PO-CH/NL/0884

PART A

Part A.

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Begins: 9/6/86.
Ends: 17/12/86.

PO -CH /NL/~~0238~~ 0884

PART A

Chancellor's (Lawson) Papers:

AVOIDANCE OF VALUE ADDED TAX

DD's: 25 Years

19/12/95

PO -CH /NL/~~0238~~ 0884

PART A

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: P Jefferson Smith

9 June 1986

MINISTER OF STATE

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Sir Peter Middleton
Mr Cassell
Mr Monger
Mr Cropper
Mr Tyrie
Mr Ross Goobey

JEFFERSON SMITH TO MST 9/6

VALUE ADDED TAX AVOIDANCE

1. You will recall that, during the debate in Standing Committee on Clause 10 of the Finance Bill, Mr Tony Blair raised what he described as a rather larger case of tax avoidance than that dealt with by the Clause, which was concerned with the disaggregation of businesses. He then described a set of circumstances in which a bank, because of its exempt activities, is unable to recover all of its input tax. It sets up a leasing company as a subsidiary: this company purchases a computer, recovers the input tax and leases the computer to the bank. After making a few leasing payments, the bank arranges for itself and the subsidiary to form a VAT group with a single registration and from then on the leasing transactions can be ignored altogether for VAT purposes. In the perfectly feasible example given by Mr Blair, almost £1.5 million tax would have been recovered, of which the bank would otherwise have been entitled to recover only a small part. We have recently become aware of a precisely similar case, so we know that the scheme is not simply theoretical.

Internal circulation:

CPS
Mr Knox
Mr P V H Smith
Mr Howard
Mr Wilmott
Mr E Taylor
Mr Tracey
Mr Michie

68/6/86

2. In replying, you gave a qualified commitment to legislate in the 1987 Finance Bill: the commitment was conditional upon finding a solution to the drafting difficulties and made it clear that inclusion in the 1987 Bill might not be possible. It was also restricted to the tax avoidance scheme referred to by Mr Blair, even though he may have wished for it to embrace other such schemes.

3. One of the CBI's tax experts was in the public seats; and other trade bodies will have been quick to see the implications of the debate. An article in the 30 May issue of "Taxation" draws the attention of readers to Mr Blair's description of the details of the scheme and says "Taxation readers will be thrilled to learn that this tax planning strategem has a shelf life of at least nine months"!

4. Item 5.4.2 of our Departmental Management Plan for 1986/87 clearly signalled our intention to tackle tax avoidance: to this end, it directed a series of special control visits in the areas which are known to be most at risk, to establish and evaluate what is happening. In particular, by 31 March 1987 special visits will have been made to about 200 important partly exempt traders; and by 30 September 1986 to 50 very large property companies (these are particularly prone to manipulate the grouping rules). We have a good deal of information already about the major avoidance schemes: but we need the additional information which we are obtaining from our control staff, before we can properly evaluate the extent of use of the various schemes.

5. We believe that several schemes are currently in use, some potentially much more serious than that mentioned in the debate. We have even seen advertising material from consultants who offer a range of such schemes to their clients. The legislation needed to deal with some of the schemes would be quite complex but some could probably be tackled in the 1987 Bill and some of the others by secondary legislation. In very general terms, provisions directed at

avoidance by taking companies into or out of VAT groups are likely to need primary legislation; but provisions related to calculation of entitlement to input tax by existing VAT groups could probably be effected by amending our partial exemption Regulations.

6. While we do not think that, taken on its own, the closing of the loophole referred to by Mr Blair would cause too much heat in financial circles, there is little doubt that other action we might take would meet vociferous opposition. On the other hand, the disaggregation clause and some of the other measures which we have taken recently have been criticised as particularly burdensome to small traders: the kind of tax avoidance with which we are concerned here is almost exclusively the province of larger traders, principally in the financial sector. While it is difficult to quantify the loss to the revenue, we are quite sure that it is substantial.

7. Your reply in the debate specifically mentioned consultation and past experience would suggest that it would be unwise to proceed in this area without testing the water. However, it would look rather odd if we were to consult simply on the less far-reaching schemes when trade bodies are well aware that we are concerned about a number of others which are potentially far more serious. We do not expect to be ready to deal with these by the 1987 Bill. For this reason, we would suggest opening the consultation document in general terms, saying that we are concerned about the extent of tax avoidance and referring to the schemes most frequently encountered. We can go on to say that we intend progressively to consult trade interests on proposals to deal with avoidance and that, as a start, Ministers are considering bringing forward measures which the paper would then enumerate. In the light of comments and of findings emerging from our special control visits, Ministers would then be in a position to choose whether or how far to act, either by Regulations or in the 1987 Bill.

8. If you are generally content with the course of action proposed in this minute, we will proceed accordingly and would hope to be able to submit detailed proposals to you, together with a draft of the consultation document, in time for you to consider it before the summer recess.

PJS

P Jefferson Smith

FROM: APS/Minister of State

DATE: 26 June 1986

APS/CHANCELLOR

C/ I understand that the MST wishes to raise this at Prayers 26/6

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Mr Cassell
Mr Monger
Mr Cropper
Mr Tyrie
Mr Ross Goobey

PS/Customs & Excise
Mr Jefferson Smith - C&E

VALUE ADDED TAX AVOIDANCE

Following your minute of 10 June the Minister of State discussed with Mr Jefferson Smith his submission of 9 June. I attach a note of their discussion.

E Frankis

MISS E C FRANKIS
Assistant Private Secretary

NOTE OF A MEETING BETWEEN THE MINISTER OF STATE AND MR PETER JEFFERSON SMITH ON VALUE ADDED TAX AVOIDANCE (P JEFFERSON SMITH'S MINUTE OF 9 JUNE) ON WEDNESDAY, 18 JUNE 1986. MR MICHIE (C&E) WAS ALSO PRESENT

Mr Jefferson Smith said that generally two types of VAT avoidance needed to be considered:

1. Companies moving into or out of VAT groups (the "Blair" example).

2. Exploitation of partial exemption rules thereby claiming excessive input tax (mainly VAT Groups).

The Minister of State asked whether the consultation outlined in Mr Jefferson Smith's minute of 9 June would cover both items. Mr Jefferson Smith confirmed that there would be only one consultation paper. He added that the certainty of the timetable depended on the aspects with which they were dealing. It should be possible to tackle the type of case at 1. above in the 1987 Finance Bill but it would be necessary to consider alongside that the problem of the EC Sixth Directive. Mr Jefferson Smith added, however, that most revenue was being lost in the group at item 2. above and this could probably be dealt with by amending the partial exemption Regulations with effect from 1 April 1987.

A provisional timetable was agreed as follows:

a. Consultation paper issued around end July, which would ask for comments by end of September.

b. Following this, various associations would meet with Customs and Excise and possibly with the Minister.

c. Customs would report to the Minister at the beginning of December. Mr Jefferson Smith envisaged that Customs would report on only the changes to Regulations at that stage. Mr Jefferson Smith added, in response to a question

from the Minister, that there would be no obligation to make an announcement of changes necessary in primary law before the Budget.

Mr Jefferson Smith said that Customs were presently looking at the possibilities for challenging some of the schemes under item 1. above under existing law. One rule in the VAT Act made it possible to prevent this practice if it was necessary to "for the protection of the revenue". However, lawyers tended to strictly interpret this rule and it was necessary to tread carefully. The Minister would be consulted as necessary.

The Minister of State asked that Customs now proceed "full steam ahead" as per the timetable outlined above. He said that the short consultation period was desirable even if it increased the flak from companies, and added that in fact the greater the flak received the more apparent it would be that action was needed.

MISS E C FRANKIS
Assistant Private Secretary

PS/CHANCELLOR

FROM M W NORGROVE

DATE 1 AUGUST 1986

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mr Monger
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/Customs & Excise
Mr Jefferson Smith
C&E

C/ See last paragraph
Any objections to consultative
paper + press notice?

CR 1/8

Catch m.

TAX AVOIDANCE

The Minister of State met Mr Jefferson Smith yesterday to discuss his submission of 25 July.

On the potential Eurobonds difficulties, updating the information available at the time of their last meeting and in paragraphs 7-10 of his minute, Mr Jefferson Smith said that it now appeared possible that we could sidestep the problem (of non-deductible income tax) by adopting the Dutch practice of exempting (instead of taxing) the commission. This should be compatible with EC law, since it would simply involve the UK ceasing to make us of one of the deregations allowed under Annex E of the Sixth Directive. The Minister of State agreed that, although it was a customary tactic for trade associations to allege that proposed tax changes would result in business going abroad, it would be particularly unfortunate if such allegations proved to be true in this case, especially given the excellent growth of this market in the UK over recent years. He agreed therefore that, in anticipation of representations from the

input! AA

Eurobond market, this option would be kept in reserve, but foreshadowed in general terms in the consultation paper (at the end of paragraph 7) as follows:-

> "The Commissioners will also examine other aspects of the Sixth Directive with a view to amending UK legislation where it might place UK business at a disadvantage in relation to businesses in other Member States".

On the question of timing, covered in paragraphs 12-14 of Mr Jefferson Smith's minute, the Minister said that, although it was obviously desirable to have only one bite at the cherry, he could see advantage in getting as many changes as possible introduced as early as possible. If "one bite" meant delaying everything until, say, October 1987, he would prefer to take two bites - changes introduced under the Provisional Collection of Taxes Act were less likely to be eroded during the passage of the Finance Bill. On the revenue implications of delay, Mr Jefferson Smith estimated that, if all changes were postponed until October, only a quarter of the forecast revenue would accrue i.e. if the full year yield was around £150 million, the first year revenue would be £37½ million rather than £112 million.

attached at A

The Minister of State was content, subject to the Chancellor's approval for the consultative paper and press notice, as drafted by Mr Jefferson Smith, to be released. Customs would plan to do this during the course of next week, once the Chancellor is content.

M W NORGROVE

CONFIDENTIAL

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: P Jefferson Smith
Date: 30 October 1986

MINISTER OF STATE

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper

VAT : TAX AVOIDANCE (STARTER No. 6)

1. In my submission of 25 July 1986, which sought your authority to issue a Consultation Paper, we undertook to report the results of the consultation. 902 copies of the paper were issued to 428 enquirers and there has been considerable interest. 102 written responses have so far been received, and although the consultation is now officially over, we know that a small number of interested parties have still to respond. We are commencing a series of meetings (25-30) with professional bodies and trade associations which we hope to complete before the end of November. This is an interim report, to forewarn you of the emerging issues. You may like to discuss it with us.

The Response

2. Predictably, responses have been generally hostile: less predictably, many have used almost identical phrases and there are some signs of orchestration. Articles in the trade and professional press have led the way, largely in saying that our existing powers are sufficient and that the proposals are out of line with Lord Young's initiative on deregulation. There is little doubt that tax

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Internal circulation:

CPS	Mr Howard	Mr Tracey	Ms Barrett	Mr Bazley
Mr Knox	Mr Butt	Mr Trevett	Mr Wilmott	Mr Michie

348/10/86

planners and many other interested parties fully appreciate the need for legislative change, but are unwilling to say so, mainly because they can foresee the revenue effectiveness of the changes which will render their existing avoidance schemes inoperative.

3. The main points emerging from written representations are as follows:

(a) **Adequacy of existing powers**: a common theme of many press articles and written responses has been that the Department already has adequate powers to prevent tax avoidance. At a recent meeting with the VAT Practitioners Group, which consists of leading tax advisers from the accountancy profession and industry, the adequacy of existing Departmental powers was discussed in some depth. We consider that the full extent of our present powers is uncertain, and they would be very difficult to apply in a fair and predictable manner. The Practitioners did not contest the fact that in some instances the existing law is seriously deficient and incapable of effective application.

(b) **The "burdens on business" argument**: much has been made of this point and the difficulties have undoubtedly been greatly exaggerated. The proposed new partial exemption rules are not incompatible with deregulation in that they would take a substantial number of small traders out of the partial exemption net altogether: but our proposals would bring into the net an even greater number of large and very large traders, who are at present avoiding restriction of input tax on very substantial exempt supplies by the way in which they have structured their VAT groups.

(c) **The short period of time allowed for consultation**: there is no doubt that certain bodies have found it difficult to evaluate the proposals, consult their members and respond

within the two month period. However, where an extension of time has been requested, it has been granted.

(d) **The short lead-time which a 1 April 1987 date of implementation would give for computer reprogramming**: on the face of it, this is a reasonable argument. However, the majority of traders who are already partly exempt will not need to reprogramme: those who will become partly exempt are for the most part large organisations with sophisticated technology and should be able to accommodate the accounting changes.

(e) **The proposed input based de minimis rules (item 8 of the Paper):** under these rules, traders who incur less than certain prescribed amounts of input tax in relation to exempt supplies may treat themselves as fully taxable. Representations have been received to the effect that the proposed rules will be much more difficult to apply than the existing output based rules. Again this is a superficially impressive argument which will need to be countered: but in our view, most businesses will be so far inside or outside the limits as to make detailed calculations unnecessary. The number of traders who will be near enough to the borderline to need to do so should be small.

However, we are considering two simplifications for smaller businesses. One would be the introduction of a further rule whereby traders whose total input tax is less than a given amount, say £5,000 per year, would automatically be able to recover all of it without any further formalities (this in turn might necessitate some changes in the other de minimis limits proposed in the Paper). This is something we would prefer to keep in reserve for use only if we appeared to be losing ground in the consultation.

The other would be the publication of a list of exempt transactions which businesses outside the financial sector would ignore for the purpose of partial exemption.

Apart from this, it may be necessary to look again at whether the de minimis rule which relates to 1 per cent of total input tax should also be subject to an upper monetary limit. We now feel that if it is not, there would be continuing scope for avoidance by manipulation of financial transaction. This would be a further restriction not proposed in the consultation paper; if it is to be done, there might be presentational advantages in announcing it at the same time as simplifications for the benefit of smaller traders.

(f) **The brewers representations:** at item 10 of the earlier submission to you, we mentioned the case of brewers with tied houses, who benefit considerably (in the region of £50M - £60M per year) as a result of concessions which they secured in 1984 after a period of concerted protest: these concessions allowed them to disregard tied house rentals (exempt) in calculating their entitlement to input tax. Following the proposed recasting of the partial exemption rules, these concessions will no longer hold good and their 1984 arguments will become largely irrelevant. As expected, the brewers have reacted vociferously against the proposals and argue that they should be allowed to retain their present advantageous position. We have arranged to meet with the Brewers' Society on 13 November to discuss their case: it is unlikely, however, that a solution can be found within the partial exemption rules. Indeed it is difficult to justify the current position under which a brewer can legitimately deduct millions of pounds of input tax per year in relation to exempt supplies, while many small businesses are caught in the partial exemption net

and required to restrict their recovery of input tax. A solution which the brewers themselves will put forward is that tied house rentals should be taxed. Provision for the taxpayer to opt for taxation of property rentals and leases is contained within the EC Sixth Directive: however, as well as brewers, many other landlords would like a similar option to be given to them so that they could recover all their input tax on improvements, repair and maintenance. This would be a costly option in revenue terms: we certainly could not justify singling out the brewery trade in this respect. In any case the option for taxing rents is one which should be held in reserve in case we lose the EC infraction proceedings over zero rating of new commercial buildings. It would be needed then in order to offset the adverse effects on the property and construction industries.

Other Points

4. There are some other points of interest, in particular the following:

(a) **Eurobond issues:** at paragraphs 7 to 10 of our earlier submission, we outlined potential Eurobond difficulties and on 7 August we discussed the matter with you. Surprisingly, there has been little direct representation on the Eurobond front, but we still consider that this is a sensitive issue which could cause problems. Our favoured solution of following the Dutch practice of exempting commission still appears to hold good and we are actively pursuing that line.

(b) **Timing:** when we last spoke on this matter it appeared likely that we would need at least two bites at the cherry in order to get the legislative changes in place: the first step being the amendment of primary law, to be

followed after Royal Assent by changes to the regulations. We have now received encouraging preliminary advice from Parliamentary Counsel and although it is still not absolutely certain, we are now much more hopeful that all the most important changes are capable of being brought into operation following the Budget, with an operative date of 1 April 1987. This assumes an early announcement of the changes (see paragraph 5 below). It also assumes that the necessary requirements in Brussels can be complied with in time: this will involve either discussion with the VAT Committee or an application for a formal derogation, depending which of the possible courses of action is decided upon. We have started work on this, and there will be preliminary Brussels discussion in December; but no real progress will be possible while the discussions relate only to possibilities, not to firm UK proposals.

(c) **Revenue:** estimating the extent of avoidance is very difficult, because we can only extrapolate from the cases known to us, taking into account also what is said by way of comment on the effect of the proposals in the consultation paper (i.e. the decibel level). We previously estimated the revenue involved as being at least £150 million in a full year. We also mentioned that we had planned a series of special visits in the areas which are known to be most at risk, in an attempt to evaluate what is happening. We have, as yet, received reports on less than a quarter of the planned visits, but early indications, combined with information secured elsewhere, suggest that the estimate of £150 million per year is significantly understated: the figure is likely to be double. However we hope that further research will throw light on this.

Assessment

5. The plan is to report to you with firm proposals about the beginning of December. If you are minded to implement them, or as much as possible, from 1 April, it will be necessary to make an announcement before the Christmas recess, for two reasons.

(a) It would be unreasonable to expect the major traders affected to make the changes with any shorter notice - as it is, they will say that three months are quite inadequate.

(b) Some of the measures to be adopted require consultation in Brussels, and this can only be done openly and on the basis of a firm statement of UK intentions.

If an announcement could not be made to this timescale, or it was wished as a matter of policy not to say anything until the Budget, this would point to a 1 July or even 1 October implementation date. Revenue may be relevant in this context: on a rough rule of thumb, 1 April would get three-quarters of the full-year figure in 1987-88, 1 July would get half, 1 October only one-quarter.

6. Of the major problems to be tackled, the most general in terms of those who would be affected relates to burdens on businesses. We will need to demonstrate that smaller traders are being taken out of the partial exemption net (the smallest are not in it now), and that the calculations to be made before a trader can tell whether the de minimis rule applies are not unduly onerous (see paragraph 3(b) and (e) above). We are actively seeking out meetings with influential bodies such as the ICAEW, which we would hope would be persuaded to accept that the burdens issue is not as serious as is being suggested. As our proposals are Budgetary and revenue raising, we regard them as outwith the remit of Lord Young's Enterprise and Deregulation Unit. Nevertheless, consultation with the EDU would seem only prudent. We suggest that you should authorise us to consult with the EDU, on the basis that you have decided in principle that the money being lost by avoidance must be recovered, but that they may wish to express views on the details of the scheme. We would make every effort to persuade them that the scheme is as simple

and unburdensome as possible, while at the same time working up the further simplifications as suggested in paragraph 3(e).

7. The other major problem is the brewers. While general opposition may be expected to our proposals, the brewers are (so far) the only individual industry to come forward claiming special treatment. We would be reluctant to concede it, for the reasons given above. But in view of the amounts of money involved, the past history, and the likely strength of feeling on the issue, we suggest that the Brewers' Society should have an opportunity to see you before a final decision is made. In view of the time constraint, it would be as well to prepare the ground now. We suggest that when we see them on 13 November, we indicate that if they feel very strongly that our position is unreasonable and damaging to them, they should seek a meeting with you, to which you would be likely to agree. May we have your agreement to this please?

PJ ~

P Jefferson Smith

CONFIDENTIAL

FROM: Minister of State

DATE: 28 November 1986

c/ MST has not circulated to officials because he was uncertain whether this was what you had in mind

CHANCELLOR

VAT: TAX AVOIDANCE (STARTER No 6)

You asked (Mrs Ryding to PS/Minister of State, 5 November 1986) for a personal political assessment of this issue, given the view that it would need very careful handling. I have deferred providing this while two meetings with the brewers were taking place, given the particular political sensitivity of that industry and its product. — notes of meetings attached.

2. Overall my conclusion is that the downside political risk for inaction, in terms of potential embarrassment caused by public perception of massive avoidance, is substantially greater than the political cost from employers and taxpayers protesting at anti-avoidance action, though I treat the brewers' case separately.

3. Our potential embarrassment in June was already considerable. Mr Blair's insertion of a single example of avoidance described in the Finance Bill Committee Stage was accompanied by his estimate that the overall loss of revenue to Customs might be of the order of £100 million. We comforted ourselves at the time that there was no way he could for certain know, but our own preliminary assessment, when considering consequential action, was that the revenue loss could be as high as £150 million, and that has now been broadened to at least £300 million. (The case of the brewers, who are admittedly brought into the net by a side-wind, has likewise been broadened from a revenue relief of £50 million-£60 million to their estimate of £75 million-£100 million.)

4. It was the scale and source of the embarrassment (the source being substantially the financial sector) which prompted us to pile on all sail with a view to legislation at the earliest opportunity, the nine month window of freedom from interference at our hands having already been advertised to our notional discredit.

5. The piling on of sail had two consequences for traders and taxpayers: an abbreviated consultation period some of which was in any case mortgaged by the absence of interested parties during the August holiday season, and a similarly foreshortened warning period between Christmas and April for appropriate programming, assuming we were going ahead. These time constraints are of course trying for everyone concerned but were a function of achieving the rapidest possible anti-avoidance timetable as a contribution to political damage limitation in the public (as against the professional) prints.

6. The timing problem is of course compounded by the parallel complication of Brussels. Brussels has to be consulted, but it cannot be consulted seriously until there is a specific British proposal of action to consider. In this instance however we are seeking latitude from Brussels rather than Brussels imposing additional complications on us.

7. The additional complications, translated into a notional burden on business, constitute the principal potential political cost outside brewing, though at a somewhat esoteric level. While it would be excessive to describe the complexity of the issues as already fiendish to a layman, anyone wishing to give us a bad name, again at the public rather than professional level, could make generalised assertions about burdens on business. It will be essential for us to be able to present ourselves beforehand to be in possession of the high ground. There are deliberate plans to exclude small traders, and large traders, especially in the financial sector, are not overflush as potential recipients of public sympathy: sadly, if anything, their public persona tends in the opposite direction. The fact that they will have brought complications upon themselves by virtue of their beneficial prior arrangements does not assist their cause.

8. The brewers are however a different case. They won a specific concession in 1983-84 and, though they acknowledge that they would properly be caught in the larger net we would now be

constructing, they can damagingly point out that it is perverse of us to have given with one hand and then within not so many months to be taking away with the other. In this instance the fact that the cost impact on the brewers would be between 1p and 2p a pint (depending how they spread it) would impinge on a wider public less conscious of the administrative niceties than of the practical implications.

9. Our problem with the brewers is that the most obvious salve (allowing them to tax their tied house rentals) is in baulk because, in its wider context of other landlords, it needs to be kept powder-dry for the possible aftermath of the European Court case on construction infraction. Assuming that salve has to be used at the later stage, brewers would then be afforded the same haven as other landlords and would only have suffered for an interim period, but that could only add to their sense of the Government's perverseness.

10. I have had one request for a meeting - from the head of Allied Breweries - but I have not yet had any personal opportunity of testing the otherwise convincing view of Customs that the brewers will not look seriously at the potential lateral aid of a partial exemtion special method until they are certain they cannot secure a larger frontal concession: knowledge of human nature suggests that this analysis is right. Any frontal concession would unfortunately create a salient through which other claimants would seek to pour. I am minded to meet the Brewers' Society.

11. The timetable is thus frankly inconvenient. On the main avoidance flank there is everything to be gained by promptness, almost as precipitately as possible: on the brewers' flank a modicum of time would be helpful, but the time we need is in my view too long to put the issue on ice.

12. There remains what now seems to be the minor issue of the Eurobonds: this could of course resurrect itself out of limbo

(just as VAT on Stock Exchange transactions did just before Big Bang) if it has been consigned there by ignorance or a lack of vigilance on the part of relevant traders, but there is an adequate reserve position if resurrection occurred.

13. I have treated on the revenue issue (in paragraph 3) in terms of potential avoidance embarrassment, but on a more positive aspect the £300 million constitutes a worthwhile prize for the effort and dexterity required, and here again promptness significantly affects the first year return.

14. I am conscious of how much personal work is going to need to go into responding to pressure and to handling not uncomplicated legislation. The brewers will need a particularly large investment of time, and I regret the conceivable consequences this may set you in the context of your Budget tactics. I do not however see any simple way out of the dilemma - though if we proceed I shall do my level best to persuade them of the likely mitigation we can provide by the special method.

15. Whereas with the brewers our purpose should be (if we proceed) to prevent them embarrassing us, I am not inclined to seek to embarrass the financial sector by highlighting the anti-avoidance argument: this seems to me generally counterproductive, and lays us open to Mr Blair's charge of why we have not acted earlier; but of course the argument would remain in reserve if in turn the financial sector were to seek to embarrass us.

for PETER BROOKE

Cathy
PPS in with you.
Moore
1/12

CONFIDENTIAL

FROM: Minister of State

DATE: 1 December 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economici Secretary
Sir Peter Middleton
Mr Cassell
Mr Scholar
Mrs Lomax
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/Customs & Excise

VAT: TAX AVOIDANCE (STARTER No 6)

You asked (Mrs Ryding to PS/Minister of State, 5 November 1986) for a personal political assessment of this issue, given the view that it would need very careful handling. I have deferred providing this while two meetings with the brewers were taking place, given the particular political sensitivity of that industry and its product.

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who are admittedly brought into the net by a side-wind, has likewise been broadened from a revenue relief of £50 million-£60 million to their estimate of £75 million-£100 million.)

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6. The timing problem is of course compounded by the parallel complication of Brussels. Brussels has to be consulted, but it cannot be consulted seriously until there is a specific British proposal of action to consider. In this instance however we are seeking latitude from Brussels rather than Brussels imposing additional complications on us.

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8. The brewers are however a different case. They won a specific concession in 1983-84 and, though they acknowledge that they would properly be caught in the larger net we would now be constructing, they can damagingly pont out that it is perverse of us to have given with one hand and then within not so many months to be taking away with the other. In this instance the fact that the cost impact on the brewers would be between 1p and 2p a pint (depending how they spread it) would impinge on a wider public less conscious of the administrative niceties than of the practical implications.

9. Our problem with the brewers is that the most obvious salve (allowing them to tax their tied house rentals) is in baulk because, in its wider context of other landlords, it needs to be kept powder-dry for the possible aftermath of the European Court case on construction infraction. Assuming that salve has to be used at the later stage, brewers would then be afforded the same haven as other landlords and would only have suffered for an interim period, but that could only add to their sense of the Government's perverseness.

10. I have had one request for a meeting - from the head of Allied Breweries - but I have not yet had any personal opportunity of testing the otherwise convincing view of Customs that the brewers will not look seriously at the potential lateral aid of a partial exemtion special method until they are certain they cannot secure a larger frontal concession: knowledge of human nature suggests that this analysis is right. Any frontal concession would unfortunately create a salient through which other claimants would seek to pour. I am minded to meet the Brewers' Society.

11. The timetable is thus frankly inconvenient. On the main avoidance flank there is everything to be gained by promptness, almost as precipitately as possible: on the brewers' flank a modicum of time would be helpful, but the time we need is in my view too long to put the issue on ice.

12. There remains what now seems to be the minor issue of the Eurobonds: this could of course resurrect itself out of limbo (just as VAT on Stock Exchange transactions did just before Big Bang) if it has been consigned there by ignorance or a lack of vigilance on the part of relevant traders, but there is an adequate reserve position if resurrection occurred.

13. I have treated on the revenue issue (in paragraph 3) in terms of potential avoidance embarrassment, but on a more positive aspect the £300 million constitutes a worthwhile prize for the effort and dexterity required, and here again promptness significantly affects the first year return.

14. I am conscious of how much personal work is going to need to go into responding to pressure and to handling not uncomplicated legislation. The brewers will need a particularly large investment of time, and I regret the conceivable consequences this may set you in the context of your Budget tactics. I do not however see any simple way out of the dilemma - though if we proceed I shall do my level best to persuade them of the likely mitigation we can provide by the special method.

15. Whereas with the brewers our purpose should be (if we proceed) to prevent them embarrassing us, I am not inclined to seek to embarrass the financial sector by highlighting the anti-avoidance argument: this seems to me generally counterproductive, and lays us open to Mr Blair's charge of why we have not acted earlier; but of course the argument would remain in reserve if in turn the financial sector were to seek to embarrass us.

for PETER BROOKE

CONFIDENTIAL

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: P Jefferson Smith
Date: 11 December 1986

MINISTER OF STATE

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Sir Peter Middleton
Mr Cassell
Mr Scholar
Miss Sinclair
Mrs Lomax
Mr Culpin
Mr Dyer
Mr Cropper
Mr Tyrie
Mr Ross Goobey
Mr Graham
(Parly. Counsel)

VAT : TAX AVOIDANCE (STARTER NO. 6)

1. This submission is to update you on developments since my interim report of 30 October and to outline our recommendations for action, in the light of your report to the Chancellor and his response, both of 1 December.

RESULTS OF CONSULTATION

2. Following my submission of 25 July 1986, you authorised us to issue a Consultation Paper. 902 copies of the paper were issued to 428 enquiries and these prompted 105 written responses. As a result, 23 meetings were held with trade and professional bodies. The meetings with trade and professional bodies have been much more constructive than the generally hostile written comments. With the

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Internal circulation:

CPS	Mr Butt	Mr Bazley	Mr Trevett	Mr Cockerell
Mr Knox	Mr Nissen	Mr Tracey	Mr Michie	Mr Aitchison
Mr Howard	Mr Wilmott	Ms Barrett	Mr Bone	Mr Hammond

178/12/86

notable exception of the Brewers' Society, those attending clearly moved a considerable way towards accepting the need for some changes.

3. The major topics discussed during the meetings were:-

(a) **Adequacy of existing powers**

Although almost every written response had made reference to the adequacy of our existing powers, no representative body sought to press the point in discussion. We believe we should now accept that some use can be made of our powers to prevent group registrations where this would be against the interests of the revenue. But the other short-comings of the existing legislation are known to most tax planners and need legislative remedy.

(b) **The "burdens on business" argument**

Many businesses have genuine fears regarding the effects of partial exemption. We have tried to put these into perspective, firstly by pointing out that we would expect that no more than 13,500 out of the total VAT trader population of over 1.5 million would be partly exempt, and secondly by explaining how partial exemption works in practice. Any increase in administrative burdens is unwelcome, but our proposals are expected to take a substantial number of small traders out of the partial exemption net, whilst drawing in more of the large and very large traders who are at present avoiding restriction of input tax by the way in which they structure their VAT groups. In our experience these large businesses usually have accounting systems which can cope with our future requirements, and we have assured representative bodies that we are prepared to work with their members to ensure that partial exemption does not result in an excessive administrative burden.

(c) **The short period of time allowed for consultation**

This has not been repeated during our meetings other than in relation to (d) below.

(d) **The short lead-time which a 1 April 1987 date of implementation would give for computer reprogramming**

Based on past experience those traders who become partly exempt should not need to introduce sweeping changes to either their accounting or computer systems. We have explained during the meetings that partial exemption special methods can be agreed with either trade bodies or individual traders and these will, so far as practicable, utilise existing recording systems. We have explained the broad detail of current agreements with trade associations in an attempt to illustrate how these special methods could work in practice.

(e) **The proposed input based de minimis rules (para 8 of the Paper)**

In my interim report I indicated that we were considering two simplification measures in relation to the de minimis rules. The first would have applied to small businesses whose total input tax was less than a given amount, say £5000 p.a. The intention was to keep this in reserve for use only if we appeared to be losing ground in the consultation. We have not found it necessary to refer to this measure during the meetings.

The second option was the publication of a list of exempt transactions which businesses outside the financial sector would ignore for the purpose of partial exemption. This has been discussed at length with representative bodies and has been well received. The proposal is founded on the principle that given supplies, when made by non-financial sector businesses, will invariably attract insignificant input tax. That being so, there is little point in these businesses having to include them in their partial

exemption calculations. The advantage of this measure is that the common exempt supplies, such as deposit interest, certain rents and commissions etc, made by non-financial sector businesses, can be ignored, leaving far fewer traders having to do a calculation in order to establish their position under the de minimis rules.

However the proposed de minimis rule which relates to 1% of input tax is now causing us serious concern. It is now clear that it would present considerable scope for abuse. We had sought to limit this by applying it to each company separately within a group, but are persuaded that this is impractical. Our recommendation therefore is that the 1% provision be dropped. We have indicated our reservations during the meetings and these have been accepted, except by the UK Oil Taxation Committee. They presented no technical or legal argument to support their objection.

OTHER POINTS

4. (a) **Partial exemption standard method**

In the course of our meetings, the CBI expressed reservations regarding the legality (in EC terms) of the proposed calculation for residual input tax as outlined in paragraph 9(ii) of the Consultation Paper. Their views were expressed in very general terms and we responded to the effect that the proposals had been cleared by our legal advisers prior to issue. Since then, the Brewers' Society has obtained Counsel's Opinion, part of which alleges that the calculation in question is ultra vires the EC Sixth Directive. Having consulted with our legal advisers, we propose to adopt an alternative form of words which would have the same effect but reduce the risk of challenge.

(b) **Capital Issues including Eurobonds**

Both the CBI and the VAT in Industry Group voiced concern that the proposals could block the recovery of VAT in respect of capital issues including Eurobonds. Our favoured solution of exempting services relating to capital issues is being actively pursued. These are matters we need to discuss further with the Treasury and the Bank of England before we can define the exact scope of the exemption.

(c) **Disposal of business property**

This again was raised by the CBI and VAT in Industry Group as in certain circumstances the exempt supply of the sale of property could lead to the restriction of input tax recovery. Some transactions of this type would escape under the proposed de minimis rules, but high value sales with significant input tax would be caught. This seems to be a proper effect of the partial exemption rules, and we do not consider that any special relief should be given.

(d) **The brewers' representations**

The Chancellor suggested that the problem of a substantial new VAT charge on the brewers could be met by a lower than revalorisation increase, or no increase at all, in the excise duty. This would indeed limit the impact on beer prices, but is open to two difficulties. Firstly, because the ECJ wine/beer judgment relates to the excise duties, a nil increase for the beer excise duty means a nil increase for wine. Secondly, the incidence of the VAT charge would vary according to the individual brewer's reliance on tied house sales, ranging from nil in the case of importers and Guinness to a heavy incidence for those small brewers with few or no managed houses. In the light of the meeting you held with the Brewers' Society on 4 December, we suggest that the better course is to agree a method of apportionment of input tax with the brewers which maintains the basic principles behind the consultation document but

treats them as generously as possible, leaving the Chancellor with the option of a shading down of any excise duty increase if he wanted to accommodate the brewers further.

Following your meeting, you had a letter from General Mangham continuing to oppose the change on arguments of equity as seen by the brewing industry. However, my informal contacts indicate that the brewers accept that they will not get anywhere on the point of principle, but that we intend to be accommodating on the actual calculations. They seem ready to work with us to produce partial exemption calculations in respect of tenanted houses which would be reasonably fair to the revenue and themselves.

REVENUE POTENTIAL

5. I have previously noted the difficulty of estimating the extent of avoidance. It is certainly substantial and growing rapidly. In my interim report I indicated that the revenue at stake was likely to be in the region of £300m. The difficulty in quantifying the figure remains. Those cases which have recently come to our attention, together with discussions with staff responsible for the control of City traders, have confirmed our growing belief that the revenue involved has previously been significantly underestimated. We now think that a yield of £400m in a full year is more likely. Of this about one third would come from measures stopping abuse related to movements in and out of group registrations and two thirds from changes to the partial exemption rules. We shall have to go nap on a figure for the Budget arithmetic and, more immediately, for public announcement. Despite our reservations, we think we can justify an estimate for 1987-88 of £300 million, on the assumption of a 1 April 1987 start date for the changes, and for 1988-89 of £400 million.

SUGGESTED ACTION

6. Our views and recommendations on each of the proposals is as follows:

6.1 **Movements into VAT groups**

(a) **Total exclusion of exempt or partly exempt businesses from VAT groups (para 5(a) of the Consultation Paper)**

It now seems likely that we can contain the abuses of the VAT grouping/partial exemption rules without resorting to this severe solution and **we do not recommend** proceeding with it. But we should give warning that we will make better use of existing powers.

(b) **Implementation of Article 20.2 of the EC Sixth Directive (para 5(b) of the Paper)**

This is not a discretionary provision of the EC Sixth Directive although to date we have not implemented it, nor come under any pressure to do so. It is an important adjustment provision and of particular value where the mix of taxable to exempt supplies by a business changes over a given period of time. Professional bodies familiar with the Directive have acknowledged that the UK should adopt the provision but have asked for a delay in its introduction from 1.4.87 to 1.4.88 so that the interaction with direct taxes can be more fully evaluated. As this could be a complicated provision to operate in practice, and as we are anxious not to impose unnecessary administrative burdens on business, we are inclined to support the request for a delayed introduction and **we so recommend**.

(c) **The creation of a charge to tax on assets when a business joins or is transferred 'as a going concern' to a VAT group (para 5(c) of the Paper)**

The transfer of a business as a going concern does not normally attract VAT. This is basically a sensible provision, but it creates a loophole, by which a business which has recovered the input tax on its assets (e.g. a

computer) can be sold as a going concern to another business which would not have been able fully to recover that input tax. As a result of representations, we have refined the proposal so that the charge to tax would only apply where a **business is transferred 'as a going concern' to a partly exempt VAT group**.

We do not anticipate that this provision would need to be used very often as its mere existence should deter those who may otherwise seek to avoid tax in this way. However, unless this loophole is closed its use would become more common as we intend to apply more rigidly the existing option of refusing group registration "for the protection of the revenue". The introduction of this change will require changes to primary law, to provide that where assets are transferred as 'a going concern' to a partly exempt VAT group they would account for them both as a supply to and by the group. We would also need to define the time of supply and the valuation method to be used.

6.2 **Movements out of VAT Groups**

(a) **Compulsory exclusion of certain companies from VAT groups (para 6(a) of the Paper)**

This solution would be unacceptable to many businesses because of the power to provide for retrospective exclusion. We do **not recommend** that this proposal be pursued.

(b) **Amendment of sections 14 and 15 of the Value Added Tax Act 1983 to restrict the recovery of input tax to that incurred in making taxable supplies (para 6 and 7 of the Paper)**

There has been no serious challenge to our view that these provisions in their present form allow the recovery of tax to a degree not intended and permitted under EC law.

Implementation of the proposed solution would require primary law changes (Section 15 of the Value Added Tax Act 1983) followed by regulations. We **recommend** adoption of this proposal.

6.3 **The 'de minimis' rules (para 8 of the Paper)**

In paragraph 3(e) I outlined current developments in relation to the de minimis rules. Although the move from output to input based rules has not been welcomed by businesses, it is a key feature of our proposals, since it is the only effective way of ensuring that the calculation of the input tax deduction is accurate and fair. The proposed introduction of simplification rules, whereby certain supplies could be disregarded, has been widely welcomed by representative bodies and we believe that the introduction of such rules removes most of the arguments against the proposed change. It would also reduce considerably the number of businesses involved in calculations to determine whether they qualify under the de minimis rules. Our suggested withdrawal of the 1% rule will not be welcomed by large firms or tax planners, as it removes a present opportunity for tax avoidance. However, its withdrawal has the additional benefit of avoiding a complication in the application of the de minimis rules to VAT groups.

We **recommend** adoption of the proposal to change from output to input based rules, and that these rules be as outlined in paragraph 8(1) of the Paper, with the exclusion of that relating to "1% of all his input tax". The proposal at paragraph 8(2) to apply the rules to individual members of VAT groups could then be safely dropped. Changes to the de minimis rules could be achieved by amendments to the existing regulations.

6.4 **Partial exemption standard method (para 9 of Paper)**

As indicated in paragraph 4(a), the CBI and the Brewers have expressed the view that part of the proposed method (outlined in paragraph 9(ii) of the Paper) is ultra vires Article 17.5 of the

Sixth Directive. We **recommend** that we proceed with the proposal to withdraw the existing standard method and replace it with that outlined in paragraph 9 of the Paper, but subject to amendment to the wording of part of the method to put beyond doubt compliance with Article 17.5(c). The change to the new method can be made by amendment to existing regulations.

6.5 **Appeals provision**

At present, a trader in disagreement with us over a partial exemption method can bring the matter before a VAT Tribunal only by appealing against an assessment made in pursuance of the method. This is undesirably circuitous. We are of the view that there should be a specific right of appeal regarding the use of partial exemption methods and we **so recommend**. This will require amendment to Section 40 of the Value Added Tax Act 1983. There is no requirement for consultation with the Lord Chancellor's Department or the VAT Tribunals before a decision is taken; but as a courtesy we would give them advance notice before it was announced.

6.6 **Further amendment to the partial exemption regulations (para 10 of the Consultation Paper)**

These regulatory changes have not been contentious and we **recommend** that we proceed with the proposals as set out in the Consultative Paper.

6.7 **Valuation of exempt supplies**

Since publication of the Consultation Paper we have identified another potential loophole where exempt supplies are made between associate companies at artificially low values thus distorting the input tax deduction calculation. This requires an amendment to paragraph 1 of Schedule 4 of the VAT Act 1983 to include exempt as well as taxable supplies. We **recommend** that this change be incorporated in this package of proposals. A formal derogation under Article 27 of the Sixth Directive will be necessary and we shall approach Brussels as soon as a decision is taken to include this item

in the package.

EC CONSULTATIONS

7. We have now so refined our original proposals as to reduce the matters requiring consultation or clearance in Brussels to only two items, the proposal outlined at paragraph 6.1(c) of this report (the creation of the charge to tax on assets) and that at 6.7 above (valuation of exempt supplies). We have arranged to discuss the former at an informal meeting with representatives of the EC. Our legal advisers are of the view that the EC Sixth Directive permits the solution outlined therein but have indicated that it would be prudent to seek Commission views. This will be done, and if the Commision view is that our solution is 'ultra vires', a formal derogation will be sought. We expect the Commission to be sympathetic to our case as the proposal is specifically designed to combat tax avoidance. On the latter, as paragraph 6.7 indicates, we shall apply for the derogation when the decision to include the matter has been made.

OWN RESOURCES

8. Although the Own Resources VAT contribution is a percentage of an agreed consumer expenditure base, it is actually calculated as a percentage of our VAT receipts. If we increase our receipts by greater efficiency or by blocking loopholes, the effect is to pay extra Own Resources. Of the estimated additional revenue yield of £300 million for 1987-88, about £20 million would be payable to the EC by way of Own Resources.

ENTERPRISE AND DEREGULATION UNIT

9. We met the EDU on 3 December to discuss the consultation paper and explained the need for changes to the present rules and our concern that the compliance costs to traders should be kept as low as possible. The EDU have now written to us asking for no decisions to be taken, even in outline, before we have prepared compliance cost assessments and answered a list of questions, which seem to have been

based on criticisms made by commentators on the consultation paper. We are replying to the effect that a decision in principle has been taken, and that this is a revenue matter on which Ministers intend to make an early announcement. But we will be ready to discuss further the details after the announcement and will then supply as full a compliance cost assessment as possible. We believe that the remit of the EDU imposes no requirement on us to go any further, and to enter into the discussions which the EDU seeks would render impossible a December announcement and a 1 April 1987 start date. But it is just possible that the EDU will attempt to get their Ministers to intervene to put off the announcement. We recommend that any such intervention should be resisted.

NEXT STEPS

10. There are still regrettably some outstanding problems and there is therefore a choice between making an announcement now, which gives as much certainty as possible and enables most businesses to plan for changes on 1 April 1987, or deferring an announcement until the loose ends have been tied up. This would lose the impetus the exercise currently has, and could imperil a 1 April 1987 start date. We therefore **recommend** an announcement as early as possible. When the PQ was answered, we could publicise it by a Press Notice and letters to respondents to the consultation paper. We would also draft a letter to the Brewers' Society, together with standard letters which you could send to others who had approached you personally, drawing attention to the announcement. We suggest an arranged PQ before the Christmas recess. A draft text is annexed: in view of the revenue significance of the matter it is drafted for answer by the Chancellor.

11. For those items requiring legislation, we **seek authority** to instruct Parliamentary Counsel. For the rest, we will draft amending Regulations. As there is criticism of making such major changes by statutory instrument subject to the negative procedure, we **seek authority** to publish the Regulations in draft, as many of those commenting have asked should be done.

P Jefferson Smith

ANNEX

To ask Mr Chancellor of the Exchequer, what representations have been received in response to a consultation document issued by Customs and Excise on 7 August entitled "VAT: Input tax: origin and scope of the right to deduct"; and if he will make a statement.

Over 100 responses were received in writing and 23 meetings have been held with trade and professional bodies. In the light of these, I propose to introduce the following measures.

1. Right to Deduct Input Tax

The right to deduct input tax as expressed in Section 14 and 15 of the Value Added Tax Act 1983 is expressed in wider terms than in the EC Sixth Directive on VAT and allows businesses to recover input tax not related to the making of taxable supplies. The right to deduct will be restricted to only such input tax as is incurred in the making of taxable supplies. An exception would be required to give effect to Article 17.3 of the Sixth Directive in favour of input tax incurred in the UK in respect of certain overseas and other non-taxable transactions.

2. VAT Group Registrations

(a) **Power to Restrict Grouping**

I do not propose to introduce new legal provisions restricting the present rights of companies to form VAT groups or to add or remove companies from existing groups. But Customs and Excise will in future exercise more strictly their power to refuse applications for group treatment where this appears necessary for the protection of the revenue.

(b) **Transfers of Going Concerns**

Where a business or its assets is transferred as a going concern to a VAT group which is or becomes partly exempt during the tax year in which the transfer takes place, the transaction will be treated as a supply to and by the group. The group would be

responsible for accounting for the tax due.

3. Valuation of Exempt Supplies

The provisions of the Value Added Tax Act 1983 governing valuation of certain supplies not made in open market conditions at present apply only to taxable supplies. To prevent input tax deduction calculations being distorted by undervaluation of exempt supplies, these provisions will be extended to exempt supplies.

1-3. Where the above proposals require legislation, I intend to include this in the 1987 Budget and Finance Bill, to take effect from 1 April 1987.

4. Partial Exemption "de minimis" Rules

The present partial exemption rules are open to serious distortion because they require proportional calculations to relate to the outputs of a business and not to its inputs. To protect against such distortions, it is necessary to prescribe that as a normal rule, all calculations should relate directly to the input tax, including those calculations which show whether the business may reclaim all its input tax on de minimis grounds. In response to representations about the possible complexities for businesses, it is proposed that these rules should be as generous and simple as possible, so that a business can readily establish whether it is eligible for "de minimis" treatment, while not open to manipulation and substantial revenue loss.

The partial exemption rules will be amended to provide as follows.

(a) Where a taxable person's input tax attributable to exempt supplies amounts to less than any of the following:

i. £100 per month on average;

ii. Both £250 per month on average and 50% of all his input tax;

iii. Both £500 per month on average and 25% of all his input tax;

all such input tax for the relevant period may be attributed to taxable supplies. For group registrations, the provisions will apply to the group as a whole.

(b) For the purpose of the above calculations, certain exempt supplies may be ignored. These supplies will be prescribed by regulation and will include:

deposit interest;
rent (where the input tax directly attributable to lettings is less than £1,000 a year);
insurance commissions;
mortgage commissions;
assignment of debts.

Businesses will not be allowed to take advantage of these simplification measures if they are within the financial sector or within other categories, which will be prescribed, which make these supplies as a significant part of their business.

These measures will have the effect of substantially reducing the numbers of businesses needing to do calculations in order to establish whether they fall within the partial exemption "de minimis" rules.

5. Partial Exemption Standard Method

Where the "de minimis" rules do not apply, the taxable person must apportion his input tax between that which relates to taxable and that which relates to exempt supplies. The rules for attribution of input tax will be revised as follows:

i. Input tax must be identified and attributed to the greatest possible extent, as between taxable and exempt supplies and any other activity and only that tax attributable to taxable supplies may be deducted.

ii. The remaining input tax which cannot be directly attributed is to be apportioned by reference to the use made of the goods and services to which it relates. Customs and Excise will accept any method of calculation which produces a fair and reasonable apportionment between the taxable and exempt activities which these goods and services (or the largest conveniently ascertainable part of them) are used to support. An apportionment which attributes this remaining input tax in the same proportion as the input tax directly attributed under (i) will always be accepted. But in making such an apportionment, no account is to be taken of input tax on goods supplied in the same state, on supplies by agents under Section 32(4) of the Act, on supplies which are subject to specific restriction, e.g. motor cars, or on supplies of transfers of going concerns treated as taxable under paragraph 2(b) above.

iii. Customs and Excise would also be enabled to allow the use of a method other than those specified above. This would include in appropriate cases a special method based on the ratio of the taxable supplies made by a business to its total supplies.

Taxable persons who have existing approval to operate a special method may continue to operate that method. Agreements negotiated between representative trade bodies and Customs and Excise would also continue unchanged. These approvals and agreements remain subject to review in the normal way. Taxable persons operating the existing standard method or becoming partly exempt because of changes in the "de minimis" rules will have to adopt the new standard method at (i) and (ii) above. **If this is impractical or it is thought that it will not produce an accurate or fair result, Customs and Excise will consider allowing an appropriate special method.** Individual buinsesses should apply to their local office; representative trade bodies should approach Customs and Excise headquarters.

6. Minor Amendments to the Partial Exemption Regulations

The following minor amendments will also be made:

i. Regulation 29(5). Amend to read: "The Commissioners may approve or direct different provisions for different circumstances and in particular may approve or direct, ..."

ii. Regulation 32(a). Delete "an exempt supply" and replace with "a supply".

iii. Regulation 32(e). Delete "exempt".

4-6. These changes will be implemented by revised Regulations made by the Commissioners of Customs and Excise and will come into operation from 1 April 1987. Drafts of the regulations will be circulated as soon as possible to those bodies which expressed an interest in seeing the text during the consultation. I will place copies in the Library of the House. The regulations are subject to the negative Parliamentary procedure.

7. Appeals

There is at present no specific right of appeal to the VAT Tribunal regarding the use of partial exemption methods. Such a right will be proposed in the 1987 Finance Bill.

8. Deduction of Input Tax on Capital Goods

The EC Sixth Directive, Article 20.2, requires the input tax on capital goods to be adjusted annually over a period of five years. The UK has not implemented this measure, even though it would be desirable for the protection of the revenue. It will now be introduced (by a further amendment to the partial exemption regulations) but with effect from 1 April 1988.

9. Other Matters

Concern has been expressed that the revised partial exemption rules could have an adverse and distortive effect on recovery of input tax, in respect of capital issues, including Eurobonds. Consideration is being given to exempting from VAT the supply of services in relation

to such issues.

The revenue effect of all these changes is estimated to be an increased yield of VAT in 1987-88 of £300 million.

CONFIDENTIAL

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: P JEFFERSON SMITH

Date: 15 December 1986

PS/Chancellor

cc PS/Minister of State
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Sir P Middleton
Mr Cassell
Mr Scholar
Miss Sinclair
Mrs Lomax
Mr Culpin
Mr Dyer
Mr Cropper
Mr Tyrie
Mr Ross Goobey
Mr Graham
(Parl Counsel)

C/ You asked for a draft to send to No 10. A draft is attached – you may think the paragraph on the brewers needs strengthening a little.

Officials suggest announcing this on Thursday (if the PM is content) which would mean tabling the arranged PQ attached at A on Wed. Content?

CR 15/12

VAT: TAX AVOIDANCE (STARTER NO 6)

Please refer to your minute of 15 December to PS/Minister of State. I understand that the Minister of State agrees to what is proposed and to the draft PQ.

2. Attached is a draft minute from the Chancellor to the Prime Minister. It is drafted on the assumption that the announcement would be on Thursday, since

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Internal distribution: CPS, Mr Knox, Mr Howard, Mr Bazley, Mr Michie, Mr Hammond.

Friday would be the last day before the Christmas recess. The other assumption in the drafting is that the Chancellor would be making the announcement. To achieve a Thursday announcement, the PQ would have to be put down on Wednesday.

3. The Chancellor suggested volunteering the first of the simplication measures in paragraph 3(e) of my minute of 11 December. We would suggest keeping this in reserve. On compliance costs we have what we hope is a reasonably persuasive story to tell - as in the draft reply to Mr Wiggin's PQ. If it appears after Christmas that this battle is not being won, the further concession could be given then, whereas if it is given now, there will be nothing further available.

P JEFFERSON SMITH

CONFIDENTIAL

CH/EXCHEQUER	
REC.	17 DEC 1986
ACTION	MST
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17/12

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

17 December 1986

Dear Cathy.

VAT AVOIDANCE

The Prime Minister has seen the Chancellor's minute of 16 December about the proposed package of measures aimed at reducing VAT avoidance.

The Prime Minister would like to know a little more about the proposals, how the changes will work, and whether legislation will be required. She is also concerned that the announcement could look like a mini-budget.

I am sure you will be able to reassure the Prime Minister on these points. You will need to put down a Question tomorrow if the announcement is to be made before the Recess, and I should be grateful for your reply to this letter by close of business tonight.

Yours

David

(DAVID NORGROVE)

Mrs. Cathy Ryding,
HM Treasury.

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