



Local Authority Leisure Services – VAT efficiencies and the rise of the agency outsourcing structure

A year on from our [previous bulletin](#) discussing HMRC's revised treatment of VAT on in-house leisure services, we look at how the sector has responded.

In March 2023, HMRC announced a significant change to the VAT treatment of local authority leisure services that could add hundreds of thousands of pounds onto revenue lines.

Prior to March 2023, local authorities managing in-house leisure centres were required to treat services such as gym memberships and other facility visits as business activities for VAT purposes and pay VAT to HMRC from the income. Now, a revised treatment of VAT states these services are classified as non-business supplies for VAT purposes. This means local authorities pay no VAT on their income, as well as reclaiming all the VAT they incur on the related costs (revenue and capital) unconditionally.

Our [previous bulletin](#) explored:

- the leisure services affected by this VAT change;
- the scope for outsourced leisure operators to improve the VAT position between themselves and their local authority clients by adopting an agency structure; and
- procurement and contract issues arising in relation to the agency structure.

In this update we look at the market's response and a few lessons learned as the agency structure has started to gain traction.

Operator and local authority benefits

As we covered in our previous bulletin, many operators are not-for-profit, meaning that they paid significant irrecoverable VAT on their costs of running leisure centres. This is a cost that is ultimately passed on to their local authority clients. By adopting a new 'agency' model, they collect income on behalf of the local authority. The income belongs to the local authority and remains 'non-business'. The operators charge VAT on their fees for running the leisure centres (as agent) on behalf of the local authority, which the local authorities can, in turn, recover from HMRC. However, because the operator has charged VAT to the local authority, it can reclaim the previously irrecoverable VAT on its costs related to running the leisure centre.

A number of local authorities and market operators have taken steps to implement this approach in their existing contracts – with the first contract variation completing in April 2024. Having taken appropriate VAT, legal and commercial advice operators continue to approach their local authority clients with revised contract drafting and ways of working to establish agency arrangements.

The financial benefits of proposing a VAT saving as a Contractor Change to an existing contract have been noteworthy. Most public sector outsourcing contracts contain gainshare provisions under which the benefits of cost savings are shared between the local authority and

operator. In the arrangements we have seen, this has amounted to a win-win situation, with both parties benefitting from improvements to their financial returns – typically in excess of £100,000 annually.

This can turn a contract that is subsidised by a local authority into a cost-neutral one, or significantly improve the annual revenues that a local authority receives from a profit-making contract. It also provides much needed financial relief to operators who have been hit by recent inflationary pressures and are still working to return footfall to pre-pandemic levels. It also provides much needed financial relief to the service, where operators and councils have been hit by volatile utility tariffs, inflationary pressures, and are considering the impact of future NIC increases.

A longer-term benefit to both operators and local authorities is that operators who adopt the agency structure when bidding for new contracts can offer a more competitive price. This increases their chances of being successful in a tender process and provides better value for money to the procuring authority. We have seen this filter through into live procurements over the last 12 months.

Procurement approach

The agency models that have been implemented to date have been by way of a modification to existing contracts. The local authorities in question have proceeded with the modification having satisfied themselves that the change complies with one of the "safe harbours" under Regulation 72 of the Public Contracts Regulations 2015 that permit modifications to existing contracts. The circumstances of each variation will differ depending on the specifics of each local authority's arrangements. Careful consideration of Regulation 72 remains essential before proceeding.

In relation to procurements for new contracts, during late 2023 and into 2024 we saw some leisure operators propose the agency structure in their response to tender opportunities that had been issued on the traditional, contractor-as-principal basis. The procurement risk arising from changing the parameters of an acceptable response, and issues of evaluating bidders on a like-for-like basis, meant that those proposals were typically rejected where procurements were already "in flight".

More recently, now that some agency arrangements have been implemented (by way of modifying existing contracts) without challenge, we are starting to see local authorities launch procurements with agency structures in mind. This takes the form of:

- raising the prospect of an agency structure as a matter to be discussed in negotiations and confirmed at final tender stage; or
- incorporating agency structures as an optional or mandatory variant bid.

Where local authorities are allowing bids to be based on the new agency structure we have seen a near unanimous response that bidders can and will implement an agency structure. Further, where bids have been submitted based on an agency structure, these have presented significantly improved financial offers as compared to the traditional model.

Key considerations when incorporating the agency option into a new procurement include:

- maintaining a level playing field by informing the market of this option at the outset;
- requiring bidders to present the contractual amendments needed to document their approach to the agency model without shifting the overall risk profile for service delivery and income generation;
- allocating the risk of the proposed model being challenged to the party responsible for the relevant failure (e.g. if the operator's internal processes do not reflect an agency in practice, the risk of an HMRC challenge sits with the operator).

Conclusion...so far

2024 has seen the agency model move from theory to practice – under both existing contracts and new procurements. However, in the absence of specific HMRC comment, it continues to carry some risk that HMRC could not accept it as a genuine agent/principal arrangement.

Despite this risk, we think that the financial and other commercial benefits that VAT efficiencies bring mean the agency structure will form part of the local authority leisure landscape into 2025 and beyond. With careful planning and advice, local authorities can secure an arrangement that realises significant financial benefits while maintaining a risk allocation that is equivalent to the traditional outsourcing model.

With these savings, there are opportunities for local authorities to provide investment into aging facilities or target the least active residents in their communities, to improve health outcomes and reduce local inequalities.

The authors of this article are working with operators and local authorities, on individual cases to assess whether an application of an agency agreement could bring savings to the partners in a way which could satisfy HMRC and legal/procurement requirements.

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