EXPLANATORY MEMORANDUM TO THE

VALUE ADDED TAX (AMENDMENT) REGULATIONS 2005

2005 No. 762

1. 1.1 This explanatory memorandum has been prepared by HM Customs and Excise and is laid before the House of Commons by Command of Her Majesty.

1.2 This memorandum contains information for the Select Committee on Statutory Instruments.

2. Description

2.1 These Regulations amend Part XIV (Input Tax and Partial Exemption) of the Value Added Tax Regulations 1995 (S.I. 1995/2518) ("the principal Regulations").

2.2 Regulation 3 amends regulation 101 of the principal Regulations (the partial exemption standard method) so as to restrict the degree of rounding up of the recoverable percentage of residual input tax. Whilst smaller businesses can still round up the percentage to the next whole number, larger businesses must round it up to two decimal places.

2.3 Regulation 4 amends regulation 102 of the principal Regulations by adding new paragraphs (5) to (8). New paragraph (5) provides that approvals given or directions made by the Commissioners must be in writing. New paragraphs (6) to (8) make provision for a use based attribution of any input tax which does not fall to be attributed either in whole or in part under an approved or directed method or under any other of the principal Regulations.

2.4 The Committee is respectfully referred to the explanatory note to the Regulations for the specific detail.

3. Matters of special interest to the Select Committee on Statutory Instruments

These Regulations have been made and laid on 16th March and come into force in accordance with regulation 1. It has been necessary to breach the 21 day rule as the Commissioners wish the changes provided for by these Regulations to have effect from 1st April 2005 (the start of a VAT accounting period and a VAT year for the majority of taxpayers) to minimise any administrative inconvenience. Provision has been made to cater for those taxpayers who have different VAT accounting periods to ensure that the changes provide for by regulation 3 only take effect from the beginning of their next VAT accounting period.

4. Legislative Background

4.1 These Regulations have been made by the Commissioners of Customs and Excise in exercise of their powers under section 26(1), (3) and (4) of the Value Added Tax Act 1994. Section 26(1) provides that the amount of input tax to which a person is entitled to credit at the end of any period shall be so much of the input tax for that period as is allowable by or under regulations as being attributable to the supplies specified in subsection (2) (taxable supplies etc).

4.2 Section 26(3) empowers the Commissioners to make regulations for securing a fair and reasonable attribution of input tax to the supplies specified in subsection (2).

4.3 Section 26(4) allows the Commissioners when making regulations to make different provision for different circumstances and for different descriptions of goods and services and to include such incidental and supplementary provisions as appear to them necessary or expedient.

5. Extent

This instrument applies to all of the United Kingdom.

6. Policy background to Regulation 3

6.1 Taxable persons can recover VAT on their purchases to the extent that those purchases are used in making taxable supplies. Taxable supplies are subject to VAT at 17.5% or 5%, or are zero-rated. In principle, taxable persons cannot recover VAT on purchases used to make exempt supplies.

6.2 VAT on purchases that are used to make both taxable and exempt supplies ("residual VAT") has to be apportioned on a fair and reasonable basis. To do this, a business will use a partial exemption method. This will generally be either the method as provided for in regulation 101 of the principal Regulations ("the standard method") or a bespoke method as provided for in regulation 102 of the principal Regulations ("a special method"). A special method must be approved or directed by the Commissioners and, once so approved or directed, remains in place until the Commissioners approve or direct use of an alternative method.

6.3 Where a taxable person uses the standard method, the old provisions allowed him, once he had calculated the recoverable percentage of residual VAT, to round it up to the next whole number. However, whilst this simplified the calculation, the Commissioners were concerned that it gave an unjustified advantage to larger businesses and enabled them to recover more VAT than was fair and reasonable. As such, they have taken steps in Regulation 3 to restrict such rounding up to small and medium sized businesses (SMEs) where it does

lead to a fair and reasonable result and to provide that those businesses whose annual residual VAT is approximately £5m or more can now only round the percentage up to two decimal places.

7. Policy background to Regulation 4

7.1 Whilst the old provisions required that the Commissioners approve or direct both the use and termination of use of a special method, they did not specify the form that such approval or direction should take. Problems have arisen where taxpayers have successfully claimed that approval has been given by action or omission and there have been a number of disputes as to what precisely has been directed or approved in a particular case. The new paragraph (5) added by Regulation 4 provides that in future an approval or direction of use of a special method (or its termination) will only be effective if given by the Commissioners in writing in the form of a document which clearly identifies itself as being such an approval or direction.

7.2 As a special method is fixed, it is on occasions unable to deal effectively with changes which occur over time in a taxpayer's business. One specific problem is where a special method which has been approved or directed does not specify how certain VAT inputs which a taxable person incurs should be treated and there are no other provisions in the principal Regulations which deal with their attribution. The Commissioners' policy in the past has been to require the taxable person to use the standard method when attributing such inputs but, in practice, this has rarely led to a fair and reasonable result. In addition, there have been cases where taxpayers have manipulated the situation (for example by creating a gap) to achieve a windfall recovery rate. The new paragraphs (6) to (8) added by Regulation 4 will ensure that in future a taxable person will only recover VAT in such a situation to the extent that the inputs in question are used to make taxable supplies. The result should be a fair and reasonable recovery rate with the Commissioners being in a position to assess in the case of excessive recovery.

8. Impact

8.1 A Regulatory Impact Assessment is attached at Annex A.

8.2 The impact on the public sector is nil.

9. Contact

Colin Strudwick at HM Customs and Excise Tel: 020 7147 0567 or e-mail: colin.strudwick@hmce.gsi.gov.uk can answer any queries regarding these Regulations.