ICAEW
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TREASURY SELECT COMMITTEE VAT INQUIRY

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ICAEW (Institute of Chartered Accountants in England & Wales) welcomes the opportunity to respond to the VAT Inquiry launched by the Treasury Select Committee on 27 March 2018.

This response of 31 May 2018 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well known names in the tax world, who work across the complete spectrum of tax, both in practice and in business.

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VAT AND THE TAX GAP

What are the root causes of the UK VAT gap and how might they be addressed?

Is government policy-making sufficiently responsive when a weakness in the UK VAT regime is identified?

Are there ways in which HMRC's compliance strategy for VAT could be better targeted to close the VAT gap? Could its resources be deployed more effectively?

Do developments such as the growth of on-line trading or changes in the labour market reflecting modern working practices require a new approach to VAT compliance?

Is HMRC's approach to large, medium-sized and small businesses appropriate for the nature of the risk to the VAT element of the tax base that each sector poses?

In what ways is the tax base in the UK vulnerable to exploitation by those determined to circumvent VAT rules, push boundaries or develop aggressive VAT planning arrangements? How might either the law or HMRC's processes and procedures be improved to reduce that vulnerability?

1. We believe there needs to be a better understanding of the constituent elements of the VAT tax gap before appropriate remedies can be identified.
2. We explain below what is known about the way the VAT tax gap arises based on information from official publications.
3. There is an absence of detailed analysis of the different causes of the VAT tax gap in the HMRC publication *Measuring tax gaps 2017 edition – Tax gap estimates for 2015-16*.
4. In such circumstances it is, therefore, difficult for anyone, including external stakeholders, to put forward practical ways to address the VAT tax gap.
5. We recommend that the Committee asks HMRC for a breakdown of the VAT gap between sectors and different sorts of non-compliant behaviour to get greater clarity on the underlying causes. We are concerned that the underlying numbers may not be sufficiently statistically robust to allow for a more detailed analysis to be published. Without it, however, we are rather working in the dark as to what should be done to address the VAT tax gap.
6. The VAT tax gap for 2016-17 was most recently estimated, on 13 March 2018 at the time of the Spring Budget, to be £12bn which is 9% of the potential full VAT collection amount. The final figure for 2016-17 will be published in the Measuring tax gaps 2018 publication which is expected to appear on 14 June 2018.
7. The most recent HMRC Measuring tax gaps publication, at page 8, shows that VAT accounts for 22% of total tax receipts but for 37% of the total tax gap, which indicates that proportionately more of the potential VAT tax take is being "lost" compared with other taxes. However, there has been a downward trend in the VAT gap from 13.6% in 2005-06 to the current figure of 9% of the VAT potentially collectible.
8. The VAT tax gap calculation is a "top-down" estimate under which independent external data on consumption is used to estimate the tax base from which a theoretical value of VAT is calculated that should be collected. This is then compared with the actual tax collected to arrive at the tax gap.
9. We recommend that the Committee asks HMRC to explain its method of calculation of the VAT tax gap in detail.
10. It has long been thought that there may be errors in the methodology that could in themselves add a significant amount to the VAT tax gap calculation. For example, the existing calculations may assume VAT at 20% for supplies that are in reality zero rated, reduced rated or exempt as a consequence of the complex VAT reliefs. The potential

problem is clearly highlighted by the fact that some foodstuffs are zero-rated whilst others are standard rated. It seems unlikely that such differences are taken into account when estimating the VAT tax gap.

11. Similar difficulties in measuring the expected tax take are likely to be encountered in industries such as construction, financial services and education, to name just a few as a consequence of the way VAT is applied, or not applied, to different supplies.

12. Based on figures from HMRC's Tax Gap report and information published as part of this Committee's Inquiry, the identified elements of the VAT tax gap for 2015-16 of £12.6bn are:

	£bn
Avoidance	0.1
VAT debt	1.6
Missing trader fraud	0.5 to 1.0
Mistakes	3.5
Total	5.7 to 6.2

13. The total comes to less than half of the 2015-16 VAT tax gap of £12.6bn,

14. This highlights the problem with adopting a 'top-down' rather than 'bottom-up' approach to collecting tax gap data. It would be very helpful if HMRC could undertake some further analysis to try and provide a further breakdown of the VAT tax gap figure.

15. The estimated VAT tax gap in 2015-16 at £12.6bn is slightly higher than the 2016-17 figure of £12bn..

16. Some element of the tax gap are likely to be down to traders operating in the black economy and either not reporting turnover or suppressing true takings eg where building and domestic services are undertaken for cash.

17. There is also an increasing problem of traders evading their VAT obligations when selling on on-line platforms goods which are then imported into the UK without payment of import VAT due, etc.

18. The figure in the above table for mistakes comes from the Treasury Select Committee's "Scope of the inquiry" which, under the heading "VAT and business", states

> "In 2015-16 over £3.5bn was lost due to mistakes in VAT returns according to HMRC figures".

19. As to the reasons behind taxpayer mistakes this could be due to administrative errors eg manual errors due to duplicate postings or omissions; alternatively the reasons may lie in the complexity of the VAT system. Further investigation as to the causes is needed.

20. We believe that the VAT system is now more complex than it needs to be and the guidance to taxpayers is not always as good as it should be. The problem of complexity is most acute in certain sectors, such as financial services, real estate, international business, travel and tourism and in those sectors which must distinguish between business and non-business apportionment of costs.

21. We believe that the amount lost due to mistakes could be significantly reduced by simplification of VAT law.

What role do advisers play in encouraging or facilitating aggressive VAT planning arrangements? Do businesses, tax advisers and professional bodies have concerns about the nature of the advice given by some practitioners?

22. The final question in the VAT tax gap section asks about the role of advisers in encouraging and facilitating aggressive VAT planning arrangements. The ECJ case of Halifax was handed down well over 10 years ago and established that the courts could strike down abusive schemes under the 'abuse of rights' principle enshrined in VAT law. The appetite for aggressive VAT tax planning has long-since expired, as evidenced by the 'handful' of VAT Disclosures and the fact that the VAT tax gap due to avoidance is just £0.1 bn.

23. The experience of our members is that they are not involved in such planning arrangements. Aside from the high risk that such planning may fail and potentially expose the taxpayer to penalties and interest, these aggressive tax planning arrangements may be contrary to ICAEW's Professional Conduct in Relation to Taxation (PCRT) and potentially expose a member to disciplinary action.

VAT AND BREXIT

What opportunities and challenges for the UK VAT regime are presented by the UK's exit from the European Union?

What are the chief concerns for HMRC and for business?

What impact will Brexit have on HMRC's efforts to reduce the VAT element of the tax gap?

24. The current state of uncertainty as to the likely new arrangements with the European Union mean that it is very difficult to predict what will be opportunities and challenges post Brexit. UK Government policy appears to be aimed at ensuring that the effect of Brexit should have a minimum impact on the UK's ability to do business with the remaining EU member states, but quite how that is going to be achieved is still uncertain.

25. Any changes brought about by Brexit which add cost or delays to businesses transporting goods to or from the UK due to the imposition of customs formalities used for shipments to or from non EU countries will be unwelcome. Post Brexit these customs formalities will also apply to trade with the remaining 27 EU countries. This could damage the economic prospects for companies trading in or with the UK.

26. In any event, we recommend that there should be only one set of changes to the VAT rules. We also think that the optimum timing for such changes would be at the end of any transitional period, so perhaps with effect from 1 January 2021. This date would have the added benefit of allowing businesses a longer period to prepare for the changes.

27. Once the UK is no longer a member of the EU it will not be bound by the VAT Directives which currently determine the parameters of the UK VAT system and the UK will, in theory, be free to reconfigure its VAT system as it sees fit.

28. Simplification may be easier to achieve in domestic service industries than in the area of international trade. For example in industries in which there is the potential for consumers to purchase services from companies established in different countries the imposition of VAT or the granting of a VAT relief which is out of step with the position adopted in the EU member states could cause distortions of competition. This was evident before the EU changed the place of supply rules for business to consumer electronically supplied services in 2015 as suppliers of such services clustered in countries which charged the lowest VAT rate on such supplies. Consequently any changes to the UK VAT system will have to take into account the VAT system adopted in the EU, which may involve accepting the associated complexities which go with it.

29. There are also a number of simplification measures found in the EU VAT law which will no longer be available to UK businesses post Brexit. Some of these are designed to apply to businesses which are VAT registered in the EU eg "triangular trade" simplification which

applies where a supplier sells goods to an intermediate supplier but delivers the goods to its customer's customer in a different EU member state. Another example in the travel industry is the tour operators margin scheme, which is a simplification scheme used by tour operators which are established in the EU and which avoids the need for a tour operator to register for VAT in all the countries in which it sells package holidays. The UK is also not likely to be able to continue to benefit from EU simplification measures such as the Mini One Stop Shop (MOSS) currently available to UK businesses which provide electronic services to EU consumers.

30. Finally the Office of Tax Simplification (OTS) is carrying out a review into potential simplification of the VAT system and published a consultation document in February 2017 to which ICAEW responded in July 2017 *Office of Tax Simplification Review of Value Added Tax*.

VAT AND BUSINESS

What aspects of VAT (either process or design) cause the biggest problems for businesses? How might they be improved?

31. Our response to the OTS review of VAT, to which a link is provided above, is an extensive review of the current system of VAT and identifies areas where there could be simplification.

32. We have recently, in February 2018, written to the Financial Secretary to the Treasury, recommending that the UK reintroduce postponed VAT accounting for imports from all countries so that no VAT is payable on importation.

33. We believe there should be a review of the existing VAT threshold which causes significant "cliff edge" problems for businesses whose turnover is at, or near, the threshold of £85,000 pa. We put forward a potential solution to this in Appendix 1 of our response document to the OTS review.

34. Our OTS response also highlighted a number of other issues for consideration many of which are relevant to the current TSC Inquiry. These include:

    - multiple rates of VAT (including zero-rating) on particular goods and services including food, printed matter, children's clothing, fuel and power and financial services etc;
    - VAT exemption and partial exemption; and
    - whether formal rulings could be introduced, for instance in relation to transfers of a business as a going concern.

VAT AND GOOD TAX POLICY

How does VAT measure up against the principles that tax policy should:

- ***Be fair***
- ***Support growth and encourage competition***
- ***Provide certainty without regular recourse to the courts - which in turn requires legal clarity, simplicity and targeting (so that taxpayers are clear whether or not they are liable for particular types of charges to tax)***
- ***Provide stability, with minimal change unless there is a justifiable economic or social basis***
- ***Be practicable, meaning that a person's tax liability should be easy to calculate and straightforward and cheap to collect; and***

- ***Be coherent, with new provisions complementing the existing system rather than conflicting with it.***
- ***Is the process of making VAT policy sufficiently open to scrutiny and debate? Are there ways in which the current process can be improved?***

35. The above principles are contained in the TSC report of March 2011 Principles of Tax Policy to which ICAEW, and in particular ICAEW tax manager Anita Monteith, contributed. That report states in its introduction:

    “We are also extremely grateful to the ICAEW, and especially grateful to Anita Monteith, Tax Manager of the ICAEW Tax Faculty, who acted as Specialist Adviser on this inquiry and worked extremely closely with Committee staff in preparing this Report.”

36. The principles were broken down into the basic principles and procedural principles. When launching the report the then Chair of the TSC stated:

    "The coherence of the system affects the basic principles of both fairness and growth—a system which is riddled with anomalies will not be considered fair and will impair economic performance. It also matters for the procedural principles of certainty, stability and practicability, since incoherence will make all of these harder to achieve."

37. The OTS review of VAT to which we have referred several times above is conducting an in depth analysis of the current VAT system and this should be the basis of any further work of fundamental review. Such a review is going to be affected by the uncertainties that Brexit is creating and the proposed digitalisation of the tax system which it is proposed will begin with VAT.

In 2015-16 over £3.5 billion was lost due to mistakes in VAT returns according to HMRC figures? Will Making Tax Digital be sufficient on its own to reduce error and significantly improve the collection of VAT? What other action would help businesses to get their VAT returns right?

38. While MTD should help to reduce errors, we are not convinced that by itself it would materially reduce the figure quoted, particularly when we do not have a more detailed breakdown of how those mistakes have arisen. There is also a danger that MTD will result in increased administrative burdens and costs which might outweigh any reduction of the VAT tax gap. The VAT system is highly complicated and such a system will result in mistakes. A high proportion of VAT registered traders also complete their own VAT returns and will not be experts in the intricacies of the VAT system. Ultimately, the VAT system needs to be simplified with fewer adjustments required to be made to the figures recorded in the underlying accounting records.

Can disagreements between HMRC and a business about how much VAT is due be resolved quickly and fairly? If not, what are the obstacles and how might they be overcome?

39. The answer to this will depend in part upon the complexity of the business, the quality of the accounting records and whether the business needs to make adjustments to the accounting figures to produce the figures for the VAT return. VAT was introduced in 1973 as a ’simple tax’ but that no longer reflects the current reality: VAT is a highly complicated tax where it is very easy to make mistakes.
40. In principle, it should be possible to resolve disagreements quickly and fairly but wherever there is an element of judgement required in making adjustments, reaching agreement may be more difficult. Again, if the VAT rules were simplified this should make it easier to reach agreement.

41. Some areas are more prone to disagreement and disputes and over the years there have been numerous court cases in relation to land and property, partial exemption, charities, finance, food and the tour operators margin scheme.

42. The penalty regime has also come under criticism for penalising, in a disproportionate way, any business which makes a relatively minor error (eg submitting a VAT return one day late).