EXPLANATORY MEMORANDUM TO

THE VALUE ADDED TAX (SUPPLY OF SERVICES) (AMENDMENT) ORDER 2007

2007 No. 2173

1. 1.1 This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

1.2 This memorandum contains information for the Select Committee on Statutory Instruments.

2. Description

2.1 The Value Added Tax (Supply of Services) (Amendment) Order 2007 (the Order) amends the Value Added Tax (Supply of Services) Order 1993 (S.I. 1993/1507) by removing articles 3A and 3B of that Order which were inserted by the Value Added Tax (Supply of Services) (Amendment) Order 2003 (S.I. 2003/1055).

2.2 Articles 3A and 3B were inserted as part of a strategy to prevent perceived tax avoidance which is explained in more detail below. Following a judgment of the European Court of Justice, it is necessary to omit these articles.

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

None

4. Legislative Background

4.1 The Value Added Tax Act 1994 (1994 c.23) ("VATA") and the subordinate legislation made under it implement the United Kingdom's obligation under EC law (principally by virtue of Council Directive 2006/112/EC ("the VAT Directive") (formerly Directive 77/388/EEC "the Sixth Directive")) to charge a turnover tax on supplies by businesses of their goods and services. Businesses may deduct the VAT they pay on goods and services supplied to them from the VAT they are required to account for provided they are used by the business for making supplies in the course of its business that are taxable supplies.

4.2 Article 26(1)(a) of the Directive (formerly Article 6(2)(a) of the Sixth Directive) requires that where goods in relation to which a business has deducted the VAT incurred on them are used for non-business purposes, the business must be treated as if it had made a supply of services in relation to

that use and account for VAT accordingly by virtue of Article 75 of the VAT Directive (formerly Article 11A1(c) of the Sixth Directive) on the "full cost" of providing those services. The United Kingdom implemented these requirements by paragraph 5(4) of Schedule 4 and paragraph 7(b) of Schedule 6 to VATA.

4.3 By 2003 it had become apparent that the uncertainty in relation to the "full cost" of the deemed supplies in relation to the non-business use of goods was being exploited by some businesses to gain significant tax advantage. This was especially so in relation to land and buildings, whereby businesses claimed credit for all of the VAT charged in relation to purchase or construction costs but accounted for small amounts of VAT for non-business use arguing that the costs should be apportioned over an extended economic life of the land or building. Economic lives of 50 years or longer were commonly claimed, even though this was contrary to long-standing guidance issued to taxpayers that a 20 year life should be used.

4.4 In addition to the cash-flow advantage arising from spreading the VAT cost of non-business use over such long periods, there was a high risk that much of the VAT claimed by businesses would never be repaid. This was because there were various ways by which the output tax charges could be escaped long before the end of the economic life claimed in respect of the land or building. These included the sale of land or buildings exempt from VAT after a period (usually at least 10 years) from the time when the VAT was incurred.

4.5 Some groups of companies also exploited the rules relating to the non-business use of goods by artificially creating such use, by making a building available free of charge to a related company. By this means it was possible to claim extra credit for VAT charged on the building purchase or construction costs.

4.6 The exploitation briefly described in paragraphs 4.3-4.5 was tackled by section 22 of the Finance Act 2003 (c. 14) (which inserted sub-paragraph (4A) into paragraph 5 of Schedule 4 to VATA) and the Value Added Tax (Supply of Services) (Amendment) Order 2003 ("the 2003 Order") (which inserted articles 3A and 3B into Value Added Tax (Supply of Services) Order 1993 ("the 1993 Order")). These legislative amendments prevented businesses claiming VAT deduction to the extent that the land or building upon which VAT had been paid would be used for non-business purposes, whilst ensuring that VAT would still be due if a business changed the use of land or buildings from wholly business use to part non-business use after the initial input tax claim ("the 2003 changes").

4.7 A similar strategy adopted by the Netherlands has been held to be unlawful by the European Court of Justice in its judgment in ***P Charles and T S Charles-Tijmens v Staatssecretaris van Financiën (Case C-434/03)***. As a result, the UK is reversing the 2003 changes described above.

4.8 Section 99(2) of the Finance Act 2007 (c. 11) repeals paragraph 5(4A) of Schedule 4 to VATA with effect from 1st September 2007. The Order completes the process of reversing the 2003 changes which now appear to be inconsistent with EC law by removing articles 3A and 3B from the 1993 Order but making no change in respect of an amendment to Article 3 of the 1993 Order made by the 2003 Order which simply clarified the operation of the 1993 Order and has not been affected by the judgment of the European Court of Justice.

4.9 The reversal of the 2003 changes does raise the risk of renewed exploitation of the VAT system in this area. However, in the light of the judgment of the European Court of Justice in ***Hausgemeinschaft Jörg und Stefanie Wollny v Finanzamt Landshunt (Case C-72/05)***, it will be possible to reduce this risk by other legislative amendments. Section 99 (4) and (5) of the Finance Act 2007 amend paragraph 7 of Schedule 6 to VATA so that the Commissioners for Her Majesty's Revenue and Customs may make regulations determining the value of supplies arising by virtue of paragraph 5(4) of Schedule 4 to VATA by reference to the full cost of the goods which are used for non-business purposes. Although it was intended that regulations made in exercise of the new power would come into force by 1st September 2007, it is now intended that they should come into force later in 2007.

5. Extent

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Financial Secretary to the Treasury, Jane Kennedy MP, has made the following statement regarding Human Rights:

In my view the provisions of the Value Added Tax (Supply of Services) (Amendment) Order 2007 are compatible with the Convention rights.

7. Policy background

7.1 Following the decision of the European Court of Justice in the case ***P Charles and T S Charles-Tijmens v Staatssecretaris van Financiën (Case C-434/03)*** it is now clear that the 2003 changes made to the 1993 Order are inconsistent with EC VAT law. Following the European Court of Justice's judgment HMRC issued a Business Brief on 9 August 2005 informing taxpayers that the 2003 changes no longer applied and invited claims which would correct the VAT treatment of business assets. These claims effectively relied on the direct effect of EC VAT law. The reversal of the 2003 changes ensures that VATA and its subordinate legislation is consistent with EC VAT law and removes any uncertainty or confusion which the relevant changes made by the 2003 Order may have caused.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 The impact on the public sector is nil.

9. Contact

David Webb at Her Majesty's Revenue and Customs Tel: 020-7147-0641 or e-mail: david.webb@hmrc.gsi.gov.uk can answer any queries regarding the instrument.

Regulatory Impact Assessment: VAT: Implementation of European Court of Justice decisions Charles & Charles-Tijmens and Wollny

Purpose and intended effect

Objective

To introduce appropriate legislative controls to 'Lennartz accounting' in order to protect VAT revenues and help clarify the process for organisations using 'Lennartz accounting', by implementing certain decisions of the European Court of Justice (ECJ) in the 'Lennartz' strand of case law.

Background

So-called 'Lennartz accounting' derives from decisions of the ECJ. It allows taxpayers to treat a new asset as a wholly business asset, even if there will be some non-business use and even if business use is very small. This means they can recover all the VAT incurred on the asset immediately and then account for VAT on the non-business use over the economic life of the asset ("non-business use charges"). This spreads the cost of irrecoverable VAT over the economic life of an asset. If Lennartz accounting is not used, the VAT is apportioned between business and non-business use at the outset and there is no further adjustment. The choice of whether to use Lennartz accounting is implicit in EU and UK law.

To date, there have been no specific rules dealing with Lennartz accounting in the UK: the ECJ's decisions have been allowed to apply directly. This is possible because the ECJ has consistently said that Lennartz accounting is implicit in EC (and therefore UK) law: the decision to allocate the asset wholly to business purposes is made at the outset and VAT law is then applied accordingly.

In 2003 legislation was introduced which was intended to prevent Lennartz accounting on land and buildings. This legislation was rendered ineffective by the ECJ's decision in *Charles & Charles-Tijmens* (C-434/03). Subsequently, HMRC accepted that Lennartz accounting could apply to land and buildings, and adopted a policy that the economic life of the asset should be 20 years. Subsequently, the ECJ decided in *Wollny* (C-72/05) that an EC member State could introduce legislation to make the Lennartz accounting period the same as the scheme for adjusting input tax on capital items (the UK's capital items scheme provides for a 10 year adjustment period).

In view of the above, the Government has decided to introduce three measures:

1. To implement the European Court of Justice (ECJ) decisions in *Charles & Charles-Tijmens* by repealing ineffective legislation.

2. To implement the European Court of Justice (ECJ) decisions in *Wollny* by limiting the period over which so-called 'Lennartz accounting' occurs.

3. To clarify the legislation to resolve what is arguably a loophole.

Rationale for Government intervention

1. Certain legislation should be repealed because the decision of the ECJ in *Charles & Charles-Tijmens* has rendered it ineffective. If action is not taken, dead wood is left which might confuse tax payers or even be manipulated by those seeking to avoid VAT.

2. The decision of the ECJ in *Wollny* allows the UK to legislate to set out the process of accounting for VAT on non-business use of 'Lennartz assets'. To date there has been no explicit process in the legislation. This change clarifies the process and helps protect VAT revenues and provide certainty for our customers. If action is not taken uncertainties will remain for affected organisations and HMRC, and VAT revenues will suffer.

3. There is a possible loophole which, if exploited successfully, could enable organisations to make an absolute VAT saving of up to 50% of the VAT initially incurred. The position is being clarified to give customers certainty and protect the revenue. If action is not taken at the same time as the above measures, it may prevent an attractive exit route for those seeking to avoid VAT.

Consultation

There has been an ongoing dialogue between HMRC and businesses for a number of years concerning the correct interpretation of number of decisions of the ECJ in this area. The first two measures above implements two clear ECJ decisions in the context of that dialogue. Draft legislation for the main change, measure 2 above, should be published in time for consultation before the intended implementation date of 1 September.

Options

Option 1 – Implement all three measures

This option repeals ineffective legislation, protects the revenue and clarifies the process for accounting for VAT on non-business use charges.

Option 2 – Implement only measure 1

This option only repeals the ineffective legislation, with a view to making the minimum change necessary to keep UK legislation in line with the ECJ case law. This option carries the risk of deterioration in terms of increased revenue loss and ongoing confusion for our customers in terms of the absence of any regulations governing the 'Lennartz accounting' process. This option might

also encourage non-compliant organisations to try to exploit the absence of ‘Lennartz accounting’ regulations.

Option 3 – Do nothing

This option carries the risk of deterioration in terms of increased revenue loss and ongoing confusion for our customers in terms of the absence of any regulations governing the ‘Lennartz accounting’ process. This option might also encourage non-compliant organisations to try to exploit the absence of ‘Lennartz accounting’ regulations.

Costs and benefits

Sectors and groups affected

These measures affect any organisation with both business and non-business activities, or any business which has regular non-business use of business assets. Primarily, organisations in the education, health and charity sectors are using ‘Lennartz accounting’, although in principle any business sector might be eligible, depending on the way their assets are used. In addition, some businesses are looking at ways to exploit ‘Lennartz accounting’ artificially.

Analysis of costs and benefits

Option 1. This option results in negligible additional compliance burden on businesses and other organisations in terms of familiarisation with the new rules. It also results in a negligible reduction in administrative burden in that (in simple terms) Measure 2 halves the period over which non-business use must be monitored and non-business use charges must be calculated and paid. Option 1 also produces the benefits of clearing ‘dead wood’ in the legislation, clarifying the process of accounting for non-business use charges and protecting VAT revenue.

Option 2. This option results in negligible additional compliance burden on businesses and other organisations in terms of familiarisation with the new rules. Option 2 has the benefit of clearing ‘dead wood’ in the legislation.

Option 3. This option has no immediate effect on costs and benefits.

Summary of costs and benefits

Option 1 involves negligible, and offsetting, compliance cost additions and reductions. It provides certainty for customers and helps to protect VAT revenues.

Small Firms Impact Test

Small firms that use ‘Lennartz accounting’ will be affected by these changes. The effect will be to regulate the cash flow advantage that has been enjoyed by those that have used ‘Lennartz accounting’.

Competition Assessment

The competition filter test has been applied and the changes passed. The changes will not impact directly on any particular markets as 'Lennartz accounting' can in principle be used across all sectors by any size of business. Sectors where assets are commonly purchased for both 'business' and 'non-business' use include, Health, Education and Charities. The introduction of legislative controls to Lennartz accounting are not expected to have any significant effects on competition in any sector although they will make it easier for those businesses that purchase assets for both 'business' and 'non-business' use.

Enforcement, sanctions and monitoring

This will be enforced through the normal operation of the VAT system, including HMRC's assurance programme. VAT repayment claims relying on 'Lennartz accounting' will continue to be separately monitored to detect trends to inform policy-making and identify artificial avoidance activity.

Implementation and delivery

These Measures involve very minor change to the VAT system, so will be implemented and delivered through the Finance Bill, secondary legislation and the normal VAT assurance programme. Measures 1 & 2 will be effective from 1 September 2007 and measure 3 will be effective from Budget Day. Guidance to customers will be provided as early as possible to ensure that the measures can be implemented as easily as possible.

Compliance Cost Review

A compliance cost review should be carried out two or three years after introduction of the legislation.

Summary and recommendations

We recommend Option 1 because it delivers real benefits to both external organisations and HMRC with no overall additional administrative burden, as well as protecting VAT revenue in a significant area.

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Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

DAWN PRIMAROLO
PAYMASTER GENERAL

Date 1st March 2007