Tax Representation

Tax Faculty

TAXREP 11/06

VAT: SCHEDULE 10 – BUILDINGS AND LAND: REWRITE OF EXISTING TAX LAW

Memorandum submitted in February 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to an invitation to comment issued in December 2006 by HM Revenue and Customs

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INTRODUCTION

1. We welcome the opportunity to comment on the consultation document published on 5 December 2005 by HMRC at http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_024838.

2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

KEY POINT SUMMARY

3. We welcome the rewriting of this complicated legislation to put it into plainer English, and consider that within the constraints of keeping policy unchanged and subject to improving the signposting and detailed points arising, the overall result is commendable.

4. However it would be appropriate to first consider the policy behind the law, including whether to adopt a purposive approach as in the European Law on which it is based.

5. We welcome relaxation of the rigid terms that apply to treating elections as valid where permission is not obtained in time, but feel that a more even balance needs to be struck between easing matters for a landlord who has not followed the letter of the law and tenants who will suffer financially if the law is not applied correctly.

GENERAL COMMENTS

Introduction

6. HMRC have announced a consultation on the rewrite of VATA 1994, Schedule 10, paras 1-3A and 9 excluding paras 2(4)-(9) and 5-7 which are to be repealed and para 8 which is dealt with in the consultation 'VAT: Beneficial Ownership of Land and Property' published on 5 December and which we are responding to in TAXREP 12/06 of even date. In the introduction to the consultation document, HMRC make it clear that this consultation is not aimed at changing any VAT law – its sole purpose is to simplify the structure and language without changing VAT policy.

The language of the rewrite

7. We welcome HMRC's proposal to rewrite this legislation. The language and layout of the proposed new law is clearer than the existing. We would suggest however that the signposting could be improved.

8. By way of explanation, the rewrite breaks everything down into smaller chunks, which is helpful. However, breaking things down does not necessarily make the law more understandable without more. There are a number of areas in the rewrite where there is a statement in the first paragraph dealing with a concept but the user of the legislation then has to read through several other paragraphs before the first paragraph makes sense. The need for better signposting is declared but the draft legislation provides signposting only at the beginning, whereas given the complexity of this topic signposting is needed at the beginning of each major concept. The absence of signposting may well mean that the rewrite is likely to make sense only if a user has knowledge of property law.

Policy

9. Since its inception we have supported and continue to be heavily involved with the Tax Law Rewrite Project for direct tax and as part of our active representation on the Steering and Consultative Committees we have responded to most of the exposure drafts published by the project team. We have always thought it a matter of regret that the terms of reference of the Tax Law Rewrite do not allow for not only simplifying the language of the law but also considering policy with a view to creating a tax system fit for, now, the 21st century and which complies with our ten tenets for a better tax system (in Annex B).

10. Given that this consultation on Schedule 10 is not constrained by the same terms of reference as the Tax Law Rewrite project, we are disappointed that HMRC have not taken the opportunity to go further. Unless a holistic approach is taken, anomalies will arise. There is a need to consider the legislation dealing with property as a whole. A prerequisite to this would be to have a proper consideration of the policy in relation to land and buildings.

11. In limiting this consultation to structure and language, the consultation discourages comment on the inherent complexity of the law that is brought about by the means adopted to counter what is now perceived as tax avoidance but which, when introduced in 1989, was not in fact so perceived.

12. The consultation document also indicates that there was a deliberate policy of avoiding a purposive approach. It is difficult to see how this can further a clearer understanding of the law. To the extent that Schedule 10 engages European Law, a purposive approach is inherent in the law. Failure to take this into account could lead to a subsequent interpretation that was not intended.

13. Because of the restrictions placed on the consultation, it is not appropriate to comment in detail on how a more wide-ranging approach would facilitate simplification. It is nevertheless appropriate to point out much of the complexity is a result of the policy that the consultation document says it is intended to maintain.

14. Our comments in this memorandum should be read subject to this caveat.

How the rewrite has been planned

15. The rewrite does three main things:
- It removes extraneous and no longer effective legislation;
- It reorders the legislation;
- It uses different language structure to that traditionally associated with tax law and particularly VAT law which has not yet seen any benefit of the tax law rewrite project.

16. In addition, despite the disclaimer of any intention to change the substance of the law, there are in fact some changes in law and policy. Because the substance is more important than the mechanisms used, comment below is given first on the substance changes with the three points mentioned in the preceding paragraph being covered as necessary in the specific comments on the draft legislation.

CHANGES IN SUBSTANCE

17. These changes are mentioned in summary at paragraphs 24(b) and (c) of the consultation document. We deal with each separately below.

Intended for use (condoc para 24(b)(i); rewritten legislation para 4(i) & 5)

18. It is difficult to see what other use than use by the recipient could have been intended by the original legislation but we agree with the policy of putting the interpretation beyond doubt.

Almost mainly for eligible purposes (condoc para 24(b)(ii); rewritten legislation para 13(2)(b))

19. The addition of the word 'almost' does not add any clarity to the clause. When the legislation was first drafted, it included specific mention of the 80%. This was withdrawn and the wholly or mainly rule substituted. Since then although HMRC have taken the view that an 80% test was intended, there has always been some doubt. That doubt is not resolved by the current change.

20. The use of the term almost mainly suggests that some flexibility is intended and indeed it would seem logical to allow for the situation where a lesser percentage than 80% might be accepted particularly where there is clearly no avoidance when the transaction is seen as a whole.

21. A better approach might be to retain the current definition and simply have a 'safe harbour' clause which says that a percentage of 80% will be taken as fulfilling the condition but leaving it open for a lower percentage to be adopted in appropriate circumstances subject to any discretion and review.

22. This would retain the power of the provision to prevent avoidance while allowing business facilitation.

Right of appeal against refusal of permission to opt (condoc para 24(c)(i); s.83 VATA 1994 not yet rewritten)

23. In general terms, all decisions of the Commissioners should be subject to the scrutiny of the VAT and Duties Tribunal and section 83 should be rewritten accordingly. However, whilst we have made this point many times over the years, it is a matter outside the scope of this consultation. Within the terms of this consultation we welcome the provision of a specific right of appeal against refusal of permission to opt.

Formal requirements required to make election (condoc para 24(c)(ii); rewritten legislation para 21)

24. There can be no objection to legislation requiring a standard format for applications. However, as with all formal requirements, the very implementation of such requirements can impose excessive burdens on taxpayers.

25. Paragraph 21 should contain a specific provision requiring that the requirements be only those as may be reasonably specified by the Commissioners in a Public Notice to that effect.

Treating an election as valid where permission not obtained in time (condoc para 24(c)(iii); rewritten legislation para 23)

26. This is a welcome change to the rather rigid terms that previously applied, but this is subject to the comments in the section after next regarding the tenant's position. Leaving that aside, given the effect of this policy change, a question arises as to whether the same objective might be achieved in a different way.

27. In essence, permission is subject to agreement as to terms and conditions (see new paragraph 20). Those terms concern mainly the fact that there must be a fair and reasonable determination of input tax that is to be deducted in relation to the taxable grants that occur subsequent to the exercise of the grant. There are two issues here, namely:

- Where input tax has previously been blocked, the extent of any adjustment that should take place under the Capital Items scheme (article 20 of the EC Sixth VAT Directive and Part XV of the VAT Regulations 1995);
- Where input tax is incurred subsequently (e.g. on a retention payment), the possibility that some or all of it is properly attributable to the exempt supplies that preceded the option to tax.

28. In general terms, there is little scope for deferring any deduction of VAT. The time when the right to deduct arises and can be exercised is broadly speaking fixed. There is however provision for the deduction to be carried forward and it is this that may allow a simpler scheme that is more in line with the ethos of the Directive and in keeping with the need for business facilitation.

29. In essence, the option to tax should be allowed regardless of whether it relates to fully taxable land or land that has been the subject of pre-option grants. Where an election is made that involves pre-option grants, the grantor should simply be required to specify how the deduction will be made in respect of the two types of deduction mentioned in 18 above.

30. HMRC will then be in a position to:
- Advise the taxpayer whether the method to be used is acceptable;
- Require the taxpayer to advise at the time any tax return is submitted the extent to which input tax claimed in a return exceeds that which would be deductible if their view was adopted; and
- Withhold any credit pending resolution of the dispute.

31. This should not increase administration since it is already the case that the information is required to determine whether permission is given or not. It would be less discriminatory, increase legal certainty and comply more closely with the Directive to allow the option but concentrate on its consequences rather than penalise a business that is perhaps a little too optimistic in its claim for input tax and which then is refused permission to opt.

Date the option takes effect (condoc para 24(c)(iv); rewritten legislation para 22)

32. The alternative outlined in the preceding section would deal with this problem. The taxpayer would exercise his option and make the required notification. The option would take effect on the specified date subject only to the effect on the right to deduct.

33. In the absence of the alternative above, this change is a progressive one which avoids the traps that have been encountered by taxable persons and in particular those taxpayers that have purported to ask for permission to opt and exercised the option even though such a procedure did not comply with the legislation.

34. It is to be repeated that except for those situations where there is an intention to withhold the option to tax – broadly those outlined in paragraph 1(3) of the proposed new Schedule 10, there should e no restriction on the option to tax. Instead, the legislation should concentrate on ensuring that the terms under which permission would have been given, namely that there should be a fair and reasonable attribution of input tax, are enforced.

Treating an election as valid where permission is not obtained in time and date the option takes effect: the tenant's perspective

35. Following on from the previous two sections on retrospective permission to opt, we are concerned that the interests of both landlord and tenant should be protected equally. It seems to us that the provisions are generally landlord centric. For example, if a tenant, who has been charged and has paid VAT (even though he did not want to because he cannot reclaim it) because his lease has no VAT clause (for example because it is an old lease) and then it transpires that landlord needed permission to opt but did not obtain it

correctly, we question whether it is fair that HMRC can override the error on the part of the landlord and allow the landlord's late election to stand, when it might be in the interests of the tenant for the law to have been applied correctly.

36. Likewise, in the case of a revocation (which is actually covered in the 'Future of the Option to Tax' document), HMRC seem to be suggesting that there will be a retrospective power to permit revocation where permission was not sought correctly - so a tenant could be faced with a landlord revoking an option (for example to encourage a bank to enter a lease in respect of a different part of the building) and he therefore having to pay more service charge (the VAT now being irrecoverable in the hands of the landlord who henceforth passes it on to the tenant as part of the service charge). The lease will not protect the tenant (because the draftsman would not have anticipated that an election could be revoked) and the law does not either, because the landlord can do what he likes provided he has the agreement of HMRC, and then, to make matters worse, the landlord can get it wrong (by failing to seek permission when he should) and then get HMRC to correct it for him.

37. Whilst the response of HMRC at the consultative group meeting was that the retrospective permission was discretionary and they would not be unreasonable, we are concerned that the position of the tenant is unlikely to be considered or even put to HMRC until it is too late – and in any event, as the law stands, it is arguably a matter of contract. We consider that it is unfair that the redraft of the law provides no protection in situations like this that the tenant could not have predicted and which are within the landlord's control, and we think that there should be a statutory requirement for HMRC to consider the tenant's position.

SPECIFIC COMMENTS ON THE DRAFT LEGISLATION

38. **Paragraph 1** – The use of the term 'option to tax' rather than 'election to waive exemption' is welcome given that most advisers, their clients and HMRC themselves make use of that term. Nevertheless, it may be appropriate to make the point in the legislation that what is technically happening is a waiver of exemption. This could be achieved by the addition of the words 'and thereby waiving the right to exempt supplies falling within Schedule 9, Group 1'.

39. **Paragraph 4** – This paragraph replicates what is currently in the legislation but a question arises whether a similar situation to that contemplated in VATA 1994, Schedule 8, Group 5, item 1 can arise in relation to a listed building where it is proposed to make an approved alteration to a building and to convert it to a residence and then make zero-rated supplies. It would perhaps also be appropriate to deal in paragraph 4(1) with how the intention is to be evidenced where the property was not previously used as a dwelling but the recipient of the supply intends it to be used as a residence. (See for example *Alison Julia White* (VTD 15388) and *SEH Holdings Limited* [2000] VATDR 324 (VTD 16771) as well as Business Brief 8/01.).

40. **Paragraph 5** – It has never been a problem but how does a charity show that a building will be used for relevant charitable purposes and not as an office if the

building can be used for either purposes? Should there be some measure dealing with this?

41. **Paragraph 6** – Sentences are usually better expressed in positive terms than negative. We suggest that consideration be given to rewording as: 'A caravan is a residential caravan if the occupant is permitted to occupy it throughout the year without any need for permission … .'. However, there is a potentially unresolved EU law point here; see the decision in *Barbara A Ashworth* [1994] VATTR 275 (VTD 12924).

42. **Paragraph 7** – Similar comments apply here to those that apply to paragraph 6 above.

43. **Paragraph 9** – Similar comments apply here as to those relating to paragraph 4 above. Ostensibly the solution that is used for housing associations should apply here too.

44. **Paragraphs 10 to 15** – General comments – This drafting shows that no matter how much effort is put into restructuring the disapplication of the option to tax, the provisions are complex and no amount of amendments to language and structure is likely to help. Thus, if there is an intention truly to simplify these provisions a more purposive approach – which has been rejected – needs to be adopted. The problem is exacerbated by the fact that in reading the legislation, the user has to retain within his mind several complex definitions, namely the meaning of development financier and exempt land (which has two parts and has further definitions within itself…).

45. **Paragraph 10** – Sub-paragraph 2 makes use of the classic circular definition by saying that the exempt land test is met if it is expected that the land will become exempt land. It must surely be better to make this sub-paragraph a signposting paragraph that summarises in a few paragraphs the basics of the provisions.

> 10. The option to tax will not apply to a supply where the grant giving rise to the supply is made by a person (the 'grantor') to a person (the 'grantee') in circumstances where at the time of the grant the grantor or any person financing the development of the land or a person connected with either –
>
> - is also either the grantee or a person connected with the grantee;
> - intends or expects that the land will be used wholly or mainly for purposes other than purposes that will entitle the grantee to a deduction for any input tax under section 26(2) of this Act or a refund of any VAT, which is not input tax, under either section 33 or section 41 of this Act, and

> the land that is the subject of the grant is or is intended or expected to be a capital item.
>
> The following definitions apply for the purposes of interpreting the paragraph above –

Definition	**Paragraph**
'Grant giving rise to the supply'	11
'Person financing the development of the land'	12
'Wholly or mainly'	13
'Capital item'	14

46. This is not intended to be a suggested wording but is merely to illustrate that what is needed is a short paragraph that will tell businesses whether the option to tax may be

disapplied in relation to a particular transaction. The starting point in that respect is whether the recipient of the supply will not be able to recover substantially the whole of the tax on the intended supply. Only if that condition is met is there any need to consider the minutiae of the whole set of definitions.

47. As it stands, apart from the use of the term 'exempt' in paragraph 10 of the draft, there is nothing in that paragraph that gives an inkling to anyone other than someone already aware of the provisions what the key factors are that result in the option to tax being disapplied.

48. **Paragraph 11** – This is a complex definition. There is again resort to negative rather than positive wording (see for example sub-paragraph 11(2)(b) where there is in effect a double negative). Sub-paragraph (3) would appear to be reasonably implied by sub-paragraph (3) and in any event given the overlap in terminology it must surely be possible to merge (2), (3) and (4) into a single simpler statement. Sub-paragraph (6) requires the reader to know what the relevant regulations are. They are not specifically mentioned in contrast to paragraph (7), which is in any event not that easy to read.

49. **Paragraph 12** – This is not as complex as paragraph 11 and is more likely to be understood although it is still long and therefore likely to create some difficulties.

50. **Paragraphs 13 and 14** – These deal with exempt land. If the appropriate signposting is included in paragraph 10, it should be possible to simplify this definition. Splitting a definition into two sections and then including a definition within the second part (paragraph 14) does not make for easy reading.

51. The various transitional situations make the overall result particularly complex. But this is a problem that arises from the history of the provision and cannot easily be overcome.

52. **Paragraph 18** – the reference to case A and case B means that a person has to read the whole provision before understanding whether it may be possible to disapply the option. It would be preferable to have an introduction that reads something like the following:

> '(1) An option to tax any land exercised by any person … which has been in force for a period of –
>
> a) less than three months since the day on which the option first had effect; or
>
> b) more than 20 years since the date when the option first had effect,
>
> may be revoked with the prior permission of the Commissioners if the following conditions are met.'.

53. By ensuring that the key features are identified in the first section, the reader is able to make a decision whether or not the option being considered may be capable of revocation. At all stages in the legislation, it should be assumed that the reader does not know the key terms and needs to be pointed to them.

54. **Paragraphs 20 to 23** – These have already been commented on in more detail above.

55. **Paragraph 27** – We suggest that consideration be given to mentioning Group 6 of Schedule 8 – Protected Buildings. There may be occasions when this is relevant.

56. **Paragraph 28** – As noted in our comments on new paragraph 18, the use of definitions such as condition A and B in sub-paragraph 28(1)(b) are not helpful because they provide no signposting of what is to come. This structure contrasts unfavourably with that in paragraph 29, which summarises the trigger points in the first paragraph.

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ANNEX A

ICAEW AND THE TAX FACULTY: WHO WE ARE

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.

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.

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.

To find our more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at tdtf@icaew.co.uk or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

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.