

EXPLANATORY MEMORANDUM TO
THE VALUE ADDED TAX (AMENDMENT) (NO. 4) REGULATIONS 2010
2010 No. 3022

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. It contains information for the Select Committee on Statutory Instruments.

2. **Purpose of the instrument**

2.1 This instrument amends the Value Added Tax Regulations 1995 (SI 1995/2518) (“the Principal Regulations”).

Regulations 3 and 4

2.2 Regulation 3 amends regulation 86 to add a reference to “other cooling” to the title and to the description of supplies which fall within paragraph (1)(d) of that regulation. Regulation 4 makes a corresponding amendment to the title of regulation 87.

2.3 These changes are a consequence of an amendment made to paragraph 3 of Schedule 4 to the Value Added Tax Act 1994 (c. 23) (“VATA”) by section 20 of the Finance (No. 3) Act 2010 (c. 33) (“the Finance Act”) to implement provisions of Council Directive 2009/162/EU (“the Technical Directive”).

Regulations 5 to 15

2.4 These regulations amend the VAT partial exemption (PE) and the capital goods scheme (CGS) regulations to give effect to provisions of the Technical Directive and make some other ancillary changes. They: (1) widen the scope of the CGS to include VAT relating to non-business activities, cater for subsequent changes in business use of assets and include ships and aircraft costing £50,000 or more; (2) widen the “clawback/payback” rules to include non-business VAT and cater for changes in business use to ensure consistency with the wider CGS; (3) introduce an option for taxpayers to seek approval of a combined business non-business PE method to calculate deductible VAT on costs; (4) simplify, update and clarify the CGS rules; and (5) legislate for a concession linked to the option to tax for CGS items acquired more than 3 years before VAT registration.

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

3.1 This instrument breaches the 21 day rule. The changes need to come into force on 1 January 2011 but depend upon certain provisions in the Finance Act which did not receive Royal Assent until 16 December 2010. It has been made and laid as soon as possible after that date.

Regulations 3 and 4

3.2 Paragraph 3 of Schedule 4 VATA provides that supplies of certain intangible commodities (such as gas, electricity, ventilation etc) are to be treated as supplies of goods. The normal time of supply rules applicable to tangible goods are not effective in determining the time of supply of intangible goods because they rely on being able to identify the point in time at which goods which are the subject of a supply are physically removed or made available, the presumption being that this will be a precise and finite event in time and space. Special time of supply rules are therefore applied to supplies of intangible goods by regulation 86 of the Principal Regulations. Regulation 87 makes similar provision in relation to acquisitions from another EU Member State.

3.3 Section 20 of the Finance Act amends paragraph 3 of Schedule 4 VATA so that the supply of cooling, in so far as it does not already amount to refrigeration (which is already treated as a supply of goods) and so falls to be treated as a supply of services, will, from 1 January 2011, be treated as a supply of goods. This amendment is necessary to implement a provision of the Technical Directive.

3.4 As a supply of cooling may cease to be subject to the time of supply rules applicable to services with effect from 1 January 2011, it needs to be made subject to the special rules governing supplies of intangible commodities with effect from that date, to avoid there being a period of time when it would be subject to the normal supply of goods rules with the result that there would be difficulties for suppliers in establishing a tax point.

Regulations 5 to 15

3.5 The changes implement provisions in the Technical Directive which Member States are required to implement by 1 January 2011. The vires for some of the changes is contained in section 24(6)(e) VATA which has been inserted by paragraph 1(5) of Schedule 8 to the Finance Act.

4. Legislative Context

4.1 This instrument amends the Principal Regulations.

Regulations 5 to 15

4.2 A transposition note dealing with the transposition of Article 168a of the Council Directive 2006/112/EC (inserted by the Technical Directive) is attached to this memorandum.

5. Territorial Extent and Application

This instrument applies to the whole of the United Kingdom.

6. European Convention on Human Rights

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

7. Policy background

Regulations 3 and 4

7.1 Supplies of natural gas and electricity are treated as supplies of goods for the purposes of VAT. However, their intangible nature makes it difficult to apply some of the normal VAT rules and so they are subject to special arrangements.

7.2 The Technical Directive corrects unintended restrictions in the scope of the existing arrangements (in so far as they apply to natural gas). It also makes other technical changes to adjust the scope of the rules including extending the application of the special arrangements to supplies of heat and cooling, which involves better defining the latter's treatment as goods.

7.3 This requires a consequential amendment to regulations 86 and 87 of the Principal Regulations which provide the time of supply and time of acquisition for the categories of goods that include cooling.

Regulations 5 to 15

7.4 Where a business incurs VAT on an asset, such as a yacht or an aircraft, which it intends using partly for private purposes, it currently has the option of recovering only the proportion of VAT relating to its intended business use. Alternatively, it would apply what is called Lennartz accounting, a mechanism that enables it to recover all of the VAT on the asset upfront and then pay VAT based on the actual private use for a period of up to 10 years - this may confer a cash-flow benefit as the VAT is recovered in full (subject to any restriction for exempt supplies) and is effectively repaid to the Exchequer over a number of years.

7.5 It was announced in the June Budget 2010 that primary legislation would be included in the Autumn Finance Bill to implement the part of the Technical Directive which, for certain assets, permits VAT to be recovered only on the business use element from 1 January 2011. This will prevent Lennartz accounting being used for land and property, ships and aircraft, thereby removing any cash-flow advantage described above.

7.6 Instead, Member States are required to introduce an adjustment mechanism that caters for changes in business use of these assets. This helps to ensure a fair recovery of VAT over their economic life. The UK currently operates an adjustment mechanism called the CGS which adjusts VAT recovery on assets with both taxable and exempt use. This will be widened to include VAT on assets relating to non-business activities and to deal with changes in business use of assets, thereby incorporating the required adjustment mechanism.

7.7 In addition, in June 2008 HMRC consulted on a number of changes to simplify the PE and CGS rules. HMRC is now in the final phase of this programme, which focuses on simplifying and improving the CGS and the introduction of a combined business non-business PE method. Given the overlap with the changes required under the Technical Directive, these pieces of work have been taken forward together and a number of additional changes are being made to simplify and improve the CGS.

Consolidation

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

8. Consultation outcome

Regulations 3 and 4

8.1 These changes are expected to have little, if any, impact in the UK and have not been subject to consultation.

Regulations 5 to 15

8.2 These changes have been consulted on and are generally supported by business.

9. Guidance

Regulations 3 and 4

9.1 As the changes are minor and technical in nature and are not expected to have any practical effect on UK businesses, no specific guidance is being issued.

Regulations 5 to 15

9.2 Guidance will be published before the changes take effect.

10. Impact

Regulations 3 and 4

10.1 An Impact Assessment has not been produced as these changes have no impact on business, charities or voluntary bodies.

Regulations 5 to 15

10.2 A full Impact Assessment of the effect that these changes will have on the costs of business and the voluntary sector is attached to this memorandum and can be found at <http://www.hmrc.gov.uk>.

11. Regulating small business

Regulations 3 and 4

11.1 The changes will have no impact on small businesses.

Regulations 5 to 15

11.2 The changes will impact on some small businesses, but will help to simplify the rules and ensure a fair recovery of VAT.

12. Monitoring & review

Regulations 3 and 4

12.1 As the changes are technical and will have little, if any, impact, no formal monitoring is planned.

Regulations 5 to 15

12.2 These changes will be reviewed within 3 years of implementation.

13. Contact

Regulations 3 and 4

13.1 Phil Bryant at HMRC Tel: 0207 147 0067 or email: phil.bryant@hmrc.gsi.gov.uk can answer any queries.

Regulations 5 to 15

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

ANNEX

TRANSPOSITION NOTE

The implementation of Article 168(a) of Council Directive 2006/112/EC as amended by Council Directive 2009/162/EU

Implementing clause and instrument:-

Schedule 8 to the Finance (No. 3) Act 2010

The Value Added Tax (Amendment) (No. 4) Regulations 2010 (SI 2010 No. 3022)

Council Directive 2006/112/EC of 28 November 2006 (OJ No L347, 11.12.06, p 1) (“the Principal VAT Directive”) on the common system of VAT provides the framework governing the harmonization of the laws of Member States relating to VAT. The Principal VAT Directive is implemented in the UK by the Value Added Tax Act 1994 (c.23) (“the Act”) and various statutory instruments.

Under existing arrangements, VAT on assets such as land and property, ships and aircraft is recoverable upfront on both business (subject to any restriction in relation to exempt supplies) and private use of the asset. VAT is then payable in subsequent years in respect of the private use of the asset. This is known as Lennartz accounting and provides taxpayers with a cash-flow benefit.

From 15 January 2010 the Principal VAT Directive is amended by Council Directive 2009/162/EU (OJ No L10, 15.01.10, p 14) (“the Technical Directive”). The Technical Directive amendments include changes that limit VAT recovery on expenditure relating to land and property to business use. They also permit Member States to apply this treatment to other assets and, as announced on 24 March 2010 and confirmed on 22 June 2010, the UK will similarly limit VAT recovery on expenditure relating to ships and aircraft to business use. The Technical Directive requires Member States to implement an adjustment mechanism to cater for changes in business use of these assets (“relevant assets”) and the UK is implementing this requirement by widening the scope of the existing Capital Goods Scheme (“CGS”) which is contained in the Value Added Tax Regulations 1995 (SI 1995/2518) (“the VAT Regulations”). These changes take effect from 1 January 2011.

The amended provisions of the Principal VAT Directive which govern the VAT deduction rules are transposed by the implementing clause and instrument listed above as follows:-

Amended Articles Dir. 2006/112	Objectives	Implementation
Introduction of Article 168(a)	<p>To limit VAT recovery on relevant assets to business use.</p> <p>To implement an adjustment mechanism to cater for changes in the business use of relevant assets.</p>	<p>Paragraph 3 of Schedule 8 to the Finance (No. 3) Act 2010 introduces a new paragraph 4A into Schedule 4 to the Act which removes the deemed taxable supply of services that would otherwise arise under that Schedule in relation to the private use of relevant assets. This limits VAT recovery to taxable business use in accordance with Articles 167, 168, 169 and 173 of the Principal VAT Directive as required by Article 168(a)(1) and provided for in Article 168(a)(2).</p> <p>Paragraph 1 of Schedule 8 to the Finance (No. 3) Act 2010 makes provision for treating VAT relating to non-business activities as input tax for the purposes of regulations made under section 26 of the Act. These include Part XV of the VAT Regulations – the CGS – which</p>

		<p>implements Articles 184 to 192 of the Principal VAT Directive into UK law.</p> <p>Regulations 5 to 15 of the Value Added Tax (Amendment) (No. 4) Regulations 2010 widen the scope of the CGS to include ships and aircraft, include non-business VAT and to cater for changes in business use of relevant assets as required by Article 168(a)(1).</p>
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