

FULL REGULATORY IMPACT ASSESSMENT

CHANGES TO THE VAT PARTIAL EXEMPTION SPECIAL METHOD REGIME

1. PURPOSE AND INTENDED EFFECT

i) Objectives

To speed-up and streamline the special method approvals process, reducing costs and improving fairness for partly exempt businesses, and freeing up HMRC resource to offer more effective business support.

ii) Background

A business can recover VAT on costs that it 'uses' to make taxable (and certain overseas supplies), but cannot normally recover VAT relating to exempt supplies. This is known as the principle of use. Businesses that make both taxable and exempt supplies are partly exempt and must operate a partial exemption method to determine their recoverable VAT. Most partly exempt businesses operate the default standard method, which is straightforward but broad-brush. But, about 20,000 of the largest and most complex businesses find the standard method unsuitable and seek approval for their own bespoke calculation called a special method. Once approved a special method is binding on both sides.

iii) Rationale for changing the special method regime

HMRC will approve any special method which it judges to be fair and reasonable in satisfying the principle of use. However, this process is inefficient and often results in delays and costs for both businesses and HMRC. Problems can arise because legally a business can seek approval for an unsuitable method which if not detected by HMRC could result in an unfair VAT recovery. Whilst serious problems are rare the VAT involved can be substantial forcing HMRC to critically review and challenge each proposal, even perfectly good ones, causing unnecessary work for both sides. Progress has been made in recent years, including making additional HMRC resource available to deal with special method proposals, and strengthening guidance to help businesses formulate fair and reasonable methods in the first place. But, despite this, delays continue and a typical special method approval still takes six months or longer.

Another problem arises for businesses making certain overseas supplies on which VAT is recoverable. In response to avoidance some years back, legislation requires this VAT to be calculated separately from the partial exemption method, which can prove difficult for some businesses resulting in additional costs and complexity. To help, and where it does not pose a tax risk, HMRC allows a 'combined method' by administrative agreement, but this can create legal difficulties when the method needs to be replaced.

2. CONSULTATION

As part of Budget 2006 an informal consultation was announced on two possible changes to the special method regime from 1 April 2007. The aim of the consultation was to help HMRC refine draft guidance and regulations, and to examine how best to implement the changes. HMRC also encouraged a debate on the effectiveness of the special method regime and other options for improving it. In all, there were over 150 respondents including advisers, business people and business representatives from across the special method community.

Whilst most respondents strongly supported the UK's special method regime, they agreed that gaining approval is a serious problem, which often creates unnecessary delays and costs for businesses. Most respondents accepted that the approvals process would be made more efficient and equitable if businesses shared the same objective with HMRC that special methods had to be fair and reasonable.

3. OPTIONS

Option 1: Method Declaration and Combined Method (recommended option)

This comprises the two changes proposed in the consultation:

- **Method Declaration**

This is a new requirement for businesses to make a declaration to the effect that to the best of their knowledge and belief their proposed partial exemption special method is fair and reasonable. If HMRC subsequently discovers that the method gives an unfair over-recovery of VAT and the signatory of the declaration knew or ought reasonably to have known this at the time the declaration was made, HMRC could require the business to recover a fair and reasonable amount of VAT. This change will speed-up the approvals process for businesses saving them both time and effort. The requirement also reduces the risk of unfair methods, improving equity for those businesses which currently propose fair and reasonable methods. Furthermore, this will release HMRC resource to better tackle unfair methods and help businesses propose fair methods.

- **Combined Method:**

This is a simplification that gives businesses the legal right to apply for, and HMRC to approve or direct, a special method that caters for VAT on overseas supplies that confer the right of VAT recovery (for example, supplies of finance and insurance to customers outside the EU). This change increases certainty and reduces compliance costs. However, this change could not be made safely without the protection of the Method Declaration.

Option 2: Replace special methods with recovery based on 'use'

This option saves the need for special method approvals by simply requiring

businesses to determine their recoverable VAT based on the principle of use. However, it would reduce certainty because businesses and HMRC could routinely go back and re-calculate recovered VAT. It also increases administrative burdens because a business would not have an agreed methodology for recovering VAT. This option was deeply unpopular among businesses.

Option 3: Automatic approval of special methods

This option would impose a statutory time limit (e.g. 6 months) after which a method would automatically be approved unless HMRC had rejected it. A rejection could be appealed. This option would not require proposed methods to be fair and reasonable, so HMRC would still have to closely examine all proposals. There is also a risk that HMRC would be pressured into approving unsuitable methods or rejecting perfectly acceptable methods thereby generating more litigation and slowing down the approvals process. This option does nothing to lessen the risk of HMRC approving an unfair method.

Option 4: Do nothing

Retain the current system, but allocate additional HMRC specialist resource to deal with approvals. Once again, HMRC would have to make detailed enquires to ensure methods were fair and would neither reduce administrative burdens nor improve equity.

4. COSTS AND BENEFITS

i) Sectors and groups affected

Around 20,000 businesses use special methods. The largest 50 of these are predominantly large banks and insurance companies. The remaining special method users cover the full range of partly exempt businesses including finance, insurance, property, retailing, charities and education.

The Combined Method is most likely to benefit finance and insurance businesses and those businesses that routinely make supplies outside the UK. It is thought that half of all special method users will benefit.

ii) Analysis of costs and benefits

Option 1: Method Declaration and Combined Method

Benefits

This option offers benefits to both businesses and HMRC:

Benefits for businesses:

- Speeds-up the approvals process by requiring businesses to propose fair and reasonable methods enabling HMRC to adopt a risk-based approach.
- Reduces the costs for most businesses of applying for a special method.

- Frees-up HMRC resources to help businesses prepare fair methods.
- Improves fairness and equity.
- Clarifies and simplifies the legislation.

Benefits for HMRC:

- Enables a more efficient use of specialist resources.
- Contributes to HMRC's target of reducing administrative burdens.
- Reduces losses through special methods as shown in the following table:

(£m)	2007-08	2008-09	2009-10
Revenue yield	+20	+20	+25

Costs

Of the 20,000 special method users around 1,000 of the largest operate the most complex methods with the rest operating relatively simple methods.

The 19,000 or so businesses with relatively simple methods fall within the small, medium and large categories. Special methods for these businesses typically last 10 years or more before the business changes such that a new method is needed. These businesses will benefit from the declaration because once they have proposed a fair and reasonable method, HMRC will give faster approval. Submitting the declaration will not require additional correspondence and would normally accompany a proposed method. We estimate the total saving for these businesses to be around £250,000 per year.

The remaining 1,000 businesses are generally large and operate more complex special methods. These businesses evolve quickly and typically need to update their methods on average every 3 years. The top 50 businesses, banks and insurance companies, continually update their methods, often by adding new sectors to a substantial and historically approved base method. These businesses have less to gain from the declaration for, whilst they too will benefit from faster approval, they will incur additional costs in having to review their entire method to ensure it is fair and reasonable. These additional costs are likely to vary significantly among different businesses. For some, the additional costs will be low because they are proposing an entirely new method or they have recently reviewed their method. However, the costs will be higher for those that have not reviewed their method for a long time. With this in mind, it is difficult to arrive at an average increase in costs for the largest 1,000 businesses, but we estimate additional costs will total to less than £250,000 per year. Over time, this should fall because once a business has checked its entire method for the first declaration, the focus for subsequent declarations will be on changing circumstances since the previous declaration.

The Combined Method will reduce administrative burdens for businesses. However this has not been taken into account as a new cost saving because HMRC already allows combined methods in many cases.

Overall this option provides a small net saving in administrative burdens. Rising from over £15,000 in the first year to almost £80,000 in the second and third years. This increases to around £135,000 in subsequent years, by which time the largest 1,000 businesses would typically have updated their methods and so reviewed them to ensure they are fair.

The savings are prepared on the same approach as used by the KPMG Report on Administrative Burdens on Businesses. The Method Declaration and Combined Method contribute to reducing the administrative burden from special methods. In the longer-term, further savings will result because as businesses work with HMRC to ensure fair and reasonable methods, they will become more robust lessening the need for regular updating. These longer-term savings have not been reported here.

Option 2: Replace special methods with recovery based on 'use'

Requiring businesses to determine recoverable VAT in accordance with the principle of use would reduce certainty and increase administrative burdens as businesses would no longer have an agreed methodology for recovering VAT.

Option 3: Automatic approval of special methods

This option would generate more litigation, slow down the approvals process and therefore increase costs for businesses and HMRC.

Option 4: Do nothing

This option would not deliver any benefits, costs would not be reduced and the risk remains that some businesses secure an unfair recovery of VAT.

5. SMALL FIRMS IMPACT TEST

Smaller firms affected by the measure are unlikely to have complex special methods and so are expected to benefit from speedier approval of their method and lower costs.

6. COMPETITION ASSESSMENT

The competition filter test has been applied and the proposed changes passed. The changes will increase consistency in fairness of input tax recovery and are not expected to have a significant impact on any group within particular markets.

7. ENFORCEMENT, SANCTIONS AND MONITORING

HMRC expect that action taken under the Method Declaration will be rare on the basis that the businesses will propose fair methods. If action is needed, the business would be required to repay VAT that it has unfairly over-recovered and in addition may be subject to interest and misdeclaration penalties. Any action will be supervised by Policy Team in accordance with robust procedures which ensure that action can never be taken without thorough review and reconsideration. HMRC will monitor the effectiveness of this.

8. IMPLEMENTATION AND DELIVERY PLAN

The changes will be implemented on 1 April 2007. To help businesses, revised guidance and legislation were circulated following the consultation and will be published on the HMRC website.

9. POST IMPLEMENTATION REVIEW

HMRC has a programme in place to ensure that the compliance cost assessments made for all Regulatory Impact Assessments are reviewed within two years from when a policy is first implemented.

10 SUMMARY AND RECOMMENDATION

Special methods are an important part of the UK's partial exemption system, offering a good balance between certainty and flexibility whilst keeping administrative and audit costs low. However, the current rules do not require businesses to propose fair methods with the result that HMRC is forced to thoroughly challenge proposals before granting approval causing delay and wasted costs. The Method Declaration will discourage unfair proposals and speed up the approvals process reducing administrative costs for most partly exempt businesses. It will facilitate better use of specialist resources that would help businesses resolve complex partial exemption issues and improve fairness and equity by helping to ensure all businesses recover a fair amount of VAT. It also realises a longer-term benefit of more flexible and robust methods, which will require updating less frequently. The Combined Method simplifies the legislation and is widely supported by businesses. Option 1, the Method Declaration and Combined Method, is therefore recommended.

CONTACT POINT

Patrick Wilson
HM Revenue and Customs
Partial Exemption Team
Room 43
100 Parliament Street
LONDON
SW1A 2BQ

Tel: 0207 147 0595

E-mail: Patrick.wilson@hmrc.gsi.gov.uk

Declaration

Regulatory Impact Assessment

Changes to the VAT Partial Exemption Special Method Regime

Statement of Ministerial Approval

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:
DAWN PRIMAROLO MP
PAYMASTER GENERAL

2 February 2007