TAXREP 57/11

ICAEW TAX REPRESENTATION

VAT: COST SHARING EXEMPTION

Comments submitted in September 2011 by ICAEW Tax Faculty in response to the HM Revenue & Customs consultation document, *VAT: Cost Sharing Exemption*, published on 28 June 2011

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VAT COST SHARING EXEMPTION

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation document *VAT: Cost Sharing Exemption* published by HM Revenue & Customs on 28 June 2011 at http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_031398.

2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

3. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty"s Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

4. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW"s regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

5. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

6. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

KEY POINT SUMMARY/MAJOR POINTS

7. We welcome the proposal for the introduction of a cost sharing exemption in UK VAT legislation and hope that it will be made widely available for use by the organisations with exempt and non-business activities, for which it is intended. We agree that it should be straightforward to operate, minimise compliance and administrative burdens and avoid opportunities for abuse of avoidance.

8. However, we are concerned that HMRC appear to be adopting unduly restrictive interpretation of the exemption in the Directive so that the proposals are unduly complicated. This is likely to increase compliance costs which far smaller organisations could be disproportionate and make the exemption far less attractive. This would be contrary to the Government"s growth agenda and the increased reliance on the third sector for delivering support and services.

9. We understand that HMRC views input tax incurred on expenses that would be regarded as residual input tax for partial exemption or business/non-business purposes as being ineligible for relief under the cost sharing exemption. Such a restriction would eliminate much of the potential benefit for many organisations that could make use of the scheme.

10. There is no right of appeal against distortion of competition. Although we do not expect that this will be a significant issue, we believe that a right of appeal should be available to a business that considers it is suffering as a result of its competitor"s use of the cost sharing exemption.

11. In order for businesses to determine the correct proportion of taxable income and eligibility to use the cost sharing exemption, HMRC needs to clarify the VAT liability of specified financial services to non-EU countries. Should they be treated as exempt or taxable?

12. Paragraph 1.5 of the consultation document states that the EC will be issuing some detailed guidance for Member States later this year on the implementation of the cost sharing exemption. In view of the considerable uncertainty at present as to the scope and purpose of the exemption, HMRC will need to take the EC guidance into account, together with the responses to this consultation, before proceeding to the next stage in the UK"s implementation process.

RESPONSES TO SPECIFIC QUESTIONS

Chapter 3 – What is an 'Independent Group of Persons' for the purposes of this exemption?

Q1: Are there any other bodies or entities that could be used to form a cost sharing group?

13. A VAT group, together with a combination of other VAT group(s) and/or other persons – see question 3 below.

Q2: Does the proposed definition of 'independent group of persons' provide any practical problems or barriers to using the exemption?

14. There may be a problem with two or more associated companies that are not in a VAT group wanting to form a CSG with other non-associated companies. This could apply, for example, where for corporate tax purposes they are connected via a holding company, but where they have completely separate reporting lines into separately run sectors of the business. This is not uncommon in large complex businesses such as banks, which have wholesale and asset management divisions with completely separately reporting, but where there is common ownership via an ultimate parent. In such cases, it is possible that the associated companies would control more than half of the CSG. We see no reason why such a scenario should not be permitted.

15. By requiring equal ownership in a CSG, the proposed approach would prevent the situation where a large charity makes its expertise available to smaller charities. In such cases, we would expect the large charity would be the major owner of the CSG and we do not see why this should be a barrier to operating a CSG.

16. HMRC should seek to reflect the underlying policy purpose of the exemption and adopt a broad definition of the exemption and what for these purposes counts as a member. That said, we are not convinced that a CSG could be either a partnership or an LLP, as both of these entities have a legal requirement to be operated with a view to profit (see for example s 2, Limited Liability Partnership Act 2000) and such a status appears incompatible with the CSG rules.

Q3: What practical problems or difficulties could occur if a VAT Group was a member of a CSG and how could these be resolved?

17. If a partly exempt VAT group that included fully taxable members joined a CSG, these fully taxable companies could become CSG members by default. In theory, this would breach the

EC condition of CSG membership requiring all participants to have exempt or non-business activities. This would be resolved if a VAT Group could be defined as a "person" for CSG purposes.

18. Where a VAT group member is part of a CSG, HMRC"s guidance would need to make very clear how the „directly necessary" test works. In particular, HMRC will need to clarify whether it only relates to that member, or to the group as a whole, and if only to that member whether more than one VAT group member can be a member of the same CSG.

19. If a CSG containing one or more VAT groups defaulted, protection would be required to ensure that joint and several liability claims could not be made against VAT group members that were not directly involved with the CSG"s transactions. An example of this could be a fully taxable VAT group member, as described at paragraph 17 above.

Q4: Are there any difficulties or problems that may arise from multiple memberships?

20. It is likely that some organisations will want to join more than one CSG, particularly those involved with a wide range of activities. We see no reason why multiple memberships should not be permitted.

21. If several VAT groups each joined several CSGs, but with each CSG having a slightly different make up of VAT groups and other entities, it would be necessary to ensure that joint and several liability claims could not be made against any VAT group members not directly involved with a defaulting CSG.

Q5: Are these characteristics appropriate?

22. We do not believe that the assumption in paragraph 3.20 of the consultation document is valid. CSG members may not be equivalent to the persons who have formed the „independent group", particularly if one or more members of the CSG is a VAT group.

23. We accept that the characteristics listed at paragraph 3.26 of the consultation document are likely to be features of many CSGs, but do not believe that they should be a requirement of membership. Consequently, we would recommend that this requirement should not be included in any legislation.

24. In particular, a CSG may wish to market its services outside its membership with a view to increasing its membership and buying power.

Q6: Do you agree that independence is a necessary safeguard against abuse and distortion?

25. We do not agree that independence is a necessary safeguard against abuse and distortion. It is the nature of the supplies between the CSG and its members that is the crucial factor here, rather than the relationship between the members of the CSG.

26. A member will join a CSG in order to reduce its costs. Otherwise, there would be no point in establishing the CSG in the first place. By joining forces, CSG members should be able to benefit from increased buying power and economies of scale, which should not in themselves be regarded as a distortion of competition.

27. If one member has contacts through which it can negotiate improved terms for both itself and the other CSG members as a whole, it should not be barred from doing so, even if it is the main beneficiary.

28. We consider that CSGs should be self-regulating and need no specific rules on independence. If one member seeks a benefit to the detriment of other members, then the other members would leave. In contrast, if the size of the benefit is unequal, this may be a situation that is agreed or even expected by the members and should not be prevented.

Chapter 4 – Exempt or Non-taxable Activity.

Q7: Do you think HMRC should introduce a specific test? If your answer is yes please indicate the threshold and timescale you think should apply.

29. There should be an eligibility requirement that, to join a CSG, an entity is unable to recover all the VAT it incurs without the benefit of a CSG membership. This restriction on VAT recovery should be because the entity concerned is partially exempt and/or all the VAT that it incurs is not input tax due to it engaging in non-business activities.

30. Other than the above general requirement for CSG membership, we do not consider that there should be any specific test for eligibility.

Chapter 5 – What does 'Directly Necessary' mean?

Q8: Do you have a preference for any of the approaches described above? Please explain why.

31. There appears to some sense in applying the rules outlined in paragraphs 5.6 to 5.9, as this would require the same analysis of purchases as is currently required for partial exemption purposes. However, we believe that the proposed ineligibility for exemption of general overhead expenditure is overly restrictive.

32. The suggestion at paragraph 5.5, to treat organisations with an 85%, 90% or 95% proportion of exempt and/non-business income as qualifying for exempt supplies from the CSG, appears to create an alternative to a partial exemption de minimis limit. Whilst we welcome this simplification, it does not seem fair to businesses that have a similar income distribution, but which are unable to establish a CSG and receive purchases relating to exempt/non-business supplies that are above the present partial exemption de minimis threshold. We therefore suggest that a high percentage of at least 90% is used if this measure is adopted.

33. We agree with HMRC"s suggested test that if a business is substantially exempt then all services are directly provided in relation to those services. That is the correct sensible pragmatic starting point. However, we also think it necessary to have the second limb, so that if a business does not meet that test then the use of the CSG should be restricted to those services "directly necessary".

34. HMRC does need to clarify whether it considers specified services (non EU exempt with input VAT recovery) to be exempt or not. If HMRC does not consider them to be exempt then this would be restrictive and distortive - it would make it almost impossible for businesses with both EU and non EU clients to use a CSG at all. In our view, Art 169(c) would suggest that they are exempt.

35. We believe that it should be permissible for organisations to receive the benefit of exemption on supplies received from CSGs to the extent that they relate to their qualifying activities, even if an apportionment of individual supplies is required. This would be particularly relevant in relation to general overhead costs.

Q9: Do you prefer another approach? If you do please outline your ideas.

36. If a CSG were required to charge VAT on all its supplies to all of its members and those members were permitted full input tax recovery on supplies received from a CSG of which it

was a member, the intended overall outcome would be met, but the process of achieving it would be simplified.

37. In this scenario, there would be the potentially significant added benefit that the CSG would not need to know whether its supplies related to qualifying use by its member.

38. We recognise that a derogation would be required to obtain the above simplification, as such treatment would be inconsistent with the qualifying conditions of a CSG under European law. However, it would be a useful simplification for business and would make the scheme much easier to operate.

Chapter 6 – The Exact Reimbursement of Costs.
Q10: Do you agree with this approach to 'direct reimbursement of costs'? If not please explain why and indicate the approach you would like to see adopted.

39. We agree, with the exception of paragraph 6.11. As stated earlier, we do not accept the principle of the independence rule. We also consider that HMRC should make it clearer that transfer pricing adjustments should be ignored.

Chapter 7 – The Distortion of Competition Test
Q11: In what circumstances do you think the 'Distortion of Competition' condition would apply?

40. As stated in response to question 6 above, a member will join a CSG to reduce its costs. Otherwise, there would be no point in establishing the CSG in the first place. By joining forces, CSG members should be able to benefit from increased buying power and economies of scale, which should not in themselves be regarded as a distortion of competition.

41. However, there may be some organisations that will wish to appeal against perceived distortions of competition created by CSGs. There is no right of appeal against distortion of competition. Although we do not expect that this will be a significant issue, we believe that a right of appeal should be available to a business that considers it is suffering as a result of its competitor"s use of the cost sharing exemption.

Chapter 9 – Process and Compliance
Q12: Are there any process and compliance aspects of the cost sharing exemption that you think might need to be addressed specifically in guidance?

42. HMRC should state clearly in its guidance
    - conditions of membership, with numerous examples.
    - the fact that non registered businesses are not eligible unless they have exempt and/or non-business activity – the current nuances in language may not make this apparent to non-specialists.
    - the fact that (subject to this consultation) HMRC considers the exemption to be an all or nothing test and that no apportionment is allowed. A failure by business to understand this point would ruin the effectiveness of most CSGs.
    - whether specified services are exempt

Chapter 10 - Impacts
Q13: Do you think that the implementation of the cost sharing exemption will have any equality impacts? If yes please indicate what the impacts are and offer suggestions about how they can be eliminated.

43. No.

Q14: On the basis of information in this document do you have any comments on the assessment of impacts?

44. No.

Q15: On the basis of this document would your organisation join a CSG?

45. Not applicable – this is a response from a representative body on behalf of its members, not itself.

Q16: What are the most valuable services (in cost terms) your organisation would want to receive from a CSG using the exemption? Please state the value of at least 3

46. Not applicable – this is a response from a representative body on behalf of its members, not itself.

Q17: Of the services listed in question 16 above what services are currently supplied by a third party? Please state the annual irrecoverable VAT you currently incur when receiving those services.

47. Not applicable – this is a response from a representative body on behalf of its members, not itself.

Q18: Of the services you have listed in question 16 above what are the annual economies of scale you would expect to make on services currently provided in-house if they were to be supplied by a CSG? Please specify these separately for each listed service.

48. Not applicable – this is a response from a representative body on behalf of its members, not itself.

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APPENDIX 1

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.com/~/media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide-4-99-towards-a-better-tax-system.ashx).