Tax Faculty

Tax Representation

TAXREP 26/04

VAT: DISCLOSURE OF AVOIDANCE SCHEMES

Memorandum submitted in June 2004 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to invitations in May 2004 from Customs to comment on two draft statutory instruments

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INTRODUCTION

1. We welcome the opportunity to comment on the draft Regulations and Order published respectively on 13 and 28 May on Customs' website at http://www.hmce.gov.uk/forms/budgetnotices/finance-bill-2004.htm.

KEY POINT SUMMARY

2. Our main concerns are:
   - The proposed legislation as it stands is insufficiently targeted. Customs have not produced any definition of what constitutes a tax advantage. The definitions in the legislation are so widely drawn that anything which does not maximise the VAT cost to business can be a tax advantage. This is likely to lead to defensive reporting by businesses.
   - Parliamentary scrutiny and supervision of these provisions is reduced by the use of secondary and even tertiary legislation to define major concepts.
   - There is considerable doubt whether the provisions comply with European law, and therefore whether they are lawful.
   - The draft statutory instruments are not easy to understand. Given that the regime is intended to be operated by businessmen rather than professional advisers, the legislation should be readily understandable and self contained.

   The Government should undertake to carry out a review on the first anniversary of the new regime.

WHO WE ARE

3. 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.

4. The 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, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

5. 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.

GENERAL COMMENTS

6. We submitted comments on 30 April to the Chancellor on the Finance Bill (published as TAXREP 19/04, see http://www.icaew.co.uk/taxfac/index.cfm?AUB=TB2I_64552,MNXI_64552) which were referred to in the Standing Committee debates on 6 and 11 May and we have given evidence to the House of Lords Economic Affairs Committee Finance Bill Sub-committee.

7. In our Finance Bill representations we set out how the Bill breaches our Ten Tenets for a Better Tax System. The Ten Tenets are reproduced again in the Annex. The draft statutory instruments fail seven of the Ten Tenets on a number of counts:
   - Statutory: many key definitions are being left to guidance in the form of, for example, Customs' Notices;
   - Certainty: the absence of certainty means that, in order to 'play safe' businesses are likely to notify transactions which are technically sound;
   - Simplicity: the SIs are not easy to understand;
   - Properly targeted: the likelihood of protective reporting indicates that the proposals are anything but properly targeted;
   - Subject to proper consultation: the unnecessary haste in which the legislation is being made and the absence of draft guidance has precluded meaningful consultation;
   - Fair and reasonable: the requirements will place a large burden on businesses;
   - Competitive: overseas businessmen are likely to perceive the UK as a less attractive place than hitherto in which to conduct business.

8. The Finance Bill and the draft secondary legislation are still a long way away from a targeted measure limited to reporting what everyone would recognise as unacceptable avoidance schemes. The provisions therefore create significant compliance costs for a large number of businesses, the vast majority of whom are not involved in tax avoidance within any normal meaning of that term.

9. The extension of the VAT reporting provisions so far beyond their original stated intention is even more surprising, given that the Inland Revenue have now tailored the reporting requirements for direct tax to be much more specific (see the Inland Revenue Press Release of 22 June 2004). We consider it unfortunate that the two branches of the tax administration are taking opposite courses on the same issue.

10. On the VAT provisions, no-one knows for example how Customs and then the courts will define or refine the terms 'tax advantage' or 'main purpose or one of its main purposes'. Rather than second guess the future, and how Customs will decide to interpret the law, businesses will decide that they need to disclose normal commercial transactions where there is no tax avoidance. Prudent businesses take tax into account when making normal commercial decisions. Others may not want to spend time seeing if there is a 'more expensive' VAT route which they could have taken, thus making their chosen route one creating a 'tax advantage'.

11. In addition, and we made the point last year as well, Customs have not always had a happy history of acting reasonably when using their extensive powers: there are too many published examples where this has not been the case. Whether or not Customs will act reasonably with these provisions is of course not yet known, but businesses, knowing the past, may be reluctant to take the risk. That too will lead to unnecessary

reporting. One of our members who works for a large commercial group has already been told by the Customs officer responsible for the group's VAT affairs that he 'will be taking a very wide-reaching view' of the disclosure requirements.

12. Both statutory instruments will take effect from 1 August 2004, with the Parliamentary debates in October. Moreover, in referring to 'Notification … in such form and manner as the Commissioners require', the draft VAT (Disclosure of Avoidance Schemes) Regulations 2004 appear to contemplate tertiary legislation, which will presumably be the Notice that Customs have undertaken to publish. Such far-reaching provisions as these should be debated in Parliament before coming into effect. Whilst the ex post facto debate in October on the secondary legislation will provide an opportunity for a measure of Parliamentary consideration, a process that involves debates on far-reaching legislation that has come into effect over two months earlier casts doubt on the Government's commitment to proper scrutiny of legislation. Even that measure of Parliamentary review is denied in the case of the provisions in Customs' Notice.

13. The statutory instruments are not easy to understand. The Order contains frequent cross references to the VAT Act and other legislation, which is not helpful when one considers that this regime is intended to be operated by businessmen, for example financial controllers and accounts managers, rather than professional advisers. The law in this case should be self contained and simple for the non-specialist to understand. It may well be that this will be covered in the Explanatory Note to the statutory instrument, which is presently blank, or in the Notice. However, such a Note is not part of the Order, cannot be relied on as a complete list of what is intended and has no effect before the tribunal or court.

14. As noted above, Customs have also undertaken to publish further guidance in a public Notice. The difficulty with this is that, in common with the Explanatory Note, it is not law, albeit some part of it may have the force of law, and Customs can change their guidance at any time. Since the cost to business of disclosing is the compliance cost, and the cost of not disclosing will be a substantial penalty, most businesses will play safe and notify normal commercial transactions which could be caught by the Finance Bill and the draft statutory instruments.

15. We consider that the provisions are in breach of European Law, both as regards the specific requirements of the Sixth VAT Directive, in particular Article 22(8), and more generally as regards issues such as proportionality (for example, when considering the penalties) and non-discrimination (for example, where a transaction reduces UK VAT but increases non-UK VAT). We gave a similar warning last year in our comments on the joint and several liability provisions for missing trader fraud. Whilst Customs at the time gave public assurances that this was not the case, we note that the High Court did not agree and in February 2004 referred these questions to the European Court of Justice. We expect a similar reference to the European Court of Justice on these provisions.

16. These measures have given rise to uncertainty and will undoubtedly generate a large number of notifications, appeals and litigation. We consider that the Government should undertake a review of how the provisions are working at around the first anniversary of the regime coming into force. Such a review should include taking

evidence from both Customs and the private sector and the evidence and conclusions should be published, with a view to reform if necessary.

17. The consultation period for the statutory instruments is about half the twelve weeks recommended in the Government's code of practice on consultations. Given the length of time that Customs' campaign against avoidance has been running, draft statutory instruments and guidance should have been available for public comment when the Finance Bill was published and consultation on both carried out in accordance with the Code of Practice. We also understand that there will be approximately one week in early July in which to comment on the draft VAT Notice. These very short consultation periods make it extremely difficult for us and others to comment properly, and bring the consultation process into disrepute.

18. The start date for the regime is intended to be 1 August. As the legislation is deficient and everybody is uncertain about what they should do, traders should not be expected to have to comply until there has been proper consultation on draft guidance and once a Notice has been published, traders have been sent the VAT Notes which refer to it.

DETAILED COMMENTS

The Value Added Tax (Disclosure of Avoidance Schemes) Order 2004

Schedule 1 – Designated schemes

19. This lists designated schemes or transactions which **must** be reported by any business with a turnover of over £600,000 per year. Since these are specific schemes, the trader will have to report them to Customs whether or not they were carried out with any intention of reducing his tax liability, and indeed, whether or not his tax liability is in fact reduced. Taking two examples:

Example 1: Item 4 – Leaseback arrangements

20. A manufacturing company ('A') buys some plant and machinery for its own use. It then decides for financial reasons to sell the plant to a third party leasing company and to lease them back. It has reclaimed all the VAT on the original cost, charged VAT on the resale to the leasing company, and will be charged VAT on the lease rental payments. If A receives bank interest or sells a motor car, or makes any other, totally unrelated, exempt supply, it will be caught and have to notify. No tax avoidance or tax saving is involved, but it still has to be notified.

Example 2: Item 5 - Value shifting

21. This will require a large range of retail promotions to be notified, since it applies whenever a retailer sells goods or services and includes linked zero-rated or exempt goods or services 'free of charge'. It would apply to:
- a supermarket giving a 'free' jar of coffee with every crate of mineral water sold (the jar of coffee is zero-rated, the mineral water standard rated (17.5%));
- a newsagent/bookshop offers a free 'book of the film' with every DVD sold (books are zero-rated, DVDs or videos are standard-rated); and
- a car hire company offers 'free insurance' with every car hired for a weekend.

22. It is not difficult to think of numerous other everyday retail promotions which would be caught: all that is required is that the linked 'free' goods or services are either zero-

rated or exempt. The correct VAT treatment of linked business promotion schemes (requiring an apportionment where both standard and zero-rated supplies are involved) is already set out in Customs Notice 700/7/02. Businesses therefore know how they have to account for the VAT. But now they will be required to make a separate notification as well.

Schedule 2 – Included or associated provisions associated with schemes

23. These are the 'hallmarks of tax avoidance' which have been referred to by Customs in their press releases etc. Every business with a turnover of over £10 million pa will be required to notify Customs if:
- the main purpose, or one of the main purposes of the scheme is that a tax advantage is obtained by any person – ie less tax is paid than 'would otherwise be the case' (paras 2 & 4, Sch 11A), and
- the transaction includes, or is associated with, one of the 'provisions associated with schemes' listed in Schedule 2 of the SI (paras 4 & 5, Sch 11A).

24. Once again, these will have a wide application, particularly since, as we have analysed in our Finance Bill representations TAXREP 19/04 at paras 84-88, tax advantage is defined as anything that does not maximise the VAT cost to the business. The three illustrations below explain the point.

Illustration 1: Confidentiality conditions

25. The intention here presumably is to require disclosure where the promoter of a tax scheme requires the taxpayer not to disclose the details to third parties. But that is not what the draft Order says, as it covers all agreements. Most normal commercial agreements contain a confidentiality clause. It would therefore mean that all of these bore a 'hallmark of tax avoidance'. For example, take a simple agreement between unconnected third parties dealing at arm's length. A previously bought goods for resale from B. However, he is offered more attractive terms by C, so enters into a normal commercial contract with C. If C has different quarterly VAT return periods from B, then A will be caught by the tax advantage definition in para 2(2), Sch 11A.

26. A is unlikely to know what C's VAT accounting periods are, and whether by buying from C the period between A's recovery of the input tax and C's accounting for the output tax will be lesser or greater than when A dealt with B. A will also not know whether C will gain a tax advantage because the invoicing or payment terms under the contract are more favourable than they were with a previous customer of C. A will therefore be uncertain whether he fails Test 1. If the agreement contains a standard commercial confidentiality clause, A will know that he has failed Test 2. A then has 2 options: he can either try to find out from B and C what are their VAT return periods, but either or both may refuse to tell him and he cannot compel them to do so, or he can notify Customs. A is likely to notify.

Illustration 2: Contingent fees

27. These are not limited to tax 'schemes'. When a business or organisation does not have the staff or expertise to check all its purchase invoices in order to claim VAT element, it is common to engage a firm of accountants or tax advisers to do this, and the fee is often set as a percentage of the additional VAT claimed. Typical examples are local authorities and NHS trusts with their expenditure generally, or normal

commercial businesses with employee expense claims. None of this has anything remotely to do with tax avoidance, but both tests appear to have been failed, so the trader will need to report.

Illustration 3: Funding by share subscriptions or loans

28. Any company forming a subsidiary will fund it by share capital, and frequently with a loan. All companies in the group are connected persons for the purposes of this legislation, and the Order does not specify how the use of the funds from the share capital or loan are to be allocated. At least at the beginning, all transactions between any group company and the new subsidiary will be caught by this hallmark. It will then be necessary for the two group companies concerned to investigate whether there is a tax advantage, which, as we have said, catches very many normal commercial transactions. If there is a more 'expensive' VAT route, whether in timing or absolute terms, then any prudent business will notify.

The Value Added Tax (Disclosure of Avoidance Schemes) Regulations 2004

29. Draft Regulation 3 says that the form and manner in which notifications shall be made will be 'as the Commissioners require'. We are concerned that important legislation is being devolved from the Finance Bill to secondary legislation; our concern is exacerbated as the secondary legislation devolves it to tertiary legislation which will presumably be in the form of a Customs Notice. This is contrary to our understanding that Government wished the majority of the legislation on disclosure to be contained in primary legislation.

30. Given that essential features of the new regime are being introduced by way of Customs' guidance, traders should not have to comply until they have received the VAT notes announcing publication of the relevant Notice. The coming into force of the Regulations, presently stated in Regulation 1 as 1 August, should therefore be delayed.

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ANNEX

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.