

# Guidance on the Cost Sharing Exemption - from 17 Jul 2012

VAT Information Sheet 07/12

You should read this information sheet along with the following:

[Revenue & Customs Brief 23/12 – Publication of Guidance on the Cost Sharing Exemption – Group 16, Schedule 9 of the VAT Act 1994](#)

## 1 Introduction - what is the Cost Sharing Exemption?

The exemption applies when two or more organisations (whether businesses or otherwise) with exempt and/or non-business activities join together on a cooperative basis to form a separate, independent entity, a cost sharing group (CSG), to supply themselves with certain services at cost and exempt from VAT.

As a result a 'cooperative self-supply' arrangement (a term the EU Commission use) is created. The CSG is a separate taxable person from that of its members. It is therefore able to make supplies for VAT purposes to its members. These supplies will be exempt if the relevant conditions are met. This type of arrangement enables the creation of the same economies of scale for smaller businesses and organisations as larger businesses and organisations naturally enjoy. Thus the more members of a CSG there are the greater the potential savings and lower the costs per member of operating the relevant CSG.

The cost sharing exemption applies only in very specific circumstances and will not cover all shared service arrangements.

See diagram of the basic structure in [Appendix A](#).

## 2. Does the exemption apply to supplies of goods?

No, unless the goods are an ancillary element of a single supply of services under the normal single/multiple supply principles.

## 3. What is meant by 'members' of a CSG?

A member of a CSG is a business or organisation that:

- is capable of jointly owning and controlling a CSG
- receives qualifying supplies from the CSG

## 4. When does the exemption apply?

As the exemption is mandatory all supplies that meet the relevant conditions will be subject to the exemption.

## 5. What are the conditions of the exemption?

There are five conditions attached to the exemption.

- a) There must be an 'independent group of persons' (a CSG) supplying services to persons who are its 'members'.
- b) All the members must carry on an activity that is exempt from VAT or one which is not a business activity for VAT purposes.
- c) The services supplied by the CSG, to which the exemption applies, must be 'directly necessary' for a member's exempt and/or non-business activity.
- d) The CSG only recovers, from its members, the members' individual share of the expenses incurred by the CSG in making the exempt supplies to its members.
- e) The application of the exemption to the supplies made by the CSG to its members is not likely to cause a distortion of competition.

All these conditions have to be satisfied for a supply to be exempt.

If any of the conditions are not met the supplies will be taxable.

Further details and how these conditions are to be applied are covered in more detail in this guidance. However it should be noted that the EU Commission are currently infracting a number of Member States in relation to how they have applied the exemption and the outcome of those infraction proceedings could impact on how HM Revenue & Customs (HMRC) currently view the operation of the exemption, as explained in this guidance. HMRC will monitor these infractions and consider whether or not any changes are necessary to the guidance. Should changes prove to be necessary, then transitional arrangements, as far as possible, will be put in place to facilitate an orderly move to the revised position.

## **6. Does the exemption apply to commercial outsourced services?**

No, the exemption only applies to the recharges, at cost, of services supplied by a CSG to its group members. The exemption does not apply to commercial outsourced services or arrangements that amount to the provision of commercial outsourced services. Such services are generally made by specialist providers to unconnected third parties on a commercial for-profit basis and would not, therefore, meet the conditions of the exemption. They are not 'cooperative self-supply' arrangements.

## **7. Can a CSG make supplies to non-members?**

Yes, but such supplies, unless covered by another exemption, will be taxable. If such supplies are cross border the normal place of supply and reverse charge rules apply.

## **8. What types of businesses and organisations can benefit from the exemption?**

Any business or organisation that is capable of meeting the relevant criteria/conditions has the opportunity to use the exemption to their benefit. The types of businesses and organisations that might benefit are:

- Charities
- Banks
- Education Institutions
- Insurance businesses
- Social Housing organisations
- Betting and Gaming organisations
- Health and Welfare businesses and organisations
- Financial Services businesses
- Local Authorities, Government Departments and NDPBs

This is not an exhaustive list.

## **9. When did the exemption become effective in UK legislation?**

The EU Directive 2006/112 (commonly referred to as the Principal VAT Directive) provides for the exemption of the services of cost sharing groups. The exemption was implemented in the UK from Royal Assent of the 2012 Finance Act with the introduction of a new Group 16 to Schedule 9 of the VAT Act 1994.

## **10. What is the new Group 16 to Schedule 9 of the VAT Act 1994?**

### **Group 16 - supplies of services by groups involving cost sharing**

Item No

1. The supply of services by an independent group of persons where each of the following conditions is satisfied:

- a) each of those persons is a person who is carrying on an activity ('the relevant activity') which is exempt from VAT or in relation to which the person is not a taxable person within the meaning of Article 9 of Council Directive 2006/112/EC,
- b) the supply of services is made for the purpose of rendering the members of the group the services directly necessary for the exercise of the relevant activity,
- c) the group merely claims from its members exact reimbursement of their share of the joint expenses, and
- d) the exemption of the supply is not likely to cause distortion of competition.

## **General provisions**

## **11. Are all supplies made by a CSG covered by the exemption?**

No, the exemption only applies to supplies of certain qualifying services (See Question 33) made by the CSG to its members which are 'directly necessary' (see Question 39) for the exempt and/or non-business supplies made by the individual qualifying member.

## **12. Does the exemption apply in any other circumstances?**

No, the cost sharing exemption does NOT apply in any other circumstances. In all other respects the normal VAT rules will apply. So, for example, the cost sharing exemption will not apply to supplies of goods, supplies made above cost, supplies to non members or to any supplies made by members who supply services directly to other CSG members. If the CSG does make supplies which do not qualify for the exemption and which are subject to the normal VAT rules, then the CSG may have to register for VAT if it exceeds the VAT registration limits.

## **13. What about supplies to a CSG?**

Supplies of all goods and services to a CSG (for example, the transfer of staff either permanently or temporarily to a CSG) will be subject to the normal VAT rules and any input tax which is incurred in relation to an onward exempt supply by the CSG will not be deductible by the CSG. If a CSG is partially exempt the normal partial exemption rules apply including the de minimis rule.

## **14. What are the normal VAT rules regarding transfers/supplies of staff?**

There is a supply of staff for VAT purposes when one party makes available someone who is contractually employed by it or is a director of it to another party (either on a temporary or a permanent basis) in return for a consideration.

Where such a supply is on a temporary or secondment basis the consideration for such a supply need not necessarily be just a fee but can also constitute charges made by the contractual employer to the other party of wages, NI and other employment costs. It also includes such costs when they are paid by the recipient of the supply directly to the worker.

Whatever the nature of the business (it does not have to be an employment business), the party making the supplies of staff is normally regarded as making such supplies in the course or furtherance of business and must account for VAT at the standard rate.

There are a few exceptions to this rule, where supplies of staff are not always made in the course or furtherance of business and thus may be outside the scope of VAT.

Further information about the permanent and temporary transfer/supply of staff, the exceptions to the general rule, including joint employment contracts can be found in [Notice 700/34 Staff](#).

If the supplying party supplies services, for example construction or care services it is not a supply of staff but a supply of those services. Such services, depending on their nature, may be zero-rated or the supply may qualify for exemption from VAT. See [Notice 701/57 Health professionals and pharmaceutical products](#) and [701/2 Welfare](#) for more information and qualifying criteria.

## **15. Can a CSG benefit from the normal VAT Reliefs and special provisions?**

Yes. A CSG like any other organisation, if it is able to meet the relevant conditions, can benefit from the appropriate VAT provisions and reliefs (for example, if the CSG is a charity, then charity VAT reliefs will apply where appropriate).

## **16. Can a UK established CSG have members in other Member States (OMS) and can a UK business or organisation belong to a CSG established in OMS?**

Members of a UK established CSG can themselves be established in other EU Member States. Similarly a UK established business or organisation can be a member of a CSG established in another EU Member State.

## **17. Do the normal place of supply rules apply?**

Yes. Cross border services will be subject to the normal EU place of supply of services rules, see [Notice 741A Place of supply of service](#) and [Notice 741 Place of supply of service](#).

## **18. What is the input tax treatment in relation to supplies to overseas customers?**

The normal UK policy when a UK taxpayer makes supplies to overseas customers that is outside the scope of UK tax but would have been exempt if made in the UK and which may or may not be viewed as exempt in the country where they are received, is that no UK input tax deduction on the cost components of those supplies is allowed.

This is based in UK law on s26 of the VAT Act 1994; the supplies are outside the scope of UK VAT, they would have been exempt if supplied in the UK and they are not specified supplies under the Specified Supplies Order, SI 1999/3121.

The UK cannot take tax treatments in other countries into account, irrespective of whether they are Member States or third countries.

## **19. What does this mean in relation to supplies received by a UK member of a CSG based in another Member State?**

If the UK member is receiving the supply in relation to a business the place of supply is the UK and as the cost sharing exemption is implemented in the UK, subject to all the conditions being met, the supply will be exempt with no need to apply the reverse charge.

If the UK member is not in business for VAT purposes the place of supply will be the Member State where the CSG is established.

## **20. Do EU Procurement Directives apply?**

The EU Procurement Directives apply to procurement by public bodies. Therefore, if a CSG member is a public body, as defined by the EU Procurement Directives, it will have to consider whether or not its purchases from the CSG are subject to the rules set out in those [Directives](#).

## **How the conditions are to be interpreted**

### **Independent group of persons**

## **21. What is a Cost Sharing Group (CSG)?**

A CSG is an independent group of persons who work together with a common purpose. The CSG is however legally separate from its members. It is established, owned and operated by the members for their cooperative benefit and is independent of any ownership, control or influence outside of the membership. It can be a group of equals or if all the members agree one or more members can have effective control and/or majority ownership of the group. In either case all members must have a legal interest in the CSG. So, for example, if the CSG was established as a limited company all members would have to be shareholders either on an equal basis or if the members agree one or more members could hold more than 50 per cent of the shares. No shares could be held by any person who was not a member of the CSG.

The CSG does not have to be a limited company, as in the example above. If it is not a limited company ownership and control will take a different form depending on the entity chosen to be the CSG. It can take any form provided it is a 'taxable person' within the Principal VAT Directive definition of 'taxable person' (see Question 22).

## **22. Must the CSG be separate from its members?**

Yes. The CSG must be a separate taxable person from its members in order to be able to make exempt supplies for VAT purposes to its members. It must therefore be able to take a legal form that is capable of being a taxable person that can be registered for VAT if it were making taxable supplies, that is, it is capable of meeting the VAT registration criteria or would be if it were not wholly engaged in making exempt supplies.

Subject to the above considerations the CSG can take whatever legal form its members decide.

See [V1- 28, Registration](#) for the types of entity that would qualify.

## **Some particular forms of CSG**

### **23. Partnerships have to be for profit, can they be CSG's as a CSG can only seek 'an exact reimbursement of costs'?**

If a 'for profit' partnership also makes supplies that fulfil the conditions of the exemption then they can form a CSG but the exemption would only apply in respect of those services that satisfied all the conditions of the exemption, including the 'exact reimbursement of costs'. This situation might occur, for example, if the partnership (as a CSG) also made supplies to third party, non-CSG (Partnership) members, where a profit element could be added and VAT would have to be charged, at the appropriate rate.

### **24. What about the different legal status of partnerships in Scotland and the rest of the UK?**

In Scotland a partnership has a separate legal personality from its members. In the rest of the UK that is not the case. However the effect of s45 of the VAT Act 1994 is to treat partnerships as a separate person for VAT purposes. It is possible therefore for members of a UK partnership to be treated as separate taxable persons from a partnership that is also registered for VAT.



## 25. What about limited partnerships?

Limited partnerships are constituted under The Limited Partnership Act 1907 and consist of general partners and limited partners. Limited partners are only liable to the extent of the amount they invest in the partnership. Limited partners may not take part in the running of the partnership business which is carried out by general partners.

For a limited partnership to be eligible to be a CSG all of the partners, both limited and general, would have to meet the qualifying test (see Question 36).

The normal procedure in the VAT Registration Units is to register limited partnerships in the names of the general partner only. Limited partnerships must register with the Registrar of Companies.

## 26. Can unincorporated associations be CSGs?

Where an organisation falls within s 46(2) of the VAT Act 1994 (which includes unincorporated associations) and is managed by its members in accordance with Regulation 8 of the VAT Regulations 1995 it will be eligible to be a CSG. Regulation 8 provides that:

“Anything required to be done by or under the Act, these regulations or otherwise by or on behalf of a club, association or organisation, the affairs of which are managed by its members or a committee or committees of members, shall be the joint and several responsibility of –

- a) Every member holding office as president, chairman, treasurer, secretary, or any similar office; or in default thereof,
- b) Every member holding office as a member of a committee; or in default thereof,
- c) Every member, provided that it is done by any official, committee member or member referred to above, that shall be sufficient compliance with any such requirement”.

If this type of association makes taxable supplies and is required to register for VAT or wishes to voluntarily register for VAT it will be registered in the name of the association.

Proprietary associations are generally not owned by their ‘members’ on the same basis as members associations so would not qualify as CSGs unless ownership was shared amongst all members and the proprietor and all members received qualifying services from the association.

## **27. Can a CSG be a charity?**

To be a charity an organisation must be, among other requirements, established for charitable purposes. So, subject to meeting that test a CSG might be able to be a charity. However, in a charity context a CSG could also be a non-charitable company limited by shares owned by a number of charities and, in practice, this model may be the more likely one. If a CSG was able to acquire charity status there are particular direct tax rules attached to the trading activities of charities that a charity CSG would have to consider, see [Charity Direct Tax Guidance](#).

## **Number of members and memberships**

### **28. Are there any limits on the number of members a CSG can have?**

Each CSG must have two or more members. There is no upper limit.

Businesses and organisations can be members of more than one CSG if they so choose. This may occur where a single qualifying business or organisation requires a number of different specialist services in connection with its exempt or non-business activities and these are provided by different specialised CSGs.

### **29. What must a CSG consider when recruiting members?**

CSGs will need to be careful when recruiting members as one of the conditions of the exemption is that it does not lead to a [distortion of competition](#). Therefore a CSG must not have the characteristics of an independent operator seeking a customer base in order to simply generate profits. A CSG may gain members in respect of its exempt supplies by recommendation, invitation, word of mouth etc., though if it engages in promotion and marketing on a similar basis to a commercial operator there is more danger that its activities will lead to distortion of competition. CSG supplies to non-members are not covered by the exemption and can include a mark up/margin and be promoted by commercial marketing.

### **30. Who is responsible for the CSG's VAT affairs - the members or the CSG?**

As a single taxable person it is the CSG itself not its individual members that is responsible for its VAT affairs. However, the application of the exemption is dependent on the use to which the recipient members put the services received from the CSG. This is different from many other VAT exemptions where it is the nature of the supply or the nature of the maker or receiver of it which determines its tax treatment.

CSGs must ensure that adequate controls exist to obtain the information necessary to correctly determine its VAT liability. It should be able to demonstrate to HMRC, when required to do so, that all the conditions of the exemption have been met by all of its members. Where a CSG has a member(s) in another (other) Member State(s) it may want to have particular rules covering non UK established members.

HMRC are not prescriptive about how CSGs should arrange themselves in this respect, as different CSGs will want to do so in different ways, in accordance with their members' wishes and requirements. However, HMRC will expect any system that is put in place to provide a clear audit trail of how the services received from the CSG are utilised by those individual members in their operations.

## **31. Will HMRC put any special process or compliance arrangements in place?**

HMRC will not initially be introducing any bespoke process or compliance arrangements in respect of the exemption. However, where businesses and organisations require confirmation that their arrangements satisfy the conditions of the exemption HMRC will, where requested, provide advice in line with its standard policy.

In terms of compliance activity, HMRC deploys its resources according to risk and use of the VAT Cost Sharing Exemption will be built into risk profiling in the same way as other aspects of the VAT regime.

The primary legislation, introducing the exemption into UK law, also contains provision allowing HM Treasury to make regulations in respect of the operation of the exemption. These powers have not been immediately exercised though the operation of the exemption will be monitored and assessed to see if regulations are required in order to ensure its smooth application.

## **32. Must all members of a CSG receive Group 16 supplies?**

Yes. All members must receive Group 16 qualifying supplies or have a realistic and genuine intention to do so.

## **33. What are 'qualifying supplies'?**

Qualifying supplies are services which are 'directly necessary' to enable a member of the CSG to engage in the exempt and/or non-business activity for which the services are supplied.

## **34. What happens if a member of the CSG ceases to receive 'qualifying supplies'?**

If an existing member ceases to receive qualifying supplies for any period of 12 months following their membership of a CSG then HMRC will presume that an intention to receive such supplies had ceased and, therefore, the member will cease to be eligible for membership of a CSG going forward. However, if the member can show that the intention to receive 'qualifying supplies' in the near future still exists then membership of the CSG can continue.

If a member ceases to be eligible for membership of the CSG there have to be at least two remaining eligible members for the CSG itself to continue to be a CSG falling within the terms of Group 16 of Schedule 9 to the VAT Act 1994 and therefore to continue to be able to make exempt supplies going forward.

## **35. Must all members receive the same type and volume of qualifying supplies?**

No. Not all members have to receive the same services. A CSG can supply different services to each member if that is what is required. Also, members can receive different volumes of the same services, if that is what is required. However the CSG must only recover from its members, at cost, their share of the costs and expenses incurred by the CSG.

## **Exempt and/or non-business activities**

## **36. Do all members have to have exempt and/or non-business activities?**

Yes.

The EU Commission accept that it is legitimate, in order to facilitate the correct and straightforward application of the exemption for Member States, under Article 131 of the Principal VAT Directive, to require that the exempt and/or non-business activities of members be carried on in a regular and consistent manner rather than merely sporadically. The relevant activities need to represent a significant (not a de minimis) part of the taxpayers business.

HMRC consider that an entity would be eligible for membership if:

- 5 per cent or more of its total supplies were exempt and/or non-business supplies in the immediate 12 months prior to joining the CSG

- or 5 per cent or more of its total supplies were exempt and/or non-business supplies in its last completed partial exemption, business/non-business year prior to its membership of a CSG
- or at the time of joining a CSG, although it does not fulfil the first two tests it:
  - i) has an intention to receive and does receive, qualifying services which are 'directly necessary' from the CSG, in the 12 month period starting from the date of joining
  - and**
  - ii) those services are directly utilised within 12 months of receipt by the member to make 5 per cent or more exempt and/or non-business onward supplies.

If a member ceases to be eligible for membership of the CSG, going forward, there have to be at least two remaining eligible members for the CSG itself to continue to be a CSG falling within the terms of Group 16 of Schedule 9 to the VAT Act 1994 and therefore to continue to be able to make exempt supplies.

If a body is wholly taxable but has a clear intention to make exempt and/or non-business supplies within the next 12 months HMRC would accept it is eligible to join a CSG.

## **37. Can businesses and organisations that are not VAT registered join CSGs?**

Yes. Businesses and organisations that are not VAT registered can also be members of a CSG provided they engage in exempt and/or non-business activity that is not de minimis. It is the activities engaged in and not registration status that determines eligibility for membership.

Businesses and organisations that are not VAT registered and engage only in taxable activity are not eligible to be members of a CSG.

## **38. What are exempt supplies?**

Any supplies falling within Schedule 9 of the VAT Act 1994 with the exception of Groups 11, 14 and 15.

It does not include supplies with the right to recovery, for example under Article 169(c) of the PVD exempt supplies?

# 'Directly necessary' services

## 39. What are 'directly necessary' services?

Article 132(1) (f) requires that supplies made by CSGs to their members must be 'directly necessary' for their exempt and/or non-business activities. If they are not the exemption does not apply and the supplies are subject to normal VAT rules.

The word 'necessary' used alone could be interpreted on the basis that any supplies used for a CSG member's exempt and/or non-business activity would be entitled to exemption. However, the word 'necessary' is, in this case, qualified by the use of the word 'directly' meaning that the supplies received from the CSG must relate 'directly' to the exempt and/or non-business supplies made by the CSG member in their own right.

HMRC has adopted a methodology for identifying services that are 'directly necessary' which has been developed with stakeholders during the consultation process in order to provide a simple and pragmatic way of identifying qualifying supplies.

If CSGs wish to suggest alternative methodologies HMRC will give them full consideration but must be satisfied that there is a direct and exclusive link with the exempt or non-business activity on which the qualification depends.

**Note** - businesses and organisations considering forming CSGs should note that recently the EU Commission have commenced infraction proceedings against Luxembourg for, among other things, their application of the 'directly necessary' condition, which is similar to the 'simplification' option offered by the HMRC in this guidance. (See Question 40, point 2.)

The Commission are seeking to establish the **principle** that 'directly necessary' services are those that are used '**exclusively**' by CSG members for their exempt and/or non-business activity. The matter has been referred to the European Court and timing is now in their hands. It could perhaps take several years to come to a conclusion, although it may conclude sooner.

The EU Commission have currently decided only to commence infraction proceedings against Luxembourg in this respect although a number of other Member States have also adopted a similar approach. However further challenges cannot be ruled out.

Decisions of the European Court are binding on Member States.

HMRC will monitor the process and consider whether or not at any stage any changes need to be made to this guidance. Should changes prove to be necessary, then transitional arrangements, as far as possible, will be put in place to facilitate an orderly move to the revised position.

## 40. How may directly necessary services be identified?

HMRC will accept services are directly necessary if they are identified using the following methodology:

1. Only supplies of services received from a CSG that can be 'directly attributable' (using partial exemption methodology) to the member's exempt and/or non-business activities will be regarded as 'directly necessary' and therefore qualify for the exemption. Expenditure on services received from a CSG that is attributable to both taxable and exempt and/or non-business activities will not qualify as being 'directly necessary' as they are NOT linked exclusively to the exempt and/or non-business activities of CSG members and will consequently be subject to their normal VAT treatment.

2. On an, optional, simplification basis, where a member of a CSG has wholly exempt and/or non-business activities or low levels of taxable activity, all the supplies they receive from a CSG will be regarded as 'directly necessary' for those exempt and/or non-business activities.

A low level of taxable activity for the purposes of this test is less than 15 per cent so, where a member of a CSG has exempt (see Question 38) and/or non-business activities that form 85 per cent or more of their total activities, all the supplies they receive from their CSG will be regarded as 'directly necessary'.

## 41. How does the 85 per cent directly necessary test work?

A member receiving supplies from the CSG of which they are a member will have to:

- have made 85 per cent or more exempt and/or non-business supplies in the immediately preceding 12 months or completed partial exemption year end prior to their membership of a CSG (the backward look), or
- have a intention in the 12 months immediately following joining a CSG to make 85 per cent or more exempt and/or non-business supplies (the forward look)

Once this test has been met the qualifying member will be entitled to receive all of their supplies from the CSG exempt for as long as their level of exempt and/or non-business supplies remains at 85 per cent or more.

## 42. How can the test be applied in practice?

HMRC will accept any calculation method that produces a fair and reasonable result.

This can be done in a number of ways. For example, as members in these circumstances will be making taxable as well as exempt and/or non-business supplies they are likely to be VAT registered, partially exempt and be completing monthly or quarterly VAT returns. Their ongoing VAT return, partial exemption and, if appropriate, their business/non-business calculations could be used to determine whether or not the test has been met. Businesses and organisations that are not VAT registered could, for example, use data from their management accounts to determine whether they meet the test or not, on a monthly or quarterly basis.

### **43. What will happen if a member meets the 85 per cent test by having an intention to make 85 per cent or more exempt and/or non-business supplies in the following 12 month period but that intention does not materialise?**

HMRC will not accept that all the CSG supplies to that member should be exempt but will permit the member to benefit from the exemption to the extent that the supplies from the CSG are 'directly attributable' (using partial exemption methodology) to their exempt and/or non-business activities. Members will only be able to use the forward look once.

### **44. What happens if a member fails the 85 per cent test after initially meeting the test?**

If a member of a CSG is not able to meet the 85 per cent or more test, HMRC will not accept that all CSG supplies to that member are exempt but will accept exemption of supplies from their CSG which are directly attributable (using partial exemption methodology) to that member's exempt and/or non-business activities. All the supplies made by the CSG will only become exempt once the member of the CSG is able to meet the 85 per cent test again. If they fail to meet the test on the forward look, having used up their one forward look test, they will have to rely on the backward look to qualify again or the member may benefit from the exemption to the extent that the supplies from the CSG are 'directly attributable' (using partial exemption methodology) to their exempt and/or non-business activities.



## **45. Can the 85 per cent test be applied on a sector/account basis?**

HMRC will, in certain circumstances, accept the 85 per cent test being applied to particular parts of a member's business provided the test can be reasonably applied. For example if the member has a sectorised Partial Exemption and Business/Non-Business method they can apply the test on a sector basis. If a particular sector qualifies the member can receive all supplies from their CSG that are attributable to that sector on an exempt basis. The test could also be applied on the same basis if, for example, a member can identify specific account codes in its accounting system; if the test is satisfied on that basis a member can receive all supplies from their CSG that are directly attributable to that account code on an exempt basis.

In these circumstances the test would have to be applied to external supplies and not to supplies made and received within the same VAT entity as they are neither exempt nor non-business supplies for the purpose of the Cost Sharing Exemption.

## **'Direct reimbursement of costs'?**

## **46. What is meant by 'direct reimbursement of costs'?**

For the exemption to apply the consideration for supplies made by the CSG to its members has to be an 'exact reimbursement' of the members' share of the joint expenses, this includes start-up costs, any general overheads incurred by the CSG in providing services to its members as well as any discounts received or input tax recovered by the CSG. Therefore there should be no profit element in the charges made by the group to its members, that is, no margin or mark-up must be factored into the cost of providing the services. So, for example, if the CSG receives discounts from its suppliers they have to be passed on to members by computing them into the CSG's charges to its members. If supplies to members of the CSG by the CSG do include a profit element the exemption will NOT apply and those supplies will be subject to the normal VAT rules.

CSGs can make supplies to non-members and in these circumstances the normal VAT rules apply and profit element may be included.

An expense can normally be defined as a cost incurred to generate revenue and would include for example:

- cash payments or liabilities
- costs incurred but not yet invoiced (accruals)
- amounts required to meet anticipated future expenditure
- depreciation in the value of the CSG's assets

How such costs are calculated and charged is a matter for the CSG members to agree. However HMRC expect CSGs to have a clear audit trail that can be checked if necessary.

## **47. What is the position if the CSG needs to raise funds?**

If a CSG wishes to raise funds, for example, to make a capital purchase or to build up a contingency fund it can do so without breaching the 'at cost' condition. It is also accepted that there may be timing differences between when expenses are incurred by a CSG and when it receives income for the supplies it makes to its members. Therefore it is probable that at any point in time a CSG could be running either a deficit or a surplus. Provided the CSG can demonstrate that the 'exact reimbursement' rule has been met over a reasonable period of time, running a deficit or surplus (provided any surplus is held for future use by the CSG for the specific benefit of its members) will not affect the use of the exemption. CSGs can demonstrate whether the 'exact reimbursement' test has been met or not by using normal accounting techniques and the judgement can be made over a period of time that is reasonable given the nature and context of the supplies being made.

## **48. How are charges for management and similar services to be treated?**

If a CSG chooses to buy in such services from third party suppliers or from a CSG member then such services will normally be taxable. If these supplies are then recharged by the CSG to its members at the appropriate proportion then they will, subject to all the conditions being met, be exempt. However if such supplies are used as a mechanism to artificially inflate costs to extract a profit from the supplies made by the CSG then they will fail to meet the 'exact reimbursement' condition and will fall to be treated as fully taxable.

## **49. What is transfer pricing and does it apply to services supplied by a CSG to its members?**

Transfer pricing is a direct tax provision and broadly concerns the terms that connected parties use when they conduct business with each other. Where the parties to the transaction are connected, the conditions of their commercial relations will not be determined solely by market forces. The price, terms and conditions of a transaction between connected parties may not be the same as those which would have been agreed at 'arm's length' between independent parties.

Where a CSG and its members are connected parties they will often be potentially subject to transfer pricing rules for direct tax purposes.

Further information about transfer pricing can be found in the [International Manual](#).

## **50. If the direct tax transfer pricing rules apply will they preclude use of the exemption as affected transactions may not comply with the 'exact reimbursement of costs' rule?**

No. HMRC accept that pricing or repricing transactions under direct tax transfer pricing rules will not preclude use of the exemption.

However, if the actual pricing of the charge by the CSG to its members exceeds an arm's length figure, such transactions would not qualify for the exemption.

Where a CSG has both unconnected and connected members for transfer pricing purposes, regardless of the tax position of the connected members, the unconnected members will still have to receive qualifying supplies without a margin or mark-up to meet this condition and to benefit from the exemption.

Please note: a Transfer Pricing Adjustment is not in itself a supply nor consideration for a supply. It is an indication that transactions or arrangements may not have been undertaken at an 'arms length' price. It may therefore point to an under valuation of the underlying supply for VAT purposes. Further information regarding Transfer Pricing and VAT can be found in VAT Guidance, V1-12: Valuation.

## **'Distortion of competition'?**

### **51. How can the exemption lead to a 'distortion of competition'?**

A CSG is a cooperative self-supply arrangement. It is not a commercial outsourcing arrangement therefore it does not exist or compete in a market. As long as all the conditions of the exemption are met, particularly that it can only supply its members on a 'direct reimbursement' basis, that is, it self supplies at cost, there should be little question of the exemption distorting a market and therefore little question of failing to meet this condition.

### **52. What does the ECJ case of Taksatorringen (C-8/01) comment on the 'distortion of competition' point?**

This point was looked at by the ECJ in the case of Taksatorringen (C-8/01 [2006] STC 1842). Taksatorringen was a Danish CSG formed by a number of insurance companies to provide them with claims handling services. The point in dispute was whether or not the arrangement breached the distortion of competition condition as such services were also provided by commercial (with profit) suppliers on an outsourced basis.

The Advocate General in Taksatorringen case stated the following:

“121. There are two fundamental requirements that must be met in order to qualify for an exemption. First, the independent external service provider must consist only of operators carrying out an activity which is exempt from, or not subject to, VAT. Secondly, it is essential that the group does not exist for purposes of gain, in the sense that it only charges its members for expenses incurred by it in order to meet their requirements, and makes no profit whatsoever out of doing so.

122. This means that the group must be entirely transparent and that, from an economic point of view, it must not have the characteristics of an independent operator seeking a customer base in order to generate profits.”

The Court itself found that the exemption can only be denied, under this condition, when it is the use of the exemption itself that gives rise to distortion of competition and a CSG cannot fail the distortion of competition condition simply because it is in a more advantageous competitive position because it complies with the requirement that it charges only an ‘exact reimbursement’ of costs.

“64. It follows that the grant of VAT exemption must be refused if there is a genuine risk that the exemption may by itself, immediately or in the future give rise to distortion of competition”

## **53. What are the practical implications of the Taksatorringen case?**

Any arrangement or interaction between a CSG and a commercial operator will need to be carefully considered as such associations are more likely to lead to distortions of competition under the terms of the exemption.

HMRC would not normally expect a third party commercial supplier to be able to meet the qualifications for membership of a CSG as they are generally fully taxable organisations who would not qualify for membership. Similarly a third party commercial provider could not act as a CSG unless it was solely constituted of (was fully owned and controlled by) members who themselves qualify for CSG membership. However should a commercial outsourcer qualify for CSG membership it cannot use that membership qualification to take advantage of the exemption for its commercial outsourcing activity.

## **54. What is the position when a commercial operator supplies a CSG?**

Normal VAT rules apply. The 'distortion of competition' condition should not affect normal customer/third party supplier arrangements. For example a CSG could, acting as an independent group of persons, freely engage a third party supplier to provide, for example, management or administrative services to the CSG and under normal commercial arrangements be able to decide to continue or not with that relationship. Such services supplied to the CSG would of course not benefit from the exemption but would be subject to the normal VAT rules and any VAT charged would be irrecoverable by the CSG to the extent that it was used for making exempt and/or non-business supplies by the CSG.

However where such charges are split so they are made directly to the individual members of a CSG as well as the CSG as a whole they may be regarded as abusive arrangements.

## **CSGs and VAT groups**

### **55. Can a VAT Group Registration be a member of a CSG?**

VAT grouping is a mechanism for accounting for tax and associated liabilities. Supplies of goods and services are made to individual members of the VAT group and the liability of those services depends on the status of the individual VAT group member, that member is able to join a CSG in its own right so long as its individual activities involve exempt or non-business activity.

Supplies received by a VAT group member from the CSG will be considered to be supplied to the representative member in accordance with the VAT Group Registration mechanism under the provisions s.43(1) of the VAT Act 1994).

However, s43(1AA) of the VAT Act 1994 allows the VAT group's representative member to be treated as a CSG member in relation to supplies which are treated as made to it but that are in reality made to the CSG member. Therefore it is the VAT group's member who is also a CSG member that must meet all the relevant cost share conditions and tests and be making the relevant exempt and/or non-business supplies to third parties, albeit that all such supplies are accounted for (under the VAT grouping mechanism) by the representative VAT group member. Note that supplies to other entities in the VAT group will not fulfil cost share conditions and tests, that is, they are neither exempt nor non-business, such supplies are disregarded for VAT purposes.

## **56. Can a CSG be a member of a VAT group?**

Yes, provided all the relevant VAT grouping conditions are met, in particular the control condition. For example if the controlling entity of the VAT group was also a CSG member and had over 50 per cent of the shareholding of the CSG (with the remaining shareholding spread between the other CSG members) the CSG would meet the control condition to be a member of the VAT group.

In these circumstances the exempt supplies of the CSG would form part of those of the VAT Group Registration and input tax incurred by the CSG would form part of the VAT Group Registration's input tax.

## **57. How do CSGs and VAT groups interact in practice?**

### **A CSG as a member of a VAT Group:**

- All supplies made by a CSG that is a member of a VAT Group to members who are also members of the same VAT group will be outside the scope of the VAT system (they are not exempt or non-business supplies for VAT purposes).
- All supplies from other VAT Groups members to a CSG that is in the same VAT Group, whether they are CSG members or not are also outside the scope of the VAT system (they are not exempt or non-business supplies for VAT purposes).
- Supplies of qualifying services by a CSG that is a member of a VAT Group to CSG members who are outside of that VAT Group will fall within the exemption (subject to all the conditions being met) and will be form part of the VAT Groups exempt supplies.

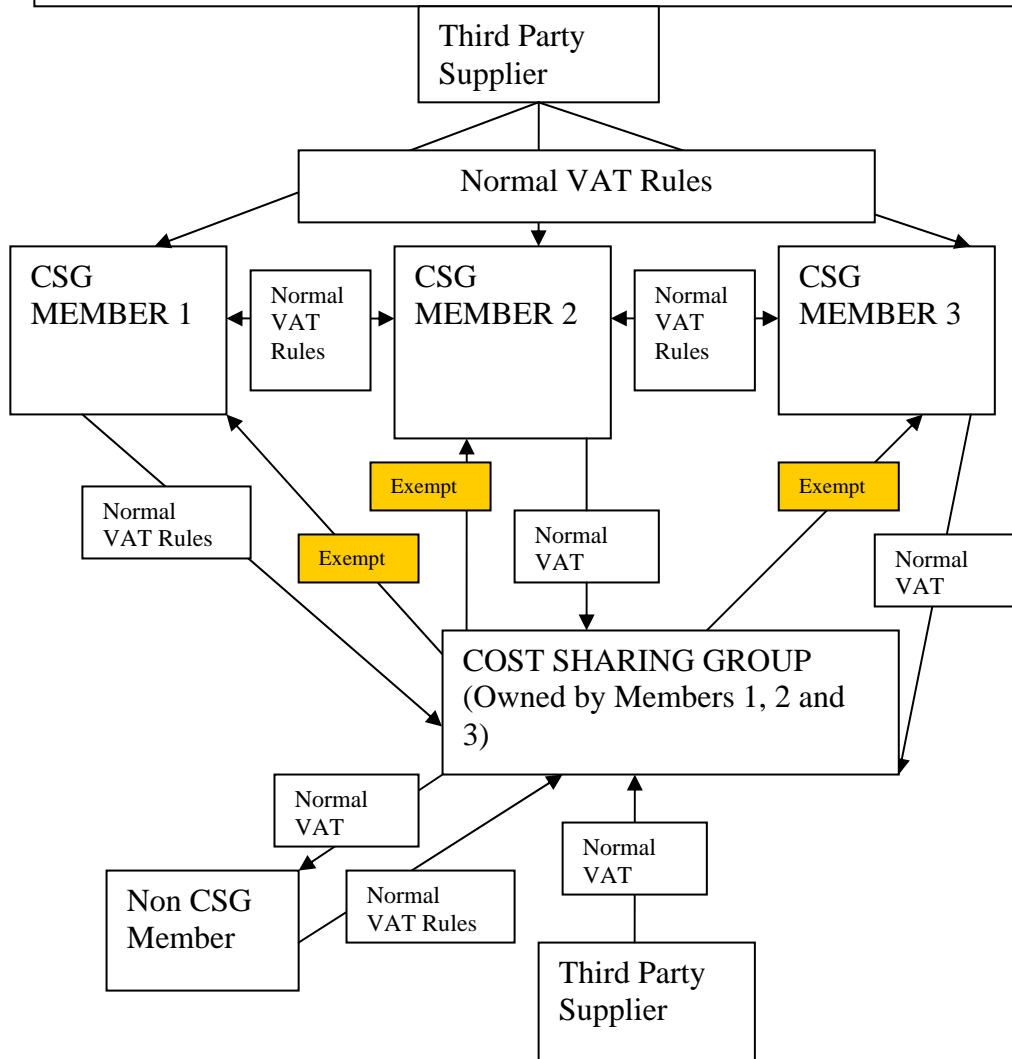
## **58. How is the 5 per cent test applied to a VAT group member?**

If a VAT group member wishes to become a member of a CSG it is that member who must meet the test and not the whole VAT group collectively, that is, the nature of the third party supplies made by the VAT group member determine its eligibility not the aggregated third party supplies of the VAT group. Supplies within VAT groups are outside of the scope of VAT rather than being exempt or non-business supplies so cannot be treated as exempt or non-business by the VAT group member to determine whether or not it is eligible to join a CSG.

## **59. How is the 85 per cent 'directly necessary' test applied to a VAT group member?**

The 'directly necessary' test is applied in exactly the same way as it is by any other CSG member but only to the third party activities of the VAT group member that is the CSG member and not the aggregated activity of the VAT group as a whole. See Questions 39 to 45.

# Appendix A



1. Assumes all (highlighted) supplies from the CSG to its members meet all the conditions of the Cost Sharing Exemption.
2. Normal VAT Rules – Could be SR, RR, ZR or could be covered by another Exemption depending on the supplies being made.
3. Supplies between CSG Members 1 and 3 above (and vice versa) are also subject to normal VAT rules.
4. Input tax relating to exempt supplies remains irrecoverable, under normal VAT rules.



## **Who can I contact for further information?**

If this VAT Information Sheet does not answer your question, please contact HM Revenue & Customs VAT and Excise Helpline on Tel 0845 010 9000 or +44 292 050 1261 for international enquiries.

The Helpline is available from 8.00 am to 8.00 pm, Monday to Friday. The advisers can help you with general queries.

If you have hearing difficulties, please ring the Textphone service on 0845 000 0200.