Tax Representation

Tax Faculty

TAXREP 19/06

VAT AND PARTIAL EXEMPTION

Memorandum submitted in July 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to HM Revenue & Customs in response to an invitation to comment in an informal consultation issued in June 2006.

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VAT AND PARTIAL EXEMPTION

INTRODUCTION

We are pleased to participate in the informal consultation on proposed changes to the partial exemption regulations described in notes and draft regulations issued by HM Revenue & Customs (HMRC) on 16 May 2006 and 15 June 2006 respectively.

1. Details about the Tax Faculty and the Institute of Chartered Accountants in England and Wales are set out in Annex A.

KEY POINT SUMMARY

2. In brief:

- We recommend that HMRC should only issue notices that a declaration is incorrect where it is reasonable to do so and where the declaration is demonstrably wrong or where manipulation is evident. They should not be issued to correct marginal unfairness where a special method over-ride notice would be more appropriate.

- We think that the proposed legislation should be changed so that it is even handed and allows businesses to correct methods from inception where they are not fair and reasonable.

- We do not think it is proper to charge penalties where there is an incorrect declaration unless there is evidence of deliberate manipulation or where there is evidence that the taxable person knew about the unfairness from the outset.

- We welcome the change to allow combined methods.

GENERAL COMMENTS

4. The two changes on which on which views are sought are first; the new requirement to make a declaration when applying for a special method that it is 'fair and reasonable.' Second, the option for businesses to apply for a combined method which also deals with 'out of country supplies' instead of dealing with them in a separate use-based calculation.

5. Partial exemption is not an exact science. It is clear that the Directive was designed on the basis of a 'broad brush' approach to partial exemption, focussing mainly on general pro-rata apportionments. It is not surprising that difficulties have arisen in fine tuning the legislation to the extent that has been done in the UK. Frequent changes have been made to the UK partial exemption regime. The system is difficult to operate and to police and the history of the regime shows that it is prone to manipulation. Changes in UK law over the years to prevent excessive input tax deductions have resulted in considerable complexity. The proposed changes will add

to the complexity. We attach at Appendix B our Ten Tenets for a Better Tax System which amongst other things recommends that the tax rules should aim to be simple, understandable and clear in their objectives.

6. We agree that it is necessary to prevent manipulation and recovery of input tax in excess of that permitted under the Directive. The new measures may well do that, but the collateral damage is that they create considerable and one-sided uncertainty for the taxable person. Whilst they permit HMRC to review the position with hindsight, they do not allow this for the taxpayer. In effect, they are likely to transfer the lengthy negotiations for an agreed partial exemption method from prior to its introduction to some later stage.

7. If the proposals are to succeed in practice, both taxpayers and HMRC will need to trust each other to operate the law in a 'fair and reasonable' way. Rightly or wrongly, trust in HMRC has diminished substantially in recent years, and the partial exemption area has been no exception. Unless trust can be re-established, we are concerned that the proposals will lead to increased litigation.

8. There is no requirement in UK law for businesses to limit their input tax deductions to the maximum allowable under the Directive where a special method has been agreed. Instead a business must claim input tax strictly in accordance with the method. If a requirement for businesses to limit claims to what is allowable under the Directive were to be introduced in UK law it would create uncertainty for businesses. This point is recognised in the consultation papers circulated for comment. It is important to provide certainty for businesses but so long as there is no requirement for businesses to so limit their claims it will be possible for them to continue to obtain an excessive deduction if the claim is in accordance with the special method agreed. In the opposite situation where the method produces a lower input tax claim than the Directive would allow, it will usually be possible for the business concerned to apply to amend his method (effectively this means applying for a new method). If the change is acceptable to both sides the legislation does not prevent a back dated change of method (to the start of the current tax year) if both sides agree. Arguably the balance is in favour of the taxpayer.

9. The proposed changes seek to redress the balance where an incorrect declaration has been given and too much VAT has been recovered. In that situation HMRC will be able to issue a notice which will have effect from the inception of the method. It will not be possible for the taxable person to do likewise in order to recover tax which should have been reclaimed had the method been fair and reasonable. Where a declaration is found to be incorrect the legislation should be even handed in dealing with corrections. We think that the proposals should be changed so that subject to the three year cap both the taxable person and HMRC should be entitled to go back and amend the method from inception. Otherwise the changes will be seen as one-sided, and therefore not 'fair and reasonable'.

Combined methods

10. We welcome the change to allow combined methods which also deal with foreign and specified supplies.

The 'Fair and reasonable' declaration

11. While the present system for exemptions for financial and insurance services continues there will be difficulties in dealing with partial exemption. We expect to see a continuation of the frequent disputes on partial exemption and to the extent that new causes of disputes will be introduced by the proposed legislation they may increase in number. That will of course depend on how the legislation is implemented in practical terms. We recommend that the new power to issue notices should be limited to instances of deliberate manipulation of the system to enable an unreasonable input tax recovery under the method used or where there is gross unfairness that the taxable person knew about.

12. Where, as a result of gradual changes to the mix of outputs or in the business being carried on, there is a change in the balance of the method so that it no longer provides a fair and reasonable input tax recovery we think that a notice should not be issued but the method should be changed. In that situation it may be possible to show that the method was marginally unfair at inception. Where this is the case and there is no sign of deliberate manipulation we think some caution should be exercised before issuing a notice that the declaration was incorrect. Clearly other factors must be considered such as how long the method has been unfair and how much tax is at stake. A special method over-ride notice may be the better way forward in these situations.

13. The term 'fair and reasonable' is uncertain because it is a matter of judgment and different minds can arrive at different conclusions. We note for example the statement of the Edinburgh VAT Tribunal in the *University of Glasgow* case (VATTR 19052):

> We agree that the first stage in arriving at a basis for calculation has to be an apportionment between business and non-business activity. Such apportionment requires to be fair and reasonable. However the fairness and reasonableness of that apportionment is not dependent upon whether the parties like the result in terms of the amount of tax due or reclaimable. To say that any apportionment does not provide the amount of revenue the Respondents would like says very little about the correctness of that apportionment.

Whilst the Tribunal Chairman made these comments in the context of an apportionment between business and non-business activities, it is equally valid for partial exemption as a whole.

14. In the practical administration of the regime it would be appropriate to give the taxable person the benefit of any doubt. We would expect HMRC and the courts to take a similar approach.

15. At present the legislation contains a provision which requires the Commissioners to 'make regulations for securing a fair and reasonable attribution of input tax to taxable supplies' (section 26(3) VAT Act 1994). Hitherto there has been no requirement that the method a taxable person applies for should be fair and reasonable. The Commissioners have the opportunity to check whether a proposed method is fair and reasonable, although we accept that this can be a difficult task for a person who has limited knowledge of the business.

16. We think that in practice most businesses ensure so far as possible that the method they are proposing to use is fair and reasonable and secures the maximum input tax relief permitted under the VAT law.

17. At first sight it does not appear to be onerous to ask the taxable person to confirm that the method he is applying for is fair and reasonable. However, the measure goes further than that and provides a means for recovering tax where the declaration is incorrect.

18. The declaration is incorrect where the taxable person knew or ought to have known it was incorrect. It is not clear how a court will interpret this provision (proposed regulation 102 (11) (b)) but it will have to consider what the person who signed the declaration ought to have known. It is easy to foresee problems with this provision in the future. For example in large organisations will the person who signs the declaration be assumed to know what all the other members of staff know? There is no reasonableness test in this provision. Should the provision say 'reasonably ought to have known?'

19. We are concerned that the UK law on partial exemption more generally already exceeds what is permissible under the Sixth Directive. For example, Reg. 103 can be applied to transactions that do not form a separate part of the business, which is not in accordance with the ECJ judgment in *Kretztechnik*. In the *Royal Bank of Scotland* case (VATTR 19429) the Edinburgh VAT Tribunal has suggested, albeit *obiter*, that Reg. 101(5) may not 'competently alter' Article 19 of the Sixth Directive. More relevantly, there is the question whether Reg. 102 properly complies with Art 17.5(c). The risk for HMRC is that, unless very carefully and sparingly applied, the new proposals will increase the risk of challenge to the UK partial exemption law. The solution is of course a much wider exercise to bring the UK law into line.

20. Article 17 of the Sixth Directive does not give Member States much discretion in determining what input tax is deductible. It is settled law that a Member State must not make it excessively difficult for the taxable person to deduct the input tax to which he is entitled under the Directive. Article 17(5) gives Member States certain powers in relation to input tax deduction. In the UK sectorisation is allowed (within a special method) - Art.17(5)(a), methods based on use are allowed - Art.17(5)(c) and insignificant non-deductible input tax is treated as nil - Art.17(5)(e). The choices open to Member States in Art. 17(5) are not clearly translated into UK law so that one can see what those choices are. A comparison of the Directive with UK legislation in this area does not appear to give the Member State all the powers relating to partial exemption methods that are given in national law. There is power to authorise or compel the taxable person to make the deduction on the basis of use. But UK legislation goes much further. The recent changes on partial exemption are straying further and further from the Directive. It is difficult to see the vires for the proposed changes. Effectively the UK wishes to take power to change an authorisation to deduct on the basis of use from one method to another with retrospective effect. As a result, and as we have said above, the validity of the proposed legislation is likely to be challenged before the courts.

21. Since there will be considerable doubt on how the terms 'fair and reasonable' are to be defined and applied in this context, it would be helpful if HMRC would consider issuing a Practice Note or Business Brief amplifying the comments in para. 9 of the Questions & Answers. Any note should also cover the position of the taxpayer who, having agreed a method, can demonstrate subsequently that too little VAT is being recovered.

Additional Compliance Costs

22. In some cases the person signing the declaration ought to have known about issues affecting the fairness of the method, but his colleagues may have failed to inform him. In that situation we assume that a notice will be issued. If that is correct VAT managers in the large businesses are going to be much more cautious and will have to spend a great deal more time ensuring that they have all relevant information. No doubt some businesses will ask their outside advisers to comment on whether a proposed method is fair and reasonable. We would expect that the proposed changes to the law will increase compliance costs, and therefore disagree with the HMRC statement that it will only have a 'minimal impact'

23. We do not see any benefits to the taxable person arising from the introduction of the new declaration. It may make agreement of a method quicker but that depends on the extent to which HMRC officers rely on the declaration rather than checking whether the method is fair and reasonable. Businesses whose methods have required protracted negotiations in the past will no doubt be involved in negotiations in the future. It is difficult to estimate whether agreements will be easier to reach thereby reducing compliance costs. Bearing in mind the increased costs of preparing and checking methods before they are submitted, we think that there will be greater compliance costs as a result of the changes.

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31.7.06

ANNEX A

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

2. Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members and students, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the ICAEW who pay an additional subscription.

ANNEX B

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory**: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain**: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple**: the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate**: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted**: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant**: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation**: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed**: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable**: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive**: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99; see http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_43160,MNXI_43160.