Faculty of Taxation

Tax Representation

TAXREP 16/03

House of Lords Select Committee on Economic Affairs – Sub-Committee on the Finance Bill 2003

Evidence submitted in April 2003 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) to the House of Lords Select Committee on Economic Affairs Sub-Committee on the Finance Bill together with supplementary evidence submitted in May 2003 on how carousel fraud could be contained

CONTENTS

House of Lords Select Committee on Economic Affairs – Sub-Committee on the Finance Bill 2003

INTRODUCTION

1. The Tax Faculty of ICAEW was invited to submit written evidence to the Sub-Committee of the House of Lords Select Committee on Economic Affairs. Written evidence was submitted on 28 April 2003 and is reproduced in paragraphs 4 to 16 below.
2. The Tax Faculty gave oral evidence to the Sub-Committee on 14 May 2003.
3. At the specific request of the Chairman of the Sub-Committee, Lord Preston, the Tax Faculty submitted supplementary evidence incorporating suggestions as to how carousel fraud could be contained. This further written evidence is reproduced in paragraphs 17 to 39 below.

WRITTEN EVIDENCE FROM THE TAX FACULTY OF ICAEW TO THE HOUSE OF LORDS SELECT COMMITTEE ON ECONOMIC AFFAIRS SUB-COMMITTEE ON THE FINANCE BILL

4. We are delighted to present written evidence to the Sub-Committee on what aspects of the Finance Bill the Sub-Committee could usefully investigate.

WHO WE ARE

5. The Institute of Chartered Accountants is the largest accountancy body in Europe, with more than 123,000 members. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions 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.

ASPECTS OF THE FINANCE BILL WORTHY OF FURTHER INVESTIGATION

VAT evasion provisions (Clauses 17 and 18)

6. The Committee should consider whether these clauses achieve a proper balance between combating evasion and imposing properly targeted measures on businesses that are not burdensome and unfair. We believe that combating VAT evasion is a laudable aim but we also believe the current proposals are an inappropriate response and may be in contravention of the Human Rights Act 1998.
7. Clause 17 enables Customs to require security from a business where Customs and Excise suspects VAT evasion on supplies made by or to that business. However, the clause is widely drafted and does not appear to provide the safeguard that it will be triggered only after a warning (see Budget Notice 14/03). We are concerned as to how a duty of confidentiality towards the suspected evader can be squared with warning the innocent customer. We are also concerned

as to whether this clause is compatible with Human Rights legislation. The person who Customs think is likely to evade tax does not have to be told that his customers are being 'warned off' by Customs and. if he finds out, he has no right of appeal even though the effect of such warnings is likely to put him out of business.

8. Clause 18 allows Customs to impose joint and several liability for VAT on everyone within a supply chain, provided that the trader it seeks to make liable "had reasonable grounds to suspect" that some or all of the VAT… would go unpaid." We are concerned at the wide ranging nature of this provision which may catch ordinary commercial transactions. For example, Mr A believes that Mr B overpaid for goods and Mr A can now buy them back from him cheaply because this has placed Mr B in financial difficulties. Under this provision, Mr A could be made liable for Mr B's VAT if Mr B is forced into insolvency. There does not need to be the slightest hint of evasion. It is sufficient that Mr A suspects that Mr B may become insolvent and not pay his VAT. Is it right that a trader should be liable for the VAT liability of another person in such circumstances? The provision should be targeted more closely at the particular abuse.

IR35 and personal service companies (Clause 135)

9. The Committee should consider why it is now considered necessary to broaden the scope of the IR35 legislation to cover not just payments by businesses for services but any payments for services, thus catching non-business/domestic services. At the time that the IR35 rules were introduced, the Revenue stressed that they did not apply to very small businesses such as builders and plumbers providing services only to householders. It is questionable whether legislation should be introduced on the back of such assurances and then amended a couple of years later to remove them. Parliament might have taken a different view of the original legislation if the assurances had not been given. The Committee should seek evidence that service companies are being used to engage domestic workers in order to save tax and NICs.

Definition of a permanent establishment (Clause 147 et seq)

10. The Committee should question why the long established concept of a branch is to be replaced by that of a "permanent establishment", which is a far broader term than a branch. The change takes effect from 1 January 2003 (see clause 150(5)), so it is being introduced with retrospective effect. We do not see that the change is so important that it justifies the comparatively rare decision to make an increase in tax burden retrospective.

11. The Treasury Explanatory Notes indicate that the definition in clause 147 is in line with that used in the UK's double tax agreements. This is not correct in relation to clause 147(2)(h) which deems a building site to be a permanent establishment. Under most of the UK's double tax agreements, that only applies where the site lasts for either six, or in some cases, twelve months. Under clause 147(2)(h), an overseas company which buys a piece of land, starts to build a road on it, and immediately sells it, is likely to have a UK permanent establishment if it is based in a country with which the UK does not have a double tax agreement (although in most cases the UK domestic law will be overridden by our very extensive range of double tax agreements). Why does UK law not follow the established norm?

Foster carers (Clause 175)

12. The Committee should consider whether it is justifiable to introduce over nine pages of legislation to provide a limited income relief for foster carers. The benefits given to society by those willing to foster children, together with the fact that the receipt will always come from a Local Authority or approved agency, tend towards the preferred solution of exempting such income from tax altogether. This will align the treatment of such receipts with the tax exemption for payments on adoption. Does the tax yield from this justify either the extensive legislation or the costs of calculating the taxable amount?

Controlled Foreign Companies (Clause 197 and Schedule 42)

13. This clause and schedule extend the Controlled Foreign Company provisions to payment protection companies. Does the outcome justify the complexity of the new provisions, introducing a new test of persons who are "habitually resident" in the UK (as a source of tainted income in respect of payment protection premiums)? Insofar as the payment protection companies are, for example, Irish IFSCs or 10% companies, this is yet another example (compounded by the removal of Ireland from the Excluded Countries Regulations) of the UK Government apparently ignoring the EU treaty and ECJ case law by targeting the establishment of payment protection businesses in another, lower tax, Member State.

Mandatory electronic payment (Clauses 201 and 202)

14. The wide ranging powers that these clauses give for legislation by Regulation gives considerable cause for alarm, as does much of the detail.

Stamp Duty Land Tax (Clauses 42 to 129 and Schedules 3 to 20 inclusive)

15. Our initial review of this legislation has raised many serious issues which should be dealt with by the Committee. We would like to submit further evidence on this new tax but in the brief space allowed, we can only draw attention to the most fundamental headline concerns.

- The consultation was incomplete since many of the provisions, such as those for reliefs, were not available at that time and have only been made available with the publication of this Bill.
- The Treasury has retained a wide ranging power (Clause 109) to vary the scope of the tax by way of regulation. Any changes to the scope should be included in a future Finance Bill and fully debated in Parliament and not delegated to secondary legislation.
- The original objectives of modernisation were stated as “fairness and e business.” There was no expressed intention to increase the yield by imposing a new tax, but this is likely to be the impact of these provisions.
- We regret the need to retain the existing volume of Stamp Duty legislation, none of which is to be repealed. As a result, Stamp Duty on land will remain for many decades to come.
- Although the clauses on contingent and deferred consideration are well thought through, the tax would have been simplified if it had been based on the receipt of consideration rather than as a tax on contract.
- The new duty will be chargeable on VAT. We think this is wrong in principle.

FOLLOW-UP

16. We would be happy to provide the Sub-Committee with further evidence on the above points, either in writing or orally. As noted, we would like to submit evidence on Stamp Duty Land Tax.

FURTHER WRITTEN EVIDENCE FROM THE TAX FACULTY OF ICAEW TO THE HOUSE OF LORDS SELECT COMMITTEE ON ECONOMIC AFFAIRS SUB-COMMITTEE ON THE FINANCE BILL CONTAINING SUGGESTIONS AS TO HOW CAROUSEL FRAUD COULD BE CONTAINED

Clauses 17 & 18 to the Finance Bill 2003

Requirement to Provide Security/Joint & Several Liability

17. In our paper to the Committee dated 28 April 2003, we set out our concerns that Clauses 17 & 18 were not acceptable as they are too wide-ranging, contain insufficient safeguards, and are therefore generally open to challenge in law. We provided more detail in our formal representations to the Chancellor of the Exchequer on the Finance Bill (TAXREP 14/03), also sent to the Committee.

18. We gave oral evidence to the Committee on Wednesday 14 May 2003. This paper is in response to the request by the Chairman of the Committee (Lord Peston) to provide the Committee with more precise suggestions as to how carousel fraud could be countered. We accept that there is no simple solution to counter such fraud,. However, we believe that there are steps that can be taken to counter such fraud which do not penalise the innocent and which do not impose unreasonable burdens on businesses or on Customs and Excise. We have set our suggestions in Section A.

19. In Section B we set out our further views on the protection of legitimate businesses from the effects of these clauses (Questions 10 and 11 of the Committee's Questions for Accountants and Legal Witnesses.)

20. In respect of the burdens placed on legitimate businesses, Clauses 17 & 18 place such heavy and wide-ranging burdens on legitimate businesses that we consider that all of our suggested approaches merit detailed consideration. All of the approaches will impose some additional administration burdens on businesses, and some impose additional administration burdens on Customs.

ANTI-FRAUD MEASURES

Removing the VAT charge

21. The 'VAT-free' cross-border supply of goods arises from the refusal of Member States to agree to alternative methods of charging VAT proposed by the European Commission. The opportunity for carousel fraud stems mainly from such VAT-free supplies as the fraudster then sells (ostensibly) plus VAT but does not then pay the VAT over to Customs and Excise. One approach to reduce this fraud is to

remove the VAT charges in the supply chain until such time as it reaches a non-VAT registered consumer. Two ways of achieving this result are as follows.

Reverse charge along the supply chain

22. To impose a 'reverse charge' procedure along the supply chain between VAT registered businesses (i.e. until the supply to the final consumer). This would mean that a business would not charge VAT to another VAT-registered business. The customer business would instead charge itself VAT, which it could deduct in the same VAT Return period. The system is already used for certain services received from abroad and, as we have stated above, for intra-EC supplies of goods. It is also used, on security grounds, for domestic supplies by non-resident businesses to resident businesses in Austria, the Netherlands, Spain and Sweden. A further advantage of this proposal is that the supplier could be required to quote the VAT registration number of the customer, thus providing a more secure audit trail.

23. Whilst this proposal would reduce the scope for charging VAT along the supply chain, it would not stop the fraudster selling the goods to private individuals/non VAT-registered businesses in the domestic market and pocketing any VAT. However, selling into the domestic market is unlikely to be viable given that these carousels trade in transactions where the underlying subject matter consists of many individual items bundled up into one transaction.

'Black box' or terminal market

24. The existing VAT rules allow in certain circumstances for no VAT to be charged on transactions between members of certain defined terminal markets. A terminal market arrangement could be established for those dealing in the particular goods subject to carousel trading. The members of this terminal market would all require to be approved in advance by Customs & Excise. We accept that, unlike existing terminal markets, the number of businesses involved may make this difficult to operate. In addition, because fraudsters are unlikely to be approved, they would still be free to charge VAT on their supplies and then disappear. However, a major advantage of a terminal market arrangement is that it enables bona fide businesses to be identified. This will then allow Customs to target their resources on those committing the fraud.

Earlier identification of fraud

Monthly or shorter VAT Return periods

25. Businesses in risk sectors could be required to file VAT Returns and payments monthly or even shorter periods. For example, Russia had a 10-day VAT Return and payment period in the early 1990s to protect the state from high inflation.

Copies of purchase and sales invoices

26. Businesses in risk sectors would be required to provide Customs with copies of their purchase and sales invoices when they submit VAT Returns. (If electronic invoicing were compulsory, daily electronic reporting of transactions could be required, providing Customs with up to date intelligence.). Customs already require this as a control measure with the first VAT Return from non-UK businesses, and it has also been used more extensively in the Netherlands.

Reporting of unusually large transactions

27. Requirement for traders in risk sectors to report unusually large transactions (as, for example, under the Money Laundering rules).

Approved turnover and/or input tax recovery limits

28. Customs to set approved turnover and/or input tax recovery limits for each business in the risk sectors. Thus, for example, a business with a normal annual turnover of £500,000 could be given a limit of £800,000. Business would have to apply in advance for permission to exceed the limit. Customs would need to respond quickly so as not to hamper legitimate business activity.

Protection of Payment

Direct payment

29. Purchasers to pay the VAT charged on an invoice directly to C&E, as currently required by the 'gold scheme'.

Secure payment by special bank accounts

30. A variation of 3.1 above, used for construction industry PAYE/NIC in the Netherlands, requires the purchaser to pay the VAT on an invoice into a specially-denominated bank account held in the name of the supplier, but under the joint control of the supplier and the tax administration. The money in that account can only be used to pay tax, unless the tax administration authorise the bank to release all (or usually part) of it back to the supplier.

ADEQUACY OF ADMINISTRATIVE SAFEGUARDS

General Comments

31. We consider that administrative safeguards are always insufficient. They are not legally binding, can be changed with no further parliamentary scrutiny, and do not need to be followed in particular cases if Customs decide otherwise. Whilst Customs could then perhaps be challenged by judicial review, the cost would deter all but the largest businesses.

32. It is clear that Customs intend to use these new powers widely. In an article in The Tax Journal of 28 April 2003, the Head of Fiscal Fraud Policy at Customs & Excise estimated that some 2,000 businesses would be affected by the guarantee/security provisions, and 20,000 businesses would need to introduce or strengthen their checking systems for the joint and several liability requirements. As Customs state on page 12 of their VAT Strategy: Joint & several liability, Consultation on reasonable checks, published in April 2003:

> **"How will Customs apply the measure?**
>
> Customs will send you a Notification Letter:
>
> - if you have bought and/or sold the specified goods; and
> - Customs believe that the transactions carried out through a particular supplier were traded within a supply chain where VAT would go unpaid.

> The purpose of this Notification Letter is to inform you that Customs consider you may be jointly and severally liable for the unpaid net tax. It will give you the opportunity to demonstrate that you have a legitimate reason for the low purchase price of the goods, or if there are other factors which you feel Customs should consider.
>
> A Notification Letter will be sent to each known trader in the chain of supply. If after a period of 21 days a legitimate reason has not been demonstrated, a Demand Notice will be issued for the unpaid net tax."

All businesses in the supply chain can therefore expect to receive the Notification.

33. Customs' Consultation paper lists possible reasonable checks which a business could carry out on its immediate supplier and customer, but is silent on what checks could be carried out further up and down the supply chain. This is perhaps not surprising, as it is difficult to see what checks could in fact be done, even though clause 18 holds taxpayers equally at risk from these remoter businesses.

34. Customs' history in introducing and applying such provisions does not provide reassurance. We referred when giving evidence to the early years of the civil penalty legislation (1985-1990) where there were many instances of judicial criticism before the law was changed and the penalties reduced. The method of introducing and applying the three year cap in 1997 has similarly been criticised by the judiciary, with the European Court of Justice deciding in 2002 that the UK law was 'incompatible with the principles of effectiveness and the protection of legitimate expectations'. (Marks & Spencer, Case C-62/00, ECR 2002, I-06325)

35. More recently, the Finance & Tax Tribunals in decisions reported in 2003 have found against Customs in a significant number of post-Hoverspeed decisions. The Hoverspeed cases concerned cross-channel shopping for tobacco and alcohol. In July 2002 the High Court ([2002] 4 All ER 912) decided that the procedures adopted by Customs in checking and detaining passengers arriving in Dover, and seizing goods and vehicles were unlawful. The UK law was subsequently changed. Customs appealed on some minor aspects, and were partly successful in a judgment of the Court of Appeal on 10 December 2002. What is significant here is not that Customs did not succeed – a tax administration will inevitably both win and lose cases – but the comments of the various Chairmen on Customs' actions. We give four examples below. The full texts of these Decisions and other cases are available from the Tribunal and selected cases are on the Court Service web site (www.courtservice.gov.uk). The amendments in square brackets are ours, inserted for clarification.

    - It is a fact that most [Customs'] reviews coming before the Tribunal are defective in law.

      (E00372, *Creamer*, para 9)

- It was [the Customs officer's] function to consider all the circumstances and to come to her own decision on the facts which were in the possession of the Commissioners. The review letter shows that she did not do that. What she did was .... to apply the Commissioners' policy....

(E00374, *Hacon*, para 18)

- I considered imposing a penalty [on Customs] for non-compliance with the original direction and would have done so if there had been no costs to award. This is not an isolated case, being one of eighteen similar cases listed before me on 12 and 13 February for non-compliance. It seems clear that the number of officers employed by the Commissioners to carry out reviews .... is wholly inadequate. In a number of other cases I have imposed penalties on the Commissioners, however I do not do so in this case. It will be another matter if the Commissioners do not comply with the new deadline.

(E00386, Kett, para 27)

- We see the sense and justice in declaring [Custom's] decision to be unreasonable and, as just stated, we do so. However we see little point in giving directions to the Commissioners for the future except to say that they should observe the law properly (and, we might add, instruct its officials to cease behaving in a bullying and intimidatory way).

E00387, *Dickinson*, para 34

These were excise appeals where there were some, but not full, judicial safeguards, and we could cite many other examples. We are therefore concerned that internal safeguards will prove insufficient.

Further Protection for the taxpayer

36. We consider that the following further legal safeguards should be introduced as a minimum.

- No taxpayer should be required to provide security for the actions of a third party unless collusion in fraudulent activity can be shown.

- No taxpayer should be held jointly and severally liable for the VAT debts of a third party unless collusion in fraudulent activity can be shown.

- On appeal to the Tribunals, a taxpayer should be able to put forward an unrestricted 'reasonable excuse' defence.

37. The financial and operational consequences to a business of both clause are severe and could force it to cease trading. In addition, where (under clause 17) security for a third party is required, any business continuing to trade is liable to a criminal penalty of £5,000 for each supply (sale) that it makes whilst no guarantee is in place. Since time will be of the essence, and Customs will already have all the necessary information, we suggest that any appeal should be heard by the Tribunals within 14 days of the date on which it was made unless the taxpayer requests otherwise. The normal waiting period is several months, but delays of that length will render many appeals otiose as the business will have had to cease trading.

38. Consideration could also be given to requiring Customs to obtain the consent of a Tribunal Chairman before they could require a business to provide security for a third party or hold them liable under the joint and several liability provisions. Customs could make the applications on an ex parte basis, and would need to demonstrate that the business involved was involved or complicit in the fraud.

39. Please let us know if you need any further clarification.

FH
18.6.03