

VAT SIMPLIFICATION REVIEW: UPDATE- DECEMBER 2007

At the 2007 Pre-Budget Report, the Chancellor announced a review aimed at simplifying the VAT rules and administration. Having carefully considered the views of businesses, in this paper we identify its initial priorities for VAT simplification work.

These include the Option to Tax land and property transactions; and the Partial Exemption regime, including the Capital Goods Scheme. In these areas, HM Treasury and HM Revenue & Customs will work with business to identify both short- and longer-term improvements. This work will be taken forward through specially created working groups as well as through existing links with businesses and their representatives.

Over a longer timeframe, the Review Team also propose to examine the scope for improvements to VAT Retail Schemes; review the thresholds that apply to VAT business schemes; and discuss with businesses the further improvements that require action at EU-level. This work will be taken forward mainly through existing links with businesses and their representatives.

Businesses are invited to express their interest in any of this work, by emailing the VAT Simplification Review Team (vat.simplification@hm-treasury.gov.uk).

1.1 As part of his 2007 announcement on tax simplification, the Chancellor announced a review aimed at simplifying the VAT rules and administration in the UK and the EU. As a first stage of this review, the views of businesses and their representatives were sought on priorities for simplification, including through an online survey and a dedicated email address. Over 270 replies were received and the Government also sought views through existing and ad hoc fora for discussion of the tax with business representatives.

1.2 A significant theme of the consultation process was that many respondents preferred simplification work to deliver substantive improvements in a small number of areas, rather than a wider range of smaller-scale 'cosmetic' changes.

1.3 This paper sets out the initial priorities for the simplification review and the work that will be taken forward in the short-term, with a view to announcement or consultation at Budget 2008. The Government has also identified longer-term work on both domestic measures and potential improvements to the EU VAT system.

BUSINESS VIEWS ON THE 2007 PRE-BUDGET REPORT PROPOSALS

1.4 At the Pre Budget Report, the Chancellor identified four potential areas for simplification, and sought the views of business and its representatives. For each of these areas this paper summarises what was announced at the 2007 Pre-Budget Report, analyses the business response, and explains how this work will be progressed in consultation with business.

1.5 The criteria used to decide priorities include: the level of business support for prioritising the work; whether there is an agreed basis for progress between business and Government; and the scope for producing measures/consultations in time for Budget 2008.

OPTION TO TAX (OTT)

Pre-Budget Report proposals **1.6** The OTT applies to around 75 per cent of all interests in commercial land and buildings. In most cases, having decided to opt to tax, a business is simply required to notify HMRC. The 2007 Pre-Budget Report proposed discussing the scope for simplifying the administrative procedures and requirements associated with the OTT – especially those where a business has made exempt supplies of the land or property prior to opting to tax future supplies of such assets

Business response **1.7** Around 30 per cent of all respondents identified the OTT as relevant to them or their clients’/members’ business activities. Among those who expressed a view, there was broad agreement (almost 90 per cent) that there was scope to simplify this part of the VAT system; and around 70 per cent felt that the OTT should be prioritised as part of the review. The main areas for improvement were:

- anti-avoidance provisions;
- obtaining proof of a valid option to tax; and
- ‘Permission’ options i.e. those that must be reported to and agreed by HMRC.

Next steps **1.8** There is a clear desire to prioritise this work but business views on possible improvements go a little wider than the areas for discussion identified at the Pre-Budget Report. The Government will take this work forward through HMRC’s Land & Property Liaison Group, beginning with a planning meeting on 25 January 2008 to agree a timetable for this work.

PARTIAL EXEMPTION & THE CAPITAL GOODS SCHEME (PE/CGS)

Pre-Budget Report proposals **1.9** Around 140,000 VAT registered bodies are partly exempt, and so required to carry out a calculation to determine the extent to which they may recover VAT that they are charged. Around 120,000 use the “standard method”, with the rest agreeing bespoke methods with HMRC. Under the CGS, partly exempt businesses must annually adjust the VAT recovered on larger capital items for a period of 10 years, to ensure that VAT recovery reflects ongoing use of the item. The Pre-Budget Report proposed discussing the scope for simplifying the standard PE method; the rules and processes around the PE *de minimis* limit; and the procedure for calculating and adjusting VAT recovery under the CGS.

Business response **1.10** Around 25 per cent of all respondents identified the PE/CGS as relevant to them or their clients and members. Among those who expressed a view, there was broad agreement (over 85 per cent) that there was scope to simplify this part of the VAT system; and around 80 per cent felt that this work should be prioritised as part of the review. The main areas for improvement were:

- The partial exemption standard method and reducing the need for businesses to apply for special methods;
- The partial exemption *de minimis*; and
- The capital goods scheme.

Next steps **1.11** Business also clearly wants the Government to prioritise this work, and their views on possible solutions fit well with the work identified at the Pre-Budget Report. As with the OTT, the Government will need to quickly agree on a timetable for this work in the short- and longer-term. This workstream will be taken forward through HMRC’s PE/CGS Consultative Group (which has been set up under the auspices of the Joint VAT Consultative Committee), which will next meet on 1 February 2008.

FREQUENCY OF RETURNS / ANNUAL ACCOUNTING SCHEME (AAS)

Pre-Budget Report proposals **1.12** Only about 1 per cent of those businesses eligible to use the AAS currently do so, with around 95 per cent of all VAT registered businesses using the current “default” quarterly returns system. The Pre-Budget Report proposed exploring whether there are obstacles that prevent businesses from using the AAS; and whether the AAS could be attractive to larger businesses.

Business response **1.13** Around 10 per cent of respondents on this topic said that they or their clients/members already use the AAS, significantly higher than the VAT population as a whole. Only 25 per cent of all respondents, and just over 50 per cent of large business respondents, thought there were obstacles to the use of the AAS. The main obstacles identified were:

- The current turnover threshold of £1.35m, which prevents larger businesses using the AAS, was cited by some large business respondents;

- concerns, mainly from tax professionals, about the potential impact on business record-keeping – the discipline of keeping and reconciling accounts on a quarterly basis was considered to be beneficial; and
- concerns, mainly from larger business, about the potential impact on cashflow e.g. because of uncertainty over the balancing payment.

1.14 A small number of large business respondents on this subject thought that use of the AAS could simplify their VAT affairs. Several respondents pointed out that the attractiveness of the AAS depended on changes in other areas, such as the voluntary disclosure threshold, the penalty regime and overseas trade reporting requirements.

1.15 Overall just 11 per cent of all respondents, and only 29 per cent of those who expressed a view on this point, felt that this subject should be prioritised as part of the simplification review.

Next steps 1.16 There is little appetite amongst business for prioritising work to simplify or extend the AAS, but the survey has confirmed the obstacles that would need to be addressed to improve take-up of the scheme. Work on improving take-up of the AAS and examining the scope for extending it to larger businesses will be taken forward outside this simplification review, as part of HMRC's existing work to reduce the administration burdens on businesses.

RETAIL SCHEMES (RSs)

Pre-Budget Report proposals 1.17 Over 200,000 businesses are eligible to use one of the 5 retail scheme methodologies published by HMRC. Around 200 larger retailers are required to agree bespoke schemes with HMRC. The Pre-Budget Report proposed exploring whether, in view of developments in retail IT systems, the existing schemes continue to simplify retail VAT accounting; and whether the requirement to agree bespoke schemes with HMRC provides the right balance between simplification and certainty in tax accounting.

Business response 1.18 Around 15 per cent of all respondents identified RSs as relevant to them or their clients and members. Among those who expressed a view, almost 80 per cent thought that there was scope to simplify this part of the VAT system; but only half felt that this work should be prioritised as part of the review. The main ideas for simplification were:

- the process for agreeing bespoke retail schemes; and
- improvements to HMRC guidance and support for those using retail schemes.

Next steps 1.19 There is no clear wish to prioritise this area as part of this initial tranche of simplification work, but sufficient interest to justify some further work. This will be taken forward, to a 2008 Pre-Budget Report timescale, by exploring options for improvements with known retail contacts in the Joint VAT Consultative Committee, and through HMRC's Business Customer Unit.

BUSINESS VIEWS ON OTHER PRIORITY AREAS

1.20 In addition to the areas mentioned above, businesses were also asked to identify other potential priorities for simplification, domestically and in Europe. This paper analyses the business response to this request, and identifies the issues to discuss further with businesses.

1.21 As previously, the Government has carefully considered priorities against: the level of business support for prioritising the work; whether there is an agreed basis for progress between business and Government; and the scope for producing measures/consultations in time for Budget 2008.

1.22 However for this part of the review business proposals have also been considered against: the scope of the review announced at the 2007 Pre-Budget Report; their fit with wider government objectives; and, in relation to EU-specific issues, the likelihood of achieving the necessary unanimous agreement of all EU Member States to potential simplification measures.

EU ISSUES

1.23 There was a wide-ranging response on longer-term simplification work in Europe, from specific ideas for improving the VAT treatment of intra-Community supplies to more fundamental suggestions, such as withdrawing from the EU. The main improvements and themes identified by business were:

- the need for common VAT rules across Europe and, particularly, a consistent interpretation and implementation of these rules by Member States;
- the case for a streamlined system for the recovery of VAT incurred in other Member States by businesses; and
- reducing reporting burdens associated with intra-Community trade.

Analysis 1.24 The Government is keen to work with business to identify the areas that could benefit most from a more uniform approach without compromising national sovereignty and manifesto commitments. The development of a strategy in this area will need to recognise that any changes require the unanimous agreement of all 27 EU Member States; and that, in some cases, a simplified and more uniform approach across the EU might lead to increased burdens on UK business. VAT invoicing, including electronic invoicing, where the European Commission has already committed to review the rules by the end of 2008, is one area where simplification may be possible to help those businesses trading in more than one EU Member State.

1.25 Streamlining the recovery of VAT already constitutes a part of the VAT Package agreed by Member States on 4 December 2007. This will bring changes across the EU that will both simplify and speed up the process of recovering VAT incurred in other Member States. The Government believes that this change is a significant step forward. However, it will continue to discuss with businesses the scope for additional changes.

1.26 The Government recognises the difficulties that businesses face in complying with reporting obligations in relation to intra-Community trade. Although the scope for change is limited by the requirement that each Member State maintain reliable information on its economy and trade, and for control of VAT, the UK's domestic information requirements are being reviewed, for example through the recent public consultation on Intrastat requirements.

1.27 Member States have also agreed that the European Commission should undertake "an in-depth analysis with a view of identifying the information needs of a modern administration for controlling in particular the EU intra-community VAT system". This will provide Member States the opportunity to consider reporting obligations in the light of the EU "Lisbon Agenda" imperative of reducing burdens on business.

Next steps 1.28 The Government will discuss the responses in more detail on an ad hoc basis with businesses involved in intra-Community trade such as multi-national businesses and some non-UK based enterprises. It also plans to use the Joint VAT Consultative Committee, the VAT Forum and other links with businesses of all sizes to identify improvements that are achievable, consistent with Government commitments, and do not undermine efforts to tackle serious threats in relation to intra Community trade, such as MTIC fraud.

DOMESTIC ISSUES

1.29 The Government also received a wide range of views on other improvements to the domestic VAT system. The main issues identified by business were:

- clarifying the boundaries between goods and services subject to different VAT liabilities, particularly those involving food products;
- streamlining the VAT registration process; and
- modernising the thresholds of various VAT schemes affecting both small and larger businesses.

Analysis and next steps 1.30 Under EU agreements, the UK is unable to extend the scope of its existing VAT zero rates. The scope of the existing exemptions from VAT is also constrained. Therefore, the only means of achieving simplification of VAT liability borderlines in many areas would be by taxing items on which VAT is currently not chargeable. Any such change would require careful consideration alongside broader Government objectives and commitments, and the Government's key principles for tax policy set out at the 2007 Pre-Budget Report.

1.31 HMRC is committed to improving its VAT registration performance and its recovery plan is starting to produce significant improvements. For November 2007, 57.5 per cent of applications were processed in 14 days, with an overall average processing time of 18 days. HMRC will continue to work hard to deliver further improvements in this important area.

1.32 Partial exemption and capital goods scheme thresholds will be considered as part of simplification work in these areas. The Government will also, to a 2008 Pre-Budget Report timetable, review the impact of other thresholds, including those that apply to the VAT small business schemes and the payment on account scheme. Where the principal reason for a threshold is HMRC's concern about avoidance and abuse, the

Government will discuss with business alternative ways of addressing such risks. HMRC has also recently completed a public consultation on the voluntary disclosure arrangements (including the threshold) and aims to report the outcome of that review in Budget 2008.

I.33 All of the other issues raised by business have been passed on to policy teams, and will be taken into account when developing options for future policy changes in the relevant areas of the tax.

CONCLUSIONS

I.34 Stage 1 of the VAT simplification review has identified priority areas for improvement in both the short- and longer-term. Representative members of the working groups identified in this paper will be invited to participate in this work. Other recipients who wish to be involved in this work should contact the Review Team (vat.simplification@hm-treasury.gov.uk) to express their interest in any of the workstreams identified in this paper.