ICAEW
REPRESENTATION 101/19

SIMPLIFICATION OF PARTIAL EXEMPTION AND CAPITAL GOODS SCHEME

Issued 26 September 2019

ICAEW welcomes the opportunity to comment on the Simplification of Partial Exemption and Capital Goods Scheme call for evidence published by HMRC on 18 July 2019.

This response is not limited by the assumption that the UK will be required to continue to apply EU VAT law, although it is recognised that future legal obligations will be determined by the outcome of negotiations over Brexit.

This response of 26 September 2019 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business.

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KEY POINT SUMMARY

1. We welcome the opportunity to provide evidence to help the government improve the operation of VAT partial exemption (PE) and capital goods scheme (CGS).
2. We agree with the OECD International VAT/GST guidelines which on neutrality (see Guideline 2.1) states that the burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.
3. Adopting the Guideline would allow all input tax incurred for business or charitable purposes to be claimed in full for all business and charitable activities. This would result in a simpler system that would remove the need for partial exemption methods and the capital goods scheme. The only type of adjustment required would then be for business/non-business use, which would affect a relatively small number of those who are VAT registered.
4. As there would be no need to complete complex partial exemption calculations, it will simplify the implementation of Making Tax Digital for VAT.
5. If such a principle were to be adopted, it would be appropriate to reconsider the exemption (without input tax credit) from many supplies that currently receive that treatment, with a view to removing some or all of them.
6. However, we recognise that such changes would potentially have considerable practical, revenue and political difficulties that would need to be addressed.
7. On the basis that existing VAT exemptions are retained, we recommend simplification of the existing partial exemption rules and removing the capital goods scheme, or, failing which, limiting CGS to property purchases and new constructions only and increasing the threshold.
8. In our comments below we review both PE and CGS and make suggestions as to how they might be simplified.

MAJOR POINTS

9. In the OECD's VAT/GST Guidelines[1] published in 2017, Guideline 2.1 states that "The burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.". The OECD goes on to note that, "this means that VAT normally "flows through the business" to tax the final consumers. It is therefore important that at each stage, the supplier be entitled to a full right of deduction of input tax, so that the tax burden eventually rests on the final consumer rather than on the intermediaries in the supply chain.".
10. We agree with the OECD Neutrality guidelines that the burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.
11. The OECD acknowledges that there may be exceptions to this basic guideline (for example where the tax base for an output is difficult to define eg, finance or for policy reasons, eg health care, education and culture).
12. Applying the OECD's Guidelines, and being able to overcome the difficulties of determining the tax base for certain supplies, then there seems no reason, in principle, why one type of business should be treated differently from another.
13. It would seem fair to allow all input tax incurred for business or charitable purposes to be claimed in full by all businesses' and charities' activities. The result would be a system that would be relatively simple to operate and remove many of the complexities and avoidance opportunities of partial exemption from the VAT regime. The need for partial exemption methods and the capital goods scheme would be eliminated. The only type of adjustment

[1] https://www.oecd-ilibrary.org/sites/9789264271401-en/1/2/2/index.html?itemId=/content/publication/9789264271401-en&mimeType=text/html&_csp_=5aeda55c6b13e05a90961dd0a07e26eb&itemIGO=oecd&itemContentType=book

required would then be for business/non-business use, which would affect a relatively small number of businesses.

14. If such a principle were to be adopted, it would be appropriate to reconsider, and potentially remove, exemption (without input tax credit) from many supplies that currently receive that treatment. As input tax would become recoverable in relation to affected supplies for the first time, this would reduce the overall VAT receipts. If the Government wishes to maintain VAT revenues at the current level, it would need to raise additional revenue, which we assume would be at least be generated in part by the imposition of VAT at either the standard or reduced rate on supplies which currently attract exemption.

15. Such a change would provide major simplification benefits in terms of the partial exemption system for the future, for businesses and HMRC alike with exemption and zero rating becoming effectively the same. The perceived risk of avoidance by tax authorities in relation to partial exemption would also be eliminated. We also think that the process of digitising business' VAT reporting systems required to implement Making Tax Digital would be made easier in the absence of complex partial exemption calculations.

16. We recognise that such a change would potentially have considerable practical, revenue and political difficulties that would need to be addressed. Unless market forces result in prices for B2C supplies remaining the same on a VAT inclusive basis, which we consider to be unlikely, there would be a transfer of the burden of VAT to consumers as businesses would add the additional VAT to their prices (subject to their right to deduct in full the VAT charged on supplies further down the chain).

17. To avoid the potentially regressive effects of such a burden on consumers, policymakers would need to examine existing exempt supplies to determine whether a zero-rate or reduced rate (or super-reduced rate) of VAT could be applied so that the overall package is reasonable and, ideally, revenue neutral (see also our comments below at Question 28).

18. Whilst recognising the significant potential benefit that such a change could deliver in terms of tax simplification, we recognise that removing exemptions (which were included for sound social purposes) could result in higher, and potentially regressive, tax charges.

19. In principle it would be difficult to justify a tax simplification that reduces business costs at the expense of increasing the amount of VAT charged to consumers. ICAEW does not, therefore, recommend such an approach at this stage. While we see clear benefits to those businesses which currently have to comply with the complexities of partial exemption, we recognise that considerable further work would be required to evaluate the costs and benefits on affected parties. Clearly, its effect on consumer spending (and inflation) would need to be considered but businesses would also need to be consulted as it could have profound effects on their future business models as well as HMRC's administration of the tax.

20. On the basis that current exemptions are retained pending any longer term review, consideration should be given to ways to simplify the existing partial exemption rules which have become highly complex as a result of changes introduced over many years. Some of these changes were stated as being intended to simplify the rules but are in themselves difficult to understand and could be viewed as complications by most people who are unfamiliar with VAT. We have suggested that the requirement to attribute input tax on the basis of use only be a requirement where the effect of such an attribution would give rise to differences in VAT recoverable in excess of an annual threshold, which we suggest is at least £200,000.

21. We suggest reintroducing the disregard for the disposal of all capital assets from any pro-rata or special method eg, the sale of a habitually occupied property.

22. It is questionable whether a partial exemption method should require approval and we believe this could be left to the business to determine.

23. Consideration should be given to removing the capital goods scheme or limiting it to property purchases and new constructions only. And also to increasing the threshold to £1m of VAT incurred on a single purchase, rather than based on the purchase price.

DETAILED COMMENTS AND RECOMMENDATIONS ON PE AND CGS

Partial exemption (PE)

24. Partial exemption only applies where there is business use, ie, first taxpayer has to undertake a business/non business apportionment. This section assumes that we are dealing with input tax, ie VAT incurred for business purposes.

25. Partial exemption can arise in almost any business, due to a one-off exempt (without credit) supply being made that is not normally made by the business concerned. An example could be the supply of a capital good, eg the sale of a property used by a business that does not normally engage in property transactions.

26. Such businesses will, in many cases, be completely unaware that they have made an exempt supply and the VAT consequences of having made it, although they should be disregarded supplies in limited circumstances in relation to the recovery of overhead or ‘residual’ input tax. Any directly attributable input tax to an exempt supply is of course non-deductible.

27. The VAT Directive currently requires member states to exclude from the calculation of the partial exemption fraction applied to residual input tax, turnover from supplies of capital goods used by the business and from incidental real estate and financial transactions. We consider that in order to preserve the neutrality of the VAT system these exclusions should be adopted in both the standard method and in agreed special methods.

28. We think the VAT rules would benefit if the meaning of “incidental” found in regulations 101(3) and 103B(2)(c) Value Added Tax Regulation 1995 be defined in statute and based upon simple criteria which give businesses greater certainty as to the circumstances in which such transactions will be excluded from partial exemption residual input tax calculations.

29. Currently the guidance on what can be considered to be incidental is not clear and it is left to taxpayers to refer to case law to establish where transactions should be excluded. For example, see the case of Mercedes Benz Italia Spa C-378/15 in which a dispute arose over the treatment of interest income which was over 70% of the company’s income but which it was contended should be regarded as incidental.

30. The sale of a habitually occupied property used to be disregarded for partial exemption purposes until a change in the standard method on 1 April 1987.

31. Paragraph 9 of HM Customs & Excise Partial Exemption Notice 706 dated 1 April 1984 reads as follows:

    > *“If you are fully taxable you remain so if you receive a capital sum for the exempt grant, assignment or surrender of an interest in land or buildings which you have habitually occupied in the course of carrying on a business (for example, if you are a shopkeeper and you sell one of your shops). You must not take account of the value of any such supply in applying the outputs rules. Any input tax related to such a supply is to be disregarded in applying the inputs rule”.*

32. This rule was abandoned when the standard partial exemption method was changed to an input tax based method with effect from 1 April 1987. It had the advantage that the sale of a habitually occupied property was not taken into consideration when applying the de minimis thresholds, which were based on the value of exempt sales prior to 1 April 1987. Thus even directly attributable exempt input tax was ignored and so fully recovered by a taxable business.

33. The reintroduction of a rule such as that above would eliminate the need for some businesses to consider partial exemption where they make no exempt supplies in their normal course of business.

34. In addition, for businesses making any exempt supplies, we would be in favour of a de minimis limit of say £20,000, so that any directly attributable input tax incurred in making exempt supplies could be considered to be used in all cases in making a business’ other supplies, ie, as though it were residual input VAT. If a business only makes taxable supplies

that input VAT would be fully recoverable. So too would its other residual input VAT as the supply of the capital asset.is excluded from the pro-rata calculation.

35. Any alternative methods need to be considered by weighing up a likely trade off in terms of the aims of simplification of the partial exemption process on the one hand and the desired aim for accuracy of input tax attribution. It seems to us that many of the complications inherent in the existing rules arise from the intention on the part of the legislators to achieve outcomes which most fairly reflect the extent to which input tax is used in making taxable and exempt supplies.

36. The partial exemption regulations have become complex and convoluted over a number of years. This has been in response to instances of perceived avoidance and the need to close loopholes. For example, the introduction of the standard method override rules requiring use based calculations, the introduction of use based apportionments in cases of attribution of input tax to foreign and specified supplies and the need for special rules to attribute input tax on services such as those of accountants and lawyers used in making incidental financial supplies, such as share sales, are all examples.

37. We think that to simplify the system all these separate "use based" measures could be done away with and replaced with a single threshold of £200,000 of residual input tax for a tax year, ie, where the deductible input tax under the standard method differs by more than this amount when compared to a use based method. It could be made a requirement of partial exemption calculations under the standard method to attribute input VAT on the basis of use in cases in which the standard (value based) method does not achieve a fair attribution of input tax in any tax year, ie, similar to the current override. This would simplify matters for all but the largest transactions. If such measures as are currently in place are considered to be necessary to preserve the integrity of the partial exemption rules we think that better guidance is needed on the application of these regulations which appear excessively complex to most businesses.

38. An alternative method of attribution was adopted by the Italian legislation under consideration in the case of *Mercedes Benz Italia Spa* case C-378/15. The issue was whether the rules in that member state which applied a pro-rata deduction to all of a business' input tax, without any direct attribution, were permitted by the directive. That system would offer some simplification benefits but may give outcomes which result in less accuracy in attribution of input tax and a disproportionate result.

39. There would also be merit in giving businesses more options to adopt simplified methods in particular industries, for example retailers which are not traditionally involved to any significant extent in making exempt supplies. However, if such methods are optional it is likely that taxpayers will only adopt them if they lead to favourable outcomes by comparison to current arrangements or if the simplification benefits outweigh any additional tax payable. Therefore, there could be a cost to the Exchequer in this case.

40. When the fair and reasonable declarations were introduced by HMRC, it was expected that approvals would become easier and quicker, because HMRC would be able to go back to the date of the declaration and correct any errors. However, this change does not appear to have improved the situation or to have made any difference to the approval process and an alternative is clearly required – on the presumption that prior agreement is retained.

41. It is questionable whether a partial exemption method should require approval. It could be left to a business to determine whether or not it was making a fair and reasonable declaration on a VAT return without formal approval. It would then be up to HMRC to determine on a future visit whether or not it considered that the VAT return declarations had been fair and reasonable, and issue an assessment if a business had been under declaring VAT – which appears to be the practice in a number of EU states. In such cases, we would expect HMRC to only take action where the business had been making declarations that were clearly contrary to the spirit of the law or clearly acting contrary to published guidance.

42. In this scenario, a business should still be able to apply to HMRC for approval of a method if it required certainty over the acceptability of the method it was using to calculate deductible input VAT, but this procedure could be made optional.

43. Another alternative might be to introduce a time limit along the lines that a method would be deemed to have been automatically approved if no approval had been formally advised by HMRC within six months of the original application by the business.

44. It may be feasible to introduce a scheme whereby a business could elect to adopt a fixed rate percentage recovery based on its trade classification as for example Belgium applies for the Tour Operators Margin Scheme. In such circumstances, we would recommend that this should be optional for the business concerned.

Capital goods scheme (CGS)

45. When the CGS was introduced as an anti-avoidance measure on 1 April 1990, it was limited to computer equipment with a purchase price of £50,000 or more and land and buildings with a cost of £250,000 or more. Not only have these values never been changed, but the scheme has been further complicated by the addition within the scheme of refurbishments, ships and aircraft. Further, given the Government's policy drive to move businesses on to digital platforms, retaining the CGS for computer systems is now contrary to that policy.

46. We understand that there are very few occasions where the CGS is applied to computer equipment, ships or aircraft. We therefore suggest that the scheme be limited to property purchases only, so that everything other than these is excluded from the capital goods scheme altogether. In most cases, any adjustments are small and disproportionate to the amount of time and effort needed for their calculation. However, we recognise that under the Directive such a simplification would not currently be permissible.

47. One of the most difficult aspects of the CGS is to establish which costs should be included in cases of property refurbishment and whether a large refurbishment should be treated as one or more separate capital items. These difficulties could be eliminated by removing refurbishments from the list of capital items included in the scheme. However, we recognise that there is an equal case for including purchases of property and improvements to existing assets. We suggest that the threshold be raised significantly from the current value of £250,000 as this of itself could avoid a large number of refurbishment projects from falling within the scheme with the consequent need to undertake CGS calculations.

48. There are many instances of complicated rules inherent in the CGS which make it difficult for businesses to comply with it and which offer scope for simplification. For example, the case of an owner of a CGS item which moves into a VAT group. This results in intervals which run to the anniversary of the date of the move. This creates obligations to undertake CGS adjustments for periods which may not coincide with VAT accounting periods, which we believe is an unwarranted complication.

49. There are many other complexities which in our view call for simplification and which seem to lack justification that they actually curtail any significant avoidance.

50. If the CGS is to remain, we suggest that the thresholds should be increased and changed from the purchase price to the VAT incurred. For example, the current £250,000 purchase value could be amended to £1m of VAT incurred on the purchase.

51. If alterations and refurbishments are to be retained as CGS items we think a threshold which is based on the amount of VAT incurred would be preferred as capital goods subject to adjustment can result from building work which is either taxed at 20% or in the case of alterations, eg, commercial conversion to residential, 5% VAT.

52. There would also be merit in giving businesses an option to adopt the CGS. However, if such an option were available it is likely that taxpayers will only adopt it if it leads to a favourable outcome. Therefore, there could be a cost to the Exchequer in this case.

53. Given the ten year adjustment period of the CGS (for real estate), retention of business records beyond the normal six year period is an issue.

ANSWERS TO SPECIFIC QUESTIONS

Partial Exemption Special Methods

Question 1. Does your business use a PESM? If so, what was your experience in getting the PESM approved?

54. Members' experience in assisting clients is that general where clients provide declarations that the proposed method is fair and reasonable, the process of agreeing with HMRC is usually long and drawn out. In spite of best efforts, HMRC always finds points that they want to query on a proposed PESM. There are usually long delays on HMRC's part in dealing with the initial and subsequent correspondence. This leaves the taxpayer in a state of uncertainty, not knowing if the request has been approved.

Question 2. How long did the approval process take?

55. Members' experiences in assisting clients is that it takes at least six months to obtain a PESM approval and that the average time is about eight months.

Question 3. Do you find the administration involved with PESMs challenging?

56. See comments above about the length of time it takes to obtain approvals which makes the administration of them more burdensome than it needs to be.

Question 4. Would allowing businesses to apply PESMs without seeking approval improve the system? Please give reasons for your answer.

57. Yes, as businesses currently need to spend a lot of time negotiating with HMRC; in addition they need certainty. It may be appropriate to adopt a similar methodology to that used for retail scheme applications, so that businesses below a certain turnover (perhaps adopt the same level of £130m used for retail schemes) do not need to apply for a PESM.

Question 5. Would there be issues created by removing the requirement to seek approval of a PESM?

58. Yes. Some businesses would be reluctant to use a special method without approval for fear of it not being accepted by HMRC on a future inspection and the possible imposition of interest and penalties at that time. This could also have the effect that businesses may take extra care to ensure that their chosen method was fair and reasonable.

Question 6. Would an increased focus on the use of sectoral frameworks be of benefit, particularly if approvals were removed?

59. Yes, as this could save affected businesses a considerable amount of time in terms of calculation, record keeping etc.

Question 7. Do you have other suggestions to improve or simplify the application of the PE regime?

60. We believe that increases in the de minimis thresholds and a clearer definition of disregarded ancillary/incidental supplies would help to simplify the PE regime. Please see above and below for more detailed comments.

Question 8. Do you have other suggestions on how the way in which HMRC interacts with partly exempt businesses could be improved?

61. On the assumption that government decides to retain the existing PESM pre-approval system, then it is clear that any interaction must be much quicker to reduce the time taken to obtain approval (presently over six months (see Question 2 above).

Increasing the de minimis limit

Question 9. What is your experience of carrying out the de minimis test?

62. This is generally simple and straightforward, especially if it is only required on an annual basis. The disadvantage of any de minimis system is that the calculations have to be undertaken to determine if the de minimis limits then apply, creating a time and cost burden falling mostly on small businesses.

Question 10. What would the advantages and disadvantages of increasing the de minimis threshold be to business?

63. The biggest advantage is likely to be that fewer small businesses would be impacted by partial exemption; although as noted in the answer to the previous question, the business still has to go through the process of determining the application of the thresholds to determine its PE position.

Question 11. Are you aware of the existing simplification, and do you make use of it?

64. We have no evidence on this point to submit.

Removal of the de minimis limit

Question 12. What would be the advantages and disadvantages of removing the de minimis test?

65. We do not perceive that any advantages would be created by removing the de minimis limit. The main disadvantage would be to small businesses that may need to consider partial exemption for the first time.

Question 13. Do you have other suggestions to improve or simplify the application of the de minimis regime?

66. See above.

Question 14. Do you have any suggestions on how to determine what can be considered as 'insignificant' that would be different to the current de minimis tests?

67. Please see our PE detailed comments and recommendations above where we have suggested that a new £20,000 threshold be considered.

CGS Thresholds

Question 15. What is your experience of the CGS?

68. Capital goods scheme calculations can be very complex and time consuming, often resulting in very small adjustments (in particular in relation to identifying business/non-business use). Difficulties are often encountered with refurbishments, where the identification of affected purchases and potential split between separate refurbishments can be problematic.
69. The record keeping requirements for CGS items acquired under a TOGC are particularly onerous in relation to real estate adjustments over ten years.
70. Accountancy firms regularly advise their clients on the application of the CGS based on their clients' particular circumstances. Many firms act mainly for SMEs, where the transactions are not usually in excess of £2m, which would be the higher end of the range for a regional SME. CGS calculations are undertaken for clients on a regular basis.

Question 16. How much time and resource do you allocate to carrying out CGS calculations? Does this have an impact on your business?

71. Considerable time is needed to carry out CGS calculations, especially when a new capital item is being created – rather than simply purchased. This is particularly burdensome for property refurbishments, where the items that need to be included may be difficult to identify. Businesses are generally unfamiliar with the detailed rules and invariably have to pass the work to their accountants to deal with, resulting in additional costs.

Question 17. To what extent does the CGS help to prevent cases of tax avoidance and unfair competition?

72. We are unaware of any recent specific examples where the CGS has prevented tax avoidance.
73. However, the EUCJ case of *Gmina Ryjewo* (C-140/17 of 25 July 2018) allows a CGS adjustment to be made on an asset initially used wholly for non-deductible purposes (non-business purposes in this case). Consequently, HMRC should allow the CGS to apply in this scenario to ensure the neutrality of the tax, and avoid distortions of competition, unless there was a clear intention to avoid VAT.
74. The CGS operates well to prevent avoidance of VAT via use of short-term uncommercial arrangements intended to secure a VAT advantage.
75. The CGS does not prevent unfair competition. It can create unfair competition as any system with a flat rate entry threshold will. If businesses are at or above the CGS threshold then they will always be advantaged or disadvantaged compared to some of their competitors who are not required to operate the CGS. See our comment above about giving businesses an option to apply the CGS.

Question 18. What would be the advantages and disadvantages of increasing the threshold for land and property businesses?

76. Increasing the threshold would have the distinct advantage of removing the necessity to perform CGS calculations for purchases below the new threshold. We suggest that any new threshold should be shown as an amount of VAT incurred, rather than a net or gross value.

77. In limited circumstances, a business could be disadvantaged by an increased threshold if there was a change of use of a property below the de minimis threshold from exempt to taxable purposes within the adjustment period. This could be overcome by allowing such businesses to voluntarily include such properties in the CGS and make CGS adjustments under the normal rules for those above the de minimis threshold.

78. Increasing the threshold would simplify matters considerably from an administrative perspective for many businesses. Our experience is that many businesses undertake a series of detailed calculations for little overall difference to the ultimate VAT payable. This is particularly the case in the area of Dispensing GP surgeries. There are also a number of pitfalls for the unwary with the CGS, particularly where properties are sold and no regular adjustments have previously been required. While these measures are in place to prevent inequitable input VAT recovery, they do catch innocent situations where this is simply not thought about as it is not a regular part of the business' calculations.

79. The limit of £250,000 does not seem appropriate any more, given it was set almost 30 years ago. Using a simple RPI comparison, this should be inflated to approximately £600,000, which would seem in keeping with the initial intention of the legislation and would remove a large number of businesses from this obligation. We would be in favour of a higher threshold of £1m VAT to take most SME's out of the scheme.

80. The obvious downside is the potential increase in tax avoidance schemes making use of the first supply rule. In general, these are hard to manufacture, such that there will always need to be a degree of commerciality in such a decision in all but the most obvious of tax avoidance cases. In such cases, HMRC would still be able to challenge on the basis that such transactions were a contrivance in any case, so the loss to the Exchequer could well be minimal.

Question 19. Would there be any other issues involved with increasing the land and property threshold?

81. Yes. If a business purchased a property (below the new threshold) where its proportion of taxable use increased in future years, there would be no mechanism to increase the initial amount recovered unless alternative means were created. This could be achieved by making the CGS optional.

82. Would transitional rules be considered? For example, properties currently within the remit of the CGS could be taken out of the scheme if their original cost was below the new limit. Given the length of time the current limit has been in place this would not be unreasonable and would simplify transactions and record keeping requirements going forwards.

Question 20. If the threshold for land and property is increased, do you think we should consider having a different threshold for alterations, extensions, annexes and refurbishments, (i.e. retain the current threshold) or would it increase complexity?

83. We believe that the CGS should be limited to property purchases only. It is recognised that this is not currently permissible under the Directive. However it would be a significant simplification as thresholds for alterations, extensions, annexes and refurbishments would not then be applicable.

84. Different thresholds for different property scenarios would create complexity. Simplification would be achieved by removing alterations and refurbishments from the CGS altogether. Again, this seems very much in keeping with the intention of the rules originally.

Question 21. Are there other ways in which the CGS can be improved?

85. We have no further comment to make.

Categories

Question 22. Do you have experience of computers being included in the CGS?

86. No.

Question 23. Would removing computers from the CGS be a simplification for business?

87. We believe that very few businesses are affected by the inclusion of computers in the CGS. It would be a simplification for all businesses if they did not have to consider the CGS when purchasing computers. It would be a greater simplification for the very few businesses currently affected by their inclusion, but as it occurs so infrequently its removal would probably have very little effect on real life situations. There seems little merit in keeping it as it only really serves as a potential pitfall in the rare event it actually applies, and appears in any event contrary to Government policy to encourage businesses to go digital.

Intervals

Question 24. What do you think of the current interval length?

88. Given that VAT records are normally only required to be kept for six years (for tax and Company's Act purposes), we believe that all CGS adjustment periods should also be limited to no more than six years. A more sensible approach may be to limit CGS adjustments to five years in all cases, eg, real estate and moveable equipment.
89. Although ten years is not unreasonable for land and property, if this were reduced to five years, it would still be a long enough time frame to prevent overt abuse by businesses.

Question 25. Would a change in the number of intervals help businesses with their administration of VAT? Why?

90. A limit of five years would avoid the need for businesses to retain records beyond the normal requirement of six years.
91. There would be an advantage to those businesses who sell a property within ten years and later discover a CGS adjustment should have been made as they have switched from wholly taxable usage to wholly exempt. This is far less likely if the adjustment period is shortened to five years.

Other possible areas to review

Question 26. Do you have other suggestions to improve and simplify the application of the PE and CGS regime?

92. If the scope of exemptions were to be reduced, there would, as a consequence, be far fewer businesses making exempt supplies and therefore a substantial reduction in the number of businesses affected by the PE rules and the CGS.
93. The CGS could be limited to single capital purchases where the VAT incurred exceeded £1m. Such a limit could potentially apply to any category of capital purchase, but we recommend that it be limited to property purchases only.

Question 27. Do you have any experience of the operation of PE and the CGS in other countries? How does the UK compare?

94. Experience of other member states – France

1.1. Basic requirement to determine the appropriate VAT regime of each part of the business.

Businesses having different activities subject to different VAT regimes are required to 'sectorise' their activities and apply the appropriate VAT PE regime to each sector[2]. A financial institution making both supplies with a right to deduct and those with no right to deduct is considered to carry on only one activity.

1.2. Business/non-business apportionment

Businesses are further required to carry out, for any input tax incurred, a two-stage appreciation of the amount of deductible input tax.

Firstly, the business/non-business apportionment 'coefficient d'assujettissement' is determined. This is done by the business (or sector) on, in principle, a purchase by purchase basis but can be determined for the whole of the business for the whole year (calendar)[3].

The business can, with prior agreement of the authorities, use a pro-rata based on receipts (eg, non-business receipts/in the scope receipts + non-business receipts (to give the non-deductible proportion)), which then applies for a full year. The approval is renewed tacitly each year but can be rescinded by the taxpayer.

1.3. Transactions giving rise to a right to deduct and those not giving rise to a right to deduct.

1.3.1. In principle the business should calculate the recoverable percentage for each good/service acquired on which input tax is incurred[4]. However, the administration allows the application of a general pro-rata based on supplies made ('coefficient de taxation') for all 'mixed' input tax (whether on fixed assets or overhead expenditure). This calculation may have to be done by 'sector' if the business has more than one VAT sector (article 173.2.b).

1.3.2. The pro-rata must be applied for the whole calendar year and is used as the provisional pro-rata for the following year with an annual adjustment undertaken by 25 April of year N+1 of the pro-rata of year N.

1.3.3. The pro-rata does not include the 'turnover' from disposals of capital assets (tangible or intangible).

1.4. Incidental supplies.

In addition, exempt incidental financial and real-state supplies have to be excluded from the pro-rata calculation. The administration follows the case law of *Régie Dauphnoise* – case C-306/94 which stated that exempt financial supplies cannot be excluded from the pro-rata where these supplies constitute the prolongation direct, permanent and necessary of the main activity of the business.

However, to be 'incidental' the supplies must be distinguishable from the main activity of the business, but must have a link to the main activity; and

The amount of input tax (or the value of the exempt supplies made) is limited.

The administration accepts that the exempt financial/real estate transactions can be considered as 'incidental' where the attributable input tax is less than 10% of total input

[2] Article 209 of annex 2 FTC
[3] Article 206 V 1° 1 of annex 2 FTC
[4] Article 206 III of annex 2 FTC

tax (ie, the attributable input tax is limited) or the value of the exempt 'incidental' supplies is less than 5% of total supplies.

Despite the European Court having expressed on several occasions its views on the nature and meaning of 'incidental' supplies in article 174.2.b and c, Member states do still appear to have differing interpretations.

95. As you are aware the EU Commission has recently launched a study[5] to consider the impact of the current exemptions within article 135.1.a-g of the VAT Directive. We suggest that before any work is finalised on the review of the PE methods that the outcome of the Commission's study is taken into account.

96. The Court in the EUCJ case of *Mercedes Benz Italia* Case C-378/15, appeared to support the Italian Government's point of view that it would make things much simpler for business to apply the pro-rata recovery to all input tax under article 173.2.d. In that case the Court held that the Italian law was in line with the Directive where it required businesses to apply a pro-rata to all input tax (even that directly attributable). We would suggest that this solution be discussed with business before any implementation.

97. The recent *Morgan Stanley* judgment (Case C-165/17) where the head-office pro-rata is used to determine the recovery of the non-UK branch's input tax (at least in part) will have an impact where this was the other way round, ie UK establishments of a non-UK bank only supplying services to their head office (ie a non-independent branch). On the basis of this decision it appears that the branch has to apply the non-UK pro-rata. How will UK tax authorities be able to review this calculation, and should there not be agreement at international level on the acceptable methods of calculation to prevent distortions of competition and possible relocation of businesses or parts of businesses?

Question 28. Do you have any other comments?

98. We believe there are benefits in the principle of exemption being abolished, or severely limited in scope and/or with a broader option to tax (see for example the New Zealand GST system), as this would greatly simplify the VAT system and reduce avoidance. Where considered appropriate, a reduced or zero rate of VAT could be applied to affected supplies as an alternative. Input tax should then be fully deductible in relation to all businesses or charitable activities, providing further simplification.

99. Exemptions were originally introduced for social reasons in the public interest, such as medical services and certain supplies to charities, or because it was too difficult to determine the tax base, such as financial and insurance services, betting, gaming and lotteries.

100. We noted above the separate exercises looking at the taxation, by VAT or otherwise, of financial services and do not propose to comment further as to how they may be subjected to VAT. However, we believe that any future taxation of financial services, whether by means of VAT or otherwise, should take into account the cost of allowing those businesses, making such supplies, to fully recover input tax incurred in relation to their business activities.

101. It is widely accepted that if exemptions were removed and replaced by a reduced rate of VAT, the cost to customers would potentially not be significantly affected due to the increase in output VAT being offset by recoverable input VAT for the supplier[6] with the latter reducing his net of VAT prices.

102. The rationale for the continued exemption of some services is questionable. For example, many postal services are now standard rated as they are supplied by other than the historical national carriers. However, there could be an impact on businesses being forced to register for VAT for the first time if supplies made by businesses that currently only make supplies that are exempt became subject to a reduced rate of VAT. To reduce this effect, certain services, such as those relating to health or education, could be treated as exempt with

[5] "Supporting Study for the review of the VAT rules for financial and insurance services, in light of the existing regulatory and other indirect taxation rules" - Request For Services No TAXUD/2019/AO-01
[6] Request for Services No TAXUD/2019/AO-01

credit or zero rated. Business involved solely with these activities would not then be required to register for VAT, but retain the option of doing so for input tax recovery purposes.

103. There are currently several exemptions targeted at charities. It can be difficult for suppliers to prove that its supplies to charities qualify for these exemptions and this burden of proof creates unnecessary complications. If charities were given the ability to recover VAT incurred in relation to their non-business charitable activities (which is not currently compatible with the Directive), the exemptions on supplies to charities could be withdrawn with minimal effect on the charities and with the benefit of simplification for the suppliers to the charities. In principle, we believe that the VAT liability of a supply should not be affected by the status of the customer, as this creates uncertainty for the supplier in obtaining satisfactory evidence of the status of the customer to substantiate the favourable VAT treatment.

104. Transactions involving land and property are often highly complex. This area is made more difficult by the option to tax rules. We believe that these complicated rules are prone to error and provide scope for fraud. We would therefore support, in principle, the abolition of the option to tax. It would seem appropriate to make all supplies relating to land and buildings subject to VAT at the standard rate with the sole exception of those relating to domestic property for social reasons.

105. Taken as an overall package, the cost of removing exemptions completely and replacing them with zero rating, reduced rating, standard rating or financial services taxes should not severely impact government revenues, but provide a simplification to the VAT regime for businesses and tax authorities alike. Further work would need to be done on the economic implications and on how, from a practical point of view, the transition should be made. We understand that the EC is also looking at this issue, with results due to be published in June 2020.