EXPLANATORY MEMORANDUM TO

THE VALUE ADDED TAX (AMENDMENT) REGULATIONS

2015 No. 1978

1. Introduction

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

2. Purpose of the instrument

2.1 Regulations 101, 102 and 103 of the Value Added Tax Regulations 1995 1995/2518 ("the 1995 Regulations") set out how the input tax incurred on the overheads of a partly exempt business is to be attributed to taxable supplies so as to calculate the proportion of input tax that a taxable person is entitled to deduct. This instrument amends those regulations to provide that, where a taxable person uses a partial exemption method that is not based on sectors, that taxable person can no longer take into account the value of supplies made from establishments situated outside the UK when calculating how much input tax it can deduct. It further provides that, where a taxable person does use a partial exemption method that is based on sectors, that method must reflect use and each sector must reflect the activities of that sector and the structure of the business as well as the use to which costs are put in that sector.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

3.1 None.

Other matters of interest to the House of Commons

3.2 As this instrument is subject to the negative resolution procedure and has not been prayed against, consideration as to whether there are other matters of interest to the House of Commons does not arise at this stage.

4. Legislative Context

4.1 Sections 24 to 26 of the Value Added Tax Act 1994 ("the Act") set out the broad circumstances in which VAT incurred by a business is to be treated as deductible input tax by a taxable person. In essence, VAT is deductible on costs used to make onward taxable supplies but is not deductible on costs used to make onward exempt supplies, such as the supply of financial services.

4.2 Section 26(2)(c) of the Act provides that businesses can deduct VAT incurred on costs related to certain supplies, where it would not otherwise be deductible, as the Treasury may specify by order ("specified supplies"). This is the vires for the Value Added Tax (Input Tax) (Specified Supplies) Order 1999/3121 ("the Order"). For the purpose of section 26(2)(c) of the Act, Article 3(c) of the Order specifies certain supplies of financial services if made to a person who belongs outside the Member States, thus giving businesses that make these types of specified supplies an entitlement to deduct

the VAT incurred on related costs. This means that, for the purpose of deduction, these specified supplies are treated as if they are taxable supplies.

4.3 A business that makes both taxable supplies (including specified supplies) and exempt supplies is partly exempt and has to work out what proportion of VAT of its overhead costs can be deducted. The method by which this calculation is carried out is known as a partial exemption method. The secondary law is set out in Part 14 of the 1995 Regulations and makes provision, amongst other things, for the various methods that can be used.

4.4 Partly exempt businesses must calculate the amount of VAT that they are entitled to recover under regulation 101 (attribution of input tax to taxable supplies; "the standard method"), unless the Commissioners agree or direct an alternative special method pursuant to regulation 102 (use of other methods; "special methods") or regulation 103 (attribution of input tax to foreign and specified supplies) applies.

4.5 The 1995 Regulations allow the value of supplies made by overseas establishments to be taken into account when calculating how much VAT may be deducted on overhead costs incurred in the UK that are used to support the activities of those overseas establishments. However, the Court of Justice of the European Union ("CJEU") has ruled (in *Le Credit Lyonnais, Case C-388/11*) that this is not permitted by the Principal VAT Directive (2006/112/EC) where the partial exemption method requires a single calculation or where it is a sectorised method with sectors that do not reflect the use to which costs are put. Further, the CJEU confirmed that a sector in a sectorised partial exemption method cannot be based on a geographic location.

4.6 This instrument amends regulation 101 of the 1995 Regulations to make it clear that the value of supplies made from establishments situated outside the UK cannot be taken into account by businesses using the standard method.

4.7 Regulation 102(1A) will be amended to ensure that:

- a business may only use a sectorised method where the method reflects use and each sector reflects the use made of goods and services by that sector, the structure of the business and the type of activities undertaken by that sector; and
- the value of supplies made from establishments outside the UK cannot be taken into account by businesses using a non-sectorised method.

4.8 Changes to regulation 103 will mirror those to regulation 102 to ensure that:

- a business may only use a calculation based on sectors where the calculation reflects use and each sector reflects the use made of goods and services in that sector, the structure of the business and the type of activities undertaken by that sector; and
- the value of supplies made from establishments outside the UK cannot be taken into account by businesses using a calculation that is not based on sectors.

4.9 For Regulation 101, these changes will have effect in relation to any 'standard method' longer period beginning on or after 1 January 2016. A business's 'longer period' is determined by reference to regulation 99(3) – (7) of the 1995 Regulations.

4.10 For regulation 102, these changes will have effect in relation to any methods approved or directed by HMRC on or after 1 January 2016.

4.11 For regulation 103, these changes will have effect in relation to VAT prescribed accounting periods beginning on or after 1 January 2016. A business's 'prescribed accounting period' is determined by reference to regulation 99(1)(b) of the 1995 Regulations.

5. Extent and Territorial Application

5.1 This instrument extends to the whole of the United Kingdom.

5.2 The territorial application of this instrument is the whole of the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

What is being done and why

7.1 UK law currently allows partly exempt businesses to recover VAT on overhead costs used to support foreign branches by reference to supplies made by those branches.

7.2 In *Le Credit Lyonnais* the CJEU found that EU law could not be interpreted so as to allow a business to take into account the turnover of its foreign branches when calculating how much input tax it can deduct in the Member State where it has its principal establishment, where the method of calculation is not based on sectors.

7.3 This instrument amends the 1995 Regulations and ensures that UK law is aligned with EU law. It also tightens the rules on partial exemption to reduce the risk of over-recovery of VAT.

Consolidation

7.4 This instrument will amend the 1995 Regulations and therefore the changes made by this instrument will be consolidated with the existing secondary legislation on partial exemption.

8. Consultation outcome

8.1 HMRC first consulted on legislative changes to implement these policy objectives in March 2015.

8.2 A further short consultation was targeted at known interested stakeholders in October/November 2015. The legislative changes have been revised as a result of the responses received.

9. Guidance

9.1 The changes made by this instrument will be reflected in published guidance on partial exemption.

10. Impact

10.1 The impact on business, charities or voluntary bodies is limited to partly-exempt businesses and organisations, who will need to review their methods to ensure they comply with the new legislation. It will mainly affect financial institutions such as

banks and insurance companies and other businesses that have both UK and overseas establishments. There will be limited one-off costs for any businesses that elect, or are directed, to change their partial exemption method.

10.2 There is no impact on the public sector.

10.3 A Tax Information and Impact Note covering this instrument was published on 18th March 2015 alongside draft legislation and is available on the government website at https://www.gov.uk/government/collections/tax-information-and-impact-notes-tiins. It remains an accurate summary of the impacts that apply to this instrument.

11. Regulating small business

11.1 The legislation applies to activities that are undertaken by small businesses.

11.2 The legislation will mainly affect large financial businesses that have establishments both in the UK and overseas, therefore no specific action is proposed to minimise regulatory burdens on small businesses.

12. Monitoring & review

12.1 The policy will be kept under review through regular communication with affected taxpayer groups.

13. Contact

13.1 Roy Taylor at Her Majesty's Revenue and Customs Tel: 03000 585532 or email: roy.taylor@hmrc.gsi.gov.uk can answer any queries regarding the instrument.