

CONFIDENTIAL



v6

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

18 December 1986

VAT AVOIDANCE

The Prime Minister has considered your letter to me of 17 December about the proposed announcement on VAT avoidance and in the light of this further information is content for the announcement now to be made.

David Norgrove

Mrs Cathy Ryding
HM Treasury.

ECU

CONFIDENTIAL



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

David Norgrove Esq
10 Downing Street

17 December 1986

Dear David,

VAT AVOIDANCE

Thank you for your letter of 17 December recording a number of questions which the Prime Minister had asked about the proposed package of measures aimed at reducing VAT avoidance. These relate to the detail of the proposals, how the changes will work, whether legislation will be required, and the possible charge of a mini-budget.

... The secondary legislation of course stems from existing primary legislation. The changes to be made are inevitably complex, as will be apparent from the attached intended answer to the PQ. More essentially, both primary and secondary legislation are involved: it is the secondary legislation which prompts the urgency. The primary legislation is for the 1987 Finance Bill, but the secondary legislation has to be in place earlier, involving detailed rules to operate from 1 April 1987: draft regulations published in the New Year would allow businesses the maximum time to prepare. All but one of the changes would take effect on 1 April.

The primary legislation changes (yielding an expected £100 million pa) will establish a more direct link between reclaimable input tax and the future supply on which recovery should depend. Present manipulation includes taking businesses into or out of VAT groups, which the legislation would block: avoidance schemes are being actively marketed, and avoidance will grow fast unless blocked.

As to the secondary legislation, partly exempt traders can at present recover input tax through a method of apportionment based on turnover. There are current rules to protect small businesses from the compliance costs of partial exemption but large companies with massive exempt supplies have been able to recover their whole input tax by sheltering inside group registrations, which can contain as many as 400 companies. Some 6,000 large and very large businesses will be affected.

The new partial exemption rules (yielding an expected £200 million pa) will be much less susceptible to this sort of distortion, though small businesses will gain more generous relief (with at least 2,000 more excluded altogether than now).

CONFIDENTIAL



This would certainly be an important announcement. But those participating since consultation began in early August are not expecting a delay till the Budget, and we have foreshadowed an early announcement in response to an unplanted PQ. Respondents to consultation have especially asked for adequate lead-time, and have acknowledged that the law needs tightening. The scale of avoidance is underestimated in the market place but is widely known to exist, which is what has informed our prompt action. As the Chancellor implied earlier, delay till a Budget announcement would cost £100 million: any political cost in a separate announcement is matched by at least an equal political cost in being seen to delay when an abuse is publicly recognised.

Yours,

Cathy

CATHY RYDING
Assistant Private Secretary

CONFIDENTIAL

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

CONFIDENTIAL

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 ~~businesses~~ ^{businesses} should apply to their local office; representative trade bodies should approach Customs and Excise headquarters.

CONFIDENTIAL

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

CONFIDENTIAL

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.