EXPLANATORY MEMORANDUM TO

THE VALUE ADDED TAX (SPECIAL PROVISIONS) (AMENDMENT) (No.2) ORDER 2006

2006 No. 869

1. This explanatory memorandum has been prepared by H M Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

2. Description

2.1 The instrument amends the Value Added Tax (Special Provisions) Order 1995 by introducing an exception to the circumstances when the disposal of goods by a person who repossessed them under the terms of a finance agreement, can be treated as neither a supply of goods or services. The excepted circumstances are where the supplier has made or can make an adjustment in the consideration accounted for on the original sale under regulation 38 of the Value Added Tax Regulations 1995 (S.I. 1995/2518) or that adjustment is made in any other way.

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

None.

4. Legislative Background

4.1 This Order is made under the powers conferred by section 5(3) of the Value Added Tax Act 1994.

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6.European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation no statement is required.

7. Policy Background

7.1 This amendment to the Value Added Tax (Special Provisions) Order 1995 affects businesses that sell goods under finance agreements. It ensures that that the Value Added Tax (VAT) accounted for by such businesses, when a sale of goods is not completed by the initial customer, is based upon the total consideration received by the business.

7.2 For the purposes of VAT, when goods (in particular motor cars) are sold a business is required to account for VAT on the full amount to be received from the customer, when the goods are removed or delivered. The customer may, if they

require finance, pay for the goods, together with any finance charges due over an extended period. Typically a sale of a motor car on finance will be made in two stages, the dealer will sell a car to a finance company who in turn will sell it to the customer under a finance agreement. The adjustment made following the initial sale will therefore typically be made be made by the finance company rather than the car dealer.

7.3 Customers may have opportunities to end such agreements early. Firstly a customer may be able to exercise their right to end an agreement early under section 99 of the Consumer Credit Act 1974. Providing the customer is up to date with repayments and they return the car in an acceptable state they can with draw from the agreement without making further payments. In addition some finance agreements provide other opportunities to withdraw from the agreement by returning the car. When this occurs the seller of the car can make an adjustment to the amount of VAT originally accounted for by using regulation 38 of the Value Added Tax Regulations 1995. The amount of the reduction is based upon the amounts the customer is no longer required to pay.

7.4 Customers may also default on repayments under finance agreements, allowing the finance company to repossess the goods. When the finance company does this and the agreement states that the customers indebtedness is reduced by the sale proceeds of the repossessed goods, then again the finance company can reduce the VAT accounted for initially. Again the amount of the reduction under regulation 38 is based upon the amount the customer is no longer required to pay.

7.5 This amendment deals with the consequent re-sale of the goods which have come back to the finance company, either as a result of a customer exercising an option to return the goods, or as a result of repossession following default. The current legislation allows the second sale to be treated as neither a supply of goods nor services, with the result that no VAT is accounted for. As the finance company will have been able to make an adjustment to the VAT accounted for on the first sale there is no reason why VAT should not be accounted for on the second sale. This amendment will correct the fault in the current legislation, by only allowing no VAT to be charged on the second sale in circumstances where the VAT on the first sale cannot be adjusted (as a safeguard against double taxation).

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 The impact on the public sector is that H M Revenue and Customs staff, as part of the assurance of the business affected will monitor compliance with the regulations. Those businesses will be subject to the usual enforcement procedures for VAT registered businesses. No additional cost for HMRC is envisaged as a result of this.

9.Contact

Ian Broadhurst, H M Revenue and Customs Tel 020 714 70288 or e-mail ian.broadhurst@ hmrc.gsi.gov.uk can answer any queries regarding the instrument.

REGULATORY IMPACT ASSESSMENT (RIA)

1. TITLE OF PROPOSAL

The Value Added Tax (Cars) (Amendment) Order 2006 and The Value Added Tax (Special Provisions) (Amendment) (No.2) Order 2006

2. PURPOSE AND INTENDED EFFECT

i) Objective

The amendments close a loophole in the VAT treatment of goods sold, for the second time, by a finance company.

ii) Background

The loophole arises where the sale of goods is made under finance agreements such as hire purchase and conditional sale agreements. These allow the cost of the goods to be spread over an extended period. For VAT purposes, provided the finance charges are clearly identified to the customer, such sales are treated as two supplies (by the finance company) - the supply of goods at the 'cash' price (which is subject to VAT) and a separate supply of finance (which is exempt from VAT). The finance company is required to account for the full amount of VAT at the time the goods are removed or delivered, as if all the payments required under the agreement had been received. However, legal ownership of the goods remains with the finance company until the customer has actually made all the payments.

The problem arises when the customer fails to make all the payments required under the agreement. This can arise in one of two ways:

- The customer exits the agreement early - either under statutory rights or under the particular terms of the agreement. In these circumstances the customer is required to return the goods to the finance company who will then sell the goods for a second time.

- The customer defaults on the agreement - e.g. by not keeping up the payments due. In these circumstances the finance company will repossess the goods and sell them in an attempt to make good their loss

Transactions affected by this proposal occur mainly in respect of finance agreements for goods (primarily cars) bought by households or by others unable to recover the VAT incurred on their purchase.

The High Court in *General Motors Acceptance Corporation* (GMAC)[1] found that, in either circumstance, the finance company could obtain relief on **both** the first **and** the second sale. As a result of this judgement an element of consumption via finance agreements goes untaxed. Based on claims received following the litigation, this is estimated to result in revenue losses of around £20 million. The current situation presents a significant a risk of further revenue losses through new avoidance activity exploiting the loophole and also leaves the UK open to infraction proceedings by the Commission.

3. CONSULTATION

Informal discussions have been held with the two main trade associations – the Finance and Leasing Association (FLA) and the British Vehicle Rental and Leasing

[1] Case reference CH/2003/APP/0230

Association (BVRLA). Whilst accepting the reasons for the changes the associations have expressed concern that changes will increase compliance costs for their members. These compliance costs are expected to relate mainly to one-off system changes required to identify the VAT treatment of goods (mainly vehicles) from the outset of finance agreements.

4. OPTIONS

Option 1: Do nothing

This option effectively maintains the current situation following the legal judgement that allows a finance company to obtain relief on both the first and the second sale of the same goods.

Option 2: Remove relief on the second sale

This option proposes to change the VAT (Cars) Order 1992 and VAT (Special Provisions) Order 1995, removing the relief on the second sale by making it taxable.

Option 3: Industry proposal

Industry representatives suggested an alternative approach. This option allows the finance company to limit its own claim for relief on the first sale and in turn retain relief on the second sale.

5. COSTS AND BENEFITS

i) Sectors and Groups affected

The trade associations we discussed the proposals with account for the vast bulk of the sector, made up of less than 50 companies, supplying goods under finance agreements.

ii) Benefits

Option 1: Do nothing

The benefits of a do nothing option are that no legislative changes would be required and there would be no compliance cost implications for businesses. However, this option does not address the risks from avoidance exploiting the loophole or infraction proceedings by the Commission.

Option 2: Remove relief on the second sale

This option ensures that each transaction made under finance agreements would bear an appropriate VAT charge and also prevents the use of the loophole for tax avoidance purposes. In addition it ends annual revenue losses of some £20 million.

However, this option does result in compliance costs for businesses although a lead-in period provides businesses with an opportunity to adapt their systems prior to the change having full effect.

Option 3: Industry proposal

In common with option 2, this option ensures that sales made under finance agreements would bear an appropriate VAT charge, prevents the use of the loophole for tax avoidance purposes and ends annual revenue losses of some £20 million.

It would have an optimal benefit in terms of compliance cost implications for businesses in having the advantage of avoiding the need to make any system changes.

However, legal advice has indicated that this option is not available as it would be directly counter to the Sixth VAT Directive 77/388. As such, this option would not ensure that UK law will apply the Sixth VAT Directive correctly, would be open to challenge by UK businesses and risk of Commission infraction proceedings would remain.

iii) Costs

Option 1: Do nothing

A do nothing option would not address the fact that the UK's current regulations do not result in the correct level of VAT being collected on goods sold under finance agreements. Continued failure to correct the situation would give businesses in this sector an unjustified advantage over other businesses and leave the UK open to infraction proceedings by the Commission. This option also gives a significant risk from introduction of avoidance schemes to exploit the loophole, which would result in revenue losses to the Exchequer and distortion between those business that adopt schemes and those that do not.

Compliance Costs

This option would have no compliance cost implications for businesses.

Option 2: Remove relief on the second sale

This option would result in the correct level of VAT being collected on goods sold under finance agreements. We do not believe that the measure would be liable to successful challenge by UK business as it brings UK law more closely into line with EU law.

Compliance Costs

The principal costs that businesses have identified relate to one-off system changes to capture information at the start of a finance agreement, which is not currently captured or is not contained within the systems that deal with the returned goods. The cost of making these system changes will vary between different businesses and will depend largely on the complexity and flexibility of existing systems. Indicative estimates for a sample of businesses received through industry representatives range from £100,000 to £500,000. It is expected that particularly large businesses with international systems will experience the most significant costs. Other costs identified include staff training and compliance checking. Ongoing compliance cost implications are not expected to be significant once the initial system changes are established.

Three approaches to implementation have been considered:

(a) Introducing with immediate effect for all existing and new agreements

This requires the system changes needed to capture relevant information at the start of agreements, training and implementation of compliance checks. However, while the system changes are being developed businesses would also need to set up and operate a temporary manual system for collecting information on existing and new agreements entered into until the permanent system changes are implemented and then transfer all the information onto the permanent system. The industry have estimated costs of around £10 million for introduction on this basis.

(b) Introducing with immediate effect for new agreements only

Compliance costs for the industry in introducing on this basis are estimated to be reduced to £7.5 million, with businesses no longer required to collect, record or transfer information about existing agreements.

(c) Introducing for new agreements where the goods are delivered on or after 1 September 2006

By introducing for new agreements, where the goods are delivered on or after 1 September 2006, it is estimated that compliance costs would be reduced further to £5 million for the industry. The reduction in set up costs is realised by avoiding the need for a temporary manual system completely.

Option 3: Industry proposal

Legal advice has indicated that this pragmatic option, allowing a finance company to limit its own claim for relief on the first sale and retain relief on the second sale, would be directly counter to the Sixth VAT Directive 77/388. There is a risk of successful challenge by UK business or of Commission infraction proceedings.

Compliance Costs

This option would have no compliance cost implications for businesses, as it would avoid the need to make any system changes.

6. SMALL FIRMS IMPACT TEST

Small businesses are not expected to be affected by changes proposed in any of the options, as finance companies are generally larger businesses. This has been confirmed in discussions with industry representatives.

7. COMPETITION ASSESSMENT

A competition filter has been completed. We consider that that there will not be a negative competition assessment for the following reasons:

- The three largest firms in the market affected by the amended regulations do not have at least 50% market share
- The amended regulations are not likely to affect the market structure, changing the number or size of firms
- The amended regulations will not lead to higher set up costs for new or potential firms that existing firms do not have to meet
- The amended regulations will not lead to higher ongoing costs for new or potential firms that existing firms do not have to meet
- The market is not characterised by rapid technological change
- The amended regulations will not restrict the ability of firms to choose the price, quality, range or location of their products

8. ENFORCEMENT, MONITORING AND SANCTIONS

HM Revenue and Customs (HMRC) staff as part of the assurance of the businesses affected will monitor compliance with the regulations. Those businesses will be subject to the usual enforcement procedures for VAT registered businesses. No additional cost for HMRC is envisaged as a result of this.

9. IMPLEMENTATION AND DELIVERY PLAN

Updated guidance on the effect of the measure will be produced in the form of a VAT Information Sheet on the day of the announcement of the measure and VAT Notice 701/49 Finance and Securities will be revised when next updated.

10. POST-IMPLEMENTATION PLAN

We will carry out a post-implementation review as soon as the change has bedded in and suitable data are available. We expect that to be within 3 years of implementation, but will monitor developments to ensure that any review is neither premature, nor unnecessarily delayed. The findings will be used to enhance the policy-making process – both in this area and across HMRC in general.

11. SUMMARY AND RECOMMENDATION

The measure is intended to close a loophole in the current UK VAT law.

The options we have are;

- do nothing; this would leave the UK open to infraction proceedings by the Commission, would allow businesses escape a VAT charge on some of the supplies they make, and would risk wider exploitation of the loophole.
- industry proposal; this would leave the UK open to challenge by UK businesses and infraction proceedings by the Commission
- introduce the above which amendment to the regulations; the Department's view is that the amendment represents the only legally sound means of preventing loss of revenue through the exploitation of the loophole

It is therefore recommended that the changes outlined in Option 2(c) are adopted.

12. DECLARATION AND PUBLICATION

REGULATORY IMPACT ASSESSMENT

The Value Added Tax (Cars) (Amendment) Order 2006 and The Value Added Tax (Special Provisions) (Amendment) (No.2) Order 2006

Statement of Ministerial Approval

I have read the regulatory impact assessment and I am satisfied that

the benefits justify the costs.

Signed by the responsible Minister:

DAWN PRIMAROLO M.P.
PAYMASTER GENERAL

1st March 2006