

TAXREP 28/02

VAT: MODERNISING THE TREATMENT OF FACE-VALUE VOUCHERS

*Memorandum submitted in October 2002 by The Tax Faculty of the Institute of
Chartered Accountants in England and Wales in response to a consultation
document issued in June 2002 by Customs*

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VAT: MODERNISING THE TREATMENT OF FACE-VALUE VOUCHERS

INTRODUCTION

1. We welcome the opportunity to comment on the proposals in the consultation paper issued in June 2002.

WHO WE ARE

2. The Tax Faculty is the focus within the Institute of Chartered Accountants in England and Wales for those Chartered Accountants working in the area of tax. It is a centre of excellence and the authoritative voice for the 123,000 members of the Institute on taxation matters. The Tax Faculty makes representations to Government and other authorities and public pronouncements on major tax issues. Chartered Accountants are in tax practices and in businesses ranging from the largest to the smallest concerns.

EXECUTIVE SUMMARY

3. We believe that the problem of VAT leakage where face-value vouchers have been sold at undervalue through intermediaries stems from a misunderstanding about what the vouchers represent, which misunderstanding is reflected in the UK law which purports to cover them, namely paragraph 5, Schedule 6, Value Added Tax Act 1994 ('VAT Act 1994').
4. The face-value vouchers that we understand Customs are concerned with in this consultation do not seem to us to confer 'a right to goods and services'. They simply represent money or money's worth and are arguably negotiable instruments.
5. 'Transactions ... concerning ... negotiable instruments' are VAT exempt under Article 13B(d)(3) of the Sixth VAT Directive (Dir 77/388/EC). Making UK law consistent with this provision coupled with, if necessary, appropriate anti-avoidance rules should be sufficient to ensure that the right amount of tax is accounted for without contravening the principles in the *Argos Distributors Ltd* case, CJEC Case C-288/94, [1996] STC 1359.

DETAILED COMMENTS ON THE CONSULTATION PAPER

6. We cannot support the proposals put forward by Customs for a number of reasons:
 - they are complicated;
 - they are potentially distortive and will be liable to collect more tax than should really be due in that they will tax the profits of any intermediary even if the vouchers are eventually used for zero-rated or exempt goods or services;
 - the vouchers are clearly not goods; and
 - they perpetuate a misunderstanding about what these vouchers generally represent.
7. We suggest that vouchers can be split into three broad types. Briefly, these are:
 - discount vouchers offering money off;

- prepayment vouchers; and
- face-value or 'gift' vouchers.

In our view, the vouchers that are causing concern to Customs are those in the third category.

8. The first category of vouchers, namely discount vouchers, are usually issued without payment and have the effect of reducing the consideration received by the person supplying the goods or services against which they are used. They are easy to identify and are adequately covered by existing law. Following the *Granton Marketing* case, [1996] STC 1359, it is clear that they will be taxable if sold so that the potential for abuse is relatively limited
9. The second kind of vouchers, namely prepayment vouchers, are generally also relatively easy to identify as there is a direct and immediate link with the goods or services against which they are used. Phone cards and postage stamps are the obvious examples of these and are referred to specifically in Customs' consultation. Both can, and probably do, confer rights to goods or services. The better solution for dealing with these could well be to treat them for what they really are, namely prepayments, and to tax or exempt them according to the normal tax point rules in Section 6 of the VAT Act 1994. Paragraph 5 of Schedule 6 merely serves to create a problem that need not exist.
10. The third category, namely face-value vouchers, are where we consider the real concerns should lie. In our view, these are not being addressed. Historically, face-value vouchers have been treated as falling within Paragraph 5 of Schedule 6 to VAT Act 1994, which applies '...where a right to receive goods or services for an amount stated on any token, stamp or voucher is granted for a consideration ...'.
11. However, in our considered opinion, vouchers of this kind do not confer any right to receive goods or services, but are, in reality, vouchers that can be accepted in full or part payment for goods or services. As such, they are a simply means of payment and should be treated as such. We consider that they should be regarded as VAT-exempt as negotiable instruments, a description of which is found in the Dictionary of Banking and Finance by Derrick G Hanson (Published by Pitman), which we attach at Annex A. In summary, the features of a negotiable instrument are that legal ownership passes by delivery, a recipient taking it in good faith receives good title and it contains a right of action in itself.
12. Treatment of face-value vouchers as exempt would not alone necessarily resolve the possibility of abuse and VAT loss. However, we suggest that there may be better ways of addressing this than the proposals made in the consultation document.
13. We agree with the Commissioners that Paragraph 5 of Schedule 6 to VAT Act 1994 needs to be changed, but for different reasons:
 - it perpetuates the misunderstanding about what these vouchers generally represent. As we have said, in contrast to things like postage stamps and the type of phone cards sold by tobacconists and newsagents, these vouchers seldom, if at all, give any real rights to goods or services. All they confer is the right to have the voucher tendered in full or part payment for goods and services, including

being paid into the bearer's store-card account. This is apparent on reading the terms of, say, a Marks & Spencer or John Lewis voucher and is what happens in practice;

- vouchers issued by persons who do not accept them for goods or services probably cannot confer rights to goods or services in the first place.
- it is difficult to see how, with the possible exception of stamps and phone cards, face-value vouchers can confer rights to goods or services when the goods or services against which they are eventually redeemed are unknown. To that extent, any thought of such rights must fail through uncertainty because there is no direct and immediate link;
- arguably paragraph 5 of Schedule 6 only applies in any event to issuers of vouchers when there can be a 'grant' and not to later sales or other supplies; and
- postage stamps and the type of phone cards sold by tobacconists or newsagents should arguably be given different treatment anyway. This is because:
 - there is a link to identifiable goods or services and
 - they usually represent a genuine pre-payment for specific goods or services:the only thing that is uncertain is the actual time and place of supply.

14. We consider that face-value vouchers (as opposed to postage stamps and the type of phone cards that a person can buy from a tobacconist or newsagent) are VAT-exempt within Article 13B(d) of the EC Sixth Directive. We are aware that Customs appear to have an Opinion that this is not correct. However:

- there are others who take a different view;
- such vouchers are treated as exempt in the Netherlands (see Annex B). This conflicts with a statement by the Commissioners in one of their notes on the different options and we wonder whether this may be the result of asking questions of other Member States on the assumption that the vouchers really do confer rights to goods or services;
- vouchers issued by some major stores such as Marks & Spencer and John Lewis can be paid into customers store-card accounts with those stores, which gives them the characteristic of money;
- their operation is similar to that of Provident cheques, which are accepted as exempt as being 'security for money'. To treat them differently would itself be distortive. They are also not dissimilar to postal orders; and
- the perception of such vouchers by the public is that they are something that they can spend, ie, they represent money or money's worth.

15. We believe that Customs' suggestions that there will be partial exemption problems from exemption are overstated, especially if Customs behave equitably in the agreement of partial exemption methods:

- the only input tax loss that an issuer that redeems the vouchers for goods or services need suffer is the VAT on the printing costs. In most cases, it would be reasonable to ignore the exempt supplies in the hands of such an issuer as incidental and something to be left out of account for the purposes of calculating residual input tax recovery. This is what happens in the Netherlands;
- there may not be the same concern in this connection about the position of an intermediary, especially if the intermediary is used for avoidance. However, even an intermediary might be able to agree a reasonable position in some situations, for example, where the vouchers are acquired for promotional purposes;

- if postage stamps sold by intermediaries such as newsagents had to be treated as exempt, it ought to be possible to agree a reasonably pragmatic solution to avoid any distortion in input tax recovery.
16. Treatment of face-value vouchers as exempt will avoid double taxation and, if suitable anti-avoidance measures are adopted, can effectively deal with avoidance and tax loss.

Comments on JVCC paper circulated on 20 September: Options Considered in Modernising the Treatment of Face Value Vouchers

17. Customs have said that anti-avoidance measures based on open market value would be difficult to apply because of the problem in deciding what open market value is and in identifying cases where the abuse/avoidance exists.
18. We consider that Customs overestimate the difficulties here, for the following reasons:
- open market value is already a concept used in anti-avoidance provisions elsewhere in Schedule 6;
 - the cases of major avoidance should be relatively easy to identify because of who vouchers are or will be issued by and a probably low number of such suppliers;
 - the existence of anti-avoidance provisions would act as a deterrent and would tend to reduce the incidence anyway;
 - there could be a benchmark, agreed, say, with a body such as the British Retail Consortium, whereby the aggregate of the issue price and the sale price by the intermediary relative to the face value could be judged, but which could be substituted by a different figure on evidence provided by the issuer. Customs mentioned 95% in their Note on the other options; and
 - the provisions could also cater for two or more intermediaries.
19. Our further comments on Customs' note are set out in Annex C.

Responses to specific questions posed in Customs' consultation document

20. Finally, we respond in Annex D to the specific questions raised by Customs in the consultation document.

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NEGOTIABLE INSTRUMENTS

Extract from the Dictionary of Banking and Finance by Derrick G Hanson (Published by Pitman)

A negotiable instrument is one which conforms to the following three tests:

1. It must be such and in such a state that the property in it (ie, the legal ownership) passes by mere delivery or in some cases by endorsement and delivery.
2. A person taking it in good faith and for value and without notice of defect of title gets an indefeasible title against all the world. Such a person is called a bona fide holder for value without notice or, in the case of a bill or a cheque, a holder in due course.
3. It must contain a right of action in itself and entitle the holder to sue in his own name.

A negotiable instrument is an exception to the general rule of law that *nemo dat quod non habet* (no one can give what he has not), for a transferee under the conditions mentioned in (2) can obtain a good title from a thief even against the true owner. To affect a transferee with notice of defect of title there must be something more than negligence, and the doctrine of constructive notice is not applicable to negotiable instruments.

Where a stockbroker pledged clients' bearer bonds to a bank who advanced money against them in good faith and without notice, the bank was held to be entitled to hold them against the true owner (*London Joint Stock Bank v Simmons*, [1892] AC 201). In the course of the judgment Lord Herschell said:

‘It is surely of the very essence of a negotiable instrument that you may treat the person in possession of it as having authority to deal with it, be he agent or otherwise, unless you know to the contrary, and are not compelled, in order to secure a good title to yourself, to inquire into the nature of his title, or the extent of his authority... . I should be very sorry to see the doctrine of constructive notice introduced into the law of negotiable instruments. But regard to the facts of which the taker of such instruments had notice is most material in considering whether he took it in good faith. If there is anything wanting which excites the suspicion that there is something wrong in the transaction, the taker of the instrument is not acting in good faith if he shuts his eyes to the facts presented to him and puts the suspicions aside without further inquiry. ... It is easy enough to make an elaborate presentation after the event of the speculations with which the bank managers might have occupied themselves in reference to the capacity in which the broker who offered the bonds as security for an advance held them. I think, however, they were not bound to occupy their minds with any such speculations. I apprehend that when a person whose honesty there is no reason to doubt offers negotiable securities to a banker or any other person, the only consideration likely to engage his attention is whether the security is sufficient to justify the advance required. And I do not think the

law lays upon him the obligation of making any inquiry into the title of the person whom he finds in possession of them: of course, if there is anything to arouse suspicion, to lead to a doubt whether the person purporting to transfer them is justified in entering into the contemplated transaction, the case would be different, the existence of such suspicion or doubt would be inconsistent with good faith. And if no inquiry were made, or if on inquiry the doubt were not removed and the suspicion dissipated, I should have no hesitation in holding that good faith was wanting in a person thus acting.’

The following are negotiable instruments: bank notes, bearer bonds, Treasury bills, share warrants and share certificates to bearer, debentures payable to bearer, bills of exchange, promissory notes, and cheques. The list of negotiable instruments is not closed and the courts will give judicial recognition to the custom of merchants to treat mercantile instruments as negotiable. A foreign instrument that is negotiable in the country of its origin is not necessarily negotiable in the UK. Share certificates in the US form, where a form of transfer is placed on the back, are treated as bearer instruments when duly endorsed by the registered holder, but they are not negotiable, for a transferee is unable to sue in his own name until he presents the instrument for registration. Bills of exchange (including cheques) are the most common example of negotiable instruments. They can lose their negotiable quality, however. A bill expressed to be payable to a particular person ‘only’ or ‘not transferable’, is neither transferable nor negotiable (Bills of Exchange Act 1882, Section 8). A bill that has been restrictively endorsed can only be negotiated subject to defects of title, ie, not negotiable (Sections 35 and 36). An overdue bill can only be negotiated subject to any defect of title affecting it at maturity and thenceforward no person who takes it can acquire or give a better title than that which the person from whom he took it had; in other words, it is not negotiable (Section 36(2)). Where a bill was payable to the order of a specified payee ‘only’ and further bore on it the words ‘not negotiable’, it was held to be limited as to its effect as between the drawer and the acceptor, and to be neither negotiable nor transferable. There cannot be a holder, let alone a holder in due course capable of suing on it (*Hibernian Bank Ltd v Gysin & Hanson*, [1930] 1 All ER 165). Where a crossed cheque bears on it the words ‘not negotiable’, he shall not have and shall not be capable of giving a better title to a cheque than that which the person from whom he took it had (Section 81). Such a cheque has lost its negotiability.

‘Negotiability by estoppel’ is a phrase mistakenly used for title by estoppel and in *Eaton v London Joint Stock Bank*, (1887) 34 ChD 95, it was made plain that no sort of negotiability can be infused into non-negotiable instruments, but that the estoppel is a personal matter of conduct, holding out, etc., wherein the instrument is evidence.

The Committee of London Clearing Bankers agreed in 1958 that the drawing of non-transferrable cheques would create serious practical difficulties for the banks and might expose them to unacceptable risks; for example, a paying banker would have no statutory protection in respect of non-transferable cheques cashed at the counter and would in each case be obliged positively to identify the payee, while the collecting banker could not become a holder for value of a non-transferrable cheque and would not be able to enforce payment in his own name. For these and other reasons, therefore, it recommended that in appropriate cases customers should be approached with a request that the practice should be discontinued.

TREATMENT OF FACE VALUE VOUCHERS IN THE NETHERLANDS

In essence, a face value voucher is regarded as a financial instrument and its sale is therefore an exempt supply (irrespective of the price charged).

Since it is an exempt supply, there is in principle no input tax recovery on the costs. However, where a business sells face value vouchers which it will later accept as payment for the supply of its own goods or services (for example, a department store chain), the disallowance of input tax is restricted to the direct costs of producing or printing the vouchers. There is no general effect on the partial exemption position of that business, and the sale is not taken into account for the purposes of any pro rata or other partial exemption calculation.

On the other hand, where the business selling the voucher is some sort of intermediary, and does not redeem the vouchers itself, then the normal partial exemption rules will apply. Thus, if the business only purchased vouchers (presumably at a discount from the ultimate supplier of the goods or services) and then sold them on at face value or whatever, it would be wholly exempt and have no input tax recovery at all.

The exemption in Dutch Law is provided for in Article 11.1.i.2 of the VAT Act 1968, as amended: Article 11 is broadly the equivalent of Schedule 9 VAT Act 1994. Article 11.1.i.2 uses almost identical wording to the (Dutch) text of Article 13B(5) of the Sixth Directive, which exempts 'other securities' ('andere waardepapieren').

Input tax recovery is dealt with in a Resolution by the Secretary of State for Finance dated 30 December 1999. A Resolution is similar to a UK Statement of Practice or Business Brief. It is binding on the tax administration, but could be challenged in court by a taxpayer. Paragraph 5 of this Resolution deals with input tax recovery, and reads (our translation):

'5. Deduction of input tax

Since dealings in securities are exempt from VAT, there are no grounds for claiming the recovery of input tax under Article 15 of the VAT Law. Taking into account that the main objective of a business supplying gift vouchers is to sell its goods or services, I can accept that the restriction on input tax recovery is limited to the VAT that directly relates to the production or purchase of the gift vouchers. This applies in principle to all businesses supplying gift vouchers. As far as centralised voucher suppliers or other businesses involved with the financial processing of the gift vouchers after their production and sale are concerned, I consider that the normal legal rules for input tax recovery, including the rules for attribution, annual adjustments and capital goods adjustments in Articles 11-14 of the VAT Implementing Decree 1968, should apply in full.'

**COMMENTS ON CUSTOMS' PAPER: 'OPTIONS CONSIDERED IN
MODERNISING THE TREATMENT OF FACE VALUE VOUCHERS'
CIRCULATED ON 2 SEPTEMBER**

We comment as follows on the respective options (the numbering follows Customs' paper):

1. Leaving paragraph 5 of Schedule 6 as it is should not be an option as it does not relate to what the vast majority of vouchers really do and possibly does not cover intermediaries. Customs' views on tackling avoidance by litigation are fair comment, although we question the difficulty in identifying schemes, because the major players amongst the issuers of these vouchers are probably common knowledge.
2. This is not in line with the treatment in the Netherlands: therefore the comments on treatment in other Member States are incorrect. We wonder whether the answers Customs have received from other Member States are the result of not asking the right question owing to a misconception of what these vouchers really represent, ie, they do not, with the exceptions of phone cards and stamps referred to earlier, give rights to goods or services.

We consider also that the point about two supplies for one is wrong and misleading. This crops up as an objection elsewhere.

- First, if it is valid, it exists already. It is merely hidden as a result of the treatment in Paragraph 5;
 - Secondly, the reality is that there are two supplies. The voucher is supplied for the consideration given on issue; and
 - The goods or services are supplied in consideration of the voucher, the value of which to the issuer/supplier of the goods or services is what he received on issue.
3. Margin schemes are probably too complicated. For a regime to work effectively, it must be simple. Margin schemes would also lead to over-taxation if tax were charged on margins where zero-rated or exempt goods or services were acquired by the consumer.
 4. The prepayment argument does not reflect the nature of the vouchers except with things like phone cards or stamps. For there to be a prepayment the specific future supplies of goods or services need to be specified and there must be a direct and immediate link. With face-value vouchers it is not possible to do this so the argument would fail through uncertainty. Even with book tokens, it is impossible to make the necessary direct and immediate link as it is not possible to tell what book they will be used for. Book tokens may even be used in some cases for standard-rated, rather than zero-rated items.
 5. We have commented earlier on exemption and partial exemption. We consider that Customs' arguments against are largely illusory.

6. We would welcome clarification of how this proposal might work in practice. In most cases the intermediary will not be agent and would not charge a commission.
7. This has superficial initial attractions, except that it fails to recognise what vouchers really represent, namely, money or money's worth. It would inevitably lead to double taxation.
8. We assume that this is not really a serious contender as it ignores what the vouchers really represent and could result in over-taxation.
9. This still ignores what vouchers really represent, but the reference to 95% could be a useful pointer to dealing with the open market value point earlier.
10. There is no real explanation of how this would work. And:
 - we consider that the difficulties over open market value are overstated.
 - we also cannot see any problem with natural tax loss, which is presumably just the reduction you get if a discount is given (ie what happens if vouchers are sold/issued for an open market price but for less than face-value).
11. We agree with the idea of option 11 and believe Customs' objections are overstated.
12. This is our favoured option as will be noted from our main points above.
13. Any new approach should be piecemeal inasmuch as we believe that a treatment different from face-value vouchers should be applied to phone cards and stamps where they either do confer rights to goods or services or are really pre-payments. We consider that the difficulties where vouchers are treated as exempt or ignored on issue or sale are over-stated. If the argument was that phone cards, for example, were not prepayments and/or did not confer rights to services, the same end result would arise, but with a timing difference. Also, we are unable to accept that natural tax loss is a problem.

**ANSWERS TO THE SPECIFIC QUESTIONS POSED
IN CUSTOMS' CONSULTATION DOCUMENT**

Questions 1–3

N/A

4. Do you believe that these proposals will help to reduce tax leakage and avoidance? If so, please state how and to what extent? If not, how should they be modified?

We do not believe that the proposals will necessarily prevent avoidance or leakage because there could well be loopholes arising from the exceptions needed to deal with things like book tokens and stamps. The whole proposal needs a re-think because it is an unbalanced and potentially complicated solution.

5. When a business issues and redeems an FVV, do you agree the tax should be collected when the FVV is redeemed, or do you think it should be taxed at the time they are issued?

We consider that tax should be collected only when vouchers are redeemed. To tax a supply by an intermediary would give Customs an unfair windfall to the extent of vouchers that are never redeemed or are used for something on which VAT is not due. The only real way to deal with this problem satisfactorily is to exempt the vouchers at each stage up to redemption.

6. Do you agree with the proposals for the Book Tokens scheme and for the sale of postage stamps? Do you envisage any practical difficulties with these proposals?

We do not agree with the proposals for Book Tokens and stamps as they are potentially distortive and discriminate against vouchers issued by the likes of Tesco, WH Smiths and Marks and Spencer, which are potentially redeemable against zero-rated, reduced rate and even VAT-exempt goods.

8. Do you know of any businesses or organisations which issue vouchers but do not themselves take on an obligation to supply goods or services in return? If so, what types of goods and services are involved?

Vouchers of the kind considered in the *Granton Marketing* case are one example. There are also Luncheon Vouchers and Provident Cheques.

11. If member states were to seek to achieve consistent treatment of FVVs across the EU, what treatment would you suggest?

Vouchers should be regarded as a financial instrument similar to a bill of exchange or postal order. In practice, the only difference is that these instruments are exchanged for cash whereas face value vouchers are exchanged for goods or services. They are nonetheless a means of payment and we consider that the supply is within Article 13B(d)(3), and most likely within the term ‘negotiable instrument’. The issue or sale of a voucher by anyone would then be exempt from tax.

We would disagree strongly with any suggestion that conflicts with the *Argos* case and do not consider that there is any necessity for a new Directive or a change to the Sixth Directive. If we take the lead of the Advocate General in *Argos* and see the vouchers as a means of payment, this should deal with most problems, subject to possible anti-avoidance rules on the lines suggested earlier. Vouchers exchanged for goods or services should only be treated as consideration equal to the face value of the voucher if the supplier does not wish to apply *Argos* or if there is clear avoidance.