

EXPLANATORY MEMORANDUM TO
THE VALUE ADDED TAX (AMENDMENT) (NO. 4) REGULATIONS 2007
2007 No. 1599

1. 1.1 This explanatory memorandum has been prepared by the Commissioners for Her Majesty's Revenue and Customs ("HMRC") and is laid before the House of Commons by Command of Her Majesty.

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

2. Description

2.1 This instrument, which comes into force on 1 July 2007, is a further instrument in a group of instruments that have been made as a result of the introduction of reverse charge accounting in relation to the supply of certain goods of a kind used in missing trader intra- community fraud (commonly referred to as "MTIC fraud" or "carousel fraud"). For further details of the fraud, see paragraph 7 below.

2.2 The other instruments came into force 1st June 2007. They are-

- (i) The Value Added Tax (Section 55A) (Specified Goods and Excepted Supplies) Order 2007¹;
- (ii) The Value Added Tax (Amendment) (No.3) Regulations 2007²;
- (iii) The Value Added Tax (Payments on Account) (Amendment) Order 2007³; and
- (iv) The Value Added Tax (Administration, Collection and Enforcement) Order 2007⁴.

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

This instrument is made under powers conferred by paragraph 2(3B) of Schedule 11 to the Value Added Tax Act 1994 ("the Act") as introduced by section 19(7) of the Finance Act 2006 (c.25) and substituted by the Value Added Tax (Administration, Collection and Enforcement) Order 2007. This is the first exercise of those powers, as substituted.

4. Legislative Background

4.1 On 16 April 2006, the UK obtained a derogation⁵ from Article 193 of Council Directive 2006/112/EC⁶ ("the Directive") (formerly article 21(1)(a) of Council Directive 77/388/EEC⁷ ("the Sixth VAT Directive") to enable it to introduce reverse charge accounting in relation to supplies of specified goods of a kind commonly used in MTIC fraud ("relevant supplies"). Under reverse charge accounting the customer is the person

¹ S.I. 2007/1417

² S.I. 2007/1418

³ S.I. 2007/1420

⁴ S.I. 2007/1421

⁵ OJ L109 26.4.2007, p 42.

⁶ OJ L 347, 11.12.2006, p.1

⁷ OJ L 145, 13.6.1977, p.1, as amended by Council Directive 2000/65/EC (OJ L269 21.10.00, p44).

liable to account for and pay the VAT on the supply to the Commissioners for Revenue and Customs, rather than the supplier. The derogation was granted subject to the UK introducing appropriate and effective control and reporting obligations on taxable persons who supply goods to which reverse charge accounting applies. Reverse charge accounting was introduced by section 19(1) of the Finance Act 2006 (which inserted a new section 55A into the Act) and has effect in relation to relevant supplies made on or after 1st June 2007⁸.

4.7 Regulation 3 of the Value Added Tax (Amendment) (No.3) Regulations 2007 amended the Value Added Tax Regulations 1995 to require a person to notify the Commissioners on the first occasion on which he makes a supply in relation to which reverse charge accounting applies. That amendment was made under powers introduced by section 19(7) of the Finance Act 2006, which inserted a new paragraph 2(3B) into Schedule 11 of the Act. This paragraph provided a power for the Commissioners to make regulations requiring a person to notify them of the first occasion on which he makes such a supply.

4.8. Paragraph 2(3B) of Schedule 11 to the Act was substituted by the Value Added Tax (Administration, Collection and Enforcement) Order 2007. This gives a power to the Commissioners to make regulations requiring a person to notify the Commissioners not only of the first occasion on which he makes a relevant supply, but also to notify the Commissioners when he ceases to make such supplies without intending to make any more or when, having so ceased, he recommences making such supplies.

4.9. These regulations introduce such notification requirements and are necessary to enable the Commissioners to comply with the control and reporting obligations to which the derogation is subject.

5. Territorial Extent and Application

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

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

7. Policy background

7.1 Missing Trader Intra Community (MTIC fraud) is a highly sophisticated and well-organised criminal attack on the VAT system. The fraud arises through contrived transaction chains involving supplies of high value goods with the tax loss occurring when the VAT charged by the supplier is not paid to HMRC but a repayment of that VAT can be claimed by the first or subsequent purchaser of those goods.

7.3 Attempted MTIC fraud in 2005-06 was estimated at between £3.5bn and £4.75bn, with an impact on VAT receipts in 2005-06 estimated at £2bn to £3bn.

⁸ S.I. 2007/1419

7.4 Reverse charge accounting makes it impossible to perpetrate MTIC fraud using the goods to which it applies, because it removes the possibility of traders claiming VAT repayments in this way.

7.5 Businesses making supplies of goods to which the reverse charge applies are required to submit to HMRC sales lists showing the VAT registration number of each of their customers for such supplies, and the total value of supplies to each customer, by calendar month. This is necessary to enable HMRC to ensure that those customers are accounting for the reverse charge correctly, and thereby provide an effective control mechanism for the reverse charge, in accordance with the terms of the UK's derogation. Businesses making such supplies also have to first notify HMRC of that fact, so that they can be given access to the on-line facility for submitting sales lists.

7.6 For related reasons, HMRC also need to be informed if businesses making reverse charge supplies stop making such supplies, so that they are no longer required to submit sales lists, and if they then resume making such supplies, so that their access to the on-line facility for submitting sales lists can be reactivated.

7.7 Informal discussions took place with businesses affected by the introduction of the reverse charge, further details of which are contained in the RIA.

8. Impact

A full regulatory impact assessment of the effect that reverse charge accounting and this instrument will have on the costs of business and the voluntary sector is attached to the memorandum.

9. Contact

Joan Gay at HM Revenue and Customs Tel: 0207 147 0289 or e-mail:
Joan.Gay@hmrc.gsi.gov.uk can answer any queries regarding the instrument.

Regulatory Impact Assessment

VAT: Reverse charge accounting for businesses trading in mobile phones and computer chips

1. Title

1.1 This is a full Regulatory Impact Assessment (RIA) on the introduction of reverse charge accounting for mobile phones and computer chips, derogating from Article 193 of the principal VAT Directive (formerly Article 21(1)(a) of the EU 6th VAT Directive).

2. Purpose and intended effect of the measure

Background

2.1 Section 1 of the VAT Act 1994 requires VAT to be charged and accounted for on a supply of goods by the:

- person *supplying* the goods where the supply is within the United Kingdom
- person *acquiring* the goods in the United Kingdom where the supply is from another Member State.

This reflects Articles 193 and 194 of the principal VAT Directive (formerly Article 21(1)(a) of the EU 6th VAT Directive).

2.2 Where goods are acquired from another Member State for the purpose of taxable business activities, the VAT accounted for can be recovered as input tax on the same VAT return, subject to the normal rules for reclaiming input tax (regarding evidence, business use, partial exemption etc.).

2.3 Over recent years, a sophisticated and systematic criminal attack on the VAT system has developed in the UK, which relies on the ability to buy and sell goods between EU Member States free of VAT. Prevalent throughout Europe, it is known as ‘missing trader intra-community’ (MTIC) VAT fraud, or in its more evolved forms as ‘carousel’ fraud.

2.4 MTIC fraud is orchestrated by criminals who register a company for VAT in the UK in order to acquire goods ‘VAT-free’ from another EU Member State. They then sell the goods in the UK, charging VAT to their customers but failing to pay it to HM Revenue & Customs (HMRC). In these circumstances, revenue losses crystallise when, later in the supply chain, the recipient of the supply dispatches the goods outside the UK and claims a repayment from HMRC of the VAT he has been charged.

2.5 The fraud generally involves high volume supplies of high value goods – typically mobile phones and computer processing chips – through contrived transaction chains. Carousel fraud is a particularly abusive form of the fraud which involves the same goods circulating repeatedly between the UK and other EU Member States, often via third countries outside the EU, with VAT being stolen on each circuit. This form of the fraud relies on the participation of a number of traders to create a contrived supply chain, or chains, the aim of which is to distance the missing or defaulting trader (who fails to pay to HMRC the VAT he has charged to his customers) from the trader who ultimately re-exports the goods and claims a VAT refund.

2.6 Based on operational data, it is estimated that attempted MTIC fraud in the UK for the financial year ending 31 March 2006 involved between £3.5bn and £4.75bn tax. Although a significant proportion of these attempted frauds were prevented, HMRC estimate that for that year alone, MTIC fraud could still have reduced VAT receipts by between £2bn and £3bn. Since then, operational indicators and Office for National Statistics trade data suggest a reduced attack on the VAT system from the carousel variant of MTIC in the 2006-2007 financial year, although specific estimates will not be available until the 2007 Pre-Budget Report. This follows from earlier operational strategies implemented by HMRC in response to the rapid growth in MTIC fraud, in particular the redeployment of significant operational resources to verify suspect VAT repayment claims before payment.

2.7 While MTIC fraud can theoretically be perpetrated using any goods that bear VAT at the standard rate, goods that are of high value, small size and readily available, with a large legitimate market are most attractive to the fraudsters, since these characteristics allow for more “efficient” attempted fraud. Historically, mobile phones and computer chips have accounted for some 90% of goods (by value) involved in suspected MTIC carousel fraud. However, the recent suggested reduction in MTIC-related activity has been larger in mobile phones and computer chips than in other goods, so that their share of total fraud has declined, although it still remains significant.

2.8 The introduction of a change in accounting rules (the ‘reverse charge’) for mobile phones and computer chips is one part of a wider strategy designed to combat the fraud; including operational activity (using both criminal and civil interventions), litigation to recover the proceeds of crime, and other legislative responses.

Objective

2.9 The measure introduces the ‘reverse charge’ for the supply to a ‘taxable person’ (that is, a person that is or is liable to be registered for VAT in the UK) of mobile phones and computer chips, as defined by the Value Added Tax (Section 55A) (Specified Goods and Excepted Supplies) Order 2007, where the total VAT-exclusive value of these goods detailed on a single invoice is £5,000 or more. Under the ‘reverse charge’, it is the customer, rather than the supplier, who is required to account to HMRC for the VAT on the transaction.

2.10 Normal accounting will continue to apply to supplies of mobile phones and computer chips below the de minimis value of £5,000 and to supplies to customers who are not VAT registered and/or are not purchasing the goods for a business purpose.

Suppliers must notify HMRC on commencing and ceasing to make supplies of goods subject to the reverse charge. Suppliers of ‘reverse charge’ goods will also be required to complete a Reverse Charge Sales List (RCSL) and submit it to HMRC on the same frequency as their VAT return. This will have to detail, for each customer receiving supplies subject to the reverse charge, the total monthly value of reverse charge goods supplied to them and their VAT registration number.

2.11 The objective of the measure is to remove the ability for fraudsters to steal VAT using those goods covered by the reverse charge. The measure is neither deregulatory nor an administrative simplification, but is proportionate to the purpose of countering fraud.

2.12 The change takes effect from 1 June 2007.

2.13 Under current rules, the introduction of the reverse charge would have brought some businesses within the scope of the Payments on Account (POA) scheme - which affects businesses with a net VAT liability of £2 million per year or more - or increased the monthly payments of businesses already in the scheme. The measure will therefore also amend the Value Added Tax (Payments on Account) Order 2006 to allow businesses to apply to HMRC for the output tax due under the reverse charge to be excluded from POA calculations.

Rationale for Government intervention

2.14 MTIC fraud, particularly in relation to mobile phones and computer chips, remains a serious and significant problem that urgently requires Government intervention to protect tax revenues. The implementation of the reverse charge reflects the Government's continued determination to tackle MTIC fraud on all levels. Office for National Statistics trade data suggests that mobile phones and computer chips (being the goods subject to the derogation) accounted for over 80% of exported trade commodities by value involved in suspected or attempted MTIC related activity over the calendar year to 31 December 2006. As the overall level of MTIC related activity has fallen, the use of mobile phones and computer chips has fallen more sharply than the use of other goods, which is believed to be partly attributable to the well-publicised proposal of a reverse charge on these goods over the past year, alongside HMRC's operational activities.

2.15 The Government's preferred approach is for a focused and targeted approach that preserves the essential features of the VAT system and minimises the impact on compliant traders, backed up by an effective exchange of information and mutual assistance between Member States. Thus, following negotiations with our European partners and representations from business, the Government has decided to target the reverse charge accounting mechanism on mobile phones and computer chips.

3. Consultation

Within government

3.1 There have been discussions between HMRC and HM Treasury on the most effective and appropriate measures to tackle MTIC fraud, and on the process for securing the necessary derogation from the EU VAT Directive.

Public consultation

3.2 In the months leading up to the European Commission's decision to put forward a proposal for a derogation, HMRC held a number of informal discussions with many of the businesses likely to be affected by this measure, as well as representative trade and professional bodies, including the Business Application Software Developers Association, British Retail Consortium and Charities Tax Reform Group. These discussions have considered closely how reverse charge accounting could be applied in a way which minimises the impact on legitimate business while ensuring that its impact on the fraud is not affected.

3.3 Legitimate business has accepted that the measure is necessary to protect public finances and they see it as 'cleaning up' the markets in which they operate. The accountancy profession has also expressed broad support for the measure. Businesses have therefore principally been concerned to ensure that:

- sufficient notice is given of its scope and implementation date so that the necessary system changes can be made in time, avoiding the need for transitional manual systems which would be impractical for large businesses to operate. A number of businesses estimated up to 6 months to implement necessary changes, although some felt longer was necessary;
- the scale and complexity of the IT accounting system changes required to accommodate the measure are recognised by HMRC;
- the measure is simplified in terms of its application as far as is reasonably possible – for example, by raising the de minimis threshold, or removing it (i.e. applying the reverse charge) for all specified goods sold to customers with whom there is a long-standing contractual relationship, or by amending the scope of the derogation (mixed views were expressed as to whether this would be best achieved by widening or narrowing it);
- clear and detailed guidance is issued as to its precise application – for example, regarding goods affected, invoicing and Reverse Charge Sales Lists requirements, and impact on particular transactions (e.g. in relation to contingent discounts); and
- a ‘light touch’ is applied to penalties on errors in the short term, particularly where no tax loss occurs.

3.4 Taking account of these concerns, the following changes have been made/action taken:

- the de minimis threshold has been raised to £5,000 (net of tax) from the initial proposed figure of £1,000, thus relieving most retailers (but not wholesalers/ manufacturers) of the necessity to become involved with the reverse charge for sales and RCSLs;
- proposed anti-disaggregation provisions have been removed in recognition of the practical difficulties businesses would have experienced in implementing them;
- a public commitment was made in Revenue & Customs Brief 24/07 issued on 20 March 2007 to taking a ‘light touch’ in dealing with errors in the 6 month period following implementation where no tax loss has occurred; and
- detailed guidance was issued on the application of the changes in Information Sheet 06/07 (issued 2 April 2007).

3.5 In addition, the proposed scope of the derogation has been narrowed to exclude a) electronic storage media used in connection with computers, mobile phones or certain other electronic devices, and b) electronic devices used for the storage, processing or recording of electronic data, following negotiations with our European partners and representations from business. As a result, the derogation targets the reverse charge mechanism on mobile phones (including other mobile communications devices, such as Blackberrys) and computer chips only.

3.6 Subsequent to political agreement being reached on the derogation by the European Council, affected businesses and other interested parties were invited to comment on the draft legislation which was also issued in Revenue & Customs Brief 24/07. Comments were also requested on general implementation issues in Information sheet 06/07 issued on 2 April 2007.

3.7 Responses received – from individual businesses, representative and professional bodies – primarily related to implementation and procedural accounting issues (for example, in relation to verification of business use and the procedures for returned goods and contingency discounts). However, one respondent did also express a preference for an even higher de minimis level and the right of appeal to the courts on a ‘reasonable excuse’ basis.

3.8 HMRC will be issuing a further Information Sheet in mid May 2007 giving guidance on the practical and procedural issues raised.

4. Options and analysis

1. *Do nothing* – i.e. allow normal VAT accounting to continue to apply to all mobile phone/computer chip transactions. Under this option, no compliance costs would arise for business. However, fraudsters would continue to be able to use mobile phones and computer chips - which are the commodities thought to offer the best “returns” by virtue of their low bulk and high unit values - in their attempts at MTIC fraud. Furthermore, revenue losses are likely to escalate as fraudsters take the lack of action to follow through on ‘threatened’ counter-measures as a sign that the government is weakening in its resolve to combat the fraud. HMRC would also need to use additional resources to try to combat any such renewed attack on public finances through operational means alone.
2. *Introduce reverse charge accounting in line with the derogation* - under this option, the customer rather than the supplier would account for VAT on the sale of specified goods. In addition, the supplier would regularly be required to submit RCSLs. This option will necessarily involve compliance costs for businesses either supplying or buying the affected goods as detailed below, but will negate the scope for fraudsters to continue perpetrating this particular type of fraud in these goods which have historically been the preferred and most lucrative ones to use. Accordingly, it will protect tax revenues and underline the Government’s continuing commitment to block this serious and criminal attack on the tax system.

MTIC fraud is also one of many activities undertaken by organised criminal gangs. The proceeds of MTIC fraud can be used to invest in further fraudulent trading, or to fund other forms of crime such as drugs smuggling. By reducing MTIC fraud, a major source of illegal income will be closed off to the fraudsters and this should have knock-on impacts in reducing the wider social harm caused by other criminal activities that may be funded by MTIC fraud.

5. Recommendation

5.1 The introduction of the reverse charge in line with the derogation provides a targeted and focused response to counter a significant element of MTIC fraud, thus protecting tax revenues whilst minimising the impact on legitimate business. It will also demonstrate to fraudsters the Government’s continued resolve to tackle MTIC fraud at all levels.

5.2 Option 2 is therefore the Government’s chosen option.

6. Costs and benefits

6.1 The following goods will become liable to reverse charge accounting from 1 June 2007 where supplied to a ‘taxable person’ (that is, a person who is, or is liable to register for VAT) and subject to meeting the de minimis threshold:

- mobile telephones, including communication devices such as Blackberrys; and
- integrated circuit devices, such as microprocessors and central processing units, in a state prior to integration into end user products.

Relevant goods sold under a second-hand margin scheme and mobile phones which are supplied with an airtime contract, including replacement phones and upgrades supplied under the terms of

an airtime contract, are excluded from the scope of reverse charge accounting. However, reverse charge accounting **will** apply to “Pay as You Go” (“Prepay”) phones.

6.2 The de minimis threshold is £5,000 total value of goods (exclusive of VAT) subject to the reverse charge and detailed on a single invoice. Normal VAT accounting will continue to apply to supplies of these goods below this value.

Business sectors/people affected

6.3 Subject to comments made in the next section specifically concerning manufacturers, wholesalers and retailers, the measure will impact on suppliers and customers of the affected goods as follows:

Suppliers:

6.4 Businesses selling goods under the reverse charge procedure will need to obtain the VAT registration numbers of all their affected customers (required for the RCSL⁹) and establish whether the goods are being purchased for a business purpose. In general, there will be no need to verify VAT registration numbers of customers with whom the supplier has an established trading relationship, unless there are specific doubts, but businesses may consider it prudent to verify the VAT registration number of new customers. Where businesses trade with customers without satisfying themselves as to their bona fides, they may be liable to pay to HMRC any tax lost as a result.

Suppliers will then need to make accounting system changes in order to:

- identify customers who are VAT registered;
- identify supplies of goods subject to the reverse charge which will be dependent on the VAT registered status of customer; business purpose test and the de minimis limit);
- ensure they no longer charge or account for VAT on supplies subject to the reverse charge;
- specify on the sales invoice that the supplies (or part thereof) are subject to the reverse charge;
- ensure the *net* value of reverse charge sales continues to be declared on their VAT return.

6.5 In addition, suppliers will need to notify HMRC within 30 days of making their first supply to which the reverse charge applies (and also when they cease to make such supplies). They will be required to complete and submit a RCSL (or make a ‘nil’ declaration for any period that the business did not make any relevant supplies but had not notified cessation of such supplies), covering the same period as their VAT return (either monthly, quarterly or annually) by the same deadline as their VAT return. RCSLs may be submitted by keying data on-line or submitting bulk data via a CSV (comma-separated value) file – there will be no facility for submitting paper returns. The information required on the RCSL will be, for each customer, their VAT registration number and the total value of reverse charge supplies made each calendar month to that customer.

6.6 Suppliers will also need to train staff in the new procedures.

Customers:

⁹ Reverse Charge Sales List

6.7 VAT-registered recipients of reverse charge goods will need to ensure that their supplier is aware that they are VAT registered and make appropriate system changes to:

- identify purchases which are subject to the reverse charge and account for VAT on the supply to them on their VAT return;
- ensure that purchases above and below the de minimis threshold are treated correctly.

6.8 VAT accounted for under the reverse charge can continue to be deducted as input tax on purchases subject to the normal VAT rules including partial exemption.

6.9 Customers will also need to train staff in the new procedures.

Businesses affected

6.10 Estimating the number of businesses affected by the reverse charge is difficult. HMRC’s administrative VAT data shows that at the end of 2006, there were around 15,000 VAT registrations within trade classifications most likely be affected. HMRC is unable to identify precisely those businesses most likely to be affected from its own VAT registration records, which do not go to the level of detail required. However HMRC expects that the vast majority of these businesses will not be affected by the reverse charge, primarily because their individual transactions are below the de minimis threshold of £5,000 or relate to mobile phones supplied with an airtime contract.

6.11 A further complication is with regard to the trade classifications as they only describe a business’s primary activity, so HMRC’s records cannot identify businesses selling these goods as part of wider business activities; for example, mobile phones can be sold by department stores or supermarkets, whose primary activity may be better described and recorded as general or grocery retail rather than mobile phone retail. Again, however, we expect that most such businesses would not be affected by the reverse charge for the reasons already stated.

Table 1: Tentative estimates of total affected numbers of businesses

	No. of businesses incurring costs from RCSLs / invoices (suppliers only)	No. of businesses incurring costs from other compliance impacts (suppliers and/or customers)
Mobile phones		
- Manufacturers / importers	20	20
- Wholesalers	50	50
- Retailers	25	480
Computer chips		
- Manufacturers / importers	20	20
- Wholesalers	50	50
- Retailers	0	200

Notes:

1. The numbers of businesses in the “other compliance impacts” column includes those businesses in the “RCSLs / invoices” column, to reflect expectations that suppliers will incur both types of cost. These tentative estimates of the numbers of affected businesses are used in the cost estimates described below.

6.12 In total therefore, HMRC tentatively estimates that just over 150 businesses might be affected as suppliers (they may also be affected as customers), with around 650 businesses expected to be affected by the reverse charge solely as customers. This will result in just over 800 businesses that might be affected in total. This total estimate also takes account of the fact that some businesses on the periphery may need to familiarise themselves with the reverse charge before concluding that they will either not be affected, or introduce precautionary arrangements in case they have to apply the reverse charge in future.

The bases for these estimates are as follows:

6.13 **Manufacturers/importers.** In the case of both mobile phones and computer chips, the markets are concentrated in the hands of a few major businesses, many of which are household names who import from their manufacturing arm overseas. As such, they will not be affected as customers, but only as suppliers of affected goods, required to comply with the reverse charge in general and, more specifically, to submit RCSLs. Following consultation, HMRC has used an estimate of 20 such businesses in each of the mobile phone and computer chip markets.

6.14 **Wholesalers.** The wholesale markets for these commodities are also believed to be concentrated into a small number of large businesses; tentatively estimated to be approximately 50 businesses in each of the two sectors concerned. (Some of these businesses may trade in both commodities.) Given the nature of the wholesale trade, these businesses are expected to be both suppliers of, and customers for, the relevant goods. They will therefore be required to comply with the reverse charge in general and the requirement to provide RCSLs.

Note – in both the wholesale and manufacturing environment, suppliers normally have a more established relationship with their customers, which means that they are in a better position to carry out checks on their bona fides, including for the purpose of the reverse charge. Legitimate businesses carry out several commercial checks on their customers covering various risks, such as to ensure acceptable use of the goods by the customers. In most instances, these checks will be adequate for reverse charge purposes provided that they are properly evidenced, unless the supplier has doubts about the reliability of the customer. Thus, HMRC expects that additional checks and extra costs arising from them will be minimal.

6.15 **Retailers (including internet retailers) – mobile phones.** HMRC's administrative data shows that around 1,500 businesses are registered for VAT with "retail of mobile telephones" listed as their primary activity. An additional, but unknown, number of businesses will also sell mobile phones as a secondary activity. According to the administrative data, many of these mobile phone retailers are very small businesses, which are considered extremely unlikely either to buy or sell in transactions of £5,000 or more.

6.16 Further, whilst a limited number of sales by retailers may still exceed the de minimis threshold, VAT is to be accounted for in the normal way where a retailer is unable to carry out the necessary checks to his satisfaction (i.e. establishing whether a customer is VAT-registered and is purchasing goods for a business purpose). However, retailers already have their own checks, usually based on value (for example, above £10,000) or quantity of goods sold, to prevent fraud or money laundering, and HMRC would expect them to apply similar checks to prevent manipulation of the £5,000 limit. As a consequence, it is considered that the de minimis limit of £5,000 will relieve the vast majority of, if not all, retailers from having to carry out the necessary checks and completing and submitting RCSLs.

6.17 HMRC therefore considers that the reverse charge will only apply to a relatively small number of retailers, most of which will be large and only a handful of which will be affected as a supplier rather than a customer, undertaking the occasional high value transaction with a VAT registered business. In all, HMRC therefore tentatively estimate that nearly 500 mobile phone retailers might be affected as customers, of which only an estimated 25 - a figure adopted in order to produce cautious cost estimates below - may also be affected as suppliers.

6.18 **Retailers (including internet retailers) – computer chips.** Computer chips can be purchased by retailers either for direct sale (for the purposes of repair, upgrade, or for use in self-built machines) or as components for installation in their own brand of computers. The latter group of retailers will be affected only as customers, since the reverse charge applies to computer chips rather than computers themselves. HMRC considers it to be very unlikely that the onward sales of computer chips by retailers (as opposed to wholesalers) to other VAT-registered businesses for upgrade/repair purposes would be in transactions of over £5,000. (And, as outlined above, normal VAT accounting applies where the retailer is unable to carry out the necessary business checks to his satisfaction.)

6.19 HMRC therefore believes that it is unlikely that any retailers of stand-alone computer chips will be affected as suppliers. Furthermore, it estimates that only around 200 retailers will be affected as purchasers of computer chips – either as stand alone units for onward sale or for integration into own-brand computers.

Charities and Local Authorities

6.20 Charities and Local Authorities may occasionally purchase goods to which the reverse charge applies, and which will be used partly for business and partly for non-business purposes. In these cases, they will be required to account for the output tax under the reverse charge procedure and apply the appropriate restriction in line with their normal accounting practices to the deduction of the tax on the purchase.

Administrative burdens and compliance costs

6.21 Implementation of the reverse charge will lead to complexities and additional compliance burdens for businesses which trade in the specified goods. Both suppliers and customers will have to make the necessary accounting system changes as outlined above to accommodate the reverse charge accounting mechanism. In most cases, this is likely to mean IT system changes; however, businesses which only have a few transactions subject to reverse charge, may wish to make the necessary adjustments manually. In addition, suppliers of affected goods will have to undertake necessary checks to establish whether the customer is VAT registered and is buying the goods for a business purpose, make adjustments to the content of invoices, and complete and submit RCSLs. It is estimated tentatively that just over 800 businesses will be affected by the reverse charge in general, including some 150 businesses which will also be required to submit RCSLs and adjust invoices.

6.22 Goods subject to the reverse charge are taxable supplies and purchases of such goods, excluding the first £1,000 each month which can be disregarded, will count towards the 'turnover' of the customer for VAT registration purposes. Non-VAT registered customers will therefore need to consider whether the purchase of goods for business purposes in principle subject to the reverse charge takes them over the VAT registration threshold, when taken in conjunction with their normal supplies. If so, they will need to register for VAT and notify their supplier accordingly. They will then have to account for VAT on all taxable supplies, including

those subject to the reverse charge, but will be able to reclaim VAT on any purchases and expenses in relation to taxable supplies in accordance with the normal VAT recovery rules. However, HMRC does not expect many small mobile phone or computer retailers to be unregistered at present, and since these businesses are small by definition they are unlikely to have to apply the reverse charge given the high de minimis transaction threshold.

6.23 In Standard Cost Methodology terms (and based on the information within the Standard Cost Model), we estimate that the total extra administrative burden of the RCSL will be around £12,000 to £13,000 per annum (current prices). These low total estimates are a result of the small number of businesses expected to have to submit RCSLs (as shown in Table 1, just over 150 in total) but come with the same degree of uncertainty as the estimates of the number of businesses affected.

6.24 This reflects the cost for suppliers of reverse charge goods of having to undertake the necessary customer verification checks and complete and submit RCSLs. The costs for submitting the RCSL have been based on those for the VAT 101 form, the EC Sales List. The majority of the additional burden (re RCSLs) will be borne by larger businesses, reflecting the larger numbers of these businesses dealing in the goods affected, and also the larger volumes of information (customer numbers, sales etc) that they are likely to have to provide. Based on businesses' experience with the EC Sales List, we estimate that it will take a large business around an hour to complete a quarterly RCSL.

6.25 The Standard Cost Model picks up administrative burdens based on businesses' information obligations required in order to comply with tax systems and rules. Businesses will also incur additional compliance costs outside the remit of the Standard Cost model; the key additional ones being in relation to:

- making changes to invoice templates (suppliers only);
- general familiarisation with the new reverse charge;
- staff training; and
- IT changes.

6.26 These will generally only need to be incurred once, upon the introduction of the reverse charge or prior to the first time a business is required to apply the reverse charge if that is not as soon as the reverse charge is implemented.

6.27 Given the high de minimis limit, these are most likely to be incurred by medium to large businesses, rather than small. As shown above in Table 1, HMRC tentatively estimates that just over 800 businesses in total would need to make most of these general preparations for the reverse charge, with only just over 150 potentially having to amend invoice templates. Based on this, alongside estimates of hourly wages and overheads consistent with data in the Standard Cost Model as a guide, estimates of these compliance costs are as follows:

- **Amending invoice templates.** The reverse charge will require suppliers to alter invoice templates so as to highlight the fact that the reverse charge applies to relevant sales. Again using the tentative estimate of 165 relevant businesses making sufficiently large sales of mobile phones and computer chips to other VAT registered businesses, HMRC estimates that the additional administrative burden of adjusting invoices to take account of the reverse charge to be around £16,500 per annum (with negligible one-off costs in the first year). This is based upon an assumed cost of £100 per business being incurred in arranging

for revised invoice templates to be printed. The continuing extra time cost from filling out these revised templates is estimated to be negligible.

- **General familiarisation.** HMRC will provide the required information on the reverse charge through information sheets and public notices. (HMRC's National Advice Service can also be telephoned for specific queries.) HMRC assumes that familiarisation with the reverse charge will take around 3 hours, which, with the number of businesses and time values used, equates to an estimated one-off general familiarisation compliance cost of around £40,000 in total. This estimate is tentative, given its reliance on assumptions.
- **Staff training.** The impact of staff training will depend on individual businesses' circumstances; how many staff require training, the training method used, and the elements of the reverse charge that need to be covered. As mentioned elsewhere, HMRC expects that the smallest businesses (those termed "nano" and "micro" businesses) will not be affected at all by the reverse charge, with the vast majority of those that are affected being "large" businesses. HMRC has little information on staff training time requirements, and assumes that training will take 6, 8 and 10 total staff hours for affected small, medium and large businesses respectively. Alongside the number of businesses and time values used, this leads to a total one-off staff training compliance cost estimate of around £130,000. This estimate is very tentative, given its reliance on assumptions.
- **IT costs - hardware.** RCSLs will have to be submitted electronically, which will therefore require access to an internet-enabled computer. As detailed above, HMRC expects that RCSLs will only have to be completed by large businesses. It is assumed that all such affected businesses will already have the required IT equipment and will not have to purchase extra hardware to comply with RCSLs or the reverse charge more generally.
- **IT costs - software.** These costs will be borne by those businesses directly affected by the reverse charge, but also some development costs will be borne by some members of the software industry. Many businesses (especially the larger ones) will have support agreements with software providers, and these agreements will be such that the software companies would have to provide adjustments for the reverse charge as part of those existing contracts rather than being able to charge for these changes. Development costs may therefore be passed on to the software industry's relevant clients depending on the existence or terms of service contracts and/or general competitive conditions.

IT software costs therefore fall into two categories: development of the amended software, and then the upgrade/service costs. These are expected to be one-off impacts, not recurring annual costs, and, based on staff time and cost estimates provided by the Business Application Software Developers Association (BASDA), overall IT software costs have been calculated by HMRC as follows:

- *Development costs.* BASDA have estimated that around 25 software developers will be providing reverse charge functionality over the next year; at an estimated cost of around £900 per staff day, with around 50-100 days required for each software company to develop and test the product. Total estimated software development costs are therefore put at between £1,125,000 and £2,250,000.
- *Upgrade costs – businesses without service contracts including support.* BASDA have advised HMRC that the cost of buying in upgrade services could range from 1-2 days of staff time for the smallest businesses to between 7-20 days for the

largest businesses. Companies without service contracts requiring these packages should mainly be smaller businesses (of whom, as set out elsewhere, relatively few are expected to be affected by the reverse charge). HMRC tentatively estimates that there might be around 450 affected businesses without service contracts, and BASDA suggests a cost of around £900 per staff day. If all of these affected businesses were to be required to pay for upgrade services, HMRC estimates that these upgrade service costs in total could be between £550,000 to £1,275,000. The wide range of service costs for the largest businesses are the main driver behind this very wide range of estimated total upgrade service costs.

If all these businesses are also required to buy upgrade packages as well as the upgrade services, additional costs will be incurred; BASDA have advised HMRC that the costs of upgrade packages could range from between £100-£1,000 for smaller businesses, to between £2,000-£50,000 for the largest. Again using an estimated figure of 450 affected businesses without appropriate IT service contracts, there could be an additional estimated cost of between £150,000 and £2,000,000 if all of them need to purchase upgrade packages as well.

- *Upgrade costs – businesses with service contracts.* BASDA has advised that those businesses with appropriate service contracts will not incur additional costs, since those contracts will cover the cost of required changes.

In total, these upgrade elements of IT software costs to affected businesses could range from around £700,000 to £3,275,000. There will also be software development costs of an estimated £1,125,000 to £2,250,000, giving total IT software costs of between £1,825,000 and £5,525,000. In addition to the wide ranges themselves, these are still very tentative estimates given the uncertainty surrounding the number of affected and relevant (i.e. with regard to IT service contract status) businesses.

6.28 Implementation will be from 1 June 2007 to maximise protection of the revenue while giving affected bodies as much time as possible to familiarise themselves with the new rules and make appropriate system changes.

Summary of effects

6.29 Businesses which become subject to the reverse charge mechanism either as a supplier or customer will incur one-off compliance costs in making the necessary system changes, as well as ongoing costs for suppliers, in terms of establishing customer details, and completing and submitting RCSLs.

6.30 Assuming just over 800 businesses are affected by the reverse charge, of which just over 150 might have to complete and submit RCSLs and adjust invoices, administrative burden (consistent with the Standard Cost Model) and wider compliance costs are expected to be around the following:

Table 2: summary of administrative burdens and wider compliance costs

	Year 1 (2007/08) or other one-off costs, £	Year 2 and thereafter (ongoing costs), £
<i>Administrative Burdens</i>		
- Reverse Charge Sales Lists	12,000 – 13,000	12,000 – 13,000

Total administrative burdens	12,000 – 13,000	12,000 – 13,000
<i>Wider compliance costs</i>		
- invoice changes	16,500	negligible
- general familiarisation	40,000	0
- staff training	130,000	0
- IT changes, hardware	0	0
- IT changes, software	1,825,000 – 5,525,000	0
Total wider compliance costs	2,011,500 – 5,711,500	0

Note: all estimates are tentative and in current prices.

Exchequer effect

6.31 The estimated revenue yield from implementing the terms of the final reverse charge derogation was estimated and published at Budget 2007, in Table A1.1 of the Financial Statement & Budget Report. This is reproduced below.

Table 3: Estimated Exchequer revenue impact of the reverse charge

	Indexed			Non-indexed
	2007/08	2008/09	2009/10	2007/08
Revenue impact £m	+135	+155	+120	+135

These estimates are on a cautious basis, as is normal for Budget revenue costings. They reflect the success of HMRC's strengthened operational strategy for tackling MTIC fraud, which has led to significant reductions in recent months in the levels of trading activity associated with the fraud. They also reflect changes to the scope and implementation date of the measure, and take account of a possible behavioural response to the implementation of the reverse charge mechanism and potential future mutations of MTIC fraud perpetrated by the fraudsters.

HMRC cannot estimate the cashflow impact for particular businesses, but it estimates tentatively that the overall impact in terms of annual cash VAT receipts should be a cost of around £10 million; receipt of this amount could be pushed back from 2007-08 into 2008-09. This one off cost to the Exchequer should translate into an equivalent cashflow gain to the affected supply chains as a whole, although there will be different impacts over different businesses within those chains.

Costs and savings for HMRC

6.32 Costs relating to the development of IT systems to support the introduction of RCSLs are estimated to total £3.5 million. This includes system support costs for the three months following the release of the system.

6.33 Subsequent IT costs relating to systems management are estimated to be in the region of £94,000 for 2008/09, and £71,000 in 2009/10. Consideration will also be given in due course to the delivery of an enhanced bulk upload system using XML files.

6.34 In addition, HMRC will require an additional member of staff at assistant officer level to handle penalty and compliance issues relating to them, costing a further £19,800 in the first year following implementation based on the average national wage for this grade. Verification of

RCSLs and VAT returns will be absorbed into existing assurance resources, and will not in itself, result in any additional costs.

6.35 HMRC will also benefit in the longer term from being able to redeploy a significant number of the staff currently engaged in dealing with MTIC fraud to other compliance duties. When these staff are redeployed - as a result of their experience on the MTIC compliance strategy - they will be better equipped to tackle other forms of evasion and fraud. The introduction of the reverse charge will also allow HMRC to respond more robustly to any future mutations of the fraud.

7. Competition assessment and impact on small firms

Competition assessment

7.1 A competition filter concludes that implementing reverse charge accounting will not have a significant impact on competition in the mobile telephone and computer chip sectors. HMRC believes that there are affirmative answers to only three of the nine questions in the competition filter.

7.2 An initial issue in this assessment is how to define the market. HMRC judges it appropriate to concentrate on the wholesale distribution of relevant goods – mobile phones and computer chips – with manufacturers/importers and wholesalers as suppliers. Although HMRC does not have detailed information on market shares of manufacturers/importers and wholesalers, the manufacture of both mobile phones and computer chips is highly concentrated. HMRC therefore believes that the answers to the three market share aspects of the competition filter test should be “yes”.

7.3 Reverse charge accounting affects wholesale distribution above the £5,000 limit within the UK, but not direct imports. The effect of reverse charge accounting on the cost of direct imports relative to the cost of buying from a wholesaler within the UK is unclear. However, the net cost of reverse charge accounting is thought to be small for most firms and substantial effects, such as a transfer of trade in affected goods between UK wholesalers and direct imports, are unlikely.

7.4 The £5,000 de minimis threshold means that the vast majority of small firms engaged in the wholesale distribution of affected goods will not have to apply the reverse charge. As detailed elsewhere in this RIA, the manufacturers/importers and wholesalers affected by reverse charge accounting are all thought to be relatively large businesses. That said, consultation responses have highlighted the fact that wholesalers in particular will have to distinguish between transactions to which the reverse charge does and does not apply; larger wholesalers may face more instances in which making such a distinction is required. However, although the £5,000 limit may segment the market, it is thought to have a relatively minor impact on the relative costs of firms of different sizes.

7.5 It is possible that a small number of firms will decide that their volume of business does not justify the costs involved in adopting reverse charge accounting. Any firm choosing to stop trading in affected goods for this reason would probably only have carried out a small proportion of its total trade in those goods and, so, would probably not be a significant part of the relevant markets. Accordingly, while there is a theoretical possibility that some firms will cease to trade in affected goods, no appreciable effect on market structure is anticipated.

7.6 New or potential firms, like firms existing at the time reverse charge accounting is adopted, will have to operate systems that comply with reverse charge accounting. Accounting software that facilitates compliance will be available to new or potential firms. New or potential firms could even be advantaged as, unlike existing firms, they will not have to make the transition from one type of accounting to another. The requirements of reverse charge accounting do not differ according to whether a firm is new or existing. Accordingly, ongoing costs for new firms will not be more than for existing firms. Similarly, there is no reason to expect the reverse charge to restrict the ability of any firms to choose the price, quantity, range or location of their products.

7.7 Although the goods in question – mobile phones and computer chips – are characterised by rapid technological change; the adopted definition of the market, i.e. wholesale distribution of these goods, is not. Either way, HMRC does not consider that the reverse charge will affect the pace of technological developments in any way. And, as mentioned above, it is considered unlikely that any business will be required to register for VAT as a result of the changes given the high de minimis limit attached to the measure.

7.8 In summary, HMRC does not consider that the reverse charge will have a significant adverse impact on competition in the affected market.

Impact on small firms

7.9 As mentioned elsewhere in this document the high de minimis limit of £5,000 is believed to ensure that the vast majority of small firms will not be required to apply the reverse charge. HMRC therefore considers that this measure will not have any significant impact on small firms.

8. Enforcement, sanctions and monitoring

8.1 Measures to ensure compliance with the changes introduced by this measure will include VAT assurance visits, the deterrent of the penalty regime, local knowledge, education and advice, as well as the normal policy assurance process.

8.2 Existing penalties will cover non-compliance, including non-compliance with the reverse charge sales list requirements. However, in the six months following implementation, HMRC will operate a ‘light touch’ with regard to errors provided no revenue loss has occurred. HMRC will use information gathered from their interventions, and from VAT returns and reverse charge sales lists to closely monitor the impact of the measure on the scale and the nature of MTIC fraud.

8.3 This measure is being introduced following informal consultation with businesses supplying the specified goods and representative bodies and associations. An invitation to comment on the draft legislation prior to implementation was also made in Revenue & Customs Brief 24/07. The Government will consider any comments from business and individuals about how the change has impacted on them.

9. Implementation and Delivery Plan

9.1 The changes will be implemented by a series of Treasury Orders and HMRC Commissioners’ Regulations subject to negative/affirmative resolution and will take effect from 1 June 2007. Notification of the changes was made by Revenue & Customs Brief 24/07 issued on 20 March 2007 with guidance on their application issued in Information Sheet 06/07 on 2

April 2007 – giving businesses affected by the changes 8 weeks to make the necessary IT system changes.

9.2 A further information sheet will be issued in mid May clarifying points raised in the consultation exercise.

9.3 All businesses which deal in mobile phones and computer chips subject to the reverse charge will be required to account for VAT under the reverse charge mechanism. They will also be able to recover any VAT charged on any related costs to the extent that they relate to their taxable supplies.

9.4 Affected businesses will already be maintaining accounting (purchase and sales) records. However, they will need to ensure that from 1 June 2007, goods subject to the reverse charge derogation are accounted for under the reverse charge mechanism and comply with HMRC's record keeping requirements. This includes completing (on a monthly basis) and submitting RCSLs for each VAT return period. These records will need to be made available to HMRC for verification purposes from time to time.

10. Post Implementation review

A further compliance cost review will take place within 12 to 24 months following implementation. In addition, the Council Decision authorising the derogation requires the UK to submit a report to the Commission evaluating its operation by 31 March 2009.

11. Summary

This measure is being introduced to counter high levels of MTIC fraud and will result in the customer, rather than the supplier, accounting for VAT on specified goods meeting the conditions laid down in the derogation. It is neither a deregulatory nor an administrative simplification, but is proportionate to the fraud being perpetrated.

12. Contact point

Jane Hyde
HM Revenue and Customs
CT & VAT: VAT Fraud
2, Broadway
Edgbaston
Birmingham B15 1BG

Tel: 0121 697 4010

Fax: 0121 697 4360

Email: jane.hyde@hmrc.gsi.gov.uk

10. Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

John Healey
Financial Secretary
8th May 2007