EXPLANATORY MEMORANDUM TO

THE VALUE ADDED TAX (AMENDMENT) REGULATIONS 2010

2010 No. 559

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

2.1 Regulation 3 corrects a drafting error.

2.2 Regulations 4 to 9 implement two changes that simplify the de minimis rules and reduce administrative burdens on businesses. The first change simplifies the calculations and saves some businesses the need to carry out detailed partial exemption calculations to confirm whether they qualify as de minimis (and can therefore deduct input tax on costs relating to exempt supplies). The second change allows businesses to apply the de minimis test annually rather than for each VAT return (normally quarterly), thereby reducing the number calculations required each year.

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

Regulation 3 corrects a drafting error reported by the Select Committee on Statutory Instruments in its second report of Session 2009/10. The reported instrument is S.I. 2009/2978 (regulation 4 of which inserted the new regulation 25A into Value Added Tax Regulations 1995 S.I.1995/2518 ("the Principal Regulations")).

4. Legislative Context

4.1 The instrument amends the Principal Regulations.

4.2 Regulation 3 corrects a drafting error in regulation 25A of the Principal Regulations and provides consistent terminology.

4.3 Regulations 4 to 9 implement changes required to the de minimis provisions following a consultation announced at Budget 2008. This consultation provided strong support for implementing these changes to reduce administrative burdens on 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

Regulation 3

7.1 Clarification is required as to the meaning of regulation 25A(12) of the Principal Regulations. The policy intention is that, where a return is made using an electronic return system, there is a presumption that the relevant electronic validation process will record the making of the return successfully and the time it is made accurately. However, this presumption is subject to the possibility of the contrary being proved in either case. Regulation 3 makes this clear on the face of the legislation and provides for consistent terminology.

Regulations 4 to 9

7.2 Businesses can recover input tax on costs relating to taxable supplies but cannot normally recover input tax relating to exempt supplies, unless it is deemed insignificant under the de minimis rules. The purpose of the de minimis provisions is to save the need for businesses to account for insignificant amounts of input tax on costs relating to exempt supplies. Currently, businesses are required to perform a full partial exemption calculation to determine how much input tax they have incurred relating to exempt supplies. Businesses can deduct this input tax if it is no more than £7,500 per annum and does not exceed 50% of total input tax.

7.3 A consultation in summer 2008 confirmed strong support for two changes to simplify the de minimis rules to reduce administrative burdens on businesses.

7.4 The simplified test saves businesses that benefit the need to carry out a full partial exemption calculation to determine whether they qualify as de minimis, thereby saving time and reducing administrative burdens. The simplified test supplements the existing test, which is retained to ensure businesses that currently benefit from the de minimis rules continue to do so.

7.5 The annual test allows businesses (in specified circumstances) to apply the de minimis test annually rather than quarterly, thereby reducing the number of calculations from five to one a year. It allows businesses that are de minimis in one year to provisionally treat themselves as de minimis in the following year, subject to an end-of-year review. If a business fails the test at year-end it would be required to repay input tax relating to exempt supplies (that it had provisionally treated as deductible under the de minimis rules) as part of an annual adjustment.

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

8. Consultation outcome

Regulation 3

8.1 There has been no consultation in relation to these changes.

Regulations 4 to 9

8.2 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. In addition, HMRC held a number of technical meetings to discuss the simplification ideas in more detail and has discussed and developed these ideas in partnership with a specially formed consultative group comprising professional advisers and representatives.

9. Guidance

Regulation 3

9.1 No additional guidance is required as the changes reflect existing HMRC policy.

Regulations 4 to 9

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

10. Impact

10.1 The changes effected by this instrument should benefit business, charities and voluntary bodies.

10.2 There is no impact on the public sector.

10.3 No Impact Assessment has been prepared in relation to the changes effected by regulation 3.

10.4 An Impact Assessment of the effect that the changes made by regulations 4 to 9 will have on the costs of business and the voluntary sector is attached to this memorandum and is available alongside this instrument on the OPSI website.

11. Regulating small business

Regulation 3

11.1 Regulation 3 applies to small businesses and should benefit them by clarifying the legislation.

Regulations 4 to 9

11.2 Regulations 4 to 9 apply to small businesses and will benefit them by reducing administrative burdens.

12. Monitoring & review

Regulation 3

12.1 No formal monitoring is planned.

Regulations 4 to 9

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

13. Contact

13.1 Paul Kinsey at HMRC Tel: 0151 703 8558 or email: paul.kinsey@hmrc.gsi.gov.uk can answer any queries regarding regulation 3 of this instrument.

13.2 Patrick Wilson at HMRC Tel: 0207 147 0595 or email: patrick.wilson@hmrc.gsi.gov.uk can answer any queries regarding regulations 4 to 9 of this instrument.

Summary: Intervention & Options

Department /Agency:	Title:	
HM Revenue and Customs	**Impact Assessment of 2 changes to simplify the VAT partial exemption de minimis rules**	
Stage: Implementation	**Version:** 1	**Date: 15/02/2010**

Related Publications: Simplifying the VAT Partial Exemption and Capital Goods Scheme Rules - Summary of Responses January 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 relating to 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 this should be done over a 3-year period. This impact assessment focuses on the implementation of 2 changes to simplify the de minimis rules, which build on the changes to simplify the standard method that were implemented in April 2009.

What are the policy objectives and the intended effects?

The de minimis rules are designed to save small businesses the need to account for insignificant amounts of VAT on costs that relate to exempt supplies. Currently, a business is required to perform a full partial exemption calculation to determine whether it has incurred an insignificant amount of VAT relating to exempt supplies. The objective is to simplify the rules by reducing the time spent on calculations, thereby reducing administrative burdens for the vast majority of affected businesses. The changes have no adverse impact on the amount of VAT that businesses can recover on their costs.

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

1. (a) Annual test, and
   (b) Simplified tests;
2. Raise the de minimis limit;
3. Do nothing.

Option 1 is preferred as it simplifies the rules and reduces administrative burdens for the vast majority of the de minimis population, without significant downside.

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 implementation Impact 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: 15 February 2010

Summary: Analysis & Evidence

Policy Option: 1	Description: Annual test and simplified tests

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		
£ 2.1 million	1		
Average Annual Cost (excluding one-off)			
£ Neg		Total Cost (PV)	£ 2.1m one-off

Other **key non-monetised costs** by 'main affected groups' None.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' Businesses will benefit from fewer and simpler calculations which will save them time.	
One-off	Yrs		
£ Neg	1		
Average Annual Benefit (excluding one-off)			
£ 3.8 million	5	Total Benefit (PV)	£ 17.8m

Other **key non-monetised benefits** by 'main affected groups' None.

Key Assumptions/Sensitivities/Risks This option would benefit at least 125,000 small businesses that benefit from the de minimis rules. The ongoing yearly benefits balance the one-off, upfront costs of this change within one year.

Price Base Year 2010	Time Period Years 5	**Net Benefit Range** (NPV) £	**NET BENEFIT** (NPV Best estimate) **£ 15.7m**

What is the geographic coverage of the policy/option?			United Kingdom	
On what date will the policy be implemented?			1 April 2010	
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?			N/A	
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 N/A	Small N/A	Medium N/A	Large N/A
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 £ 2.8million	**Net Impact**	£ -2.8million

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

Evidence Base (for summary sheets)

Objective

1. To simplify the partial exemption de minimis rules to reduce administrative burdens on businesses.

Background

2. A business can recover VAT on costs (input tax) relating to taxable supplies, but cannot normally recover input tax relating to exempt supplies (unless it is de minimis). There are at least 175,000 partly exempt businesses (see par. 7) 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 their taxable supplies.

3. Of the 175,000 partly exempt businesses there are at least 125,000 small businesses that incur insignificant amounts of input tax relating to exempt supplies and can deduct this input tax under the de minimis rules. The remaining 50,000 are required to restrict input tax relating to exempt supplies.

4. In summer 2008, HMRC consulted on ideas to simplify the partial exemption rules to reduce administrative burdens on businesses. The consultation focused 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 non-business method – further details can be found in the consultation document dated June 2008 entitled: “Simplifying the VAT Partial Exemption and Capital Goods Scheme Rules”.

5. Responses to the consultation confirmed that the vast majority of partly exempt businesses would benefit from simpler rules and a reduction in administrative burdens if the ideas were implemented. Overall, respondents felt that it was sensible to develop and implement the ideas in phases over a 3-year period. The first phase was completed with the implementation of a package of 4 changes to simplify the standard method - further details can be found in “Impact Assessment of package of 4 changes to simplify the VAT partial exemption standard method” dated 23 March 2009.

6. This impact assessment examines the benefits and costs of implementing 2 changes to simplify the de minimis rules, which build on the simplification of the standard method and further reduce administrative burdens on businesses. The changes were strongly supported by respondents to the consultation.

Affected population

7. It had previously been our assumption that there are around 140,000 partly exempt VAT registrations of which around 100,000 are treated as being de minimis. Recent analysis has however indicated that this assumption is now out of date and that there are now between 175,000 and 200,000 partly exempt VAT registrations of which between 125,000 and 160,000 are treated as de minimis. It is therefore tentatively estimated that up to 125,000 businesses will potentially benefit from these changes.

8. For the purpose of calculating the admin burdens savings from this measure we have therefore assumed that there are around 125,000 de minimis businesses.

Benefits and costs

Option 1: (a) Annual test, and

(b) Simplified tests

9. The purpose of the de minimis rules is to save small businesses that incur insignificant amounts of input tax relating to exempt supplies from having to carry out detailed partial exemption calculations, by allowing this input tax to be recovered in full. The rules are derived from EU law and benefit at least 125,000 small businesses each year. Option 1 is to implement the following 2 changes:

(a) Annual test (the option to apply the de minimis test on an annual rather than quarterly basis); and

(b) Simplified tests (to help save the need for the smallest de minimis businesses from having to carry out a full partial exemption calculation).

Annual benefits

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

<u>Change (a): Annual test</u>

11. Under the previous rules, a business was required to carry out the de minimis test at the end of each quarter. If it passed the test, it could recover all of its input tax on costs relating to exempt supplies. However, this was provisional because it was required to confirm its de minimis status at year-end and account for any under or over-recovery of input tax by way of an annual adjustment.

12. The annual test allows a business to apply the test on an annual rather than quarterly basis thereby reducing the number of calculations from five to one a year. If a business passes the de minimis test in a given year it could provisionally treat itself as de minimis in each quarter of the following year, subject to a cap of £1m input tax per annum to minimise the risk of larger businesses seeking an unfair cash-flow advantage. There will be no requirement to notify HMRC. If a business does not pass the test in a given year then it is required to carry out quarterly calculations in the normal way. In both scenarios, the business is still required to

review its de minimis status at year-end and account for any under or over-recovery of input tax as part of its annual adjustment.

13. Not all de minimis businesses will be eligible to carry out the annual test and some may choose not to do so. Those that will not carry out the annual test will fall into one of the following 3 categories:

(a) They are not eligible as they expect their total input tax to exceed £1m per year. From analysis carried out on the identifiable partly exempt population it is tentatively estimated that around 5% of de minimis businesses have annual input tax of more than £1m.

(b) They are not eligible as they are newly registered. New VAT registrations currently account for around 10% of the total trader population.

(c) Those hovering just below the de minimis limit may prefer to do the calculations quarterly to avoid having to make unexpected payments to HMRC at year-end. This would arise if they could provisionally treat themselves as de minimis during the year – and so claim back all of their input tax on exempt supplies – but then failed the test at year-end and were required to repay input tax to HMRC. From analysis carried out on the identifiable partly exempt population it is tentatively estimated that around 5% of de minimis businesses have annual exempt input tax of between £6,000 and £7,500 (there may be an element of double counting here with those businesses that have total input tax of more than £1m but to be cautious we have ignored this).

14. On this basis we have tentatively estimated that around 80% (around 100,000) of de minimis businesses will opt for the annual test.

15. This will result in a total saving to businesses of complying with the de minimis rules of around £3.6m per year at 2010 prices.

16. In terms of administrative burdens (see note below), the Standard Cost Model (SCM) is based on the previous population estimate of 100,000 de minimis businesses. Therefore, the total admin burden saving to businesses from applying the annual test comes to £2.6m per year at 2005 prices.

Note 1: HMRC is subject to quantified targets to reduce one aspect of compliance costs in particular, the admin burden on businesses of disclosing information to HMRC or to third parties. This burden is assessed through the SCM, an activity-based costing model which identifies what activities a business has to do to comply with HMRC's obligations, and which estimates the cost of these activities, including agent fees and software costs.

Change (b): Simplified tests

17. A business that incurs no more than £7,500 of input tax on costs relating to exempt supplies can treat itself as de minimis and recover all of its input tax (with the proviso that input tax relating to exempt supplies is no more than 50% of total input tax) . This requires a business to carry out a full partial exemption calculation in order to quantify the amount of input tax relating to exempt supplies.

18. This change introduces two additional simplified tests that save businesses that qualify the need to carry out a full partial exemption calculation to establish their de minimis status. A business can treat itself as de minimis if it passes either of the following tests:

Test 1: Total input tax is no more than £7,500 and the value of exempt supplies does not exceed 50% of the value of all supplies, or

Test 2: (Total input tax minus input tax that relates exclusively to taxable supplies) is no more than £7,500 and the value of exempt supplies does not exceed 50% of the value of all supplies.

Note 2: the 50% condition is necessary to deter predominantly exempt businesses from registering for VAT just to reclaim input tax relating to exempt supplies but applies to turnover rather than input tax.

19. From analysis of the current identifiable de minimis trader population it has been tentatively estimated that around 40% (50,000) of the total de minimis population will be able to apply the new simplified tests as opposed to the current and more time consuming test. As it is likely that these businesses will also choose to carry out the calculation annually rather than quarterly this means that any additional admin burden savings will only relate to one calculation per year.

20. Based on operational experience it has been tentatively estimated that the new tests will take on average around 50% of the time taken to carry out the existing test.

21. On this basis it has been tentatively estimated that the introduction of a new simplified de minimis test will give a total saving to businesses of just over £225,000 per year at 2010 prices.

22. This is equivalent to an admin burden saving of £150,000 at 2005 prices using the SCM population.

Summary of admin burden saving:

	Saving at 2010 prices with revised assumptions (£)	Saving at 2005 prices against baseline target (£)
Annual test	3,600,000	2,600,000
Simplified tests	225,000	150,000
Total	3,825,000	2,750,000

One-off compliance costs

23. There will be some one-off compliance costs as affected businesses will need to familiarise themselves with the changes.

<u>Change (a): Annual test</u>

24. The SCM distinguishes between businesses that prepare their own VAT returns and those that outsource. It is estimated that of those de minimis businesses that prepare their own VAT returns, around 60% (75,000) of the total will require on average around half an hour to familiarise themselves with the introduction of the annual test. To be consistent with the SCM we have assumed an average hourly rate of £21.73 and this leads to a one-off compliance cost of just over £800,000.

25. The remaining 40% (50,000) that outsource the preparation of their VAT returns will rely on their tax adviser familiarising themselves with the change. Given that individual tax advisers will act on behalf of numerous de minimis businesses we estimate that around 2,000 advisers will require an average of around half an hour to familiarise themselves with the introduction of the annual test. To be consistent with the SCM we have assumed an average hourly rate of £21.73 and this leads to a one-off compliance cost of just over £20,000.

26. This gives a total estimated one-off compliance cost for the annual test of just under £850,000.

<u>Change (b): Simplified tests</u>

27. Similarly those de minimis businesses that prepare their own VAT returns will need to familiarise themselves with the simplified tests. It is estimated that around a half of these will very quickly establish that they are not eligible to use the new simplified tests and will therefore only require on average half an hour of familiarisation time. It is estimated that the remaining businesses will require on average around an hour familiarisation time. To be consistent with the SCM we have assumed an average hourly rate of £21.73 and this leads to a one-off compliance cost of just over £1.2m.

28. The remaining businesses that outsource the preparation of their VAT returns will rely on their tax adviser familiarising themselves with the change. Again, given that individual tax advisers will act on behalf of numerous de minimis businesses we estimate that around 2,000 advisers will require on average around an hour to familiarise themselves with the introduction of the annual test. To be consistent with the SCM we have assumed an average hourly rate of £21.73 and this leads to a one-off compliance cost of just over £40,000.

29. This gives a total estimated one-off compliance cost for the simplified tests of just over £1.25m.

Overall position

30. Based on the analysis above it is estimated that the implementation of option 1 could result in a one-off compliance cost of around £2.1m and annual administrative savings of around £3.8m.

Option 2: Raise the de minimis limit

31. HMRC also consulted on raising the de minimis limit above the current £7,500 to keep pace with inflation. The idea was that additional businesses (that exceed the limit of £7,500) would qualify as de minimis. While we are keen to do everything possible to help small businesses, it was necessary consider that:

- the UK has the highest limit of all member states, which typically set the limit at nil or a few hundred Euros per annum;
- although raising the limit in line with inflation to around £12,000 could benefit up to 30,000 businesses, it would cost the Exchequer around £250m per annum;
- the purpose of the de minimis limit is to ease administrative burdens on businesses: they are not a tax allowance and so the case for linking them to inflation is not clear cut; and
- at least 125,000 businesses currently benefit from the de minimis rules and most should benefit from simpler and less time-consuming calculations as a result of the changes in Option 1.

Taking account of these issues, it was decided not to raise the limit on this occasion although this will be kept under review.

Option 3: Do nothing

32. The cost to businesses of applying the de minimis rules would remain the same.

Sectors affected

33. Changes to implement the annual and simplified de minimis tests potentially benefit up to 125,000 small businesses that are involved in financial services, property, education, charities, gaming and funeral services.

Impact on HMRC

34. These changes will result in some minor savings for HMRC, mainly from a reduction in time spent checking calculations.

Implementation

35. The changes take effect from 1 April 2010.

Impact tests

Competition Assessment
36. We have applied The Office of Fair Trading competition filter to these changes and concluded they have no impact on competition.

Small Firms Impact Test
37. Consultation with small businesses and their representatives has confirmed that small businesses would benefit from simpler and less time-consuming calculations, and there should be no adverse impact.

Legal Aid
38. There will be no need for new criminal sanctions or civil penalties.

Sustainable Development
39. The changes will be in accordance with principles of sustainable development.

Race Equality, Disability Equality, Gender Equality and Human Rights
40. An initial equality assessment has confirmed that the changes have no negative impacts.

Rural Issues
41. The changes will not have a significantly different effect in rural areas.
Neither will they significantly impact on Carbon Emissions, Other Environment or Health.

Specific Impact Tests: Checklist

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 businesses 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 businesses and 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.