VAT. This VAT cost is not automatically irrecoverable, but the ability to recover VAT, and the proportion of VAT incurred that can be recovered varies for each organisation. We have set out our understanding of the VAT recovery position for each type of Relevant Organisation.
- Relevant Organisations selling heat and power may be liable to a Direct tax upon profit, such as but not limited to any excess of the price paid by the Relevant Organisation for the energy and the price that the energy is sold for. Unlike VAT which is a tax on supply, corporation tax is payable on chargeable profits.
- Scottish Water are chargeable to corporation tax, however, most of the rest of the Relevant Organisations should be exempt from corporation tax.
- Universities and colleges should qualify as charities, and in general, registered charities are exempt from corporation tax on their income and gains provided they are applied solely for the charity's charitable purposes.
- NHS Boards are exempt from corporation tax under section 985 Corporation Tax Act 2010.
- Government departments are not subject to corporation tax, as they have a Crown exemption. However Non-Departmental Public Bodies, variously called Non-Government Organisations or Quangos, do not (with very few exceptions) enjoy the Crown exemption therefore may be chargeable to corporation tax on any profits from the trade of energy.
- Registered social landlords which are registered charities can benefit from the exemptions applicable for charities, as described above. Co-operative housing associations, mutual trading associations, management co-operatives and self-build societies benefit from various exemptions, but may be chargeable to corporation tax on any profits from the trade of energy.
- There may be other direct tax issues to consider with regards to any lease premiums, reverse premiums or contributions to capital expenditure paid between parties.

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# Overview

SFT is developing guidance on aspects of District Heating and wishes to include, in general terms, an explanation of the VAT implications for Relevant Organisations within the Scottish Public Sector that could have a significant role in District Heating schemes.

For the purpose of this paper, “Relevant Organisations” who are considered likely to become participants in District Heating schemes will be:

- (i) local authorities;
- (ii) universities and colleges;
- (iii) NHS Boards;
- (iv) central government and its agencies;
- (v) Registered Social Landlords; and
- (vi) Scottish Water.

SFT is keen to ensure the Relevant Organisations are aware of the potential VAT implications, obligations and liabilities that they may encounter, either as suppliers or purchasers. SFT also wants to engender awareness in Relevant Organisations of any VAT efficiency structures – such as implementing a Cost Sharing Group – that could reduce the administrative burden and financial costs the Relevant Organisations may suffer.

SFT has engaged PwC to produce a summary paper that considers the VAT positions for the different types of Relevant Organisation, and highlights any other relevant tax considerations.

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# *Cost Sharing Group Exemption*

We have considered whether SFT and/or the Relevant Organisations (or some of them) could create a Cost Sharing Group (“CSG”) in order to benefit from the Cost Sharing Exemption (“the exemption”).

## *Background*

The exemption is intended to help organisations that have non-business activities (whether as a result of statutory obligations or as a result of providing goods or services free of charge) or exempt activities. Organisations undertaking non-business and/or exempt activities usually suffer a restriction on their ability to recover VAT incurred on costs, as a fundamental principle of the VAT system is that in order to be able to recover VAT on costs, it is necessary for those costs to be incurred for the purpose of making onward taxable supplies. Accordingly, the Cost Sharing group Exemption is – prima facie – an attractive option for Public Sector organisations.

The Cost Sharing Group Exemption permits two or more organisations to create a CSG if the following conditions are satisfied:

- The CSG is independent;
- Members of a CSG make exempt and/or non-taxable supplies;
- Supplies by the CSG to its members are made at cost;
- The services supplied by the CSG to its members are ‘directly necessary’ for the members’ exempt and/or non-taxable supplies; and
- Cost sharing, using the CSG exemption, must not cause a distortion of competition.

Once a CSG is in operation the supplies it makes to its members will be VAT exempt, so the members do not suffer a VAT cost. It should, however, be noted that supplies between CSG members are treated in their ordinary way. That is, they are not covered by the exemption afforded to supplies made by the CSG to its members, and supplies between members would only fall to be VAT exempt if the supplies made fell within the exemptions contained in Schedule 9 to the 1994 VAT Act.

The EU and UK legislation which allows CSG exemption is intentionally limited such that it only applies to the supply of services. It is only applicable to goods to the extent that goods are ancillary to the main supply of a service.

## *Application to District Heating*

A key question relates to whether implementing a CSG is a viable option in a District Heating project, whereby the Relevant Organisations would create a CSG to implement a District Heating CHP project, in becoming members of the CSG, the Relevant Organisations could enjoy supplies of energy which were exempt from VAT.

Based on the current EU & UK VAT legislation and confirmed in HMRC guidance, it is not currently possible for a CSG to be implemented for District Heating projects.

The principle reason for this is the primary UK VAT legislation which states that:

“the supply of any form of power, heat, refrigeration [or other cooling] or ventilation is a supply of goods” – VAT Act 1994, Schedule 4, Paragraph 3.

As explained above, the CSG exemption will only apply to the supply of services, and cannot therefore apply to the supplies of heat or power (goods) by a CSG to its members.

Further, the exemption will not cover other supplies between CSG members, and hence the anticipated sales/purchases of other goods and services between members would all take their ordinary VAT liability.

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# *Capital costs*

This section considers the VAT position on capital costs that will be incurred, and considers the most efficient method of structuring project works to improve the VAT position.

## *VAT recovery and/ or mitigation position*

When a supplier constructs a CHP plant or DH unit it will have to charge standard rate VAT at 20% on its invoice to its (Relevant Organisation) customer.

The Relevant Organisation will, by default, be entitled to recover the VAT it incurs to the extent it uses the CHP plant or DH scheme to make taxable supplies, and it may require a bespoke agreement with HMRC to be able to calculate recoverable VAT.

The ordinary default basis is that if the Relevant Organisation uses the CHP or DH scheme for fully taxable purposes – such as selling heat and power to third parties, where VAT is always accounted for on income – it should be entitled to immediately recover all of the VAT it incurs on the costs.

However, if the Relevant Organisation will use the CHP or DH scheme for a non-taxable/non-business use – in full or part – it will suffer a restriction on the recovery of some or all of the VAT it incurs on the construction of the CHP or DH scheme. This could be where a Relevant Organisation makes taxable supplies of heat and power to other Relevant Organisations, as well as using the heat and power for its own non-taxable use.

Consequently this requires that consideration is given to how the CHP or DH construction is paid for.

## *Possible purchase structure*

If there is a risk that the Relevant Organisation that procures and pays for the CHP or DH works will have to restrict its VAT recovery, it could consider alternative arrangements.

For example, the Relevant Organisation could purchase CHP plant and lease it to a subsidiary company or to another Relevant Organisation, who would then use the CHP or DH scheme to generate and sell heat and power to the other Relevant Organisations.

The lease would be treated as a fully taxable supply, which permits the acquiring Relevant Organisation that purchases the CHP or incurs DH construction costs to recover all of the VAT it incurs on the construction costs.

The lessee Relevant Organisation would incur a standard rate VAT cost at 20% on the leasing charges. However, the lessee would be entitled to recover the VAT to the extent it uses the CHP or DH scheme to make taxable supplies. If the lessee sells all of the heat and power it generates it is entitled to recover all of the VAT, on the basis it is accounting for VAT on all of its income.

If the lessee allocates some of the heat and power produced for its own use, and it has a mixture of taxable and non-taxable uses, or completely non-taxable uses, it will have to restrict or block the VAT it incurs on the lease charges.

If there is a need for a VAT restriction on lease charges this will result in a cost for the lessee. However, this option achieves full upfront VAT recovery on the capital costs of creating the CHP plant or DH scheme, and allows a less significant VAT cost over a period of time.

## *Capital Allowances*

If this structure is to be used, whereby one party constructs the CHP or DH asset, holds the interest in the land, and then leases the CHP or DH asset onto another party, then the capital allowances position / long funding lease rules may need to be considered for any tax paying parties. If the long funding lease rules are relevant then the party constructing the plant is not entitled to capital allowances. Instead the lessee effectively receives relief for the capital construction costs through their lease payments. Whether a long funding lease is in place depends on whether the lease is longer than 5 years (and in certain circumstance 7 years) and meets one of the following tests:

- The finance lease test – under GAAP the lease is treated as a finance lease or loan in a person's accounts or in the case of a lessor, the lessor's accounts or any person connected with him;
- The lease payments test – the present value of the minimum lease payments equals 80% or more of the fair value of the leased plant or machinery;
- The useful economic life test – the term of the lease is more than 65% of the remaining useful economic life of the leased plant or machinery.

If the long funding lease rules are not applicable the lessor should be entitled to claim capital allowances on the qualifying plant and machinery costs. Where the lessor and lessee are not connected, then it may be possible for the lessee to elect to claim capital allowances on any premium paid for the lease (under section 183 Capital Allowances Act 2001), with the lessor's claim to capital allowances being restricted by this amount. A section 199 (Capital Allowances Act 2001) agreement should then be signed by both parties which will fix the value that should be deducted from the lessor's capital allowances pools, and added to the lessee's pools. This agreement became mandatory from 1 April 2014. The amount fixed by the agreement must not exceed the original claim of the lessor, or the capital sum paid for the lease.

If the lessor is not entitled to claim capital allowances, then it may be possible for the lessee to claim capital allowances on any premium paid for the lease (under section 184 Capital Allowances Act 2001), even if the parties are connected. Again a just and reasonable apportionment of the CHP or DH asset should be undertaken to establish what proportion of the CHP or DH scheme should be claimed as qualifying for capital allowances.

Note that it is unlikely that the lessee could claim Enhanced Capital Allowances as the plant & machinery would not be new and unused.

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# *Climate Change Levy*

This section considers the impact of Climate Change Levy (“CCL”), and the associated financial and administrative considerations. We recommend professional advice is always sought to ensure the CCL responsibilities are clear, and obligations are satisfied.

## *Background*

CCL applies to the taxable supply of specified energy products for use as fuels (such as lighting, heating and power) by business consumers.

CCL relief is available to a Relevant Organisation operating a CHP plant if that plant’s inputs and outputs are energy efficient. The CHP will be subject to the CHPQA regime (see below) and a suitably qualified consultant will be required to sign an annual declaration to confirm whether the relief is available, by virtue of certifying that the energy produced is efficient.

If the energy produced is not deemed to be energy efficient, CCL will apply on the CHP’s inputs and outputs. Consequently the Relevant Organisation operating the CHP plant must undertake an analysis of the energy it will produce to confirm whether the relief applies. Qualifying for the relief will result in a financial saving.

## *Carbon Price Floor (“CPF”)*

CPF is a tax on fossil fuels (such as gas, oil and coal) that are used to generate electricity. The purpose of this levy is to encourage a change in business behaviour in the UK to reduce energy consumption and/or consider using energy produced from renewable sources such as wind farms, solar energy and hydro power.

The tax was introduced on 1 April 2013 and amended the existing CCL regime by applying Carbon Price Support (“CPS”) rates of CCL to gas, solid fuels and liquefied petroleum gas (“LPG”) used in electricity generation.

The Relevant Organisation that operates the CHP will have to register and pay CCL to HMRC, at the rate for a CHP, if the CHP generating capacity exceeds 2 megawatts.

## *Combined Heat and Power Quality Assurance (“CHPQA”)*

CHPQA is a voluntary programme that provides the means to assess and monitor good quality CHP capacity. Operators can apply for registration and certification of their schemes in accordance with established criteria for Good Quality CHP and if accepted can qualify for benefits such as the CCL exemptions.

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# *VAT grouping*

We have considered whether SFT and/or Relevant Organisations could create a VAT group in order to have supplies between and among VAT group members free of VAT (such supplies are “disregarded” for VAT purposes).

## *Background*

Two or more corporate bodies (which includes Limited Liability Partnerships) - can register as a VAT group under a single VAT registration number. The principal benefit of registering as a VAT group is the members of the VAT group are treated as a single entity for VAT purposes.

VAT grouping reduces administration, as there is only a single VAT account to administer, i.e. a single VAT return is submitted which includes all the members of the group.

Transactions between VAT group members that would ordinarily be subject to the normal VAT rules are disregarded, so that one VAT group member making a supply to another VAT group member does not have to account for VAT on the transaction.

To form a VAT group the corporate bodies who will be members of it must satisfy various conditions: for ease of understanding these may be summarized as follows, although in practice professional advice should be sought as to the ability of Relevant Organisations to form a VAT group:-,

- 1) each body has its principal or registered office in the UK
- 2) the bodies are under common control, for example one or more company is a subsidiary of a parent company

## *Application to District Heating*

VAT grouping is unlikely to be a viable option to achieve VAT savings within a District Heating project.

Although the benefits of VAT grouping would be attractive as they reduce administration and financial costs, it is unlikely the Relevant Organisations could satisfy the VAT group criteria. Whilst likely members will be based in the UK, it seems probable that Relevant Organisations could satisfy the other criteria.

Even where the Relevant Organisations are bodies corporate, it is unlikely that the common control criteria would be satisfied.

In addition, each member of a VAT group automatically and unavoidably assumes joint and several liabilities for any VAT debts, errors or liabilities for the VAT group as a whole, and this obligation is likely to be unacceptable, from a governance perspective, for most of the Relevant Organisations.

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# *Relevant Organisation selling heat and power*

Relevant Organisations that sell heat and power must consider the appropriate VAT treatment of their supply.

## *Background*

Supplies of fuel and power are subject to standard rate VAT (20%) unless they fall within one of the specific provisions for reduced rate (5%) for qualifying use.

Reduced rate VAT applies to the following supplies of energy:

- fuel and power for domestic use
- fuel and power for charity non-business use
- fuel and power where the amount supplied does not exceed defined de minimis limits
- fuel and power partly for qualifying use and partly for other purposes, where 60 per cent or more of the supply is for qualifying use

Standard rate VAT applies to wholesale supplies of fuel and power.

## *VAT rate applicable to sales of heat and power*

Where a Relevant Organisation supplies heat and power it must consider the above rules in order to ensure it accounts for VAT at the appropriate rate.

Ultimately the Relevant Organisation must charge VAT at the standard rate on supplies of fuel and power unless it supplies consumers, charities (for a non-business use), small businesses and partial qualifying users.

## *Practical considerations*

Supplies to consumers (such as tenants) should be straightforward to identify. It can however be difficult to identify the position in other cases, but the onus is on customers in such cases to notify the supplier if they believe they have the right to receive supplies where VAT is charged at the reduced rate.

There are some specific exceptions to the generality of the VAT treatment outlined above in the previous section, as follows:

For example, if a Registered Social Landlord supplies un-metered heat and power as part of its tenancy agreement with tenants the charge for the energy must be treated as part of the VAT exempt rent charged for the principal supply of domestic accommodation. However, the Registered Social Landlord would treat the heat and power as reduced rated if a meter is used.

Further, there are special rules that allow certain public bodies – such as local authorities, and in some cases NHS Boards and Government departments – to treat what would ordinarily be classified as a business activity as a non-business activity. These rules will have a significant impact on the VAT treatment. Accordingly it is important that each public body analyses the VAT rules that apply to them, in order to ensure they adopt the correct VAT treatment.

That said, the EC VAT Legislation requires that some supplies are always to be treated as a business activity, and subject to VAT, to avoid distortion of competition with private sector organisations. The supply of water, gas, electricity and steam is such an exception. Consequently the normal VAT rules will always apply where local authorities, NHS Boards and Government departments make supplies of heat and power, under CHP or DH schemes.

Relevant Organisations should always consider their own individual VAT position in advance of making supplies of heat and power, and should seek professional advice as appropriate, regardless of whether such supplies are made to Relevant Organisations, other public sector bodies, or to private sector customers.

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# *Relevant Organisation buying heat and power*

On the basis that a Relevant Organisation is not able to implement a tax efficiency structure to minimise VAT costs on the purchase of heat and power it will default to recovering VAT using the normal VAT rules.

All of the Relevant Organisations will incur a 20% VAT charge unless they satisfy the “qualifying use” criteria, in which case 5% VAT will apply.

The generally accepted VAT recovery position for the Relevant Organisations is summarised below.

## *Local Authorities*

In Scotland a Local Authority is a regional, islands or district council within the meaning of the Local Government (Scotland) Act 1973, any combination and any joint committee or joint board established by two or more of the foregoing and any joint board to which section 226 of that Act applies.

Local Authorities are ordinarily classified as Section 33 bodies for VAT purposes. Classification as a body falling within the definitions contained in Section 33 of the 1994 VAT Act entitles that body to recover the VAT it incurs on expenditure that is attributable to non-business activities. In simplified terms a non-business activity is one which is not undertaken under ordinary commercial terms but is undertaken in the discharge of statutory functions and obligations, and it is provided to the recipient free of charge or for a low value, and is funded by grant-in-aid, grant funding and/or donations.

If a Local Authority incurs VAT costs in operating a CHP plant or DH scheme it is likely to be in a position to recover the VAT if it uses the heat and power for a non-business activity. For example, if a Local Authority uses the heat or power to provide energy to its housing stock tenants under the terms of a rental agreement, this is usually a non-business activity and we expect its VAT costs on the operation of a CHP plant or DH scheme will be recoverable under the provisions of s33 of the 1994 VAT Act.

It is likely that each Local Authority will have a different VAT recovery methodology agreed with HMRC which may or may not permit such VAT to be recovered. Further analysis should be undertaken to establish the VAT recovery position.

## *Universities and Colleges*

Universities and Colleges in Scotland generally have a mixture of taxable, exempt and non-business activities, and in consequence, most Universities have a heavily restricted recovery of VAT on costs.

We anticipate that a University or College that buys heat and power will use the energy for its whole campus. Accordingly recovery of the VAT incurred would be blocked to some extent, depending on the mixture of activities and VAT calculation in operation.

Relevant Organisations such as Universities and Colleges are therefore likely to have to revisit their VAT recovery position, and agreements with HMRC (where applicable) may have to be renegotiated, to determine the likely cost of VAT on purchasing heat and power.

## *NHS Boards*

NHS Boards fall under Section 41 of the 1994 VAT act; Section 41 status benefits NHS Boards as it permits the recovery of VAT incurred on certain defined services, bought in from private sector suppliers (and also from

public sector suppliers), where the service is “consumed” in the course or furtherance of carrying out statutory non-business functions. The provision of NHS healthcare to NHS patients is such a non-business function.

As the Section 41 status is limited to the procurement of certain defined services, it will not prove beneficial for the NHS Boards in respect of the purchase of heat and power, which are classified as goods.

Consequently NHS Boards should always expect to suffer irrecoverable VAT when procuring heat and power. The only scenario where such VAT can be recovered is where the energy costs are embedded in a PFI/PPP/NPD structure, and even here, recovery is not permitted in every PFI/PPP/NPD project, and consequently the extent to which VAT can be recovered is dependent on the individual NHS Board’s VAT position.

Each NHS Board should visit their VAT recovery position and agreements with HMRC (where applicable) to determine the likely cost of VAT on purchasing heat and power.

## *Central Government*

Government departments are also likely to enjoy Section 41 VAT status. Section 41 status benefits Central Government as it permits the recovery of VAT on some contracted out services, in the same way as for NHS Boards, as described above. As the Section 41 status is limited to the procurement of certain services, it will not prove beneficial for Central Government in respect of the purchase of heat and power, which are classified as goods.

Consequently Government departments should always expect to suffer irrecoverable VAT when procuring heat and power. The only scenario where such VAT can be recovered is where the energy costs are embedded in a PFI/PPP/NPD structure, and as for NHS Boards, recovery is not permitted in every PFI/PPP/NPD project.

Consequently Government departments are likely to suffer irrecoverable VAT cost when procuring heat and power. Departments often carry out significant taxable business activities as well as their statutory non-business functions and accordingly they may be able to recover VAT incurred under the normal VAT recovery rules which are applicable to private sector bodies.

Central Government should visit their VAT recovery position and agreements with HMRC (where applicable) to determine the likely cost of VAT on purchasing heat and power.

## *Central Government Agencies*

Central Government Agencies will have a variety of VAT positions.

For example, Executive Agencies of a department will usually benefit from Section 41 status, which permits limited VAT recovery on some contracted out services, or to the extent the VAT is attributable to taxable supplies. Arm’s length bodies (ALB’s) are often Non Departmental Public Bodies (NDPB’s) which are excluded from s41 status, as such VAT recovery is wholly restricted to the extent it is attributable to taxable supplies.

Agencies will usually undertake predominantly non-business activities for VAT purposes. As such it is likely that Executive Agencies and ALB’s will only be entitled to recover a small proportion of the VAT incurred on heat and power.

However, as there is considerable scope for Agencies to carry out business activities which could give rise to the right to recover VAT incurred on costs, including energy costs, under the normal VAT rules and regulations, each agency should consider its own VAT position and agreements with HMRC (where applicable).

## *Registered Social Landlords*

Registered Social Landlords make wholly VAT exempt, or predominantly VAT exempt supplies of the letting and leasing of domestic property. As has already been highlighted, VAT incurred on energy and other costs cannot be recovered, unless it is linked to a taxable supply.

In practice it is likely that the VAT incurred on heat and power will be irrecoverable, on the basis the energy will be supplied to tenants as part of the single supply of VAT exempt domestic accommodation. However Registered Social Landlords may have entered into arrangements whereby they make separate and stand-alone supplies of fuel and power to tenants occupying dwellings, and such supplies will be liable to VAT at the reduced rate, which in turn gives rise to the right of VAT recovery by the Registered Social Landlord.

Registered Social Landlords should consider their own VAT position and agreements with HMRC.

## *Scottish Water*

Scottish water has been specifically named as a Relevant Organisation. For VAT purposes, Scottish Water is not considered to be a Public Sector body. It is therefore subject to the same VAT rules and regulations as any other private sector organisation.

Supplies made by Relevant Organisations such as Scottish Water will have a mixture of VAT liabilities. For example, water and sewerage services supplied to some business customers will be liable to standard rate VAT, while the same services supplied to domestic consumers will be zero-rated. However, some property related transactions are VAT-exempt, as are certain financial transactions. It is therefore likely that Scottish Water will incur costs which are consumed in the making of both taxable (whether liable to 20%, 5% or 0% VAT) and potentially VAT exempt.

If Relevant Organisations such as this incur VAT on heat and power it must attribute the cost to how it consumes that energy within its business. For example, if the heat and power is used at the head office it will be a general overhead cost attributable to the totality of the business's activities.

Such Relevant Organisations should consider the VAT liability of all the activities undertaken in that office, and if required restrict the VAT to some extent. As such Relevant Organisations may carry out a wide and diverse range of business activities – some of which might be exempt – it is not possible to evaluate any further whether all of the VAT incurred on heat and power might be recovered. Such Relevant Organisations are likely to have VAT recovery methodologies already agreed with HMRC, and these should be reviewed and revisited as necessary.

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# *Direct tax considerations*

## *General*

Direct tax may be charged upon chargeable profits. This includes the excess of the price paid by the Relevant Organisation for the energy and the price that the energy is sold for less any deductible expenses and capital allowances, and including other income for example interest income.

It should also be noted that any time a building (or land) is sold from 1 April 2014, tax paying property owners **must** identify all fixtures in their property which qualify for capital allowances **and** make a claim on these in their tax return and supporting computation if they want to pass the value of the capital allowances on to a purchaser. A section 198 (Capital Allowances Act 2001) agreement should then be signed by both parties. Failure to do so means the purchaser will not be able to claim allowances on these items. In practice this may expose the vendor to an element of risk, as HMRC may agree that the purchaser can claim allowances even when an election has not been submitted, thereby reducing the purchaser's claim.

Where the vendor is not a tax payer, there is still value in conducting a capital allowances review of the property before sale, as this will maximise the claim to capital allowances for the purchaser, as the vendor will be best placed to analyse the construction costs, and the vendor will be in a better position to consider this value in negotiations over the transaction price.

## *Scottish Water*

Scottish Water is chargeable to corporation tax. It will be able to claim capital allowances on the qualifying construction costs. A deduction from taxable profits is available at 18% per annum (or 8% if the assets will have a useful economic life of more than 25 years, or are deemed to be integral features of a buildings) of the qualifying construction costs. It may be possible to claim enhanced capital allowances for these costs if they meet certain qualifying conditions, such as being new and unused, and either water or energy efficient, as defined by DEFRA and the Carbon Trust respectively. Enhanced capital allowances allow the company to claim relief for 100% of the qualifying costs in the year that they are incurred.

If the company is loss making, it may be able to surrender the loss created by these allowance for a tax credit claimable from HMRC. This credit is equal to 19% of the surrenderable loss, although this is subject to an upper limit of the greater of:

- the company's total PAYE and NIC liabilities for payment periods ending in the chargeable period; and
- £250,000.

## *Other relevant Organisations*

However, most of the rest of the Relevant Organisations should be exempt from corporation tax.

Local authorities are exempt from corporation tax under section 984 Corporation Tax Act 2010.

Universities and colleges should qualify as charities, and in general, registered charities are exempt from corporation tax on their profits from their primary purpose trade provided they are applied solely for the charity's charitable purposes (section 478 Corporation Tax Act 2010). The primary purpose of the university is the provision of education and generation of power from CHP activities is unlikely to be a primary purpose trade. Universities often set-up subsidiary companies to conduct any non primary purpose activities, which may be subject to corporation tax. Profits from these subsidiaries can then be paid via gift aid to the registered charity, which will count as a deduction from the taxable profits of the subsidiary, provided that the university or college applies the funds only for charitable purposes (section 473 Corporation Tax Act 2010). This mechanism effectively removes tax on the CHP profits.

NHS Boards are exempt from corporation tax under section 985 Corporation Tax Act 2010.

Government departments are not subject to corporation tax, as they have a Crown exemption. However Non-Departmental Public Bodies, variously called Non-Government Organisations or Quangos, do not (with very few exceptions) enjoy the Crown exemption, therefore may be chargeable to corporation tax on any profits from the trade of energy.

Any registered social landlords which are registered charities can benefit from the exemptions applicable for charities, as described in the section above on universities and colleges. Co-operative housing associations, mutual trading associations, management co-operatives and self-build societies benefit from various exemptions, but may be chargeable to corporation tax on any profits from the trade of energy.

If any LLP structures are to be used, it should be noted that the LLP will be treated as a “look through” vehicle from a corporate tax perspective. As a result the corporate tax liabilities arising from the partnership’s activities are taxed at partner level, with any exemptions as described above being applicable to the taxable profits.

There may be other direct tax issues to consider with regards to any premiums, reverse premiums or contributions paid between parties, and as these will depend on the specific nature of individual project arrangements, these should be considered separately, and in detail by each Relevant Organisation, as and when required/ appropriate.



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