EXPLANATORY MEMORANDUM TO

THE VALUE ADDED TAX (AMENDMENT) (NO. 2) REGULATIONS 2008

2008 No. 3021

1. 1.1 This explanatory memorandum has been prepared by HM Revenue and Customs 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 These Regulations amend the Value Added Tax Regulations 1995 (S.I. 1995/2518) ("the principal Regulations").

2.2 Regulation 3 amends regulation 15 of the principal Regulations (change of rate, credit note). It extends the time period during which a credit note has to be issued in circumstances where there is a change of VAT rate and a supplier makes an election under section 88 of the Value Added Tax Act 1994 from 14 to 45 days. It also enables the Commissioners to extend this period by general or special direction.

2.3 Regulation 4 amends regulation 55K of the principal Regulations (flat rate scheme for small businesses, category of business) by substituting a new table. The new table includes revised percentage figures for the categories of business listed in it and is reformatted in alphabetical order.

2.4 The Committee is respectfully referred to the explanatory note to the Regulations for the specific detail.

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

The Regulations will breach the 21 day rule as they are to be made and laid on the date of the Pre Budget Report (PBR) when a package of changes to the VAT rate is to be announced. The changes made in the Regulations are consequential on one of the rate changes to be announced (the temporary reduction in the VAT rate from 17.5 per cent to 15 per cent) which will come into force on 1st December 2008 and are therefore required to come into force on the same date. It is Government policy not to publicise the package of VAT rate changes in advance of PBR.

4. Legislative Background

4.1 These Regulations have been made by the Commissioners for Her Majesty's Revenue and Customs in exercise of their powers under sections 26B and 88(5) of, and paragraphs 2(1), 2(10) and 2A of Schedule 11 to, the Value Added Tax Act 1994.

4.2 Section 26B allows the Commissioners to make regulations to make provision under which, where a taxable person so elects, the amount of his liability to VAT in respect of his relevant supplies in any prescribed accounting period shall be the appropriate percentage of his relevant turnover for that period (the flat rate scheme). The regulations may designate certain categories of business and prescribe the appropriate percentage for each category of business.

4.3 Section 88(5) allows the Commissioners to make regulations to make provision for the replacement or correction of any VAT invoice which relates to a supply in respect of which an election is made under that section but which was issued before the election was made.

4.4 Paragraph 2(1) of Schedule 11 allows the Commissioners to make regulations relating to the keeping of accounts and the form and manner in which returns must be made.

4.5 Paragraph 2(10) of Schedule 11 allows the Commissioners to make regulations which allow VAT paid in one period to be treated as chargeable in another. Such regulations may make provision relating to the making of entries in accounts relating to adjustments (including the correction of errors); the making of the consequent financial adjustments and the documentary evidence required in such cases.

4.6 Paragraph 2A of Schedule 11 allows the Commissioners to make regulations requiring a taxable person supplying goods and services to provide a VAT invoice in a prescribed manner and form and within a prescribed period.

5. Extent

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 The changes effected by these regulations are consequential on a change (a temporary reduction in the rate of VAT) which is being made as part of a package of measures designed to stimulate the UK economy and ensure the sustainability of public finances. The temporary reduction in the rate of VAT is being made by Order as it is required to come into effect on 1st December 2008. The other changes will be announced at PBR and will be legislated for in the Finance Bill 2009.

7.2 Regulation 3 provides an easement to businesses that make an election under section 88 of the Value Added Tax Act 1994 to apply the later lower VAT rate where allowed to do so and are as a result required to issue credit notes to their customers. It extends the period during which a credit note must be issued from 14 to 45 days from the date of a rate change and allows the Commissioners to extend this further by general or special direction.

7.3 Regulation 4 substitutes a new table into regulation 55K containing percentage figures revised to take account of the temporary reduction in the VAT rate. It also sets out the categories of business in alphabetical order to make the table easier to navigate.

8. Impact

An Impact Assessment relating to the changes effected by this Instrument (amongst others) is attached to this memorandum.

9. Contacts

John Brandwood at HM Revenue and Customs Tel: 0151 703 8661 or e-mail: john.brandwood@hmrc.gsi.gov.uk can answer any queries regarding these Regulations.

Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	**Impact Assessment of changes to the standard rate of VAT**	
Stage: Implementation	**Version:** 1	**Date:** 24 November 2008

Available to view or download at: http://www.hm-treasury.gov.uk/consult_ria_index.htm

Contact for enquiries: Charlette Holt-Taylor and Nick Catton **Tel:** 020 7270 4392 / 020 7147 2975

What is the problem under consideration? Why is government intervention necessary?

As explained in the Pre Budget Report, major shocks have hit the economies of every country in the world. While commodity prices have recently eased, the credit shock has intensified in to the worst global financial crisis for generations. These developments mean that economic prospects are subject to exceptional uncertainty, but it is clear that the UK, like many advanced economies, has moved in to recession. The Government's immediate priority is to continue to support the economy through these difficult times and provide further support for growth and incomes during the economic downturn. To do this, the Government will complement the action to date with a fiscal stimulus.

What are the policy objectives and the intended effects?

As explained in the PBR, the proposed changes will provide further support for growth and incomes during the economic downturn. They will provide a fiscal stimulus to the economy, while supporting the Government's fiscal policy objective of ensuring the sustainability of the public finances, in order to protect economic stability and long-term growth.

What policy options have been considered? Please justify any preferred option.

As part of the PBR process, the Government identified the appropriate way to deliver an immediate fiscal stimulus while ensuring the sustainability of the public finances. To avoid the suppression of activity between announcement and introduction, the Government is implementing its preferred option for a fiscal stimulus as rapidly as possible. This is a reduction in the standard rate of VAT from 17.5% to 15% from 1 December 2008 until 1 January 2010, when the rate will return to 17.5%.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The Government is always looking to improve its compliance cost assessments **and would welcome feedback.**

Ministerial Sign-off for Implementation Impact Assessment:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister: Stephen Timms

Date: 24 November 2008

Summary: Analysis & Evidence

Policy Option: 2	Description: Changes to VAT standard rate

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	Expected costs are from familiarisation with the changes, re-pricing, book-keeping and accounting checks, and system changes. Costs are expected to be higher for the first rate change and lower for the second as the rate returns to familiar levels and businesses will use experience of the earlier change.
£ 175m and £125m	2	
Average Annual Cost (excluding one-off)		
£ 0		**Total Cost** (PV): **£ 300m over 2 years**

Other **key non-monetised costs** by 'main affected groups' Businesses will have to decide how to respond to the rate change and whether or not to consult advisors or renegotiate contracts. We have only looked at the actions all businesses have to take to comply with the rate change. No other compulsory key non-monetised costs are expected.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	The overall benefits of the policy are discussed in the PBR document. The announced fiscal stimulus amounts to the delivery of around 1 per cent of GDP of support to the economy.
£		
Average Annual Benefit (excluding one-off)		
£		**Total Benefit** (PV): **£ Not quantifiable**

Other **key non-monetised benefits** by 'main affected groups'

The key benefits will be felt across the whole economy, as the cut in the standard VAT rate from 1 December 2008 to 31 December 2009 gives further support to the economy.

Key assumptions: the time businesses will require to implement the rate changes; the costs of system alterations; and the degree of increased efficiency for the move back to 17.5% in 2010. Estimates have been made using the standard cost model's data where available, such as for indicative values of businesses' time and to inform relevant business populations.

Price Base Year	Time Period Years	**Net Benefit Range** (NPV) £	**NET BENEFIT** (NPV Best estimate) £

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			1 December 2008	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			£ Negligible	
Does enforcement comply with Hampton principles?			N/A	
Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£ 0	
What is the value of changes in greenhouse gas emissions?			£ Not quantifiable	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)				(Increase - Decrease)
Increase of £ 0		Decrease of £ 0	**Net Impact**	£ 0

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Evidence Base

Rationale for intervention

The twin global shocks of the credit crunch and the recent surge in energy and food prices have impacted the global economy and have led to economic downturns in many countries around the world, including the UK. As household budgets have been squeezed, consumers have cut back on spending. The Government is acting now to reduce the economic impact of the financial shock, leaving individuals and businesses better off, while ensuring the sustainability of the public finances.

Policy objective

The objective of the proposed change is to support economic activity and mitigate the size and duration of the economic impact of the credit crunch by providing an immediate fiscal stimulus to the economy. Reducing the standard rate of VAT from 1 December 2008 is estimated to inject around £3.8 billion into the economy by April 2009 and a further £8.6 billion in 2009-10. It will benefit all businesses and individuals through supporting their finances and spending power in the short-term, and by reducing the relative price of current spending compared with future spending, will encourage consumption to be brought forward.

The Government recognises that changing the VAT rate imposes compliance burdens on business. But businesses will benefit from the broader economic stimulus that this change delivers. This impact assessment focuses on the identified compliance costs and does not seek to quantify the wider economic benefits that businesses will derive.

Proposed changes

VAT rates and exemptions

VAT is a tax on the final consumption of goods and services, collected at every stage of production and distribution. It is charged on the majority of goods and services at the standard rate of 17.5%. The proposed changes will temporarily reduce this to 15% from 1 December 2008. The standard rate will then return to 17.5% from 1 January 2010.

VAT is charged on a select group of goods and services at either a zero rate (including most food and non-alcoholic drinks, books and magazines, children's clothing and footwear, construction of domestic dwellings, domestic passenger transport, and drugs and prescriptions) or a reduced rate of 5% (including domestic fuel and power). These rates will be unaffected by the proposed changes.

A number of goods and services are exempt from VAT because it is considered inappropriate to tax them (including public services such as health, education and welfare) or they are too technically difficult to tax (including financial services). There will be no change to the VAT exemptions.

Number of businesses affected

There are just over 2 million businesses registered to pay VAT in the UK. There are also 2.7 million businesses in the UK that are not registered for VAT. All VAT registered businesses will be affected to some degree by the proposed changes, and will have to make appropriate changes to their business systems. 75% of registered businesses are assumed to deal in standard rated goods and services, and around 140,000 are thought to be partly exempt from VAT.

Compliance Cost Analysis

The ongoing costs of complying with the VAT system are unaffected, as the obligations to register for VAT, complete returns and pay VAT are unchanged by this measure. These ongoing costs are measured by the Standard Cost Model and represent the administrative burden of the VAT system which is unchanged. But administrative burdens are only a subset of overall compliance costs. Other compliance costs include the costs of transition and change (such as time spent becoming familiar with new VAT rules) and they are the key compliance costs for this measure and the ones on which this impact assessment focuses.

The expected compulsory transitional costs fall into the following categories:

- Familiarisation
- Re-pricing
- Extra book keeping checks
- Extra accountancy costs
- System changes/upgrades

Many of the costs listed above will be incurred for both rate changes. It is expected that experience of the first rate change will lead to a reduction in these costs for the second; furthermore, where the change to 15% and the change back to 17.5% are relatively close together, it is possible that some changes back to applying VAT at 17.5% will involve undoing the first change and/or returning to what is already familiar. As such, it is expected that the changes back to 17.5% will be much less costly than the initial change to 15%.

There could be other potential costs to businesses such as choosing how to respond to the rate changes, consulting advisors, or (if businesses have contracts inclusive of VAT) potentially renegotiating terms of contracts. However, while it is recognised that some businesses may decide to incur them in practice in light of commercial realities, since these costs arise from commercial decisions they are not analysed as part of this impact assessment.

All monetary amounts given in the sections below are in 2008 values. Although there is no administrative burden impact, the Standard Cost Model has been used to inform some details such as the affected populations, distributions of affected businesses within those populations, and hourly time values.

Key caveat on the compliance cost analysis

For each size group of affected businesses, we aim to describe the impact on the modal business i.e. a business in the middle of the distribution in each size band. It is acknowledged that every business is different, and that there can be a very wide variation in many business characteristics not explicitly captured by describing them simply as “small” or “large” businesses. For example, we expect a very long tail in the distribution of small businesses; with the very smallest having very simple VAT affairs and potentially much lower costs than one towards the other end of the range of “small” businesses. In view of this, we aim to focus on businesses around the middle of each size band but recognise that because of this, many businesses may feel they are not described perfectly by the text in sections below. **This assessment identifies the categories of expected compliance costs and includes our best estimates of what the compliance costs will be focussing on businesses in the middle range of each size band. We recognise that there will, therefore, be businesses whose compliance costs are either higher or lower than the ones quoted in this assessment.**

Familiarisation

This category focuses on the time businesses will need to spend reading about and comprehending the nature of the change. We have assumed a range of between half an hour for a small business with the simplest VAT affairs to three hours for a large business (large businesses may also want to consult advisors). Using hourly rates informed by the Standard Cost Model, the estimated cost for a typical small business is around £7 and for a larger business might be around £100.

Businesses would need to familiarise themselves with changes to the VAT rate for both the cut to 15% and the later return to 17.5%; although the pre-announcement of the two rate changes should make this process slightly less onerous than if they had been announced separately, businesses will still have to ensure they remember when the later rate change and consider the consequences in light of the business conditions of the day.

In total, familiarisation is estimated to cost around £24.5 million for the change to 15% in 2008, and around £16 million for the return to 17.5% in 2010. The cost of going back to 17.5% is less on the expectation that a return to the familiar rate will be less time-consuming for businesses.

Re-pricing

This category focuses on the costs businesses will incur in re-pricing their standard rated goods, and in particular those selling to final consumers at VAT inclusive prices. Examples of this might be re-labelling goods and altering bar code system databases, including on tills. It is assumed that a smaller business might spend around two hours making these changes, while a larger business could spend upwards of fifty hours.

Costs per business may be in the region of £25 and £600 for smaller and larger businesses respectively, although again the distributional issues around the VAT population will mean that many businesses may incur more or fewer cost than these figures. Large businesses selling many different products in many different outlets (such as supermarkets in particular) may incur particularly high re-pricing costs. Businesses operating primarily through catalogues will also face higher than average costs.

Businesses selling standard VAT rated goods and services would need to re-price for both VAT rate changes. We expect some businesses to become slightly more efficient at re-pricing over time with the pre-announced increases.

In total, re-pricing costs are estimated to be around £50 million for the change to 15% in 2008, falling to around £45 million for the return to 17.5% in 2010. It is also recognised that businesses will need to consider whether to reprint or reproduce published material such as catalogues. Some businesses may do this as a result of the change, others may wait until their next planned printing round. We recognise this is a potential additional cost but because of the uncertainty have not built this into our costing.

Extra book keeping checks (for businesses that complete their own VAT return using manual records)

Businesses keeping manual VAT records will need to take extra care with their billing and accounting systems and in particular when completing their first VAT return after the rate change. This category recognises the extra costs involved. We assume that electronic accounting systems which can alter the VAT rate (see below) will include these checks automatically. However, it is expected (based on recent HMRC research) that relatively few businesses use non-electronic accounts and the vast majority that do have paper records are small businesses with relatively simple VAT affairs.

These businesses will need to pay extra attention to checking their accounts both times the VAT rate changes. We expect some businesses to become slightly more efficient for the second change, which is also a move back to the more familiar standard rate of VAT.

It is assumed that these extra checks would take between one and fifteen hours for small businesses, at a cost of between around £13 and £450 each. In total, it is estimated that the cost would be around £5 million for the first VAT rate change in 2008, and around £3.5 million for the return to the familiar rate of £17.5%.

Extra accountancy costs (additional accountancy fees incurred by those who rely on an agent to complete their VAT return)

Businesses outsourcing their accounts may incur extra accountancy fees to cover any extra book keeping checks carried out by accountants immediately after the VAT rate change. It is assumed that the smallest businesses using accountancy services would require one extra hour of accountancy time, with possibly around ten extra hours for larger businesses. In terms of estimated costs per business, smaller businesses might incur extra costs of around £25 each and larger businesses might incur extra costs of around £275.

Relevant businesses would probably need to incur extra accountancy fees for both VAT rate changes, but as with other types of costs we expect checks for the second rate change to be more efficient than the first time.

In total, extra accountancy costs from checking might be around £26.5 million for the first rate change in 2008, and around £17.5 million in subsequent rate changes in the series.

System changes/upgrades

This category focuses on the costs involved in changing systems and upgrading software to cope with the change and we expect this to be the biggest cost for business. Some business electronic accounting systems may not be able to automatically alter the VAT rate and new systems or upgrades will be required. This might include either purchase costs and/or time costs from installing those new systems. The estimates for this section are particularly tentative due to a lack of information on system upgrade and purchase costs. But it is assumed that VAT accounting packages will have the flexibility to adapt to the change.

It is expected that the vast majority of VAT registered businesses will need to alter systems. In terms of time costs, it is assumed that smaller businesses might take one hour and larger businesses with more complex systems might take around fifty hours; the estimated costs per business in relation to time are around £13 and £325 for the small and large businesses respectively.

Purchase costs are largely unknown. Smaller businesses might have to purchase patches or upgrades to accounts packages; on the other hand, these upgrades might be provided free by software providers as part of existing upgrade processes. Larger businesses might have to purchase upgrades to systems to accommodate the changes, while on the other hand these changes may be captured by terms of existing IT support contracts and not represent an additional cost. On the whole, it is expected that the majority of businesses would be able to obtain any necessary upgrades as part of existing upgrade or contract processes; it is thought that the majority of accounting packages already have the flexibility to alter the rate of VAT, so upgrades will not be required. As a result, it assumed that only 20% of businesses might have to incur purchase costs as well.

For those smaller businesses that might incur purchase costs (typically with relatively simple accounting systems) the assumed cost is £10 each, while larger businesses might have to pay around £500 each - but these are no more than assumptions.

We expect most affected businesses to apply a quick fix solution to the VAT rate change in the very short run, due to the short time between announcement and implementation of the first change. Given that the 15% rate will only be in place for 13 months, it is expected that many businesses will move back to applying the 17.5% rate by undoing the alterations put in place for the first change; as such, the second phase of IT system changes is expected to cost less than the first.

On the basis of the assumptions described above, total costs in terms of both time and purchases are estimated at around £70 million for the first VAT rate change to 15% in 2008; this is assumed to fall to around £45 million when the rate returns to 17.5% in 2010.

Summary of total business cost impacts

As stated above, all the identified costs are wider compliance costs rather than pure administrative burdens. The summary of these compliance costs is as follows:

Table 1: Total compliance costs summary (2008 values, £ millions)

	2008-09	2009-10
Familiarisation	24.55	16
Re-pricing	50	45
Extra paper accounts checks	5	3.5
Extra accountancy checks	26.5	17.5
System changes	70	45
Total - unrounded	176.5	127
Net present value (NPV)	176.5	122.5
NPV – rounded to nearest £5m	**175**	**125**

All costs should be zero after 2009-10 as the rate remains at 17.5% from then on. The grand total is rounded to the nearest £5 million to reflect the uncertainties involved in these estimates. The net present value is calculated by applying an annual discount rate of 3.5% after 2008-09. Over the two VAT rate changes together, the net present value of estimated compliance costs is around £300 million.

Impact on HMRC

HMRC computer systems will require updating to reflect the changes to VAT rates; however, the cost of these changes is minimal. Providing advice and guidance on changes to the tax system is a routine part of HMRC's business and does not represent an additional cost to HMRC.

Competition assessment

All businesses selling standard rated goods and services will be affected equally, so competition between these businesses will not be affected. VAT on supplies made by businesses to other fully taxable businesses can be reclaimed in full, regardless of the standard rate of VAT. There may be marginal competition effects (becoming more competitive in terms of relative prices) where standard rated products sold to final consumers can be substituted for zero rated or reduced rated products. Aside from general economy-wide substitution effects, this factor may be concentrated in areas in which 'borderlines' exist between standard rated goods and services and products with other VAT liabilities within particular sectors, such as in the VAT treatment of food. Exempt products may also become more competitive for the duration of the 15% rate, as 'stuck VAT' incurred on standard rated inputs used in the production of exempt outputs (which cannot be reclaimed) will be reduced.

There may also be marginal effects on the degree of competition between VAT-registered and unregistered businesses dealing in goods that (if sold by a registered business) would be standard rated; registered businesses charging VAT would become relatively more competitive while the 15% rate is in place. However, this would be tempered to an extent by the fact that unregistered businesses cannot reclaim VAT they pay on their own inputs, and the 15% rate of VAT in VAT would decrease the amount of 'stuck VAT' they incur.

Changing the standard rate of VAT should not limit the number or range of suppliers, directly or indirectly. Subject to the expected marginal effects noted above, changing the VAT rates should also not significantly limit the ability of suppliers to compete, or significantly reduce incentives to compete. In contrast, the boost to demand resulting from the cut in VAT may result in increased incentives and opportunities to compete.

Small firms impact test

An estimated 2.7 million of the smallest businesses are not registered for VAT. At £67,000 the UK has one of the highest VAT registration thresholds in the EU. These businesses would not incur compliance costs, and would benefit from a reduction in stuck VAT incurred on standard rated inputs while the standard rate of VAT is at 15% (although possibly becoming relatively less competitive against registered businesses, who would be charging less VAT than before while the 15% rate is in place).

For small businesses registered for VAT their compliance costs may represent a slightly higher burden relative to larger businesses as a percentage of turnover. However, small businesses are less likely to incur the relatively more expensive compliance costs involving advisors and system changes/upgrades. VAT arrangements for small businesses are also expected to be simpler than those of larger businesses, which should mean that a small business will take less time to implement the changes. Given this, we do not expect small businesses to incur any material competitive disadvantage by changes to the VAT rate, relative to larger businesses.

Because the Government does not consult on rate changes, we have had to rely on our best assumptions. The Government is always looking to improve its compliance cost assessments and is interested in feedback.

Specific Impact Tests: Checklist

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No