COMPLIANCE COST REVIEW

VAT STRATEGY : INPUT TAX DEDUCTION WITHOUT A VALID VAT INVOICE

1. Introduction

1.1 Background

In line with Government commitments to reduce the compliance burdens that are placed on businesses, HM Revenue & Customs (HMRC) assesses the likely change in compliance costs whenever a policy is introduced or changed. The results of that analysis are published in a final Regulatory Impact Assessment (RIA) when the associated legislation is laid before Parliament. Where a consultation document is published during the analysis period, it is accompanied by a partial RIA.

This document summarises the outcome of a post-implementation review of the final RIA that was published in August 2003 for the above-mentioned measure by HM Customs & Excise (HMCE) prior to creation of HMRC. The measure was implemented with effect from 16th April 2003. A copy of the published final RIA is attached.

This review re-assesses the compliance cost analysis published in the original RIA and addresses two main questions:

- whether the estimates of compliance costs used in the RIA were correct, with hindsight; and
- whether the processes used to estimate compliance costs were appropriate and reasonable, given the circumstances at the time.

HMRC intend to use this review to improve the RIA process, and also to assist in future policy development and evaluation work in general. As such, the emphasis is on identifying learning points for future assessment of compliance costs. The review does not revisit the original policy decision.

2. The published RIA

2.1 Description of the policy change

On 16 April 2003, the Government changed its regulations in respect of claims for input tax. The changes were made to address the increasing problem of invalid invoices and were part of the Government’s strategy to address fraud, avoidance and non-compliance in the VAT system. The change was targeted to address business sectors where the use of invalid invoices had become prevalent. These were computers, telephones, alcohol products and oils held out as road fuel.

In essence, the change permitted HMCE to request further information, not just documents, where a taxpayer made a claim for input tax supported by an invalid invoice. In circumstances where the taxpayer could not return to their supplier and get a valid VAT invoice, they had to demonstrate to HMCE that they had taken reasonable commercial steps to ensure their supplier and supply were *bona fide.* This requirement was a proportionate response to concerns that some businesses were buying goods, often at reduced prices, from new suppliers who were involved in VAT fraud.

Consultation with businesses in the affected sectors had revealed that, for their own protection, many were already carrying out most of the suggested checks on their suppliers. This was particularly so in the mobile phones and computer sectors where trade in the high value goods had for many years been marred by fraud e.g. sale of counterfeit product, sale of stolen goods etc.

The measure is still in force today.

2.2 Anticipated compliance costs or savings

The RIA made an initial estimate of the costs to business of carrying out reasonable checks. In order to arrive at this cost, the following assumptions were made:

- Each business making the checks would need to verify up to 6 new suppliers per year.
- Around 25% of businesses within the affected trades were not recording the results of checks they already carry out.
- Recording checks already carried out would take around 12 minutes of a staff member's time per business checked.
- In general, around 12% of businesses within the affected trades would need to institute checks on the bona fides of their suppliers.
- Instituting checks in these cases would take around 1 hour of staff time per business checked.

These assumptions were based on estimates provided by HMCE's internal economists, and their validity was assured as part of consultation with business at the time. The assumptions were presented in the RIA to aid interpretation of the compliance cost figures.

HMCE estimated that the total number of businesses affected by this measure would be about 180,000. This represented approximately 10% of the total VAT register. Of those, 36,000 businesses in these sectors would need to put in place systems to carry out and record the additional checks they made about their supplies and their suppliers. HMCE estimated the overall cost to businesses in the affected sectors would be about £2.2 million per year.

Of this, £1.2 million related to the compliance costs of businesses in the alcohol sector and purchasers of oil products. The remaining £1 million related to those sectors affected by missing trader fraud, namely computers and telephones. However, these latter costs were subsumed within those arising from the complementary joint and several liability measure to tackle this type of fraud, which was also announced in Budget 2003.

3. Conduct of the review

Each compliance cost review is conducted individually, and the review process is adapted to suit the particular circumstances applying in each case. The emphasis is on making sure that the review itself - and any burden of consultation - are sufficient to meet the objectives of the review, but proportionate to the likely benefits.

In this case, to help inform the review, HMRC sent a questionnaire to selected businesses and representatives of the affected sectors, namely petrol retailers, authorised computer dealers and retailers of alcohol. The questionnaire covered how the change in legislation had affected their business but focussed on what additional costs they had incurred as a result of the change and whether the RIA assumptions about compliance costs were reasonable.

HMRC's Input Tax policy team led the review and was responsible for consulting the stakeholders.

4. Were the original estimates of compliance costs accurate?

This section addresses two main aspects – the nature of the change in compliance costs (i.e. what did people have to do differently) and the monetary impact of that change (what did it cost or save them).

Question	**Comments**
Were the specific types of cost and benefit identified in the RIA (e.g. reading legislation, filling in forms, updating IT systems, saving time etc.) incurred?	Yes. The RIA arrived at a total time estimate for a business to carry out a check on a new supplier. This estimate incorporated all aspects of the check including carrying it out and recording the results.
Were costs/savings incurred at the expected time?	Yes. The expenses associated with carrying out checks would have been incurred at the time the checks were actually carried out. This was anticipated at the time the measure was introduced.
Were costs/savings incurred by the expected people?	Yes. The measure was targeted at businesses dealing in 4 particular groups of specified goods. It potentially had compliance cost implications on all businesses within these sectors and this

	was reflected in the original estimate. As well as businesses needing to carry out checks, the changes would also have affected those businesses being checked. This was not specifically mentioned in the RIA but the effect is minimal because most *bona fide* businesses would routinely provide appropriate paperwork or references anyway.
Were any other costs/savings, not identified in the RIA, incurred ?	There are no indications that other costs were incurred by business.
If the type of costs/savings varied from the original estimates, why was that?	Not applicable.
Could such variances have been foreseen at the time?	Not applicable.
What is the assessment now of the total value of costs and savings?	From the responses HMRC received from the consultation, it would appear that the measure has had a more limited impact than initially anticipated and compliance costs have been less than expected. Feedback from representative bodies for the two largest sectors affected by this measure (alcohol and fuel) indicated that although their members were aware of the measure, it had had little or no impact on their compliance costs. This is because most businesses within these sectors purchase their goods from well-known national or well-established local concerns and would therefore not be required to carry out any checks of new suppliers. Similarly, in the other two sectors, phones and computers , we know that many businesses already look into the bona fides of new suppliers and again, unless they are specifically involved in fraud, tend to use recognised suppliers or distributors.
If different from the original RIA, what has caused the discrepancies?	The original estimates were made for a measure which affected a relatively high number of VAT-registered businesses. Within the computers and phones sectors, HMCE knew that checks were already being carried out and that the marginal increase in compliance costs would be low. Within the larger sector of alcohol and fuels the picture was less clear. Because of this uncertainty, the RIA presented

	an estimate which erred on the side of caution (i.e. assumed a worst case with compliance costs being high). It is now clear that compliance costs were less than this assessment, partly because the worst case did not happen and partly because many businesses were already doing the types of check formalised by the legislation.
With hindsight, were the compliance cost estimates accurate?	Compliance costs were less than the RIA assessment. The identification of types of costs which would have been incurred by business was accurate. The cost estimates for carrying out these checks also appeared to have been assessed reasonably. However, with the benefit of hindsight, it would appear that the RIA over-estimated the number of businesses that were actually affected by this measure.

5. Was the process used to estimate compliance costs reasonable?

Irrespective of whether the analysis turned out to be correct, the review has considered whether the original analysis was completed in a reasonable way.

Question	Comments
Who worked on the original RIA?	The RIA was produced by HMCE's Input Tax Policy Team in consultation with internal analysts.
Was an adequate audit trail maintained?	Yes.
Was Cabinet Office and/or internal HMRC guidance on RIAs followed correctly?	Yes, all relevant guidance was followed.
How much effort was devoted to compliance cost estimation, and was that effort proportionate in the context of the policy measure?	This measure formed part of a wider package of anti-fraud measures and was subject to considerable scrutiny accordingly. HMCE were careful to ensure the views of business were reflected and arrived at a solid estimate of costs. The potential trader population affected by this measure was sizeable and legitimate businesses had expressed concern about how they would be treated under this provision. A consultation exercise ensured that HMCE's understanding of how legitimate business operated was correct and also that the

	compliance cost estimates were reasonable. In summary, although considerable time was spent on estimating compliance costs, it was proportionate to the potential impact and profile of the measure.
Were the right people (both internal and external) consulted, and were their views reflected appropriately?	Yes. HMCE consulted businesses within the affected sectors and worked closely with internal Law Enforcement policy and analytical colleagues. All views were properly reflected in the final estimates.
Did those who were consulted when the RIA was written express views on the reasonableness of the process?	No. The focus was on the policy itself and the compliance costs analysis presented in the RIA.
Have those who have been consulted now as part of this compliance cost review expressed views on the reasonableness of the process?	No – but there are no indications of there being any significant problems.
Were compliance costs estimated for all options mentioned in the RIA?	The RIA presented 3 options: the change implemented, a status quo option and a third option which was not recommended because it required a legal derogation. Full costs were provided for the main option, while the impact of doing nothing was zero.
Were compliance costs estimated separately for key groups (such as small businesses, large businesses, self-employed)?	The RIA stated that the measure would impact on all groups of businesses within the affected sectors. There was (correctly) no distinction drawn between large and small businesses, or type of business. There is nothing in more recent research to change this assessment.
Was an appropriate analytical approach used, with economists or other analysts consulted appropriately?	Yes – HMCE analysts were involved in the process and supplied cost estimates based on data available to them.
Was there sufficient time to produce a robust assessment of compliance costs?	Yes.
Were any assumptions reasonable, given the circumstances at the	Yes. Assumptions made about the checks undertaken by businesses entering into deals

time?	with new suppliers were based on HMCE's understanding of the practices of legitimate business. These assumptions were tested in the recent consultation exercise and no respondents suggested that the original assumptions were unreasonable.
Were any estimates of compliance costs caveated appropriately?	No - however on reflection it would have been appropriate to do so.
Were any risks correctly identified, addressed and explained?	Yes. There were inherent difficulties in assessing the impact of a measure where businesses were being asked only to do what a normal business would as a matter of course. In addition, although this measure was targeted at businesses involved in fraud, it had to make provision for all those potentially affected (which included legitimate businesses). Because of this, it was difficult to assess compliance costs.
Were any disagreements identified and reflected appropriately (e.g. if the figures were disputed by businesses, or if more than one set of figures was available)?	Not applicable.
Would HMRC do anything differently if the exercise were repeated, and hence could the RIA process have been improved?	In general, the review has confirmed that the basis used in estimating costs was sound and reasonable. The original RIA was produced on a worst case scenario basis. This was in line with guidance and appropriate in this case. Having opted for this approach the RIA could have caveated the estimates and/or given a figure which was based on a best case scenario to act as a balance to the overall cost estimate.

6. Learning points arising from the review

6.1 Learning points for future work in this policy area

- The review has not identified any learning points unique to the particular measure. Generic learning points are listed below.

6.2 Learning points for the RIA and compliance cost process in general

- Where analysis is uncertain, RIAs should caveat the final published figures accordingly.
- Guidance to policy-makers could be improved on how to handle and present uncertain assessments of compliance costs. In this case, the RIA presented a worst-case scenario (with high compliance costs) but a best case, or most likely case could also have been considered.
- Where a policy is specifically targeted on businesses involved in fraud, any impact on legitimate business should be clearly identified. If there are difficulties assessing the extent of the impact across those two groups, or across affected sectors, then that should be explained.
- Where policy changes require businesses to interact with other businesses (carrying out security checks in this case) then the compliance cost analysis should consider all those businesses affected, not just those initiating the contact. Guidance on how far an RIA should consider indirect effects could be usefully enhanced .

7. The way forward

Comments are invited on any aspect of this report or the wider compliance cost review programme.

The learning points are being fed into the policy development process directly if particular to one RIA or policy area. More generic recommendations are being collated across the review programme overall, and will be used to create an action plan for HMRC to take forward to improve the RIA process and development.

8. Contact points for further information

For issues relating to this particular VAT policy measure:

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For issues relating to the compliance cost review programme generally:

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ANNEX : THE PUBLISHED REGULATORY IMPACT ASSESSMENT