# EXPLANATORY MEMORANDUM TO

# THE VALUE ADDED TAX (AMENDMENT) (NO. 2) REGULATIONS 2009
# 2009 No. 820

1. This explanatory memorandum has been prepared by HM Revenue and Customs (HMRC) and is laid before the House of Commons by Command of Her Majesty.

## 2. Purpose of the instrument

The instrument implements a package of four changes to simplify the partial exemption standard method to reduce compliance costs for businesses. The first allows businesses to provisionally recover input tax by reference to the previous year's recovery percentage, saving the need for a separate recovery percentage calculation for each VAT return. The second allows businesses to finalise their provisional recovery of input tax in the final VAT return of the year, saving the need for a separate provisional calculation for that return. The third allows new partly exempt businesses to recover input tax on the basis of "use", saving the need for approval of a special method. The fourth widens the scope of the standard method to include certain overseas supplies, saving the need for approval of a special method.

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

This instrument breaches the 21 day rule. The amendments effected by this instrument are partial exemption simplification measures which are required to come into force on 1st April 2009 in order to provide the maximum benefit to business. The changes need to be pre-announced. Normal practice would be for them to be included in the Budget speech but this is not possible given the delayed date for Budget 2009. As such, the Minister decided to announce them on 31/03/09 in advance of the Budget. This instrument has been made and laid as soon as possible after the Ministerial announcement. Most of the affected businesses have a VAT tax year commencing on 1st April and a later implementation date would reduce first year benefits as these businesses would be required to perform two sets of calculations in their first tax year (one under the current rules and another under the new rules).

## 4. Legislative Context

The instrument amends the Value Added Tax Regulations 1995 S.I.1995/2518 ("the Principal Regulations") to implement changes required to the partial exemption provisions following a consultation announced at Budget 2008. This consultation provided strong support for implementing this package of changes to simplify the partial exemption rules and reduce compliance costs for businesses.

## 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 negative resolution procedure and does not amend primary legislation, no statement is required.

## 7. Policy background

7.1 A business can recover VAT on costs relating to taxable supplies but cannot normally recover VAT on exempt supplies. There are around 140,000 partly exempt businesses that make taxable and exempt supplies and need to calculate how much VAT they can recover under the partial exemption rules as attributable to taxable supplies. Of these, around 120,000 mainly smaller-sized businesses operate the default standard method which is a turnover-based calculation set out in law. The remaining 20,000 seek approval of a special method that can be tailor-made to the individual needs of the business.

7.2 A consultation in summer 2008 confirmed strong support for a package of four changes to simplify the standard method and reduce compliance costs for businesses.

7.3 A business operating the standard method must provisionally calculate the percentage of recoverable VAT on costs (input tax) at the end of each quarter and then adjust for any under or over-recovery of input tax by way of an annual adjustment at the year end having calculated an annual recovery percentage. The first change allows provisional recovery by reference to the previous year's annual recovery percentage - the default position - while allowing the option of using the quarterly recovery percentage (there is no requirement to notify HMRC). This removes the need to calculate separate provisional recovery percentages for each quarter and will save some businesses the costs of seeking approval for a special method.

7.4 The default position requires a business to account for its standard method annual adjustment in the first quarter following the end of the year. The second change removes the need for this additional calculation and allows for a more timely completion of the VAT account by allowing the annual adjustment to be carried out in the final quarter of the year.

7.5 New partly exempt businesses are sometimes unable to operate the standard method either because they have not yet started trading and have no turnover to go into the calculation or because the calculation produces an unfair result because turnover is low or erratic. Under the previous rules, such a business would normally seek approval of a special method resulting in additional costs. The third change allows a new partly exempt business to select its own fair and reasonable calculation (or recovery on the basis of "use"), thereby removing the need to apply for a special method.

7.6 The standard method previously only catered for input tax on taxable supplies made in the UK and excluded certain overseas supplies as potentially distortive. A business had to deal with these supplies separately or seek approval of a special method. The fourth change reduces the costs of having to perform separate calculations and seeking approval of a special method by allowing certain overseas supplies to be included in the standard method, where there is minimal risk of distortion.

7.7 There are no projects presently on hand to consolidate the Principal Regulations.

## 8. Consultation outcome

8.1 HMRC launched a consultation on ideas to simplify the partial exemption rules with publication of a consultation document on its website. The consultation ran from June to September 2008. Fifty-five replies were received from businesses, advisers and representative bodies. In addition, HMRC held a number of technical meetings to discuss the simplification ideas in more detail and has discussed the responses to the consultation with a specially formed Consultative Group comprising professional advisers and representatives.

8.2 The consultation confirmed that the vast majority of mainly smaller-sized partly exempt businesses would benefit from implementation of the changes which are being effected by this instrument as they would reduce compliance costs, mainly due to simpler and less time-consuming calculations.

## 9. Guidance

HMRC publishes guidance on the partial exemption rules in Notice 706 VAT: Partial Exemption and in V1-15 of guidance. These will be amended in due course to reflect thee changes effected by this instrument.

## 10. Impact

10.1 The four simplification changes should benefit business, charities and voluntary bodies that operate the partial exemption standard method.

10.2 There is no impact on the public sector.

10.3 An Impact Assessment is attached to this memorandum.

## 11. Regulating small business

The legislation applies to small businesses that operate the standard method and should benefit them by reducing compliance costs.

## 12. Monitoring & review

The costs and benefits of these changes will be reviewed within 3 years of implementation.

## 13. Contact

Patrick Wilson at HMRC Tel: 0207 147 0595 or email: patrick.wilson@hmrc.gsi.gov.uk can answer any queries regarding this instrument.

# Summary: Intervention & Options

| Department /Agency: | Title: | |
|---|---|---|
| **HM Revenue and Customs** | **Impact Assessment of package of 4 changes to simplify the VAT partial exemption standard method** | |
| **Stage:** Implementation | **Version:** 2 | **Date:** 23 March 2009 |

**Related Publications:** Simplifying the VAT Partial Exemption and Capital Goods Scheme Rules - Summary of Responses January 2009, Consultation Document June 2008.

**Available to view or download at:**

http://www.hmrc.gov.uk

**Contact for enquiries:** patrick.wilson@hmrc.gsi.gov.uk **Telephone:** 0207 147 0595

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

A business can recover VAT on costs relating to taxable supplies, but cannot normally recover VAT on exempt supplies. The partial exemption rules enable businesses to calculate how much VAT they can recover as attributable to taxable supplies. Businesses identified these rules as a priority for simplification and, following consultation, most felt the ideas should be developed over a 3-year period. This impact assessment focuses on the first phase, which is a package of 4 changes to simplify the standard method.

What are the policy objectives and the intended effects?

Around 120,000, mainly smaller-sized businesses, operate the partial exemption standard method. This allows a business to recover VAT on its costs by reference to the proportion of taxable to total turnover. The objective is to simplify the standard method with the aim of reducing compliance costs for the vast majority of affected businesses. None of the changes affect the amount of VAT that businesses are entitled to recover on their costs.

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

1. Implement the package of 4 changes to simplify the standard method:
- Change A: In-year provisional recovery rate;
- Change B: Early annual adjustment;
- Change C: Use-based option for new partly exempt businesses; and
- Change D: Widening the scope of the standard method.

2. Do nothing. Option 1 is preferred as it simplifies the rules and reduces compliance costs for businesses.

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

Within 3 years from the date of implementation.

**Ministerial Sign-off** For final proposal / implementation stage Assessments:

***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) that the benefits justify the costs.***

Signed by the responsible Minister:

Stephen Timms

........................................................Date: 23 March 2009

# Summary: Analysis & Evidence

| Policy Option: 1 | Description: Implement the package of 4 changes to simplify the standard method. |
|---|---|

## COSTS

| ANNUAL COSTS | | Description and scale of **key monetised costs** by 'main affected groups' Businesses will need to spend time familiarising themselves with the changes. |
|---|---|---|
| **One-off** (Transition) | **Yrs** | |
| **£ 1.5 million** | 1 | |
| **Average Annual Cost** (excluding one-off) | | |
| **£ Neg** | | **Total Cost** (PV) **£ 1.5m one off** |

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

## BENEFITS

| ANNUAL BENEFITS | | Description and scale of **key monetised benefits** by 'main affected groups' Businesses will benefit from simpler calculations which will save them time. Some will also benefit from not having to seek approval from HMRC to operate a special method. |
|---|---|---|
| **One-off** | **Yrs** | |
| **£ Neg** | | |
| **Average Annual Benefit** (excluding one-off) | | |
| **£ 1.5 million** | 1 | **Total Benefit** (PV) **£ 1.5m per year** |

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

Key Assumptions/Sensitivities/Risks This option would benefit up to 120,000 mainly smaller-sized businesses. The ongoing yearly benefits balance the one-off, up-front costs of this change after one year so the total costs and benefits have been evaluated over that period.

| Price Base Year 2009 | Time Period Years 1 | **Net Benefit Range** (NPV) £ | **NET BENEFIT** (NPV Best estimate) £ |
|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| What is the geographic coverage of the policy/option? | | | United Kingdom | |
| On what date will the policy be implemented? | | | 1 April 2009 | |
| Which organisation(s) will enforce the policy? | | | HMRC | |
| What is the total annual cost of enforcement for these organisations? | | | £ Nil | |
| Does enforcement comply with Hampton principles? | | | Yes | |
| Will implementation go beyond minimum EU requirements? | | | No | |
| What is the value of the proposed offsetting measure per year? | | | £ N/A | |
| What is the value of changes in greenhouse gas emissions? | | | £ N/A | |
| 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 £ | Decrease of £ 250k | **Net Impact** | £ 250k |

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

**Objective**

1. To simplify the partial exemption standard method to reduce compliance costs for businesses.

**Background**

2. A business can recover VAT on costs (input tax) relating to taxable supplies, but cannot normally recover input tax on exempt supplies. There are around 140,000 partly exempt businesses that make taxable and exempt supplies and need to calculate how much input tax they can recover under the partial exemption rules as attributable to taxable supplies.

3. Of the 140,000 partly exempt businesses around 120,000, mainly smaller-sized businesses, operate the default standard method which is a simple turnover-based calculation set out in law. The remaining 20,000 seek approval from HMRC of a special method that can be tailor-made to the individual needs of the business.

4. In summer 2008, HMRC consulted on ideas to simplify the partial exemption rules to reduce compliance costs for businesses. The consultation focussed on 3 areas identified as priorities by businesses:

- Standard method;
- De minimis; and
- Capital Goods Scheme (CGS).

Additionally, HMRC invited comments on the possibility of a combined partial exemption and business / non-business method. Please refer to the Consultation Document June 2008 entitled: Simplifying the VAT Partial Exemption and Capital Goods Scheme Rules, for further details.

5. Responses to the consultation confirmed that the vast majority of partly exempt businesses would benefit from simpler rules and a reduction in compliance costs if the ideas were implemented. While no comments were received specifically in relation to the consultation stage impact assessment, responses were generally in line with the analysis of costs and benefits set out in that document. Overall, respondents felt that it was sensible to take the work forward as part of a 3-year programme starting with ideas to simplify the standard method.

Please refer to the Summary of Responses January 2009: Simplifying the VAT Partial Exemption and Capital Goods Scheme Rules, for further details.

6. This impact assessment examines the benefits and costs of implementing a package of 4 changes to simplify the standard method, which respondents to the consultation strongly supported.

**Benefits and costs**

***Option 1: Implement 4 changes to simplify the standard method***

7. The standard method is the default calculation used by most smaller-sized partly exempt businesses to determine the amount of input tax they can recover. It is a simple calculation that determines a percentage of recoverable input tax by reference to the proportion of taxable to total turnover. Option 1 is to implement the following 4 changes:

- In-year provisional recovery rate (calculating the amount of input tax that is provisionally recoverable using the prior-year annual recovery percentage);
- Early annual adjustment (bringing forward the annual adjustment to the final return for the partial exemption year);
- Use-based option for new partly exempt businesses (giving new partly exempt businesses the option to recover input tax in accordance with the principle of use); and
- Widening the scope of the standard method (including certain overseas supplies within the standard method).

***Annual benefits***

8. The annual benefits of each change are considered below.

<u>Change A: In-year provisional recovery rate.</u>

9. A business operating the standard method must calculate the percentage of recoverable input tax at the end of each quarter. This is provisional because at the end of the year it must calculate an annual recovery percentage for the whole year and adjust for any under or over-recovery of input tax by way of an annual adjustment. This change gives businesses the option of applying the prior-year recovery percentage as an in-year provisional recovery rate and finalising the actual rate as part of the annual adjustment. The finalised annual adjustment sets the provisional recovery rate for the next year and so on. The provisional recovery of input tax

using the prior-year recovery percentage becomes the default position, with use of a quarterly recovery percentage the option (there is no requirement to notify HMRC).

10. HMRC estimates that of the 120,000 businesses that operate the standard method, around 20,000 will benefit (the remaining 100,000 potentially benefit from an annual de minimis test which is under consideration for Budget 2010). Of the 20,000, it is estimated that around 75% will elect to use the prior-year recovery percentage. Based on operational experience it is estimated this would save the average business around 15% of the time taken to carry out its partial exemption calculations for each of its quarterly VAT returns. Based on this assumption, the standard cost model indicates this could deliver admin burden savings on each of the quarterly VAT returns giving a cumulative total saving of around £200,000 per year.

11. Based on operational experience, it is estimated that around 50 businesses a year would no longer need to seek approval of a special method to use the prior-year recovery percentage as an in-year provisional recovery rate. The standard cost model estimates the average cost to a business of seeking approval of a special method is between £3,000 and £9,000, although as many of the businesses that would benefit would be smaller-sized, the average cost is likely to be at the lower end of this range. Implementation of this idea could therefore result in an estimated annual compliance cost saving of between £200,000 and £300,000 per year.

Change B: Early annual adjustment

12. The partial exemption rules require a business to account for its standard method annual adjustment in the first quarter following the end of the year as the default. This change saves the need for a separate fifth calculation by giving businesses the option (without notifying HMRC) of carrying out the annual adjustment calculation in the final quarter of the year.

13. Of the 20,000 businesses that could potentially benefit (the remaining 100,000 potentially benefiting from annual de minimis test which is under consideration for Budget 2010), it is estimated that around 50% might take up the option of an early annual adjustment. Again based on operational experience, it is estimated this could save the average business around 15% of the time taken to carry out its partial exemption calculations for one of its quarterly VAT returns each year. Based on this assumption and the standard cost model, this could deliver admin burdens savings of between £25,000 and £50,000 per year.

Change C: Use-based option for new partly exempt businesses

14. New partly exempt businesses are sometimes unable to carry out the normal standard method calculation, as they have not yet started trading and so have no turnover to go into the

calculation. Alternatively, the calculation may produce an unfair result because turnover is small or erratic. Under the old rules, a business in this position would normally have sought approval of a special method which resulted in additional costs. This change allows a new partly exempt business to select its own fair and reasonable calculation for recovering input tax, thereby removing the need to seek approval of a special method from HMRC.

15. Operational experience suggests that in an average year around 100 new partly exempt businesses (this number may be less in a period of economic downturn and greater in a period of strong economic growth), would no longer need to seek approval of a special method each year. The standard cost model estimates the average cost to a business of seeking approval of a special method is between £3,000 and £9,000, although this change would mainly benefit smaller-sized businesses, so the average cost is likely to be at the lower end of this range. Implementation could therefore result in an annual compliance cost saving of between £350,000 and £450,000 per year.

Change D: Widening the scope of the standard method

16. Under the old rules, the standard method only catered for input tax on taxable supplies made in the UK and excluded certain overseas supplies. These included supplies of finance and insurance to customers outside the EU and also supplies to customers outside the UK that would have been taxable had they been supplied to customers within the UK such as legal, accounting and consultancy services. They were excluded as they could potentially distort the standard method calculation and to reduce this risk, businesses were required to deal with the input tax on such supplies in a separate calculation or, alternatively, seeking approval of a special method. This change reduces the costs of having to perform separate calculations and seeking approval of a special method by including certain overseas supplies within the standard method, where there is a minimal risk of distortion.

17. Based on operational experience, it is estimated that around 100 businesses that make overseas supplies will no longer need to seek approval of a special method each year. The standard cost model estimates that the average cost to a business of seeking approval of a special method is between £3000 and £9,000. Given that many of the businesses that would potentially benefit from this change would be smaller and medium sized, it has been estimated that the average cost per businesses would be around £5,000. Implementation of this idea could therefore result in an estimated annual compliance saving of around £500,000 per year.

Summary of Admin Burden and Compliance cost savings

| | Estimated Annual Admin Burden savings | Estimated Annual Compliance cost savings |
|---|---|---|
| Change A | 200,000 | 200,000 -300,000 |
| Change B | 25,000-50,000 | |
| Change C | | 350,000-450,000 |
| Change D | | 500,000 |
| Total | 225,000-250,000 | 1,050,000-1,250,000 |

***One-off compliance costs***

18. There will be some one-off compliance costs associated with these changes as affected businesses will need to familiarise themselves with any changes. It is estimated that, of the 120,000 partly exempt businesses, around 20,000 will require an average of around 2 hours familiarisation time as they might be affected to a greater extent. It is estimated that the remaining 100,000 businesses would be less affected and only require half-an-hour familiarisation time. Based on an average hourly rate from the standard cost model, this will lead to a one-off compliance cost of around £1.5 million.

***Overall position***

19. Based on the analysis above, it is estimated that the ideas in option 1 could result in a one-off compliance cost of around £1.5m, annual administrative savings of around £250,000 and annual compliance cost savings of around £1.2m. It should be noted that the average annual benefit figure has increased from the £1 million shown in the consultation stage impact assessment to £1.5 million (see page 2). This is due to an estimated increase in benefits resulting from Change A: In-year provisional recovery, which becomes the default position; and Change C: Use-based option for new partly exempt businesses, which can now be applied by existing taxable businesses as well as those in a start-up position. It is also due in part to the estimated admin burden saving figure being omitted from the previous total in error.

**Option 2: Do nothing**

20. The cost to businesses of operating the standard method would remain the same.

**Sectors affected**

21. Changes to simplify the standard method would potentially affect around 120,000 mainly smaller-sized businesses including those operating in the financial services sector, property companies, educational organisations, charities, gaming operators and undertakers.

**Impact on HMRC**

22. These changes will result in some minor savings for HMRC, mainly from a reduction in time spent checking calculations on assurance visits and a reduction in the number of special methods to approve.

**Implementation**

23. The changes take effect from 1 April 2009.

**Impact tests**

24. Consultation with small businesses and their representatives has confirmed that small businesses will benefit from these changes and there should be no adverse impact.

25. These changes do not impact on Race Equality, Disability Equality, Gender Equality or Human Rights. There is no impact on Competition, Legal Aid, Health or the Environment.

# Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

**Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.**

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

# Annexes

**A brief outline of the Standard Cost Model**

The 'Standard Cost Model' (SCM) has been used to derive an estimate of the costs to business of complying with HMRC obligations in this area to disclose information to HMRC or to third parties. The SCM considers which activities a business has to undertake to comply with HMRC obligations and requirements, how many businesses have to comply, and how often they need to comply. The SCM considers the burdens which apply to different sizes of business and by whether they outsource their compliance activities. It also differentiates between businesses which use e-solutions and those which do not.

The SCM estimates the costs of using agents and other external providers; the costs of undertaking work in-house, using a pre-defined set of activities; and the costs of actually transmitting the information. The SCM does not consider one-off costs or transitional costs of a change in policy. The SCM does not consider costs which a business would have incurred anyway had the relevant HMRC obligation or requirement not existed. It considers the costs which apply to a normally efficient business. The SCM does not consider any wider compliance cost issues, such as the costs of business uncertainty or cash flow costs. The SCM figures are based on wage rates, prices and populations which existed in May 2005.