Special VAT focus
VAT anomalies and suggested improvements

Following an announcement in Budget 2012, HMRC has consulted on addressing 'borderline anomalies' in VAT. The consultation, which closed on 18 May, sought views on draft legislation changing the VAT treatment of supplies of catering, sports drinks, self-storage, hairdressers' chair rental, holiday caravans and alterations to listed buildings (see www.lexisurl.com/d6TOr.) In light of the consultation, *Tax Journal* invited views from practitioners on what they regard as the anomalies in the VAT system and recommended changes.

Will VAT ever be a simple tax?

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The VAT code contains numerous examples of anomalies whereby a different VAT rate is applied in essence to what could be viewed as the same activity.

Nearly 40 years on from the launch of VAT as a 'simple tax', we saw in the March 2012 Budget, the most recent attempt to simplify it. The consultation document *VAT: Addressing borderline anomalies* was issued on Budget Day, 21 March 2012, requesting responses by 4 May (subsequently extended to 18 May). The consultation invites comments on the draft legislation changing the VAT treatment of supplies of catering, sports drinks, self-storage, hairdressers' chair rental, holiday caravans and alterations to listed buildings. In essence, the draft legislation either marginally extends VAT at the standard rate to these areas or confirms the current standard-rated treatment.

There are various items provided for in VATA 1994 which are VAT-free (0%) or subject to VAT at the reduced rate of 5% (VATA 1994 s 30 provides for the zero-rating of goods and services listed in Sch 8, and s 29A applies the reduced rate for goods and services listed in Sch 7A.) But what would be the impact of broadening the VAT base to simplify these anomalies? Take children's car seats, currently eligible for VAT at the 5% reduced rate, while pushchairs are subjected to VAT at the standard rate of 20%. Or bicycle helmets which qualify for 0% VAT while bicycles themselves are subject to 20% VAT, and that new motorcycle helmet qualifying for 0% VAT, but its replacement visor being subject to 20% VAT. Would chocolate covered cakes be subject to an increase of 20% to remove the 'anomaly' with chocolate covered biscuits? There is also possibly the most obvious (and probably contentious) of all being the disparity in treatment of books and newspapers (0% VAT) and their electronic equivalents (20% VAT).

Moreover, there are other examples of anomalies whereby a different VAT rate is applied in essence to what could be viewed as the same activity. For instance, we still see debate involving the short-term letting (subject to 20% VAT) and long-term letting (exempted from VAT) of playing fields, and the pending litigation involving members' golf clubs fees (exempted from VAT) and visitor's fees (subject to 20%).

Treatment of public bodies under VATA 1994 s 33

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There is a growing anomaly affecting the VAT recovery of many public bodies, including local authorities.

The National Crime Squad (NCS) and National Crime Intelligence Service (NCIS) wanted to be included in the VAT refund scheme for public authorities under VATA 1994 s 33(3)(*k*). What was the point, they argued, of receiving taxpayer funding and then paying part of it back in the form of irrecoverable input VAT? This constituted pointless recycling of tax revenues. HM Treasury denied their request. In *R v HM Treasury, ex p Service Authority for the National Crime Squad* [2000] STC 638 (the *NCS* case) NCS's application for judicial review of the Treasury's decision failed.

The case illustrates a wide and growing anomaly which affects many public bodies, including local government.

When VAT was introduced in 1973, a parliamentary undertaking was given that local government would not have to bear a VAT cost, which would reduce the value of central government grants. The result was FA 1972 s 15 (now VATA 1994 s 33). Local authorities do not charge VAT on public services, but can recover VAT charged to them.

Ironically, April 1973 coincided with the introduction of the Local Government Act 1972. After that date, it may be said, local government ceased to be both local and governmental. Local authorities have ceased to be multi-functional, self-sufficient, politically accountable providers of services through their own employees. Instead, there has been a transfer of functions to specific purpose bodies. Alternatively, local authorities enter into private contractual arrangements, and move from a supplier role to become buyers in of services through outsourcing.

The tax question is: to what extent do these changes alter the incidence of VAT? Not every public body which is now discharging what historically would be considered as local government functions can get its input VAT back, because it may not be carrying on a business in the VAT sense, but fall outside the parameters of the VAT refund system in s 33.

This is because the scope of s 33 is limited to local authorities and public bodies therein designated, eg, the BBC. The frontier between the public sector (non-business in VAT terms) and the private sector (business in VAT terms) is shifting and uncertain. As a safety valve, in borderline cases, the Treasury may under s 33(3)(*k*) admit individual bodies on a case-by-case basis to the VAT refund scheme.

Like any other public authority, the Treasury must exercise its powers reasonably. The criteria which the Treasury seeks to apply in deciding whether or not to admit bodies to the refund scheme are set out in para 42 of the judgment in the *NCS* case, quoting a letter from the Chancellor of the Exchequer of 19 February 1998. The criteria are inevitably somewhat elastic.

It is unsatisfactory to leave the demarcation of the public/private sector to the discretion of a government department, even as august a body as the Treasury. Law works by imposing distinctions. Either you fall on one side of the line or on the other. That is how VAT works. Either you are a taxable person or you are not.

The truth of the matter is that the VAT consequences of extensive political changes have simply not been worked out. The reduction of the scope of local government has not been matched by any concomitant increase in the scope of VAT recovery.

My solution would be a general legislative provision, which says that if you cannot charge VAT because you are a public body (as defined), you get back your input tax under s 33.

The VAT registration threshold

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Is it right that the VAT registration threshold should be set at its current, relatively high, level?

In the last Budget the VAT registration threshold was increased more than 5% to £77k. This clearly helps businesses with significant exempt but relatively little taxable activity, but does it help the small business which has a low turnover, all of which is taxable?

For most small and micro-businesses which make B2B supplies, the option to register voluntarily is in any case the sensible choice. But B2C suppliers will want to remain unregistered if possible, and with a threshold of £77k, a business where labour is the largest cost will provide a living without needing to suffer VAT. This benefits micro-businesses.

The problem comes when a business wants to upgrade to a small business, perhaps providing a living for two or more people, but targeting the same customers. Because the VAT threshold does not work as an allowance (as in income tax) the very act of breaching the limits brings the full business turnover within VAT. This presents a 'cliff-edge' to any business that wants to grow. The higher the threshold, and the higher the VAT rate, the bigger the gap. Can the business generate enough turnover and profit to compensate for the VAT impact? What if the growth requires it to take on employees – can it afford that cost as well as the VAT?

To illustrate this, consider the 'labour-only' builder which, if registered, might choose to use the flat-rate scheme. He must pay 14.5% of his turnover to HMRC. At £77k that equates to £11,165. This means he needs a turnover of around £90k to get back to where he was if he was just below £77k and not registered. To achieve £90k he might have to employ another worker which increases his costs, and means he faces lower profit for himself even at £90k turnover. And that assumes he can grow the business to that level, either soon or at all. The VAT threshold can, in some trades, create a powerful incentive not to grow and create jobs.

The point becomes more marked when we consider that a typical EU threshold is around £25k – covering any business that is capable of offering a living wage to one person. The threshold for distance selling VAT registration is much lower in most EU states, so a UK business that distance sells goods to Spain at £40k turnover is liable for Spanish VAT, but an extra £25k of UK sales escapes UK VAT altogether. EU traders distance selling into the UK must register at a turnover of only £70k, and from December 2012, all EU businesses that make supplies in the UK (of certain kinds) will have a nil threshold, thus creating a major disparity between UK and EU traders.

Despite all this, there may be good reasons for keeping the high threshold, but if so, they should be publicly debated, and the view that high thresholds must be better should not automatically be accepted.

VAT and e-books

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E-books, like physical books, should be zero-rated. HMRC's current policy is an overly narrow interpretation of the Principal VAT Directive.

HMRC's published policy is that e-books, unlike physical books, are standard-rated for VAT purposes. That policy is based on three propositions. The first proposition is that, according to the established case law, a book, in the context of the zero-rating provision in VATA 1994 Sch 8 Group 3 Item 1, must have certain physical characteristics (for example, it must have a significant number of leaves, usually of paper, held together front and back by covers); e-books obviously lack such attributes.

But it is clear that (in the words of the Tribunal in *Harrier LLC* (TC 01562) 'a provision which provides for zero-rating for a category of goods cannot itself stand still, any more than the commercial world can (or will) do so. Technological advances in printing mean that products which in 1991 would not have been conceived of are now a reality, and fall to be classified for VAT purposes. If the construction of the domestic provisions encompasses those new products, they will fall to be zero-rated.'

The second proposition is that the principle of fiscal neutrality (which prohibits different VAT treatment of products which meet identical or similar customer needs) does not apply, since some e-books have functionality (search facilities, for example) which make them sufficiently dissimilar for the principle not to apply.

The error here is that at most this proposition would prove that some e-books are not zero-rated, but the argument proves nothing about those e-books which have no significant added functionality.

Finally, HMRC claims that if the principle of fiscal neutrality did apply, then the European Commission would require the UK to impose VAT on physical books, rather than remove VAT from e-books.

That would be because Article 110 of the Principal VAT Directive, which is the vires for the UK's zero-rating of books, allows a *maintenance* of the current zero-rate provisions, but not their *extension*. HMRC's current policy is to limit zero-rating to physical books; a removal of that restriction, so the argument goes, would breach the standstill nature of Article 110.

That argument is, in my view, misconceived; it fails to distinguish between an extension of scope of a zero-rating provision, and correcting an overly narrow interpretation of that provision. There is no express restriction in UK law which would have to be removed for e-books to be zero-rated; all there would have to be would be a change of policy by HMRC; that would not breach the standstill provision.

Berwin Leighton Paisner LLP has an appeal pending before the Tribunal on VAT and e-books. We expect the hearing to be in late summer. If the Tribunal finds in our favour, then this long standing anomaly will, we hope, finally be laid to rest.

VAT on hot foods

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The new proposals on VAT on hot takeaway food will create a new set of problems. A better solution would be to adopt the guidance on 'catering versus food' laid down by the CJEU.

HMRC claims that there continues to be uncertainty about the treatment of hot and cold takeaway food, with retailers arguing that the purpose of heating their products is to improve their appearance or to comply with health and safety regulations, rather than to enable them to be consumed hot. Therefore, although many retailers and takeaway outlets charge VAT on the sale of hot food, some retailers and bakery chains sell similar products at the zero rate.

To ensure that all hot takeaway food is taxed consistently HMRC's answer is to apply the standard rate to all food which is above the ambient air temperature at the time that it is provided to the customer, with the exception of freshly baked bread.

Even the most optimistic reader would have to concede that the taxation of something based upon its ambient air temperature is likely to be fraught with difficulties. For example, will the ambient air temperature have to be determined on the basis of a national average? Or will local variations be applied? Is the temperature relevant at the exact time of sale, or over an average period? The food will presumably have the potential to be untaxed in the summer months as the ambient air temperature increases!

Another issue which concerns HMRC is the 'on premises' consumption of all food (standard rated), and the 'off premises' consumption of cold food (zero rated). The issue here arises with food courts in shopping centres and whether the tables and chairs outside form part of a retailer's premises. HMRC's proposal is that premises will include all areas that are set aside for the consumption of food even if they are shared with other retailers.

It is difficult to see why this change – which will mainly affect cold food, as most hot food is liable to the standard rate of VAT – is necessary. The CJEU has already provided guidance on what constitutes 'catering' in the case of *Manfred Bog and others* (C-497/09 et al). The Court decided that for a supply to be one of catering, there had to be a predominant service element that went beyond the mere preparation, cooking and serving of food. Furthermore, the provision of rudimentary facilities, such as a few tables, was not of sufficient importance to change the nature of the supply from one of goods (food) to services (catering).

One cannot help feeling that the new proposals will only serve to create a new set of issues. While it may not be possible to turn back the clock to simplify the liability of 'hot food', the failure to adopt the relatively clear guidance on 'catering versus food' laid down by the CJEU, looks like a missed opportunity to provide clarity and certainty for businesses grappling with complex rules.

The DIY house builders scheme

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The DIY claims scheme should be extended to allow VAT on all services used in the course of construction or conversion of eligible buildings to be recovered.

VAT-registered businesses which build new residential properties for sale, or which convert commercial properties into residential properties for sale, are entitled to recover all input VAT on costs of construction. This is because the sale of new housing is subject to VAT at the zero rate (VATA 1994 Sch 8 Group 5 Item 1(*a*) and (*b*) refer), meaning that all input VAT costs associated with the construction and sale of new or converted residential properties can be recovered using a business's VAT returns.

Against this an individual wishing to construct or convert their own dwelling would be in a far less favourable position as they would be unable to recover any of the VAT cost. However, in an apparent effort to remove this disparity between an individual and VAT registered businesses, VATA 1994 s 35 contains provisions for a refund of VAT to persons constructing certain buildings. This has become known as the DIY (Do-It-Yourself) House Builders and Convertors VAT Refund Scheme.

Whilst allowing any non-VAT registered person to recover VAT on a non-business expense is perhaps anomalous in itself, the relief still falls far short of putting the individual on the same footing as a VAT registered business.

This was highlighted succinctly in *Wood* (1978) 1 BVC 1,073, where the Tribunal said of the DIY Scheme: 'It is clear from the provisions of this Act that the relief for 'do-it-yourself' builders extends only to goods and not to services. The appellant submitted that he ought to be able to claim a refund of input tax in the same manner as if he had been in business as a builder constructing the house, but that is not what Parliament has enacted...'

Since 1996 when a revised s 35 was substituted into VATA 1994 by the Finance Act of that year, the DIY scheme can be used to recover VAT on services of building contractors who charge VAT on work to convert empty or non-residential properties into residential use. However, VAT recovery on services is still strictly limited and the scheme cannot be used to claim VAT on the hire of tools, scaffold, skips or other equipment. At the same time a VAT-registered housing developer is normally entitled to recover VAT on the costs of architects, surveyors and consultants employed in the construction project; whereas, VATA 1994 s 35(1C) specifically excludes the services of such contractors from the scheme.

In order to rectify this anomaly, and to encourage more house building, the DIY claims scheme should be extended to allow VAT on all services used in the course of construction or conversion of eligible buildings to be recovered.

HMRC's guidance on the use of the DIY scheme is available via www.lexisurl.com/GXIWA.

Exempt payment services following *AXA*

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The judgment of the CJEU in *AXA UK PLC* (C-175/09) introduced material uncertainty to the scope of the VAT exemption for payment services. It is to be hoped that this uncertainty will be clarified by a further reference to the CJEU or that the legislation changes as a result of the EU financial services review.

Article 135(1)(*d*) of the VAT Directive exempts 'transactions, including negotiation, concerning … payments, transfers, debts … but excluding debt collection', and this is implemented in UK law by VATA 1994 Sch 9 Group 5 item 1, which exempts 'the issue, transfer or receipt of, or any dealing with, money'.

AXA concerned the activities of Denplan which, for a fee charged to a dentist, collected a monthly payment from the dentist's patient by direct debit and then transferred the amount to the dentist via BACS, after deducting its fee and an insurance premium.

The High Court had held that Denplan's services constituted exempt payment handling following the Court of Appeal in *FDR* [2000] EWCA Civ 216 and *Bookit* [2006] EWCA Civ 550, and did not consider whether they might fall within the VAT Directive's carve-out for debt collection, which was previously only thought to apply to the collection of debts that were already overdue. In *AXA*, the CJEU overturned this accepted legal wisdom, holding that 'debt collection' should be interpreted broadly as including the collection of all debts, including those that are paid on their due date, with the result that Denplan's services were taxable. HMRC has said that 'all services principally concerned with collecting payments from the person owing them for the benefit of the entity to which those payments are owed', regardless of due date, fall within the exclusion and so are taxable (*HMRC Brief 54/10*).

This has caused uncertainty, because Denplan's activities arguably cannot be materially distinguished from other financial services that have previously been accepted by HMRC and the UK courts as exempt, and it is not easy to reconcile *AXA* with the earlier UK cases. Indeed, it seems arguable that all transfers of money necessarily involve the 'collection' of a sum from one party (the debtor) and its transfer to the person to whom that sum is owed (the creditor), and this was the case in *FDR* and *Bookit*. In fact, following *FDR*, this previously seemed to be the sine qua non for exemption. If *AXA* and HMRC's view are taken to their logical conclusion, then the exemption could be deprived of its intended effect.

In February, HMRC issued revised guidance in its *VAT Finance Manual* to reflect *AXA*. While HMRC seems unwilling to contradict existing UK cases to impose VAT where exemption is well established, it seemingly wants to apply *AXA* to new and as yet unlitigated transactions, such as bill payment services and internet payment services (IPS). HMRC says (at para VATFIN2440) that where an IPS has a payment transferred into its bank account by a merchant acquirer before passing it to the retailer, then this will be taxable debt collection; but it is not clear how this differs from the role performed by a merchant acquirer in a typical credit card transaction (considered in *FDR*), which is considered exempt.

It seems strongly arguable that a 'debt collection' service cannot be provided to the debtor, as it seems nonsensical for a person to pay someone to collect a debt that they owe. *Bookit* is distinguishable from *AXA* in this way (because the service was provided to the customer as debtor). But this introduces an element of absurdity and distortion because it will often be possible to restructure arrangements to fall outside the exclusion by providing that the debtor pays for the 'collection' service; eg, what if Denplan purported to charge the patient for its payment service, rather than collecting an undifferentiated sum and then deducting its commission? The economic result would be the same, but the service might be exempt.

It is to be hoped that these uncertainties will be clarified by a further reference to the CJEU (which seems almost inevitable) or that the legislation changes as a result of the EU financial services review.

Supplies made by lawyers

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The interaction of a decision of the CJEU and VATA 1994 Sch 4A para 16 created an anomaly in certain circumstances where a lawyer acts as an arbitrator.

VATA 1994 s 7A provides that business-to-business supplies of services are treated as made in the country in which the recipient belongs and business to non-business supplies of services are treated as made in the country in which the supplier belongs.

For these purposes, the recipient of the supply does not need to be registered under VATA 1994 to be a business as any person who, independently, carries out in any place any economic activity is also a business.

VATA 1994 s 9 sets out the rules to be used to determine where a supplier or recipient belongs. It provides that a 'business person' belongs in the country in which he has a business establishment or some other fixed establishment provided he does not have business establishments and/or other fixed establishments in more than one country.

Where a person has business establishments and/or other fixed establishments in more than one country, he belongs in the country in which the business establishment or other fixed establishment most directly concerned with the supply is located. If the above two rules do not produce a country in which the business person belongs then he is treated as belonging in the country in which his usual place of residence is. A non-business person is treated as belonging in the country in which his usual place of residence is.

The rule in s 7A is, however, modified by the rules in VATA 1994 Sch 4A. Schedule 4A para 16 provides that services of lawyers which are provided to a non-business person who belongs in a country which is not an EC Member State are treated as made in the country in which the non-business person belongs.

However, in the CJEU case of *von Hoffmann v Finanzamt Trier* (C-145/96) [1997] STC 1321, it was held that a lawyer acting as an arbitrator is not regarded as providing the services of a lawyer. Accordingly, para 16 is not applicable where a lawyer acts as an arbitrator.

This decision can lead to anomalous results in that, if a UK lawyer went to Paris to act as an arbitrator in respect of a dispute between say, a US business and an individual from a non-EC Member State, the supply by the lawyer would be treated as taking place in the UK (assuming that is where the lawyer belongs) and therefore subject to UK VAT.

The education anomaly

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Tuition provided by a sole trader or partners in a partnership can qualify for the VAT exemption in VATA 1994 Sch 9 Group 6 Item 2 but tuition provided to the same people at the same time by employees of the sole trader or partnership cannot.

There are possibly always going to be anomalies when there are different rates of VAT and when some goods and services are exempt or outside of the scope of VAT. One of these concerns the VAT exemption for 'the supply of private tuition, in a subject ordinarily taught in a school or university, by an individual teacher acting independently of an employer' (VATA 1994 Sch 9 Group 6 Item 2).

As a general point, VAT exemptions are usually dependent on the nature or subject matter of the transaction, not the nature of the supplier. This point was considered in *Sparekassernes Datacenter (SDC) v Skatteministeriet* (C-2/95) [1997] STC 932 when the CJEU held that the exemption for finance is not restricted to transactions effected by financial institutions or any particular type of legal person.

However, the exemption for education is very much dependent on the nature of the supplier. This point was considered in *Marcus Webb Golf Professional* (TC00323), on which HMRC has provided the following guidance (in HMRC's *VAT on Education Manual* at VATEDU40300):

> '*Marcus Webb Golf Professional* (TC00323) concerned a three-way partnership: a golf professional, his wife, and their related limited company. HMRC accepted that golfing tuition supplied by the golf professional as a partner was exempt (as golf lessons could be included under the definition of "a subject ordinarily taught in a school or university") but said that tuition supplied by him as director of the limited company was standard-rated. HMRC also said that tuition supplied by a partnership employee was standard-rated. The Appellant appealed the ruling on the grounds that it violated the principle of fiscal neutrality.
>
> 'However, the Tribunal ruled that as neither the golf professional nor the employee was a body covered by public law with education as its aim, the only exemption possibly available was tuition given privately by a teacher, covering school or university education. The term "privately" was defined by the ECJ in *Haderer* (later supported by the Court of Session in *Empowerment Enterprises*) as requiring the teacher to provide the tuition on his own account and at his own risk, something an employee would not do. The term acting independently of an employer in the UK exemption reflects that definition of "privately". The Directive had been correctly transposed and there was no claim. The principle of fiscal neutrality was overridden by the terms of the VAT Directive, which envisaged different liabilities applying to the same supply of tuition, depending on the status of the supplier.'

Many providers of private tuition may prefer to qualify for the VAT exemption for private tuition, particularly if there is a going rate for the lessons and their customers cannot recover VAT. This could affect whether or not a tutor operating as a sole trader incorporates their business. However, it can sometimes be beneficial to turn an exempt supply into a taxable supply by incorporating a sole trader tuition business. For example, there may be a significant cost on the horizon when it would be useful to be able to recover the VAT – a piano teacher needing to replace their grand piano perhaps.