Explanatory Memorandum to the

The Value Added Tax (Groups: eligibility) Order 2004 No. 1931

This explanatory memorandum is laid before the House of Commons by Command of Her Majesty. This memorandum contains information for the House of Commons Select Committee on Statutory Instruments. It is submitted by H M Customs and Excise.

This Order is made by the Treasury in exercise of their powers in section 43AA of the Value Added Tax Act 1994 (c.23; "the Act"). By section 97(3) of the Act[1], this Order is subject to the affirmative resolution procedure and is required to be laid before the House of Commons only.

Description

This Order imposes further conditions that certain bodies corporate must satisfy in order to be eligible to be treated as members of a VAT group. In addition to the existing conditions that apply in respect of VAT groups generally, these conditions will apply to bodies that make supplies to other members of the group and are managed or partly owned by third parties. VAT grouping will be denied such bodies if they are run primarily by or for the benefit of the third party.

Legislative background

This is the first exercise of the order-making power concerned, which was introduced by section 20 of the Finance Act 2004 (c.12).

These changes are being made to prevent a particular type of misuse of the VAT grouping rules. This misuse allows large companies to avoid VAT on high value, taxable services bought in from third parties.

VAT grouping is a business facilitation measure. Members of a VAT group are treated for VAT purposes as a single taxable person. This means that no VAT is charged or reclaimed on supplies of goods or services between the group members. In short, companies in a VAT group are in the same VAT position as divisions within a single company.

VAT grouping brings a tax benefit where a member of the group would otherwise be unable to recover all of the VAT it incurs on purchases from other group members. For example, banks, insurance and property companies make supplies that are exempt from VAT. They cannot deduct VAT they incur on goods and services purchased for use in making the exempt supplies, so this VAT is a real cost to them. However, they do not pay VAT if the supplier is in the same VAT group.

[1] Section 97(4) of the Act lists the instruments that are subject to the affirmative resolution procedure. Paragraph (ca), which was inserted by section 20(5) of the Finance Act 2004 (c.12), refers to orders made under section 43AA(1) that have the effect of causing companies to cease to be eligible to be treated as members of a group. Section 43AA was inserted by section 20(1) of the Finance Act 2004.

Under section 43A of the Act, companies and other bodies corporate are eligible to be VAT grouped if they are under common "control". By section 43A(2), control is defined by reference to the Companies Act 1985[2] (c.6) definition of a "holding company". This definition normally coincides with the reality of control, but can be abused so as to allow a purchaser of services to be VAT-grouped with a supplier that is in reality run by and for the benefit of a third party. This tax avoidance scheme has been used by large companies in the finance and insurance sectors and their suppliers, particularly for information technology (IT) services.

How this particular type of tax avoidance works in practice is perhaps best illustrated by an example. A bank wishes to buy in IT services from a third party supplier, on which it will be charged VAT. Banks make exempt supplies and so cannot recover all of the VAT they incur. So, to avoid incurring VAT on the IT services, the bank and the third party supplier set up a contrived, jointly-owned company that will employ the staff needed to provide the IT service.

The bank owns "A" shares in the jointly-owned company that give it voting rights that are just sufficient to satisfy the "holding company" test, but give little or no entitlement to dividends or assets on winding up. The third party supplier owns "B" shares that give it rights to actually run the jointly-owned company and an entitlement to all or nearly all the profits it earns, by way of dividends or management charges. In practice the third party supplier can run the jointly-owned company as it sees fit and take the benefits of doing so.

The bank acts solely as customer, exercises no influence over how the jointly-owned company is run and receives little, if anything at all, of the profit from the company's activities. Nonetheless, the normal VAT group eligibility rules allow the jointly-owned company to be VAT-grouped with the bank. As a result the bank avoids VAT on the IT services it is buying in.

The additional eligibility rules imposed by the Order will prevent this. They will apply in very limited circumstances. First, the company concerned must be partly owned, or managed, by a third party, or be the general partner of a limited partnership. However, there are exceptions for where the group is not making supplies above a total value of £10 million, and where the company is a statutory corporation, pensions trustee or charity. Secondly, the company or limited partnership must have a business activity that involves making supplies that are subject to VAT to another VAT group member that would not be entitled to recover such VAT in full. These requirements target the new rules on a small number of VAT group members where the mischief described may be occurring.

The very small number of companies or limited partnerships affected (termed "specified bodies" in the Order) will then have to satisfy two additional conditions in order to be VAT grouped. These tests are based on who receives the benefits of their activities, and who in reality controls them, as evidenced by consolidated group accounts.

Limited partnerships are included above because they are capable of being used as jointly-owned suppliers for this type of avoidance. Limited partnerships are made up of one or more general partners, who run the partnership business, and limited partners, who have limited liability and are effectively just investors (they do not participate in running the business). For VAT purposes, limited partnerships are identified with the general partners, so if there is

[2]Specifically, section 736, as substituted by section 144 of the Companies Act 1989 (c.40).

just one general partner that is in a VAT group, then the limited partnership's business is treated as carried on within the VAT group. Supplies by the limited partnership to VAT group members therefore escape VAT.

Extent

This Order applies to the whole of the United Kingdom, as VAT does generally.

European Convention on Human Rights

It is the view of the Economic Secretary to the Treasury that the provisions of this Order are compatible with the Convention rights. The Chancellor has already stated that he considers the Finance Act 2004 to be compatible.

Policy background

The Government is committed to reducing the revenue losses from tax avoidance, including VAT avoidance. This includes revenue losses from misuse of VAT groups. As section 43AA was inserted by the Finance Bill 2004, this Order could not be laid until after Royal Assent. The Order will come into force on 1 August 2004. It is expected to raise revenue of £50 million in the year 2004/05 and any delay in its coming into force would reduce that gain.

The Government accepts the resulting loss of VAT revenue on intra-group supplies where the companies concerned are genuinely part of the same corporate group. However, as described above, some large companies have exploited the flexibility of the normal VAT grouping requirements to avoid paying tax on supplies from a body that is in substance part of a third party's corporate group – in effect an outside supplier. This leads to significant revenue losses (estimated at around £75m in a full year), and to distortions of competition. In particular smaller competitors are disadvantaged because the scheme is only available to large companies (this is because it requires staff that are largely dedicated to supplying that particular customer).

Customs and Excise have been aware of this abuse for some while, and at the beginning of 2001 announced that they would use their "protection of the revenue" powers to prevent such VAT grouping. These powers, conferred by sections 43B(5)(c) and 43C(2) of the Act, allow Customs to refuse new VAT grouping or dismantle existing VAT groups where they consider it necessary for the protection of the revenue. Nonetheless the abuse has continued.

Customs can only take action after finding and investigating the schemes. This can take years, particularly if the company delays the investigation process. Some businesses benefit considerably more than others, depending on Customs' success in finding their schemes. Businesses have complained about this, and about the uncertainty regarding where Customs will draw the line. Legislating to prevent the abusive VAT grouping in the first place should deal with these problems.

In a consultation document in December 2003, the Government suggested changing the basic rule for VAT group eligibility to one based on consolidation in the corporate group's financial statements. 20 businesses and professional and trade organisations responded. Most respondents accepted the need to act on the abuse, in order to create a level playing field, but they said that the changes went further than necessary to tackle the abuse and would create significant extra costs for VAT groups generally. The Government responded to these

concerns by announcing a much more closely targeted test that would only have to be applied by a small number of VAT group members.

This affirmative Order comes into effect before Parliamentary debate. However, as undertaken during the debate on clause 20 in the Committee of the Whole House, the Order was published in draft to provide an opportunity for fuller consideration in advance of Parliamentary scrutiny. The draft Order was also circulated to respondents to the consultation document and published on the Customs website. Comments were received from about a dozen businesses and organisations, although many simply requested clarification of certain details of the Order. However, as a result the exception for smaller groups (with turnover not more than £10 million) has been adopted and the benefits condition has been made more focused. Drafting changes to assist clarity have also been made.

The Order should not have wide-ranging effects beyond stopping the avoidance at which it is directed and thereby increasing VAT revenue. Most normal VAT grouping is unaffected. A few VAT group members will need to consider the new tests, but if the companies concerned are genuinely part of the same corporate group, they should have no trouble passing them.

Impact

A copy of the Regulatory Impact Assessment that was published on 8 April 2004 is attached.

There is no regulatory impact on the Exchequer.

Contact

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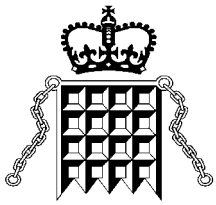
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VAT Strategy: Tackling VAT Group Abuses

Regulatory Impact Assessment

APRIL 2004



HM Customs and Excise

1. INTRODUCTION

This regulatory impact assessment (RIA) considers the costs and benefits of the Government proposal to amend the law on VAT group eligibility to prevent VAT group abuse. In preparing the assessment, we have taken into consideration the responses on the consultation exercise on ***Tackling VAT Group Abuses*** (available as an Adobe PDF file on the Customs and Excise website) published in December 2003.
http://www.hmce.gov.uk/business/consultations/tackling-vat-group-abuse.pdf.

2. THE MEASURE

2.1 Issue

(a) The current rules permit VAT grouping of corporate bodies that are under common control as defined by reference to the definition of holding company and subsidiary in UK company law.

(b) The rules have been subject to abuse and tax avoidance. This is because the definition is wide and makes it possible for a jointly owned entity to join a VAT group even though it is run by and for the benefit of an external third party. This can allow what is, in effect, a third party supplier to provide goods and services to VAT group members free of VAT, which should otherwise be subject to tax.

(c) Whilst Customs can use discretionary powers to refuse VAT grouping or dismantle abusive VAT groups, this has not been fully satisfactory. Some businesses have benefited for significant periods until Customs were able to find and stop the abuse; and businesses have been uncertain about when Customs will use their powers.

2.2 Objective of the measure

The main objectives of the measure are:

- better prevention of avoidance revenue loss;
- greater certainty for businesses;
- fairness.

This is a targeted measure that will have limited impact and allows the Government to prevent avoidance revenue loss. The main effects will be on the sectors that use the abusive structures. The main users are the finance and insurance sectors, and suppliers of IT service to these sectors.

3. OPTIONS

Option A

Do nothing.

Pros

- There are no obvious advantages on this option.

Cons

- continued uncertainty for businesses;
- continuing revenue loss;
- companies involved in abusive arrangements would continue to have competitive advantage over competitors;
- compliance costs for Customs and businesses in investigating possible schemes.

Option B

Group accounts consolidation test as set out in the consultation document.

Pros

- the test would prevent VAT grouping abuse;
- single, consistent test across the board relying on information that most groups should have easily available.

Cons (from response to consultation)

- the measure would not be as simple or easy to apply as current VAT grouping rules, and is likely to impose significant extra compliance costs on all businesses involved in VAT grouping, including SMEs;
- there could be uncertainty about how accounting rules would apply, particularly after acquisition of a new company, before the next audit;
- has a wider effect than is necessary to prevent the avoidance;

- compliance costs imposed on some “fully taxable” joint venture companies that are currently VAT grouped for administrative convenience, with no VAT revenue saving;
- need for specific reliefs to prevent some unwanted side effects on acceptable VAT grouping.

Option C

Retain current eligibility rules with the addition of two further tests applying only in limited circumstances and based upon:

- economic benefit;
- group accounts consolidation.

The “limited circumstances” would be where;

- the company is not a wholly-owned subsidiary, or is managed by a third party, or is the sole general partner in a limited partnership; and
- the company (or limited partnership) makes positive-rated supplies to other VAT group members (except for incidental and ancillary supplies); and
- the VAT group cannot recover VAT on such supplies in full.

Pros

- should still prevent abuse;
- the measure will give businesses legal certainty;
- the measure will only apply to a few VAT-grouped businesses in circumstances where there is a risk of avoidance; therefore, modified measure is proportionate to tax avoidance risk;

Cons

- more complex in principle than Option B;
- applies a “two-tier” test for grouping, with a few companies having to meet more stringent tests than the rest;
- risk that businesses may be able to circumvent the definition of “limited circumstances” and so avoid the additional tests.

Decision

The Government consulted businesses and professional advisers on option B. The responses raised concerns. In light of the responses, the Government has decided to introduce **a modified measure based upon option C,** which is more targeted on avoidance**.**

The present rules on VAT grouping eligibility will therefore remain, but they will be supplemented by two additional tests. These tests should apply in very few cases and should not impose any additional burdens or changes on the vast majority of VAT groups.

4. BENEFITS

Tax Avoidance

4.1 The modified measure will prevent the identified abuse, while minimising the additional compliance burden on most businesses that are not involved in this form of abusive arrangement.

Fairness

4.2 The modified measure will ensure greater fairness, since it will apply equally to all businesses that are engaged in this form of abusive arrangement, not just those that Customs have found and against whom they have taken action.

Business certainty

4.2 The modified measure should in practice give businesses more certainty on what is an acceptable VAT group.

5. COSTS

5.1 This measure will have a limited impact on compliant (non-avoiding) businesses because under **Option C,** the Government is retaining the current rules on VAT grouping eligibility, but with additional tests that will apply in very limited circumstances. The compliance costs for most businesses in VAT groups will therefore be confined to confirming that the limited circumstances are not present.

Fully taxable groups

5.2 There are no compliance costs for fully taxable groups, since they cannot be affected by the measure.

Partly exempt and non-business groups

5.3 These VAT groups will need to review their structure to determine whether they include a company that has to consider the additional tests. This should be a straightforward, non-technical procedure based on the ownership of subsidiaries and the nature of the activities they undertake. It should take only a few minutes to check a small group.

5.4 We estimate that when the measure is introduced about 1000 larger groups will have to spend around two hours each on average, costing around £30 each. The groups may also have to spend around an hour a year (on average) monitoring the effect of changes in the VAT group, costing £15.

Groups with a company subject to the additional tests

5.5 We estimate that about 100 VAT groups will have a company subject to the additional tests (excluding abusive arrangements), and that for each the new tests should take no more than 1 hour on average, costing around £25.

Companies caught by the additional tests

5.6 We estimate that, excluding abusive arrangements, around 20 joint ventures will be caught by the new additional tests and will have to leave the VAT groups. As a result they will incur extra compliance costs in charging VAT on supplies to VAT group members and preparing separate VAT returns.

5.7 Notification to C&E and amendment of systems to charge VAT on intra group supplies should take about 2 hours, costing around £45. On-going cost of preparing separate VAT returns should take no more than 45 minutes per quarter, costing around £30 per year.

5.8 These analysis confirms that the costs imposed on businesses are relatively minimal because of the limited application of the test. The

Government did not identify any other costs to society or the environment.

6. THE SMALL FIRMS IMPACT TEST

In our view, the measure will not have any impact on small firms generally. Relatively few such firms are companies within VAT groups. Where they are in VAT groups, it is highly unlikely that they will fall within the circumstances for the extra tests to apply.

7. COMPETITION ASSESSMENT

A competition filter was completed and this confirmed that the revised proposals would not make it more difficult for new entrants to the markets involved (the finance / insurance sector, and suppliers to them of IT services).

8. ENFORCEMENT AND SANCTIONS

The new legislation should prevent new groups that would be abusive. Most businesses will comply with it. Where they do not (whether through mistake or otherwise), Customs will be able to unwind the incorrect VAT grouping.

9. MONITORING AND REVIEW

We will be monitoring the impact of the legislation on businesses after the legislation is introduced.

10. RESULT OF CONSULTATION

The consultation began on 23 December 2003 and ended on 1 March 2004. Most of the responses were from professional bodies and trade associations.

The Government believes that this consultation has been successful at identifying and responding to business concerns. Most of the respondents commented that it was not a good idea to impose the group accounts consolidation test as the basic test for group eligibility across the board. The reasons are those set out under **Option B** in section 3.

In light of responses to the consultation, the original proposal has been modified to make it more targeted on cases where there may be avoidance. This is **Option C** in section 3.

11. SUMMARY AND RECOMMENDATION

The modified measure is a proportionate response to abusive VAT groups. The measure will give businesses legal certainty and will effectively prevent abuse and consequent revenue loss. The costs imposed on businesses are relatively minimal and do not outweigh the significant benefits.

12. DECLARATION

I have read the Regulatory Impact Assessment and I am satisfied that the balance between cost and benefit is the right one in the circumstances.

Signed

by the responsible Minister .....

Date .....