



ICAS response to the OTS progress report and
call for evidence:

Review of Value Added Tax

29 June 2017

About ICAS

1. The following submission has been prepared by the ICAS Tax Board. The Board, with its five technical committees, is responsible for putting forward the views of the ICAS tax community, which consists of Chartered Accountants and ICAS Tax Professionals working across the UK and beyond, and it does this with the active input and support of over 60 committee members. The Institute of Chartered Accountants of Scotland ('ICAS') is the world's oldest professional body of accountants and we represent over 21,000 members working across the UK and internationally. Our members work in all fields, predominantly across the private and not for profit sectors.
2. ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. From a public interest perspective, our role is to share insights from ICAS members in the many complex issues and decisions involved in tax and financial system design, and to point out operational practicalities.

General comments

3. ICAS welcomes the opportunity to contribute to the progress report and call for evidence 'Review of Value Added Tax', issued by the Office of Tax Simplification (OTS) in February 2017.
4. The report identifies numerous aspects of the VAT regime which could usefully be simplified. There may be a case for considering reform in stages. As the report notes, whilst the UK remains within the EU there are numerous constraints on what the UK can do. After Brexit, it should be easier to undertake radical reform.
5. Much of the complexity in the present regime could be eliminated by reducing the number of rates. As the report notes a truly radical solution could involve standard rating everything – and reducing the VAT rate to produce a revenue neutral outcome. Slightly less radical would be an approach which scrapped exemption, making everything taxable at standard, zero or reduced rate.
6. These options would be worthy of consideration in the longer term, as they would eliminate some of the aspects of VAT which cause the most difficulty. However, removing exemptions/zero rating for all products and services would be unlikely to be acceptable because of the social impact, for example potential increases in the cost of basic food, health and housing. A balance would certainly need to be struck. Our response concentrates on less radical options which are more feasible in the short to medium term.
7. The VAT registration threshold is updated every year. However, other thresholds and de minimis limits within the VAT regime (for example, in the partial exemption rules and the capital goods scheme) have not been revised for many years and are no longer fit for purpose. As a general principle, all thresholds and limits should be brought up to date (taking account of inflation and other relevant factors) and then regularly reviewed and increased as required. An annual review might not be required in all cases; for some of the thresholds and limits a longer interval might be appropriate.
8. Some of the issues around VAT penalties and appeals (and disputes generally) could be tackled through genuine collaborative working between HMRC and taxpayers, with prompt access to HMRC specialists. Most businesses want to get their VAT right but find it difficult, particularly if they are smaller businesses, to get access to the appropriate HMRC support in a reasonable timeframe. Large businesses with HMRC CRMs find it easier to access specialists but can still encounter delays and problems resolving issues.
9. Compliance and voluntary disclosure would also be assisted if there was general recognition within HMRC that a mistake does not automatically mean that there has

been a lack of reasonable care (meaning that a penalty is due). HMRC support and guidance needs to be improved to help businesses avoid errors.

10. The report discusses Making Tax Digital. ICAS believes that this should offer an opportunity to simplify aspects of the VAT regime – but it is unlikely that this will be feasible if the current timetable for MTD for VAT goes ahead.
11. The proposed timescale for MTD is already so tight that large companies are concerned that they will not have sufficient notice to change their systems to accommodate the final requirements (which are still not available). Given that most businesses already file quarterly returns for VAT, so that the suggested benefits of MTD are less obvious for VAT than for direct tax, it would make sense to defer MTD implementation for VAT to allow time for sensible simplification of the rules to be built into the process.
12. We have identified the VAT treatment of the public sector as another area the OTS should consider. This suffers from numerous distortions and complexity, as discussed in detail in our response to section 8 of the report.
13. In the past many services were delivered by local authorities, government bodies or the NHS, ie bodies within the provisions of sections 33 and 41 of the VAT Act allowing VAT to be recovered in certain circumstances. Due to constraints on public spending and pressure to achieve efficiencies it is increasingly common for the provision of the same services to be transferred to other not-for-profit entities, including charities, that do not fall within sections 33 or 41.
14. There are several undesirable consequences arising from the lack of fiscal neutrality in the VAT regime for the public sector. The cost of providing public services may increase. Bodies providing services may enter into arrangements to mitigate the VAT impact, giving rise to disputes between HMRC and public sector bodies. Both parties then incur additional costs (ultimately paid for by taxpayers) and may become involved in litigation – leading to publicity and giving a poor impression to taxpayers. In view of the public sector procurement rules there may also be issues for entities which use complex VAT arrangements to get the best possible return for public expenditure.
15. Consideration also needs to be given to potential conflicts around VAT recovery on devolved spending. The creation of national bodies for the police and fire services in Scotland in 2013 means that they now suffer a VAT cost. Prior to the creation of the single force, local police and fire services in Scotland were controlled by local councils (eligible for VAT recovery, as noted above).
16. We note that the financial services sector was specifically excluded from the scope of this review. However, this is an area of significant VAT complexity and we consider that the VAT regime for the financial services sector (including insurance) should be reviewed after Brexit.

Specific questions

Section 1: Identifying the implications of the level of the registration threshold

Q1.1. Why are businesses below the VAT threshold registering – how does that 44% break down?

17. The reasons identified on page 4 of the OTS interim report are likely to be the main ones. Looking at the list on page 4 we have specifically had feedback that some businesses below the threshold are registering through ignorance of the rules and/or poor advice. We have also had input that many small B2B businesses below the threshold register because it is advantageous to do so.

18. One other reason, not on the page 4 list, which has been suggested to us is that some organisations include a requirement (in their procurement guidance) for suppliers to be VAT registered, regardless of their turnover. The perception is that being VAT registered means that a supplier has in some way been 'vetted' by HMRC and also that this would often push the supplier towards being a limited company (perceived as reducing the risks related to status, associated with using sole traders).

Q1.2. What would be the impact of raising the threshold significantly? With and without the option for voluntary registration?

19. ICAS believes that there are arguments for and against either raising or lowering the threshold; we have outlined key factors to be considered below.
20. The UK threshold is already high compared to the threshold in most other jurisdictions. Significantly raising the threshold could exacerbate distortions caused by the threshold (some of which are mentioned in the OTS interim report).
21. It is also likely that the relatively high VAT threshold is one of the factors driving the rapid growth of the 'gig' economy in the UK. Running a business through a number of 'self-employed' contractors (or individuals using personal service companies) can be used as a way of keeping the business below the VAT threshold. Leaving aside the potential adverse consequences for individuals and the exchequer, this prevents businesses operating on a level playing field.
22. If the threshold were to be raised voluntary registration should be retained. There are legitimate reasons for a business to wish to register voluntarily and it should be a choice open to businesses to make.
23. The Gulf states have recently opted for a threshold of 100,000 dollars – attempting to strike a balance between administration costs for businesses and revenue raised. An analysis of potential business costs against exchequer receipts, arising from any significant changes to the UK threshold might be a useful exercise to undertake.

Q1.3. What would be the impact of reducing the threshold significantly? How would HMRC and businesses who were brought into the VAT net manage?

24. As noted in the OTS interim report this would level the playing field. It would remove one disincentive to expanding a business and to taking on more staff, for those just below the current threshold. It would also remove one of the factors driving the growth of the 'gig' economy as noted above.
25. Whilst reducing the threshold would remove a disincentive to expansion for businesses just below the current threshold it might act as a significant deterrent to those contemplating starting a small business in the first place. Many newly established businesses find it valuable not to have to register for VAT as soon as they start trading because of the increased administrative burden. For new and existing B2C businesses there would also be a detrimental financial impact.
26. The OTS interim report points out that many traders register voluntarily so many of them presumably find that VAT is already simple enough for them to choose to use it (perhaps with some help from an agent). It is not clear whether these businesses are predominantly those which are fully taxable, rather than partially exempt. Making Tax Digital should provide an ideal opportunity to simplify some of the more complex areas of VAT so that bringing more smaller businesses into the VAT regime would not present insuperable problems for HMRC or the businesses themselves.
27. Making Tax Digital will require smaller businesses (the current proposals affect any business with turnover above £10,000) to report data quarterly in due course (2019 for those below the current VAT threshold). This should make it easier for them to adapt to

VAT reporting, particularly if the MTD software is as user-friendly as HMRC claims it will be.

28. It has been suggested by many of those responding to the MTD consultations that businesses below the VAT threshold should be permanently exempted from mandatory quarterly filing under MTD. If adopted this approach would add to the incentive to keep business turnover below the VAT threshold, potentially exacerbating the distortions noted above.

Q1.4. In both cases what would be the impact on economic activity?

29. Unless the VAT threshold could be raised very significantly (which is not currently possible, as the OTS report notes) the 'cliff edge' would only be moved to a slightly higher level and the distortions noted by the OTS (and the effect on the 'gig' economy) would remain largely unchanged.
30. A significant future increase in the threshold would have implications for government finances. Any drop in VAT revenues would be likely to be clawed back through increases in other taxes (and possibly via an increase in VAT rates). Straightforward rate rises or reductions in allowances have political implications, so there might also be a temptation to raise revenue through less obvious changes which tend to involve increased complexity, rather than simplification.
31. As noted above an analysis of the likely balance between business costs and exchequer receipts, could usefully be undertaken if a significant reduction or increase in the threshold is contemplated.
32. A significant reduction in the threshold would be unlikely to be regarded as simplification by small businesses, faced with the increased administration burden. It could deter some from starting a business. This perception might change over time if Making Tax Digital is successfully implemented, particularly if some aspects of VAT were simplified to assist with implementation of MTD.

Q1.5. Are there any other approaches that could simplify the regime? Does Making Tax Digital (see below) have an impact?

33. Making Tax Digital is unlikely to offer simplification, in itself. It is also likely to cause problems in the short term because currently only 12% of VAT returns are currently submitted direct from software. This will need to increase to 100% for Making Tax Digital. The main obstacle is the complexity of the VAT regime.
34. However, MTD could be used as an opportunity to address some of the main areas of complexity in the VAT regime, that impede the use of software to submit returns. This would require a change to the timetable for implementing MTD for VAT which already looks unrealistic (especially for larger entities which need time to make changes to their VAT systems).
35. MTD is discussed in more detail in section 7 below.

Section 2: Multiple rates: Causes of complexity?

Q2.1. Where are the categories that most give rise to boundary issues and so complexity for traders?

36. The OTS report notes the complexity arising around the differing VAT treatment for food items. It is very hard to see any continuing justification for the different treatment of corn chips and potato chips – or the different treatment of cakes/biscuits and chocolate covered biscuits. There have been numerous tribunal cases considering these boundaries. The OTS report also notes the multiplicity of cases on cereal bars.

37. Supplies in the course of catering have also produced large numbers of tribunal cases. Legislative changes in 2012 attempted to clarify some aspects of the rules (particularly around the sale of 'hot food' to be consumed away from the supplier's premises). However, this is still a complex area giving rise to problems.
38. There are boundary issues around health and disabled adaptations where the definitions for exemption/zero rating are very narrowly drawn.

Q2.2. Why have these difficulties arisen? Is it product development/technological advance or other reasons?

39. The OTS notes that much of this complexity arises for historical reasons; the development of supermarkets and diversification by more traditional shops has undermined any rationale which originally existed. For example, zero-rating for cakes and bread was designed so that everything sold by the local baker would be zero-rated – but supermarkets sell a range of both standard rated and zero-rated items and traditional bakeries have diversified and now also sell standard rated items as well as zero-rated ones.
40. Problems with the supply in the course of catering rules have become more common because of social changes and the appearance of large numbers of outlets which are not traditional cafes (or restaurants) or fish and chip shops; they may provide seating/café facilities but also provide takeaway food (some of which can be zero-rated, leading to the display of two prices on menus for some items). The baker of the past frequently now sells a range of takeaway food – one of the issues addressed by the 2012 changes. Supermarkets have also diversified into takeaway prepared food.
41. As noted above there have been boundary issues around health and disabled adaptations. Professional practices and products change over time but the exemption/zero rating definitions are narrowly drawn so that activities/products fall outside them because they do not fit the narrow definitions, even though they clearly fall within the intention of the legislation.
42. Technological advances have also resulted in new products and methods of service delivery which may be hard to classify for VAT purposes. Financial services are excluded from this review. However, they provide an example of an area where technology is leading to changes in, for example, payment services. Transactions may no longer require human intervention but are now performed by machines. We have been told that HMRC's approach can give rise to inconsistency in VAT treatment when the transaction itself has not changed – only the mechanism for carrying it out.

Q2.3. Would it be possible to simplify some of the definitions to allow more leeway for reasonable trade decisions?

43. It should be possible to simplify some of the definitions – but care would need to be taken to ensure that the amended definitions did not simply lead to more tribunal cases, in order to establish the boundaries of the new definitions.
44. Amending some categories to address identified anomalies and problems (which currently lead to numerous tribunal cases) would be worth considering.
45. As noted above it is hard to see any ongoing justification for treating potato chips and corn chips differently – or for distinguishing between chocolate covered biscuits and other biscuits.
46. In the area of health and disabled adaptations, more broadly drawn definitions could address the problems noted in our response to Q2.2. The aim would be to allow emerging products and procedures to be taken into account more easily, without requiring redrafting of the legislation (as had to happen to bring in new definitions of practitioners).

Q2.4. If part of the problem is commerce developing faster than the VAT law, how might VAT law best keep up?

47. Technology and commerce clearly move faster than VAT law. More broadly drawn definitions might help in some areas, as discussed in our answer to Q2.3.
48. Going beyond this and adopting a principles based approach to all category definitions would allow the system to deal with new products and services without the legislation needing to be rewritten. The possible downside of this approach (or broader definitions) could be loss of certainty. This could be addressed through the introduction of an optional process for obtaining a formal ruling on the correct classification of new products and services. Such a process could also help, even if there were no changes to the approach to category definitions.
49. A business introducing a new product or service would be able to apply to HMRC, or potentially an independent body of experts, for a formal ruling on the correct classification. The possibility of payments for rulings would need to be considered but this could put small businesses, unable to afford a ruling, at a disadvantage and potentially at risk of penalties. Formal rulings are discussed further in our responses to questions in Section 8.

Q2.5. What would be the impact of introducing much broader definitions in areas such as food? Would this help or cause more difficulties in practice?

50. See our comments in response to Q2.3 and Q2.4 above. Broader definitions for food would probably be helpful but care would need to be taken in devising them to avoid generating a new raft of tribunal cases on the interpretation of the new categories.
51. Broader definitions around health and disabled adaptations could also be used to address issues arising from developments in products and processes.

Q2.6. Could Making Tax Digital (see below) be used to resolve complexities associated with types of supply, either on its own or in conjunction with other changes?

52. See our response to Q1.5 above and our detailed comments in section 7 below. Making Tax Digital in itself is unlikely to resolve complexities but it could be used as an opportunity to drive simplification.

Section 3: Partial exemption methodologies, options to tax and capital goods scheme simplification

Partial Exemption

Q3.1. Where does partial exemption arise in practice unexpectedly? What is the impact on the businesses concerned?

53. We agree with the suggestion in the interim report that partial exemption has become far more of an issue for charities. This is discussed further in our responses to the questions in section 8 below.

Q3.2. Would it be practical to exclude more of these 'accidental' partially exempt businesses in some way? Would that just mean raising the de minimis amounts and changing incidentals guidelines?

54. The de minimis amounts should certainly be raised. They are out of date and exclude businesses which should be able to take advantage of them. Many farmers who have diversified, as noted in the interim report, are therefore forced into partial exemption.

55. The VAT registration threshold is updated each year but the partial exemption amounts are not regularly reviewed or updated. They should first of all be brought up to date – and then periodically (not necessarily annually) reviewed and updated.

Q3.3. What alternative methods would you recommend – or recommend avoiding?

56. An alternative approach could be to consider an exclusion from partial exemption based on a percentage rather than a fixed amount (as noted above a fixed amount needs to be periodically adjusted to remain effective). If the residual recovery rate of a business exceeded a fixed percentage, say 90 or 95%, the business would be treated as fully taxable. The level of the fixed percentage would need to be carefully considered and it would require work to determine whether and how far this would help to remove unintended partial exemption.

Q3.4. What alternatives or improvements could be put in place to make the process of agreeing a partial exemption special method with HMRC simpler, easier and quicker? Would a flat rate or sector-specific methodology for PE calculations be better than the flexibility of agreeing a bespoke method?

57. A flat rate PE method would be too blunt an instrument and would not allow sufficient flexibility to deal with variations within business sectors. It would only work fairly in sectors where businesses have similar (or even identical) business models and revenue streams.
58. Development of sector specific methodology is worth exploring. HMRC has already issued Partial Exemption Frameworks¹ for partial exemption special methods in some sectors, including higher education, insurance and housing associations. These provide additional guidance put together by HMRC working with sector representative bodies; the aim is to allow special methods to be agreed which are fair and consistent, with the minimum of time and costs to both sides.
59. There remains a degree of flexibility, which is desirable in terms of recognising differences within a sector, but means that a special method still has to be agreed with HMRC. The Higher Education framework² is intended:
- “to improve fairness and consistency and reduce administrative burden by:*
- Giving HEIs and their advisers clear guidelines on what constitutes a fair and reasonable, but simple to operate, PE method; and,*
 - Enabling HMRC to give speedy approval with the minimum of additional enquiry. For these benefits to be realised, both HEIs and HMRC officers must embrace the spirit of fairness and reasonableness which underpins this Framework. HMRC will take robust action against HEIs that exploit PE flexibility.”*
60. This should be very useful but we understand that in practice, lack of HMRC specialists with relevant expertise can mean that it still takes nearly two years to agree a partial exemption method in this sector.
61. If HMRC resourcing could be addressed, the development of additional sector frameworks has the potential to streamline the process and address some of the problems noted in the report, without losing all of the flexibility which is valued by businesses.
62. It is also essential that both HMRC and taxpayers and their advisers commit to genuine collaborative working and embrace ‘fairness and reasonableness’ to make a sector specific framework approach, incorporating some flexibility, work.

¹ <https://www.gov.uk/government/publications/partial-exemption-frameworks>

² https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/366126/frame-hei.pdf

Option to Tax

Q3.5. Could the process of Opting to Tax be simplified? How?

63. The two stage process causes confusion in practice and there appears to be a widespread lack of awareness, of both the Option to Tax and the process of opting, amongst those who do not have specialist VAT advisers. This leads to practical problems, some of which only come to light much later (for example, when a building is to be sold and questions are asked about whether an option to tax has been made). VAT may have been charged on rents – even though the opting process has not been completed - but HMRC have not challenged the VAT returns.
64. It is not clear that simplification of the process would assist greatly, given that many practical problems seem to arise due to lack of awareness or to an inability to produce evidence of opting years later (often when a building is being sold).

Q3.6. Could a system where, say, all commercial property is considered as opted by default work? Would this cause complexities with awareness?

65. It is not clear whether this question is indicating that there would be the ability to opt out of the suggested default treatment – we assume not as that would create additional complications and defeat the purpose of the default position. We do not therefore believe that this approach should be adopted, as there would be issues for those who would prefer to be making exempt supplies.
66. There would also still be problems caused by lack of awareness – as there are with the current regime. In some circumstances – for example sale of a commercial property as part of a TOGC – the suggested default position could help. In the TOGC example the purchaser and vendor would not need to worry about proving that the property was opted. However, if the purchaser is unaware of the default approach (or of its significance) or in other scenarios, the adoption of a default approach would still be likely to lead to incorrect VAT treatment.

Q3.7. Could a central database be created? What value would this provide and would that outweigh privacy considerations? Would you be willing to incur the burden of providing data to HMRC to allow such a database to be accurate and up-to-date?

67. A central database would be useful. It would prevent many queries to HMRC and save time and effort for both advisers and HMRC. The absence of a central register means that legal agreements in property transactions often include clauses to deal with the lack of certainty arising from the absence of a definitive record.
68. It would be difficult to pick up past options, although owners could be invited to have options made in the past added to the database. However, adding all new options going forward would gradually build up a reliable database.
69. In view of the advantages of a database it seems unlikely that there would be many objections to providing the data. The administrative burdens would presumably be minimal, given HMRC's plans to move to a fully digital approach to tax – although currently options to tax have to be sent by post. From a privacy perspective, it seems likely that much of the data would already be in the public domain for various reasons (land registry, LBTT register etc). We assume that the key information for the database would be date of the option, VAT number and property details.

Q3.8. Can the notification process be improved? Does this require confirmation from HMRC?

70. One of the problems with the notification process is the lack of any central database, so that it can be difficult to obtain evidence of the option to tax later.

71. GOV.UK states that HMRC do issue acknowledgements (within 15 working days) but we have been told that this does not always happen. It would be helpful to have a formal confirmation system. It would also be useful to have an online process for submitting options and receiving confirmations. This would need to be able to cope with complex notifications requiring reference to attached maps and plans.
72. An online process for notification and confirmation could be used in the development of a central database of options.

Capital Goods Scheme (CGS)

Q3.9. What burdens does the CGS create in practice?

73. We agree with comments in the report that many businesses do not understand CGS – unless they operate in sectors (such as financial services) where it is likely to be a significant issue and they have in-house VAT expertise which allows them to apply CGS correctly.
74. Businesses which are not initially partly exempt are particularly unlikely to realise that CGS could potentially apply to them. A fully taxable business could have purchased a building costing more than £250,000 which is used for wholly taxable purposes for 5 years; the business then expands by taking up an exempt activity and the building is used partly for that exempt activity. Adjustments under CGS could then be required – but the business may not appreciate this. It is unclear how often HMRC review CGS within a business (particularly smaller businesses without CRMs) and therefore how likely they would be to pick this up.
75. In line with comments in the report we have been told that the record keeping involved where there are only marginal changes in the use of a building are disproportionate to the VAT at stake; for example, the partial exemption standard method override considers a difference to be substantial if it exceeds £50,000, but the current CGS rules could require an adjustment of as little as £50 (or £20 for computers).
76. We have also had feedback that a multinational financial services enterprise may devote considerable amounts of time to working out an annual CGS adjustment, which is of little benefit to anyone because the residual recovery rate is relatively static.

Q3.10. Are there examples in practice of the application of the computer strand of CGS? What of ships and aircraft?

77. We agree with the comments about computers in the OTS report: it seems unlikely that many, or any, would now fall within the scheme. No examples have been raised with us in preparing this response.
78. It would make sense to remove computers from the scheme, as suggested in the report, so that businesses would no longer need to consider them in the context of CGS.

Q3.11. Can the aims of CGS be achieved in simpler – possibly more targeted – ways?

79. The capital expenditure threshold for land and property was set at £250,000 in 1990. It is now far too low. If CGS remains in its present form the threshold for land and property should be brought up to date – and then regularly reviewed (at a specified interval, say, five years). This would mean that many taxpayers would no longer need to consider CGS.
80. As noted in our response to Q3.9 a disproportionate amount of effort is being expended on CGS calculations, where the adjustments are insignificant. A reform which might reduce this problem would be only to require a CGS adjustment if the movement in

taxable use of the building was, say, 5% either way – with the option for the taxpayer to opt to make an adjustment for smaller movements.

Q3.12. As far as land and property is concerned, does the option to tax make a difference or have a part to play?

81. We have no comments on this question.

Section 4: Special Accounting Schemes

Flat Rate Accounting Schemes

Q4.1. Is it possible to reduce the number of different FRS rates?

82. It is unlikely that the number of FRS rates could be reduced without introducing possibilities for abuse. One of the reasons behind the recent anti-avoidance changes was abuse of the 'catch-all' category for activities which did not fit elsewhere.

83. If abuse is tackled by increasing the flat rates, businesses using the scheme are likely to leave – unfortunately this affects genuine users as well as the abusers. As a result of the recent changes many businesses which fall into the 'limited cost trader' category are likely to leave the scheme even though they were not using it for abusive purposes.

Q4.2. Will there be a sufficient simplification benefit to require traders to state what scheme they are using on their VAT return?

84. We have no comments on this question.

Q4.3. Is it possible to further increase knowledge of schemes up front when traders first register?

85. We have no comments on this question.

Q4.4. Can measures directed at abuses of the schemes be better targeted? Perhaps by framing eligibility differently?

86. We understand from information provided at an HMRC consultation meeting that HMRC considered other approaches to tackling abuse of FRS before introducing the recent changes but concluded that other options would not be effective.

87. However, we would have liked to have seen other alternatives tried, for example using legislation to tackle promoters/organisers of the abusive usage of the scheme.

88. Another alternative would have been to adopt an approach similar to that used in the agricultural flat rate scheme so that FRS could not be used where the benefit exceeded a set amount per year (the agricultural scheme figure is £3,000).

Q4.5. Overall, do these schemes still work? Is there still a sufficient simplification benefit to justify their retention or would it be simpler just to simplify particular aspects of the general VAT system? Will MTD make them less relevant?

89. FRS is still attractive to traders outside the limited cost trader category – although they may have problems with the calculations required to determine whether they are limited cost or not. As the report notes FRS removes any need to consider partial exemption. Traders within the limited cost category can remain within (or join) the scheme but simplicity now comes with a higher cost which has reduced its attractiveness. MTD is discussed in detail in section 7 below.

Retail schemes

Q4.6. Do any complexities arise in operating retail schemes?

90. We have no comments on this question.

Q4.7. How common is modern accounting software in the retail sector?

91. We have no comments on this question.

Q4.8. What specific complexities with VAT accounting do the retail schemes help manage?

92. We have no comments on this question.

Q4.9. Would there be a simplification benefit in moving to systems that send information to HMRC straight from the till, as is now in use in some other countries? And would the simplification outweigh any implementation and running costs?

93. We have no comments on this question.

Tour Operators Margin Scheme (TOMS)

Q4.10. What arrangements and transactions are caught in TOMS nowadays? Are these 'tours' as envisaged?

94. The scope of TOMS now extends beyond tours. For example, chauffeur driven cars are now caught. This can be problematic if the business outsources its drivers, as this can create supplies inside and outside TOMS. This complicates what is effectively an upmarket taxi business.

Q4.11. Does TOMS still help the sort of tour operators originally targeted?

95. Yes, where those businesses incur VAT in other EU countries.

Q4.12. Can TOMS be simplified to still target the original arrangements but excluding things that should not be in its ambit?

96. We have no comments on this question.

Q4.13. Should TOMS apply to supplies that solely occur in the UK?

97. It is not obvious how this would work. The essence of TOMS is to facilitate allowance for VAT recovery on costs incurred in other EU countries. Restricting TOMS to the UK would not achieve that purpose. Disapplying TOMS on UK only supplies would have some benefit for incidental TOMS transactions but would create a need for a separate VAT method for true package supplies.

Q4.14. What should be done to maintain or increase alignment with international regimes where this offers greater simplicity?

98. We have no comments on this question.

Agricultural flat rate scheme (AFRS)

Q4.15. How widely used is the AFRS and is it still necessary?

99. We have no comments on this question.

Q4.16. What would be the impact of removing this scheme: what sort of businesses would lose out? How much would they lose, bearing in mind administrative costs?

100. We have no comments on this question.

Cash Accounting

Q4.17. Are there any problems with the current VAT cash accounting system?

101. We are not aware of any significant problems with the VAT cash accounting system. It remains a useful system for small businesses and should be retained.

102. The threshold for VAT cash accounting was increased in 2007. As noted in our general comments we consider that there should be a mechanism for periodic review and updating of all thresholds and de minimis amounts in the VAT regime.

Q4.18. Does the impact of wider direct tax cash accounting with MTD, with its differing thresholds, cause any difficulties?

103. The differing thresholds for direct tax cash accounting do add complexity – and small businesses need to be made aware of the differences. However, VAT cash accounting remains useful which probably outweighs any potential confusion caused by the direct tax approach.

Annual Accounting Scheme

Q4.19. How much simplification does the AAS provide in practice? Since its presence adds yet one more scheme for a business to consider, should this be retained at all?

104. See our response to Q4.20 below.

Q4.20. Will the AAS be compatible with Making Tax Digital plans, given quarterly reporting?

105. It is hard to see that VAT annual accounting will be compatible with MTD. As the OTS report notes it can lead to poorer record keeping and unanticipated liabilities – both problems which MTD is specifically intended to tackle. If businesses must keep digital records in real time and report quarterly for direct tax, the justification for annual accounting for VAT no longer appears to exist.

Section 5: VAT admin, penalty and appeals processes

Administration

Q5.1. We would be interested in your experience in relation to VAT guidance. Are there particular types of guidance that cause issues? Or issues about accessing guidance?

106. There are problems with GOV.UK which affect all HMRC guidance – not just guidance relating to VAT. Searching is difficult and there are also problems with out of date guidance and inaccuracies in guidance – and difficulties getting these corrected when they are reported via GOV.UK.

107. We agree with the comments in the report about difficulties obtaining clarification from HMRC when guidance is contradictory or incorrect. It may also not cover the precise circumstances in question. HMRC frequently responds to requests for clarification by referring agents or taxpayers back to the inadequate guidance which has led to them contacting HMRC in the first place.

108. We have had some positive comments on the three existing VAT Toolkits for agents. Use of the toolkits is not restricted to agents but they are not publicised to others. They

could be useful to some taxpayers because they provide guidance on errors that HMRC frequently see in returns and set out steps which can be taken to reduce these errors.

109. Publicity for the toolkits beyond agents might be useful but because they are clearly written for agents, others might be deterred from using them. HMRC could consider producing adapted versions of the toolkits for non-agents. Self-service tools for small businesses could take them through difficult areas and reduce pressure on HMRC helplines. Even if they still needed to contact a helpline, someone who had worked through the self-service tool would be more likely to provide the right information and hence to get the right answer. Links could be provided from online business VAT accounts.

Q5.2. Would it help if there was a search function or site map for guidance?

110. The GOV.UK HMRC landing page for VAT <https://www.gov.uk/topic/business-tax/vat> is reasonably helpful as a starting point for finding key VAT guidance from HMRC. As noted above the search functionality for GOV.UK is very poor.

Q5.3. Would it be simpler if there was an automatic notification feature for all new and amended guidance that also told you precisely what the amendments were?

111. It would be helpful if updates to content on GOV.UK gave details of precisely what the amendments were.

Q5.4. What other areas of VAT administration cause complexity? Are VAT repayments a problem in practice?

112. We have no comments on this question.

Q5.5. How could the VAT overpayments regime operate fairly to ensure that only one repayment of the overpaid VAT is made and that it is made to the right person (the person who bore the economic burden)?

113. We have no comments on this question.

Penalties

Q5.6. What are the major concerns with the penalties regime?

114. As noted in our general comments some of the issues around VAT penalties and appeals (and disputes generally) could be tackled through genuine collaborative working between HMRC and taxpayers, with prompt access to HMRC specialists when needed. Most businesses want to get their VAT right but find it difficult, particularly if they are smaller businesses, to get access to the appropriate HMRC support in a reasonable timeframe. Large businesses with HMRC CRMs find it easier to access specialists but can still encounter delays and problems resolving issues.
115. One of the main concerns with the penalties regime in general (not exclusively for VAT) is that HMRC is unwilling to accept that reasonable care has been taken and seeks a penalty even where the error is voluntarily disclosed as soon as it comes to light.

Q5.7. How could we provide more clarity regarding the voluntary disclosure regime to encourage more compliance?

116. We agree with the comments in the report about consistency and reasonable care. Compliance and voluntary disclosure would be assisted if there was acceptance within HMRC that a mistake does not automatically mean that there has been a lack of reasonable care (meaning that a penalty is due). Whilst this was the general view, we have also had feedback (similar to that noted in the report) that sometimes an HMRC officer has not raised a penalty following a voluntary disclosure when one was

expected; it was suggested that this was due to the additional time and paperwork which would be involved, particularly if the taxpayer challenged the penalty.

Q5.8. Could the penalties system be more like speeding fines, with only exceptional excuses?

117. ICAS has submitted a response to the HMRC Consultation Making Tax Digital: sanctions for late submission and late payment. This sets out in detail our views on a new penalty regime – including discussion of a points based system and suspension. The response can be found on the ICAS [website](#).

Appeals procedure

Q5.9. Would improvements to decision letters help improve understanding about the statutory review process?

118. We agree with the comments in the report about lack of understanding amongst unrepresented taxpayers. This may not be helped by the slightly different processes for VAT and direct taxes. It would be useful to review and amend the content of the decision letters to try to improve understanding. However, we also agree that the process is often seen as a rubber-stamping exercise so some taxpayers will always want to go to the Tribunal for an independent review. Those with specialist advisers who feel they have a strong technical case may also wish to save time by going straight to the Tribunal.

Q5.10. Are there areas of complexity with the statutory review process that need addressing? If you don't use statutory review, why not? Is your experience different in the context of other taxes?

119. We have no comments on this question.

Q5.11. Should anything be done to encourage greater use of ADR in VAT?

120. We consider that greater use of ADR would be helpful for both HMRC and taxpayers – it reduces costs and time spent. Even if cases ultimately go to the Tribunal, ADR still appears to be useful in clarifying the points at issue and saving time and costs in preparing for the Tribunal.

121. More publicity for ADR would be useful in raising awareness that it is a possibility. Some taxpayers may also be deterred by the use of HMRC facilitators who may not be perceived as neutral – although we appreciate that the use of genuinely independent professional mediators raises cost issues.

122. We have been told that there may sometimes be difficulties getting HMRC to agree to ADR in VAT cases. For example, in a largely fact-based dispute we have been told that the taxpayer tried to get HMRC to agree to using ADR but the CRM and the Solicitor's Office pressed for a Tribunal hearing. After a succession of assessments and challenges, the taxpayer's position was finally accepted by HMRC but the taxpayer had by then incurred costs almost equivalent to the VAT at stake. Use of ADR at an early stage could have saved time and costs on both sides.

Q5.12. In general, are there any simple routes to making the dispute resolution process, including the Tribunal stage, less time consuming and costly? Would lowering barriers risk encouraging too many appeals? Could anything be done to make a tribunal less time consuming and costly? And would lowering these barriers help or simply result in more appeals that could congest the system?

123. See our responses to Q5.6 and Q5.11.

Section 6: Formal ruling system

Q6.1. What are the areas of the VAT system that most need rulings? Why are these needed – and how many would arise in a year?

124. Ideally legislation should be clear and simple so that HMRC guidance and/or rulings would not be required to the same extent as is currently the case. Currently, the legislation is often unclear and guidance on interpretation and also (at least until after Brexit) on the impact of EU judgments, is essential. HMRC guidance is therefore necessary but is frequently inadequate, with problems arising in practice because HMRC declines to give a ruling – referring agents and taxpayers back to the inadequate guidance which has led to them contacting HMRC in the first place.
125. It can also take a considerable amount of time to obtain a ruling from HMRC, in cases where they are prepared to give one. Requests are referred between different teams within HMRC, causing delays at each stage.
126. Most areas of the VAT system would benefit from rulings because of the issues with guidance – see our response to Q5.1. However, as noted in our response to Q2.4, one area which would particularly benefit from formal rulings would be establishing the correct treatment of a new product or service. It might be worth considering the establishment of an independent body to provide rulings which would be binding on both HMRC and the taxpayer. Such a body would need to have access to a range of VAT expertise and be adequately resourced so that rulings could be obtained quickly. This might mean that paying for rulings would need to be considered, which could disadvantage smaller businesses.
127. The report also raises the possibility of publishing anonymised rulings. We agree that this could be useful and should be considered. It might help to prevent duplication of effort by taxpayers and HMRC – although small differences in the facts between cases could mean that taxpayers are still left with uncertainty and would therefore still want to seek their own ruling which they could rely on. Even in these circumstances, the ability to consult published anonymised rulings might assist the process by helping people to identify the key points they should concentrate on and the supporting information which might be required.

Q6.2. Could an agreed certification procedure between a buyer and seller work for issues such as compliance with TOGC liability rules? How could HMRC be protected against abuse?

128. It might be possible for HMRC to approve some agents to be authorised agents who could 'certify' particular transactions, such as TOGC compliance. A taxpayer who wanted speed and certainty could choose to pay the approved agent to check the facts and papers and certify compliance. The cost might deter smaller businesses.

Q6.3. Are there examples of practices in other countries that are particularly worth investigating – or emulating?

129. We have been told about experience with an independent body providing binding rulings in Spain. Independence is perceived to be an advantage, as is the fact that the rulings are binding on both parties (provided the facts have not been misrepresented). There is no charge for the rulings but we understand the body is not well resourced so obtaining a ruling can be very slow.

Q6.4. What other routes could be used to achieve the needs of businesses for rulings without setting up a formal system?

130. The need for some rulings could be avoided or reduced if there were improvements to HMRC guidance and it was kept up to date. Where rulings remained necessary, the existence of better guidance and the ability to consult a database of anonymised rulings could assist people to formulate better requests for rulings (including identifying key

areas and supporting information which might be required). This could streamline the process and make it less time consuming for taxpayers and HMRC. See our responses to Q5.1 and Q6.1.

Section 7: VAT and Making Tax Digital Alignment Opportunities

Q7.1. What are the areas of the VAT regime that require simplification to be compatible with MTD?

131. Only 12% of VAT returns are currently submitted direct from software. This will need to increase to 100% for Making Tax Digital. The main obstacle is the complexity of the VAT regime. Many large companies (which already automate many processes) cannot submit direct from software because of the complexity of their VAT computations (particularly partial exemption) – they use spreadsheets to complete these before entering the figures manually and submitting the online VAT return. Smaller entities also use spreadsheets for various reasons (we understand HMRC is conducting research into the details) – including the need to make manual adjustments prior to submission because software cannot deal with the calculations required.
132. There is considerable business concern about the approach to MTD for VAT and the proposed timetable for implementation. MTD could be used as an opportunity to address some of the main areas of complexity in the VAT regime, that impede the use of software to submit returns.
133. Unfortunately, the proposed timescale for MTD is so tight that this is unlikely to be feasible. Given that most businesses already file quarterly returns for VAT, so that the suggested benefits of MTD are less obvious for VAT than for direct tax, it would make sense to defer MTD implementation for VAT to allow time for sensible simplification of the rules to be built in to the process.
134. As noted above partial exemption is most frequently raised as an area which will not be compatible with MTD because of the need to use spreadsheets to carry out the complex calculations. It is a major factor which currently makes it impossible to file VAT returns direct from software.
135. HMRC has suggested that it will be possible to design software which will be capable of taking data from spreadsheets into the software to enable MTD filing – but there is no evidence so far that this is the case and the timescale for the introduction of MTD is likely to be too tight to ensure that such software will be available.
136. Large companies are concerned that they require up to 2 years to change their VAT systems but final MTD requirements are still not clear – with introduction currently scheduled for April 2019.
137. Other areas which are problematic include special accounting schemes, such as TOMs.

Q7.2. Does MTD mean that VAT annual accounting and other simplified schemes are redundant?

138. As noted in our response to Q4.20 above it is hard to see that VAT annual accounting could continue once MTD is introduced. As the OTS report notes it can lead to poorer record keeping and unanticipated liabilities – both problems which MTD is specifically intended to tackle. If businesses are being forced to report quarterly for direct tax (albeit with an end of year finalisation process), it cannot make sense to allow them to adopt annual accounting for VAT.
139. Other simplified schemes should have a place in MTD. As noted in our responses to questions in section 4, cash accounting remains useful to small businesses and should be retained. The attractiveness of the flat rate scheme has been adversely affected by

the recent changes but for those outside the limited cost trader category it still provides useful simplification which is compatible with MTD.

Q7.3. What opportunities does MTD offer to further simplify VAT for businesses?

140. As noted above the timescale for MTD for VAT should be extended so that MTD can be used as an opportunity to address some of the main areas of complexity in the VAT regime, that impede the use of software to submit returns.

Q7.4. What can we learn from other countries that have a more digitised VAT system?

141. We have no comments on this question.

Section 8: Further areas for investigation

Q8.1. Are there other business sectors that have particular VAT issues beyond those we have noted?

142. The OTS should investigate the VAT treatment of the public sector which suffers from numerous distortions and complexities. See our response to Q8.3 below.

143. As noted in our general comments we also believe that the VAT regime for the financial services sector (including insurance) should be reviewed after Brexit.

Q8.2. Do you have examples to contribute of good and less good communications issues? Are there ways to improve matters easily?

144. We agree with the comments in the report about the benefits of CRMs, although even large companies with CRMs can still encounter delays and problems resolving issues; this may be due to a shortage of HMRC specialists.

145. It would be helpful if HMRC introduced dedicated agent helplines for VAT to enable agents acting for those outside the large business CRM mechanism to access support. Any such helplines would need to be adequately resourced by staff with appropriate expertise.

146. We have received feedback on communication problems arising from the 64-8 process (authorisation for an agent to act). Examples include: 64-8s submitted with correspondence but HMRC responding that they cannot deal with the agent because there is no 64-8; there is ongoing correspondence (ie a 64-8 is recognised to be in place) but HMRC ceases to communicate citing the absence of a 64-8; an agent speaking to one part of HMRC such as General Enquiries which confirms that a 64-8 is in place but then being transferred to debt management who will not discuss the client because there is no 64-8. Some of these issues may be resolved by the new HMRC Agent Authorisation online process which is being developed. A note in the online business VAT account of the authorised agent's details would also help.

Q8.3. Bearing in mind our terms of reference, are there other areas of VAT that we should be investigating?

147. The OTS should investigate the VAT treatment of the public sector which suffers from numerous distortions and complexities. In the past many services were delivered by local authorities, government bodies or the NHS, ie bodies within the provisions of sections 33 and 41 of the VAT Act allowing VAT to be recovered in certain circumstances. Due to constraints on public spending and pressure to achieve efficiencies it is increasingly common for the provision of the same services to be transferred to other not-for-profit entities, including charities, that do not fall within sections 33 or 41.

148. The UK VAT regime for the public sector is not fiscally neutral because the different VAT status applicable to different parts of the public sector provides a VAT recovery shelter for some organisations but not others – even though they are delivering the same services to the same end users.
149. VAT cost sharing was introduced in the UK in July 2012 to allow independent groups of persons to form cost-sharing groups to provide shared services without charging VAT. This does not address the limited scope of sections 33 and 41 but should have helped not-for-profit organisations to minimise irrecoverable VAT. However, take up has been low because of the onerous nature of some of the conditions and uncertainty around EU infraction proceedings against other jurisdictions. There have also been problems for some not-for-profit entities trying to use cost sharing, due to the complexity of the regime which concentrates on anti-avoidance rather than helping organisations to cost share.
150. ICAS produced a detailed paper on VAT and the Public Sector in 2014. This included a detailed analysis of the distortions and problems arising from the UK approach to VAT and the Public Sector. A substantial extract from this paper appears in the Appendix to this submission and includes detailed examples of the VAT problems and additional costs caused by the current UK rules applying to different public sector bodies.
151. ICAS also raised the cost and value for money issues arising from the current VAT regime for the public sector in a Budget submission in 2017 together with some suggestions for government actions to address the problems: these are set out in the following paragraphs:

Costs and value for money

152. Taxpayers' money is being used to provide public services. Where the provision of services is transferred from a body within s33 or s41 to another not-for-profit entity outside these provisions and so unable to benefit from the VAT recovery, it will increase the cost of providing the service by up to 20%. Increasing the cost of providing a public service is not a desirable outcome; increased VAT receipts for the Treasury will be offset by increased costs for other government departments/local authorities - or service levels will be reduced.
153. It may be possible to put in place arrangements to mitigate the VAT impact of the provision of services by a different body (see Categorisation examples 1 and 2 in the paper contained in the Appendix), but this in itself costs money for advice, implementation and agreeing the tax treatment with HMRC. In some cases, there will also be ongoing costs of operating what can be complex arrangements. It is not a good use of taxpayers' money for HMRC and bodies providing public services to be devoting time and incurring costs trying to get round problems caused by the fact that the underlying VAT regime for the public sector is not fit for purpose.
154. The use of arrangements to mitigate the VAT impact may also give rise to disputes between HMRC and public sector bodies. Both parties then incur additional costs (paid for by taxpayers) and may become involved in litigation – leading to publicity and giving a poor impression to taxpayers. In view of the public sector procurement rules there may also be issues for entities who use complex VAT arrangements to get the best possible return for public expenditure.
155. The differences in VAT recovery act as a disincentive to implementing new and innovative service delivery models across the public sector.

Actions the government could take

156. Undertake a fundamental review of the current VAT regime for the public sector to address complexity and provide a level playing field for all organisations in the sector.

The wider VAT reforms likely to arise from Brexit offer a good opportunity to consider a new approach.

157. Introduction of additional targeted refund schemes as a short term interim measure. Various targeted refund schemes have been introduced, for example, for UK search and rescue and air ambulance charities and for hospices. Whilst this piecemeal approach is ultimately unsatisfactory because it fails to address the underlying problems, additional targeted schemes would be useful in the short term.
158. Improve the cost sharing regime by relaxing the onerous conditions for not-for-profit entities and charities - and changing the focus for these bodies to provide help rather than concentrating on anti-avoidance. Currently, this would be subject to the constraints of EU law but post-Brexit there would be scope to go further.
159. Mandate HMRC to set up a specialist team to administer VAT in the public sector. There is a very strong argument for HMRC to treat the public sector as a special sector administratively and to have dedicated resources for dealing with its issues. A dedicated HMRC team open to discussion with public sector bodies and their external advisers would help to address issues consistently and to minimise expenditure of public money on disputes around complex VAT queries.

Appendix: Extract from the ICAS 2014 Paper: VAT and the Public Sector

1. BACKGROUND

In April 2014 ICAS responded to a consultation issued by the European Commission on the impact of the current VAT system on public sector organisations³. This project identified a number of areas in the UK's system where the current rules give rise to distortions in the way that different parts of the public sector are subject to VAT on essentially the same transaction. ICAS has been asked by its members to look in more detail at the position and identify areas where the UK Government should focus its attention on ensuring a level playing field across the public sector.

Our focus in this area has also been informed by the public sector procurement rules. These rules were changed from 1 April 2013 for central government contracts of more than £5 million and require bidders for these contracts to self-certify their tax compliance as part of the tender process. The introduction of these rules has had an impact across the public sector and many organisations find themselves in the position of needing to include information on tax compliance on tenders to national governments. This is against a background where there may be strategies adopted by public sector organisations to maximise VAT recovery that appear to be in contravention of this rule, even where these are treated as acceptable tax planning by HMRC.

Definition of public sector

The term “public sector” needs to be clarified. We are using this term in this paper to cover all not for profit organisations as the VAT issues are common across the sector. We have used the term to include:

- Central Government.
- Local Government.
- The public health sector – the NHS.
- The public education sector.
- The charitable sector.

2. UK LEGISLATION – CATEGORISATION OF VAT ENTITIES

The UK has applied article 13 of the European Directive⁴ by implementing specific rules regarding the VAT treatment of public sector organisations which splits these organisations into four types:

- Local Authorities and similar organisations (including the BBC) – section 33 VATA 1994 allows these organisations to recover all VAT incurred on activities related to the non-business functions of the organisation. There can be issues where the organisation receives non-statutory sources of income where these new activities are outside the scope of section 33.

³ A copy can be found at <http://icas.org.uk/Technical-Knowledge/Tax/Consultations-and-Submissions/>

⁴ The text of the Article is as follows:

“States, regional and local government authorities and other bodies governed by public law shall not be regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with those activities or transactions.

However, when they engage in such activities or transactions, they shall be regarded as taxable persons in respect of those activities or transactions where their treatment as non-taxable persons would lead to significant distortions of competition.

In any event, bodies governed by public law shall be regarded as taxable persons in respect of the activities listed in Annex 1, provided that those activities are not carried out on such a small scale as to be negligible”.

- Government departments and the NHS and associated organisations – Section 41 VATA 1994 allows these organisations to recover input VAT in certain circumstances but they cannot recover VAT on non-business activities. The Treasury lists the services on which these departments are able to receive funding to compensate for irrecoverable VAT in the London, Edinburgh and Belfast Gazette.
- Other public sector organisations – these are organisations that do not have any specific provisions that allow them to recover VAT on their activities which are for the public good. These organisations use the standard income method to split their activities between business and non-business, and operate an appropriate partial exemption method to determine what input tax can be recovered. In the UK organisations dealt with under these arrangements are mainly charities, housing associations, universities. In effect, these public sector bodies are not treated under article 13 as they are not “bodies governed by public law” as defined by the Principal VAT Directive.
- Non-Departmental Public Bodies (NDPBs) which are effectively a separate category for VAT purposes. These are organisations which have a role in the processes of government, but are not a Government Department or part of one, and which accordingly operate to a greater or lesser extent at arm’s length from Ministers. As these organisations are separate from central government they do not benefit from the section 41 treatment unless they are Crown NPDBs. An NDPB is only able to register for VAT where it makes taxable supplies and can only recover VAT in connection with those supplies and its residual input tax allocated to those supplies under the partial exemption method adopted. This can be a very complex area as the funding of NDPBs relies on grants from Government and often this funding is calculated on the basis that VAT can be recovered in line with section 41 VAT 1994. It is only once plans to transfer services to the NDPB are advanced that VAT is considered and there can be significant issues to overcome in this area.

3. IMPACT OF UK LEGISLATION ON CATEGORISATION

To demonstrate how these regimes would work in practice, consider the example of an organisation in each category incurs £1,000,000 input tax on implementing a new payroll solution across the organisation where the work was outsourced to an external contractor. The VAT recovery position would be:

- Local authority – would be able to recover the £1,000,000 in full under the terms of section 33.
- Central government, NHS – would be able to recover the £1,000,000 in full under the terms of section 41 provided the services were covered by the Treasury List.
- Other public sector organisations – universities, charities etc – if the organisation was able to be VAT registered the £1,000,000 input VAT would be treated as belonging in the partial exemption “pot”. Partial exemption is the method used to allocate input tax incurred on general activities in proportion to an organisations ratio of taxable supplies to total supplies. These types of organisations will have predominantly exempt supplies so full recovery is not possible. Assuming a recovery rate of 15% (this figure is illustrative of the VAT recovery rate for the sector) would mean that the organisation would only be able to recover £150,000 of the VAT incurred, leaving it with a balance of £850,000 to cover with funding from other sources.
- NDPBs - if the organisation was able to be VAT registered the £1,000,000 input VAT would be treated as belonging in the partial exemption “pot” with similar issues as above. The partial exemption rules would apply to these organisations but as they carry out government functions which are non-business for VAT, they are unlikely to have very significant levels of taxable supplies. Assuming a recovery rate of 5% (this figure is illustrative of the VAT recovery rate for the sector) would mean that the

organisation would only be able to recover £50,000 of the VAT incurred, leaving it with a balance of £950,000 to cover with funding from other sources.

This example demonstrates the wide variation across the public sector and the value to the organisations of the statutory shelters in sections 33 and 41. It also illustrates the issues associated with transferring responsibilities from within government to new organisations – either NDPBs or other types of organisations – and the impact on funding for the new organisations.

The VAT cost is a significant burden, and at the moment these rules act as a disincentive to implementing new strategies for delivering public services. There is not a level playing field across the public sector and we believe it is time to address this issue within the UK.

To try and illustrate how this affects the running of the public sector we have looked at two scenarios where the same transaction carried on by bodies with differing status has a very different tax impact.

1. Categorisation example 1 – social housing

The first example is the provision of social housing which is exempt from VAT in the UK. Where the housing is provided by a local authority they are able to recover the VAT incurred on repairs and maintenance under the generous partial exemption de minimis rules available to local authorities. If the same housing is provided to the same tenant by a Housing Association they are not able to recover these amounts of VAT. A Housing Association is generally a not-for-profit body which may have charitable status and is likely to receive public money; many evolved from the outsourcing of social housing provision in the UK.

The VAT anomaly can lead to issues when there are transfers of social housing stock from the local authority sector and where the successor landlord does not benefit from the local authorities' VAT shelter outlined above. This can result in convoluted structures to allow the repair and maintenance obligations to remain with the local authority so that VAT can be recovered as the cost of making a complete transfer of all obligations is the 20% of VAT incurred on repairs and maintenance. There are significant professional and legal costs associated with structuring the transaction in this way. The bulk of these costs are on the initial transaction but there are on-going compliance costs.

To give some idea of the financial impact of the VAT in these cases we have looked at the VAT costs of refurbishment programmes under housing stock transfers from Glasgow City Council. The technical issue concerned the recovery of VAT on future refurbishment costs associated with the social housing. As noted, housing associations do not fall into the section 33 shelter available to local authorities and cannot recover VAT incurred on refurbishment work. The additional cost of this VAT threatened the financial viability of the transfer of social housing stock and the third party funders pushed for action to mitigate this cost so the transfer could proceed. A structure was designed, with HMRC consent, to effectively allow the cost of refurbishment to remain with the local authority.

Glasgow Housing Association acquired the social housing stock of Glasgow City Council in 2003 with an intended budget of £1.47 billion for refurbishment costs. The level of future costs anticipated on refurbishments where Glasgow Housing Association includes both the debtor due from Glasgow City Council and the creditor for future upgrades disclosed at 2012 is £250 million.

As indicated by the example above, it is possible to enter into contractual arrangements which benefit from the VAT recovery position of the local authorities. However, without detailed approval from HMRC this type of tax planning could be seen as falling foul of the guidelines included in the Treasury document "Managing Public Money" issued in April 2013 which states at paragraph 5.6.1:

"Public sector organisations should not engage in, or connive at, tax evasion, tax avoidance or tax planning..... artificial avoidance schemes should normally be rejected".

The guidance notes that tax advisers can be used for normal compliance activity but it casts doubt on the ability of Government bodies, including NDPBs, to adopt planning strategies which are justifiable in terms of deliverables and governance if one of the aims is also to maximise the VAT recovery on their activities. There is a tension between this requirement and the need to use public money effectively. Paying more tax than is required could be the result of this tension.

2. Categorisation example 2 – “relevant residential purpose” or “relevant charitable purpose”

The other example to consider is the provision of accommodation for “relevant residential purposes” or “relevant charitable purposes”. Where the development falls within either of these categories the construction work will be zero-rated with no VAT cost charged on construction costs from the main contractor. This zero-rating covers most work on student accommodation for Universities and work for charities on providing premises to be used for the non-business activities of the charity.

On substantial capital projects of this nature there are normally significant costs from architects, surveyors and other consultants which cannot be treated as part of the construction and are subject to VAT at 20%. If these costs are incurred by either a university or charity the VAT incurred would not be recoverable.

The approach to this that has been used is for the university/charity to set up a separate subsidiary to act as the main contractor on a design and build contract for the organisation. This structure allows the subsidiary to use the composite supply rules to zero-rate the whole supply it makes to the organisation – so it is able to recover all the VAT incurred on associated architects, surveyors’ etc. costs. Using a separate subsidiary is the method used to ring-fence the property activity and make sure that the VAT can be recovered while giving the organisation the control over the appointment of main contractors on the project and apply for funding for the project while under the control of the organisation.

This is a normal planning strategy, and has been accepted by HMRC. HMRC reviewed the position in 2011 as a result of the Talacre case at the European Court of Justice (C-251/05) and after discussion with the Charity Tax Group decided that the treatment as a composite supply would be available for zero-rated construction services in Group 5 Schedule 8 VATA 1994. The Charity Tax Group took Counsel’s opinion on the issue as part of their discussions on the issue and HMRC accepted that the Talacre judgement did not affect the approach in these particular circumstances.

3. PUBLIC SECTOR PROCUREMENT RULES

As the planning for transfer of housing stock outlined above demonstrates, this is tax planning by the public sector to enhance VAT recovery. The procurement rules across the whole public sector will require organisations to consider whether they can justify the use of this type of planning to eliminate VAT costs on property transactions. To the man in street, the use of a single purpose vehicle property development company can look like part of an avoidance scheme and using this type of structure does not add to overall transparency. There is now a tension between planning for financial viability and the need to be seen to be tax compliant even if this would mean a higher tax bill for the organisation.

4. ADMINISTRATIVE COMPLEXITIES

4.1 Business and non-business activities

There are further layers of complexity in VAT recovery for public sector organisations in dealing with VAT. The first step is that these organisations will be involved in splitting their activities between business activities and non-business activities. This is a complex area in itself and there is a wealth of case law that covers the issue, along with a full manual of guidance for HMRC staff at <http://www.hmrc.gov.uk/manuals/vbnbmanual/index.htm> .

4.2 Partial exemption

Once this has been calculated the organisation then has to consider its partial exemption position applicable to its business supplies. A large number of public sector organisations are partially exempt – their supplies for VAT purposes include both taxable supplies and exempt supplies – and they are required to agree a formula with HMRC for apportioning the input VAT that is incurred across the business activities of the organisation between its taxable activities and its exempt activities.

This can be a very complex process and involves work to ensure that the accounting system and the staff who operate the system can distinguish between taxable and exempt supplies and purchases. For example, it becomes important that income from car parking activities is allocated to either taxable or exempt for some organisations. The operation of the partial exemption scheme is dependent on this level of detail being available to complete the calculation for all public sector bodies.

5. ADMINISTRATIVE COMPLEXITY PARTICULAR TO THE PUBLIC SECTOR

There are a number of areas where there are particular problems for public sector bodies as a result of the complexity of UK VAT regulations and this paper will now go on to consider these in more detail to give a flavour of the types of issues that these organisations have to deal with in practice. The examples to be covered are:

- Issues around prescribing within the NHS.
- Issues around cost sharing across the public sector.

1. Administrative complexity example 1 - prescribing within the NHS

The NHS is treated in a very complex way by the VAT rules and their interpretation by HMRC. We are focusing on the issue of prescribing within the NHS as a discrete issue but in the bigger picture the rules around partial exemption calculations and the interaction with contracted out services cause significant practical issues for the day to day running of the NHS. The HMRC guidance on this issue is here <http://www.hmrc.gov.uk/menus/frame-nhs.pdf> and gives some flavour of the issues and problems associated with this area

As noted above the NHS is a section 41 organisation and is able to recover input VAT in certain circumstances. For most of the organisations covered by section 41 the supplies they make are outside the scope of VAT or exempt so there is no requirement to account for VAT.

Prescription services offered by the NHS are zero-rated for VAT in certain circumstances under Group 12 of Schedule VATA 1994. This means that the VAT incurred in purchasing the medicine can be recovered while there is no VAT to be accounted for on any prescription charges.

The UK legislation in this area applies the zero-rating as follows:

“1) the supply of any qualifying goods dispensed to an individual for that individual's personal use on the prescription of an appropriate practitioner where the dispensing is:

- a) By a registered pharmacist; or
- b) In accordance with a requirement or other authorisation under a relevant provision”.

There is HMRC guidance which defines the terms used in the legislation so that most prescriptions issued under the NHS prescribing guidelines fall into this zero-rating. It is worth noting that drugs and medicines supplied in hospital are treated as part of a supply of healthcare to the patient which is outside the scope of VAT and the VAT incurred by the hospital on these drugs and medicines cannot be recovered by the NHS.

However, there are developments in the ways that prescriptions are issued by the NHS in line with policies to try and reduce the pressure on general practitioner workloads. One of the areas that is causing difficulties from a VAT perspective is prescribing by local clinics for medicines to be used by non-named individuals, and thus outside condition one. This occurs for many emergency prescriptions such as for drug treatment where the clinic is not able to get a suitable prescription for the individual. If the conditions cannot be met, the supply is treated as standard-rated so that the clinic is required to account for VAT on the cost of the drugs or medicine and this can create significant problems.

There are plans to expand the powers of local clinics in this area, and it is likely that they will be able to issue emergency prescriptions for a wider range of drugs and medicines, including expensive cancer treatment drugs. This additional VAT cost will have significant impact on funding for the NHS and it is vital that HMRC adapt their guidance to ensure that it reflects an up to date approach to prescribing within the NHS.

2. Administrative complexity example 2 - cost sharing across the public sector

In July 2012 legislation was passed that allows an independent group of persons to form cost-sharing groups to provide shared services without charging VAT in line with Article 132.1(F) of the Principal VAT Directive. Until this legislation was introduced, organisations were able to set up cost-sharing groups but the services provided by the cost-sharing group were subject to VAT which is a disincentive where organisations are not able to fully recover VAT. The legislation is intended to combat this position and allows the cost-sharing group to treat its services as exempt from VAT. This VAT exemption gives the group the scope to realise the savings of shared services without the additional VAT costs.

The UK legislation is rules based and is included in Group 16 Schedule 9 VATA 1994. The primary conditions are as follows:

- There must be an independent group of persons supplying services to persons who are its members.
- All the members must carry on VAT exempt and non-business activity.
- The services supplied by the cost-sharing group must be directly necessary for a member's exempt and/or non-business activity.
- The Cost-sharing group must only recover the member's individual share of the expenses incurred by the cost-sharing group in making supplies to its members.
- The application of the exemption to the supplies made by the cost-sharing group must not likely to cause a distortion of competition.

As with most rules-based tax legislation the terms used are further defined, and these impose additional conditions for organisations who are considering whether a cost-sharing group would be appropriate to their circumstances. The conditions outlined above include a requirement that the services supplied are "directly necessary" to a member's exempt and/or non-business activity. HMRC interpret this as requiring that the organisation has exempt/non-business activity which represents at least 85% of the total activities.

For many Higher Education Institutions and charities, this limit is very problematic as they are actively involved in trying to generate more business income to address funding concerns – through business partnerships, holiday rentals, consultancy work etc. The conflicting demands of funding issues for the organisation may mean that it cannot satisfy this test and it cannot be involved in cost-sharing groups. The 85% threshold is not included in the Principal VAT Directive and was included by HMRC primarily to prevent organisations with higher levels of taxable activity using this as an opportunity to manage their VAT position.

The conditions outlined also illustrate the complexity of the legislation for the public sector. To be able to determine if they are within the conditions the organisation must undertake a number of calculations using accurate and reliable information and understand all the strands of its activities. This ought to be straightforward – but as recent Tribunal cases such as Brockenhurst College TC02569 demonstrate, this is still an area where organisations need to keep up to date with developments.

This rules based interpretation of the Principal VAT Directive into UK legislation illustrates some of the major issues for the public sector. The UK legislation is driven by rules rather than principles and these particular rules narrow down at each stage of the process the organisations that are eligible for the shelter provided. The legislation does not focus on helping organisations to cost-share and includes anti-avoidance rules within the relief granted – the 85% test and the requirement that this exemption does not distort competition. The underlying attitude which appears to be evidenced by the legislation is that organisations are trying to take advantage of the VAT system, when in fact most organisations are trying to understand and comply with their responsibilities under the UK's tax laws.