

## Summary: Intervention & Options

<b>Department /Agency:</b> HM Revenue and Customs	<b>Title:</b> Simplifying the VAT Partial Exemption (PE) and Capital Goods Scheme (CGS) Rules	
<b>Stage:</b> Consultation	<b>Version:</b> 1	<b>Date:</b> 23 May 2008
<b>Related Publications:</b> Consultation Document - Simplifying the VAT Partial Exemption and Capital Goods Scheme Rules		

### Available to view or download at:

<http://www.hmrc.gov.uk/>

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### 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 PE rules enable businesses to calculate how much VAT they can recover as attributable to taxable supplies. The CGS requires adjustments to VAT recovered on certain types of expenditure, mainly on land and buildings, where taxable use changes. Businesses have identified these as a priority for simplification. HMRC is therefore consulting on ideas to reduce compliance costs in these areas with a view, subject to consultation, to further development.

### What are the policy objectives and the intended effects?

The objective is to simplify the PE and CGS rules with the aim of reducing compliance costs for businesses. Most of the ideas being considered would not affect the amount of VAT that businesses can recover on their costs.

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

1. Ideas to simplify the partial exemption standard method.
2. Ideas to simplify de minimis and the combined PE Business / Non-business (BNB) method.
3. Ideas to simplify the CGS.
4. Do nothing

Options 1, 2 and 3 are preferred as they would potentially simplify the rules and reduce 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 that any idea is implemented.

### Ministerial Sign-off

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible Minister:

Jane Kennedy.....Date: 14 June 2008

## Summary: Analysis & Evidence

<b>Policy Option: 1</b>	<b>Description:</b> simplifying the standard method which is the default PE method used by around 120,000 businesses to calculate recoverable VAT on costs.
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<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups' Businesses would need to spend time familiarising themselves with any changes.
	<b>One-off</b> (Transition)	<b>Yrs</b>	
	<b>£ 1.5 million</b>		
	<b>Average Annual Cost</b> (excluding one-off)		
	<b>£ Neg</b>	<b>Total Cost (PV)</b>	<b>£ 1.5 million</b>
Other <b>key non-monetised costs</b> by 'main affected groups'			

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups' Businesses would benefit from simpler calculations which would save them time. Some would also benefit from not having to seek approval from HMRC to operate a tailor-made special method.
	<b>One-off</b>	<b>Yrs</b>	
	<b>£ Neg</b>		
	<b>Average Annual Benefit</b> (excluding one-off)		
	<b>£ 1 million</b>	<b>Total Benefit (PV)</b>	<b>£ 1 million</b>
Other <b>key non-monetised benefits</b> by 'main affected groups'			

**Key Assumptions/Sensitivities/Risks** This option would benefit up to 120,000 mainly smaller-sized businesses.

Price Base Year	Time Period Years	<b>Net Benefit Range (NPV)</b> £	<b>NET BENEFIT (NPV Best estimate)</b> £
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What is the geographic coverage of the policy/option?	United Kingdom				
On what date will the policy be implemented?	N/A				
Which organisation(s) will enforce the policy?	HMRC				
What is the total annual cost of enforcement for these organisations?	£				
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?	Yes/No				
Annual cost (£-£) per organisation (excluding one-off)	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">Micro</td> <td style="width: 25%; text-align: center;">Small</td> <td style="width: 25%; text-align: center;">Medium</td> <td style="width: 25%; text-align: center;">Large</td> </tr> </table>	Micro	Small	Medium	Large
Micro	Small	Medium	Large		
Are any of these organisations exempt?	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 25%; text-align: center;">Yes</td> <td style="width: 25%; text-align: center;">Yes</td> <td style="width: 25%; text-align: center;">N/A</td> <td style="width: 25%; text-align: center;">N/A</td> </tr> </table>	Yes	Yes	N/A	N/A
Yes	Yes	N/A	N/A		

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)		(Increase - Decrease)
Increase of £	Decrease of £ 100-200k	<b>Net Impact</b> £ 100-200k

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

## Summary: Analysis & Evidence

**Policy Option: 2**

**Description: simplifying de minimis which allows businesses to recover insignificant amounts of VAT relating to exempt supplies. BNB not included.**

<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups' Businesses would need to spend time familiarising themselves with any changes.	
	<b>One-off</b> (Transition)	<b>Yrs</b>		
	<b>£ 2.5 million</b>			
	<b>Average Annual Cost</b> (excluding one-off)			
	<b>£ Neg</b>		<b>Total Cost (PV)</b>	<b>£ 2.5 million</b>
Other <b>key non-monetised costs</b> by 'main affected groups'				

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups' Businesses would benefit from simpler annual calculations which would save them time.	
	<b>One-off</b>	<b>Yrs</b>		
	<b>£ Neg</b>			
	<b>Average Annual Benefit</b> (excluding one-off)			
	<b>£ 3-4 million</b>		<b>Total Benefit (PV)</b>	<b>£ 3-4 million</b>
Other <b>key non-monetised benefits</b> by 'main affected groups'				

**Key Assumptions/Sensitivities/Risks** Simplifying the de minimis provisions would benefit up to 100,000 mainly smaller-sized businesses. There would be an associated cost to the Exchequer of raising the limit which will be quantified in the light of the responses to the consultation.

Price Base Year	Time Period Years	<b>Net Benefit Range (NPV)</b> £	<b>NET BENEFIT (NPV Best estimate)</b> £
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What is the geographic coverage of the policy/option?			United Kingdom		
On what date will the policy be implemented?			N/A		
Which organisation(s) will enforce the policy?			HMRC		
What is the total annual cost of enforcement for these organisations?			£		
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?			Yes/No		
Annual cost (£-£) per organisation (excluding one-off)		Micro	Small	Medium	Large
Are any of these organisations exempt?		Yes	Yes	N/A	N/A

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)			(Increase - Decrease)		
Increase of	£	Decrease of	£ 3-4million	<b>Net Impact</b>	£ 3-4 million

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

## Summary: Analysis & Evidence

Policy Option: 3

Description: simplifying the CGS

<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups' To be considered further during consultation.
	<b>One-off</b> (Transition)	<b>Yrs</b>	
	£ TBC		
	<b>Average Annual Cost</b> (excluding one-off)		
	£ TBC		<b>Total Cost (PV)</b> £
Other <b>key non-monetised costs</b> by 'main affected groups'			

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups' To be considered further during consultation.
	<b>One-off</b>	<b>Yrs</b>	
	£ TBC		
	<b>Average Annual Benefit</b> (excluding one-off)		
	£ TBC		<b>Total Benefit (PV)</b> £
Other <b>key non-monetised benefits</b> by 'main affected groups'			

Key Assumptions/Sensitivities/Risks

Price Base Year	Time Period Years	<b>Net Benefit Range (NPV)</b> £	<b>NET BENEFIT (NPV Best estimate)</b> £
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What is the geographic coverage of the policy/option?				
On what date will the policy be implemented?				
Which organisation(s) will enforce the policy?				
What is the total annual cost of enforcement for these organisations?		£		
Does enforcement comply with Hampton principles?		Yes/No		
Will implementation go beyond minimum EU requirements?		Yes/No		
What is the value of the proposed offsetting measure per year?		£		
What is the value of changes in greenhouse gas emissions?		£		
Will the proposal have a significant impact on competition?		Yes/No		
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	Yes/No	Yes/No	N/A	N/A

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)		(Increase - Decrease)
Increase of £	Decrease of £	<b>Net Impact</b> £

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

## Evidence Base (for summary sheets)

### Objective

1. Simplifying the PE and CGS rules to reduce compliance costs for businesses where it is sensible to do so.

### Background

2. 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.

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. About 100,000 partly exempt businesses are able to recover VAT on costs relating to exempt supplies, where that VAT is deemed insignificant under the de minimis provisions. This is intended to lessen the burden on the smallest businesses by not requiring them to restrict VAT recovery.

5. Businesses, such as charities and educational bodies, are required to apportion VAT on costs between business and non-business (BNB) activities. VAT relating to business activities is input tax, which is then subject to the PE rules. VAT relating to non-business activities is not input tax and is irrecoverable.

6. Some expenditure, mainly on land and buildings, falls within the CGS and requires a business to review the extent to which it is used in making taxable supplies for a period of up to 10-years, making adjustments to previously recovered input tax where necessary.

7. It was announced in Budget 2008 that HMRC would consult on ideas to simplify PE rules to reduce costs for businesses. The consultation focuses on 3 areas identified as priorities by businesses:

- Standard method;
- De minimis; and

- CGS.

Additionally, HMRC invites comments on the possibility of a combined PE BNB method.

8. This impact assessment explores potential costs and benefits of implementing the ideas to simplify the standard method and de minimis provisions. Ideas to simplify the CGS and the combined PE BNB method are still at a very early stage and it is necessary to consider these further as part of the consultation before estimating costs and benefits. All ideas are explained in more detail in the consultation document.

## **Benefits, costs and risks**

### ***Option 1: Ideas to simplify the standard method***

9. The standard method is the calculation which most smaller-sized partly exempt businesses use 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 supplies. Option 1 considers the following ideas:

- In-year provisional recovery rate;
- Early annual adjustment;
- Use-based option for start-up businesses;
- Including certain overseas supplies in the standard method; and
- Alternative standard methods.

### ***Annual benefits***

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

#### In-year provisional recovery rate.

11. 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 idea would allow a business to apply the prior-year recovery percentage as an in-year provisional recovery rate and finalise the actual rate as part of the annual adjustment. The finalised annual adjustment would set the provisional recovery rate for the next year and so on.

12. HMRC estimates that of the 120,000 businesses that operate the standard method, around 20,000 might benefit as the remaining 100,000 potentially benefit from an annual de minimis test (see below). Of the 20,000, it is tentatively estimated that around 50% might elect to use the prior-year recovery percentage. It is tentatively estimated this would save the average business around 15% of the time taken to carry out its partial exemption calculations. Based on this assumption, the standard cost model indicates this could deliver savings of between £100,000 and 150,000 per year.

13. 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.

#### Early annual adjustment

14. The current rules normally require a business to account for its standard method annual adjustment in the first quarter following the end of the year. The idea is to save the need for the fifth calculation by allowing the annual adjustment calculation to be carried out in the final quarter of the year.

15. Of the 20,000 businesses that could potentially benefit (the remaining 100,000 potentially benefiting from the annual de minimis test), it is tentatively estimated that around 50% might take up the option of an early annual adjustment. Again, it is tentatively estimated this could save the average business around 15% of the time taken to carry out its partial exemption calculations. Based on this assumption and the standard cost model, this idea could deliver savings of between £25,000 and 50,000 per year.

#### Use-based option for start-up businesses

16. Newly formed businesses are sometimes unable to operate the standard method because 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. Currently, a business in this position would normally seek approval of a special method which can result in additional costs. The idea is to introduce a use-based option for start-up businesses that would allow them to select their own fair and reasonable calculation for recovering input tax, thereby removing the need for them to apply for a special method.

17. Operational experience suggests that around 75 start-up businesses 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 idea 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 £300,000 and £400,000 per year.

#### Including certain overseas supplies in the standard method

18. Currently, the standard method only caters for input tax on taxable supplies made in the UK and excludes certain overseas supplies. These include financial and insurance services provided to customers outside the EU and also supplies to customers outside the UK that would be taxable if they were supplied in the UK such as legal, accounting and consultancy services. They are excluded as they can potentially distort the standard method calculation. Under present rules, to reduce the risk of distortion, a business must deal with these supplies in a separate calculation or, alternatively, seek approval for a special method. The idea is to reduce the costs of having to perform separate calculations and seeking approval of a special method by including certain overseas supplies in the standard method.

19. Based on operational experience, it is estimated that around 100 businesses that make overseas supplies would 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 £3,000 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 tentatively 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.

#### Alternative standard methods

20. The current standard method does not always result in a fair recovery of input tax and so some businesses have to apply for a special method. It has been suggested that it would be helpful if a business could choose between two or three alternative standard methods which would save the cost of applying for a special method.

21. If businesses were able to choose alternative standard methods this might reduce the compliance costs that some businesses incur in seeking approval of special methods. However,

it is necessary to consider this idea further during the consultation before estimating costs and benefits.

### ***One-off compliance costs***

22. There would be some one-off compliance costs associated with simplifying the standard method as affected businesses would need to familiarise themselves with any changes. It is estimated that, of the 120,000 partly exempt businesses, around 20,000 would 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 would lead to a one-off compliance cost of around £1.5 million.

### ***Overall position***

23. Based on the analysis above, it is tentatively estimated that the ideas in option 1 could result in a one-off compliance cost of around £1.5m, annual administrative savings of between £100,000 and 200,000 and annual compliance cost savings of around £1m.

### ***Option 2: Ideas to simplify de minimis and the combined PE BNB method***

24. The de minimis rules are applied by most small partly exempt businesses to determine whether they have incurred insignificant amounts of input tax relating to exempt supplies (exempt input tax). Option 2 considers the following ideas:

- Annual test
- Simplifying the de minimis test
- Raising the limit
- Combined PE BNB method

### ***Annual benefits***

25. The annual benefits of each idea are considered below.

#### Annual test

26. The idea is to apply the de minimis test on an annual rather than quarterly basis, to cut the number of calculations from five to one each year.

27. Using figures from the standard cost model as a starting point, it has been tentatively estimated that an annual test could result in an annual average saving for a de minimis business of over £30. If it is assumed that all 100,000 de minimis businesses are eligible to apply an annual test and choose to do so, this could lead to an administrative saving of between £3,000,000 and £3,500,000 per year.

#### Simplifying the de minimis test

28. Under the current rules, a business is classified as de minimis if its partial exemption method determines that exempt input tax is £625 or less per month on average and no more than 50% of total input tax. If it is de minimis, it can recover all of its input tax. The idea is that by simplifying the de minimis test, businesses would no longer be required to carry out full partial exemption calculations and could instead apply a straightforward test that relied on information readily to hand. One suggested test can be found in the relevant chapter of the consultation document.

29. There are around 100,000 businesses that apply the current de minimis rules to establish whether they can recover all of their input tax. It has been tentatively estimated that a simpler test could reduce the time spent applying the test by up to 50%. Again using figures from the standard cost model as a starting point it has been tentatively estimated that this idea could deliver annual savings of over £5 for each business and therefore reduce burdens by between £500,000 and £600,000 per year.

#### Raising the limit

30. It is not yet clear whether raising the limit would result in more businesses having to apply the de minimis test or how many additional businesses would, as a consequence, be able to recover all of their input tax. There would be an associated cost to the Exchequer of raising the limit which will be quantified in the light of the responses to the consultation.

#### Combined PE BNB method

31. This may reduce the time businesses spend calculating how much input tax they recover and would mean that some businesses would be able to apply for a single combined method to determine recoverable VAT rather than two separate methods. However, it is necessary to consider this idea further during the consultation before estimating costs and benefits.

#### ***One-off compliance costs***

32. As with option 1, there would be some one-off compliance costs associated with implementing the de minimis ideas as those affected would need to familiarise themselves with

any changes. It has been assumed that only those 100,000 businesses that qualify would require familiarisation time, which would take an average of 2 hours. Based on an average hourly rate from the standard cost model, this would lead to an estimated one-off compliance cost of around £2.5 million.

### ***Overall position***

33. Based on the analysis above, it is tentatively estimated that the ideas in option 2 (excluding the combined PE BNB method) could result in a one-off compliance cost of around £2.5m and annual administrative savings of £3-4 million.

### ***Option 3: Ideas to simplify the CGS***

34. The expectation is there is scope to simplify the CGS and reduce costs for businesses. However, it is necessary to consider these ideas further during the consultation before estimating costs and benefits.

### ***Option 4: Do nothing***

35. The cost to businesses of operating the PE and CGS rules would remain the same.

### **Sectors affected**

36. Changes to simplify the standard method, de minimis and allowing a combined PE BNB 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. Changes to the CGS would potentially affect larger-sized businesses that incur VAT-bearing expenditure on land and property of £250,000 or more and on computers of £50,000 or more.

### **Impact on HMRC**

37. It is likely these ideas would 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**

38. Subject to the outcome of consultation, legal advice and analysis, we propose a 3-year programme of change with a view to implementing changes to the: standard method in 2008/09, de minimis rules and combined PE BNB method in 2009/10 and CGS in 2010/11. This allows

time for consultation and implementation of ideas to simplify the standard method in Budget 2009. Changes to the de minimis rules and CGS are more complex, with EU issues to consider, follow-up discussions with businesses and detailed analysis.

### **Small firms impact**

39. The expectation is that implementation of these ideas would benefit small businesses, but HMRC welcomes responses on this during the consultation.

### **Competition Assessment**

40. It is possible that any increase in the de minimis limit could have an impact on competition, although this is not expected to be significant.

## 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	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
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