VAT AVOIDANCE AND THE FINANCE BILL 2004

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The phrase "VAT avoidance" stirs complex emotions. One view is that because tax avoidance is "legal" as opposed to criminal, the act of arranging a taxpayer's affairs in a way which gives a tax saving yet defeats the intention of the legislation is perfectly acceptable. Providing the taxpayer stays within the boundaries of what it regards as legal or non-criminal, then it is nothing to the point that it puts in place an arrangement which saves the taxpayer an amount of tax which in the ordinary course of events he would expect to pay. In the corporate sector, it will be argued that the company has a duty to its shareholders to minimise the amount of tax it pays. Appeals to the better nature of taxpayers, be they individuals or corporations, can fall on stony ground. An appeal to the avoiders' moral senses, based on the need for tax to fund schools and hospitals for the benefit of the whole community may cut little ice with individuals who often do not use those services because they educate their children privately and use private health insurance.

To my mind a more powerful argument against avoidance centres on unfair competition. This is the aspect of tax avoidance Customs come across most frequently. The well-known "merchant acquirers" (or Debenhams) scheme is a case in point. This is the device used by many retailers to siphon off 2.5% of the amount paid for goods by customers and treat it as consideration for some kind of exempt card handling service. The customer knows nothing about the details of

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the arrangement because if he did, he would probably ask for a discount if he paid cash. All he will see is a sentence on his credit card slip which more often than not goes unread. If the shopper enquires at the checkout as to the meaning of the 2.5% figure he may be told, as I was recently, that it is to do with "European regulations" or even "you don't need to worry about that – it is for our benefit". Still, at least that is truthful.

When the scheme was first marketed, Customs were approached by retailers who did not believe the device achieved the technical tax result which was intended. Accordingly, we were told, they would not be implementing the device. As the popularity of the scheme grew, more and more retailers joined it. After all, if you can save VAT on 2.5% of turnover why not "go for it". And more to the point, if your competitors are "at it" then the business may feel that it has little choice but to join it and "get a slice of the action". The result of this growth in the scheme was that retailers who told us that they would not be joining the scheme had a change of heart. The problem was the long delay in bringing the lead scheme before the tribunal which meant that they were suffering a continuing competitive disadvantage. So they, too, joined the scheme.

Let me give you another thought on avoidance. I was intrigued to find out what accountants were saying about the budget rules on disclosure of avoidance schemes so I went to a couple of websites. Here is a quote from the website of a leading firm of chartered accountants on the subject of avoidance:

> *"There are undoubtedly instances where loopholes in the legislation are exploited by businesses in an attempt to get around the purpose of the law. Clearly, in these instances, Government tax receipts are affected and anti-avoidance measures are required. The problem is that so many anti-avoidance measures of this type do not address the precise issue at stake and the end result is that* ***businesses are forced to change their normal operational practices because they have suddenly become the focus of tax law."***

In the Debenhams scheme there were no loopholes in the legislation, it was the companies who changed their operational practices to try to make the scheme work. In another case the centre of the business was purportedly switched to the Channel Islands to try to create a tax advantage. In yet another case an Irish phonecard company was set up to try to avoid tax in both Ireland and the UK. Nothing forced those businesses to change their "operational practices" – it was the chance to make a fast buck at the expense of the public purse.

Let me give you another little gem from the same website:

> *"There is little doubt that widely drawn anti-avoidance measures generate additional tax revenue for the Government but they do so at the cost of the businesses that get caught in the crossfire. It is also important to realise that businesses have to consider the impact of the new measures just in case they are affected. Adding layer upon layer of anti-avoidance measures to a system already creaking with complexity does nothing to help either the Revenue or businesses."*

I did think this was a "bit rich". And talk about which comes first – the chicken or the egg? It is precisely because of devices put in place to avoid tax that we have to burden legislation with complexity. Take the VAT option to tax rules in respect of property. When these came into effect in April 1989 they were relatively straightforward. Now they are a minefield for the unwary. Why has that happened? Because of the activities of those who wish to seek a tax advantage where under "normal operational practices" (I quote from the website) they would have none. Our most recent anti-avoidance legislation was introduced in this Budget to block certain "arrangements" perpetrated by exempt or partly exempt businesses who were acquiring property by means of the transfer of the property business as a going concern. We were losing VAT on these arrangements and they had to be stopped. Not only does the blocking complicate the legislation but it also means that more businesses must now consider the full disapplication test (a device to remove the option to tax for some businesses).

Regrettably, that is an inevitable consequence of the actions of business seeking to avoid the tax properly due on the transaction.

Our strategy on avoidance is to attack it wherever we find it, in a variety of ways. Thus we rigorously "proof" new legislation to ensure that it does not lend itself to creating avoidance opportunities. When we find new schemes we act to close them by legislation. We do our best to ensure that we do not affect non-abusive arrangements but sometimes that is inevitable. Blame the avoiders, not Customs, for that. And at the same time as closing schemes down by legislation, we will attack those schemes which we do not believe achieve their purpose in the Courts by litigation.

One thing we have learnt in Customs is that many avoidance schemes fail either for lack of expertise in implementation or because they are not technically robust. But the first challenge for the Revenue departments is to uncover the scheme. Sending large numbers of technically able staff into businesses to uncover avoidance schemes is heavy on resources. Nor is it the most stimulating experience to have to conduct an inquisition to attempt to drag out of the tax manager and finance director every last nuance of tax planning.

So we have the disclosure provisions announced in the Budget by the Chancellor of the Exchequer and unveiled in the Finance Bill.

The overall policy objective of these provisions is to enable Customs to obtain information about tax avoidance schemes earlier than is the case at the moment. Apart from that, the policy on avoidance remains the same. With the earlier knowledge we will be able to consider the earlier introduction of blocking legislation. We will be able to commence the challenge of schemes which we do not believe will work. Under these arrangements, though, there is no bar on businesses challenging our ruling, just as they do at present.

I think it is worth running through those provisions and then looking at the Statutory Instrument which contains the detail.

Dealing with the Finance Bill clauses first of all:

Clause 19 of the Bill introduces the disclosure provisions. That clause gives effect to Schedule 2 to the Bill which adds Schedule 11A to the VAT Act 1994.

Paragraph 2 of the Schedule defines the meaning of the phrase “obtaining a tax advantage”. This is an important phrase as it is one of the “filters” which businesses need to consider when they decide if they need to make a disclosure.

Essentially a person obtains a tax advantage if either the amount by which output tax exceeds input tax is less than it otherwise would be, or he obtains a VAT credit when he would not otherwise do so, or obtains a larger VAT credit or obtains a VAT credit earlier than otherwise would be the case. There is a further circumstance, in addition to the previous ones, when a person obtains a tax advantage. That is where the person recovers input tax as a recipient of a supply before the supplier accounts for output tax, the period between the time when the input tax is recovered and the time when the output tax is accounted for is greater than would otherwise be the case.

Paragraph 3 gives the Treasury power to “designate” i.e. list a scheme where it appears that a type of scheme has been or might be entered into for the purpose of enabling anyone to obtain a tax advantage and it is unlikely that anyone would enter such a scheme unless the main, or one of the main purposes of so doing was to obtain a tax advantage. The designation will be made by Statutory Instrument. The fact that the Treasury does not believe that the scheme actually works in the taxpayer's favour does not stop the scheme from being "listed" – see paragraph 3(2) of the schedule.

The SI will allocate a number to each scheme. That number plays an important part in the disclosure arrangements.

"Scheme" is defined as including "any arrangements, transaction or series of transaction".

There is also power to designate (paragraph 4) certain provisions associated or included in avoidance schemes. A "provision" is defined as including any agreement, transaction, act or course of conduct." This is the second part of the disclosure scheme and is sometimes referred to as the "hallmarks" of avoidance. Again, these will be set out in a SI and will contain provisions which will often feature in avoidance schemes. We have published the draft SI with the "hallmarks" and we will examine those shortly.

Either where a scheme is "designated" or although it is not a designated scheme it meets two conditions (A & B), it is a "notifiable scheme" (para. 5). Condition A is that the scheme includes or is associated with a "provision". Condition B is that the scheme has as its main or one of its main purposes, the obtaining of a tax advantage by any person. These conditions will apply to the "hallmarks" part of the disclosure arrangements. Condition B is important as it acts as a "filter" to avoid the need for businesses to notify any use of one or more of the provisions to Customs.

Paragraph 6 contains the duty of taxable persons to notify the Commissioners of the use of schemes. The duty to notify arises where the amount of VAT shown in a return for a period as payable by or to him is less than or greater than it would be but for any notifiable scheme to which he is a party. Or he claims a repayment of output tax or an increase in credit for input tax for a period where a return has already been delivered and the amount claimed is greater than it would be but for such a scheme.

Where the scheme is a designated scheme then the taxable person must notify us of the number of the scheme within the time and in the manner specified in regulations. If the scheme is not a designated (i.e. "listed") scheme – but it is a notifiable one because it meets Conditions A & B under para. 5(2) and (3) ("hallmarks") – then certain information must be provided to Customs. However, there is no need for the taxable person to provide this information – it can be provided by "any person" – in practice this is likely to be the promoter of the scheme.

The information can be provided at any time (see para. 9) and if it is provided Customs will allocate a reference number and notify it to the person giving the information. The person who is provided with the reference number must provide it to the taxable person.

Paragraph 7 provides de minimis limits. Thus under the designated scheme the limit is £600,000 and under any other notifiable scheme (the "hallmarks" disclosure scheme) it is £10,000,000. Where there is a group undertaking, as defined in part 7 of the Companies Act 1985, the de minimis provisions apply to the group. Those limits are calculated by reference to twelve months ending before the period when the person makes the return which shows the benefit of the VAT advantage. There is an apportionment rule where less than twelve months has elapsed before the period when the return is made which discloses the tax advantage. In case you have in mind disaggregating businesses to get below the de minimis thresholds, paragraph 8 gives Customs power to make directions to cope with artificial separation of businesses for the purpose of avoiding the reporting obligations.

There are penalties for failing to notify the use of a notifiable scheme (para. 10). However, the defence of "reasonable excuse" is available in the first instance if they can satisfy Customs or, on appeal, the VAT and Duties Tribunal. There is also a "double jeopardy" safeguard if the person is also convicted of an offence or is assessed under section 60 of the VAT Act. Furthermore, the tribunal has power to mitigate the penalty.

Where the failure to notify relates to a notifiable but not a designated scheme – namely a "hallmarks" scheme – the penalty is £5000.

Where the failure to notify is in respect of a designated scheme then the penalty is 15% of the VAT saving. The calculation to arrive at the VAT saving is described in para. 11(3). Even where the scheme results in more VAT being payable than would be the case if the scheme were not used, that VAT is treated as "saved" – for example if a business sets up a scheme which converts an exempt supply into a taxable one to enable input tax recovery.

The amount "saved" is aggregated to the VAT which has been claimed by virtue of the use of the scheme, after deduction of the VAT which would have been claimed if the scheme had not been used.

The period of the assessment starts with the period when the duty to disclose arose and ends either when disclosure was made or when Customs notified the assessment. The fact that disclosure had been made does not prevent the issue of an assessment. Where it is not possible to "readily attribute" the VAT saving to a particular period there is power for Customs to decide in which periods the savings arose and assess to the best of their judgement. A time limit applies in that Customs have two years to assess from the time when sufficient facts came to their attention to indicate that there had been a failure to disclose a notifiable scheme. Appeals can be made against the aggregation direction, the liability to a penalty, the assessment and the amount of the assessment – although the tribunal only has power to reduce the penalty to the appropriate amount under paragraph 11.

So what are the listed schemes? Customs have now published the draft Statutory Instrument which sets out the schemes and the "hallmarks". The first scheme involves what Customs consider the abuse of "person constructing" status, namely the grant of a major interest in a refurbished building to create a zero-rated supply, thereby claiming back all the input tax. The building owner continues to occupy the building by virtue of an exempt leaseback from the subsidiary. The second listed scheme catches grants of major interests linked to management and service charges which wraps up the ongoing building costs to the zero-rated grant of the major interest. The third scheme is the card handling scheme which most of us who use credit cards to shop come across. The next scheme involves a taxable education provider setting up a subsidiary as a non-profit making body to supply the education it provides. In this way it avoids having to account for VAT on its supplies. The next scheme is the reverse of this. It involves an eligible body which provides exempt education setting up a subsidiary which is not an eligible body. This company provides taxable education so it can recover input tax. Of course this arrangement is only set up when the recipient can recover any VAT charged.

Lease and leaseback schemes are also caught where the lessor is partly exempt and recovers all the VAT and then leases the goods to a taxable person who leases them back to the lessor. Value-shifting is also listed. We are seeking to find "carve out" schemes where the value of a standard-rated supply is reduced on condition that another item at a lower rate of VAT is purchased at or about the same time. Another scheme we have listed relates to extended approval periods for mail order. In some cases we have seen businesses extend approval for up to 12 months – often in cases where the goods have been consumed and where they have been paid.

Our old favourite A:B share schemes is also listed. These seek to arrange the grouping of a partly exempt company with its supplier – usually an IT supplier – to avoid irrecoverable VAT on the third party supplies.

Although we have amended the VAT grouping legislation to prevent such schemes we still need to direct that groups must be dismantled, hence the listing.

Turning now to the "hallmarks", we have approached this on the basis that there are two kinds of hallmarks. The first set of hallmarks is those associated with schemes. Thus we have specified the need for: (1) disclosure of confidentiality conditions imposed by promoters, (2) the sharing of the tax advantage with another party to the scheme or with the promoter, and (3) disclose of schemes where they are contingent on tax savings from the scheme.

The second set of hallmarks is those which have the characteristics of avoidance schemes. Thus, prepayments between connected parties, funding by share subscription or loans also between connected parties. Also off-shore loops where there is a supply of a service within article 3 of the VAT (Specified Supplies) Order 1999, which are used in making Schedule 8 or 9 supplies to a person belonging in the UK. Finally, property and construction supplies to connected parties are also disclosable as falling within the hallmarks scheme.

It is important to note that just because a business carries out a transaction which meets the hallmarks test it does not follow that the arrangement is disclosable. To be disclosable the scheme must have as its main purpose or one of its main purposes, the obtaining of a tax advantage. As I indicated earlier, the phrase "tax advantage" is defined and the scheme in contemplation would need to fulfil that criterion as well. So if a business decides on a particular arrangement it would need to decide whether by using the arrangement it would obtain more input tax (say) than would otherwise be the case if it had not used the arrangement. If it does then it will have to decide if its main purpose, or one of its main purposes, is to obtain that tax advantage.

Having spent some sixteen years as an adviser in the VAT arena, I have to say that I do not believe that a business cannot judge whether the main purpose, or one of its main purposes, for entering into an arrangement is or is not for saving tax. It is possible to "dress up" transactions so that they have a veneer of commerciality but in its corporate heart of hearts the business will know the true reason for its course of conduct.

We have held very constructive meetings with the Big 4 firms of accountants as well as representatives of some of the smaller firms. A number of useful and valid comments have been made about the legislation and the schemes – both listed and hallmarks – and we will be considering what, if any, changes we need to make. As a further stage in what is an informal consultation exercise, we are offering a "workshop" to firms for their clients to help them understand the rules.

Needless to say a number of points and questions have been made already by other bodies we have spoken to and which we are examining to see which ones we should adopt. We are inviting representations up to 30th June on the SI and indeed any other aspects of the legislation. The SI will be of the affirmative resolution variety which means that there will be a debate about it – albeit after the SI takes effect on 1st August. The advantage of using this procedure rather than making changes in the Finance Bill is that it enables Customs to make changes either by adding to or removing schemes as and when necessary. Importantly, it also allows more scrutiny of any proposed additions to the SI since it will receive more Parliamentary time than it would perhaps receive if it were part of a larger block of legislation.

The procedures for complying with the disclosure rules will be set out in a Statutory Instrument, although subject to the negative resolution procedure.

Another important piece of guidance will be the Public Notice containing details of the changes. This will cover the policy on penalties and assistance to businesses in making the decision whether they need to disclose arrangements.

The proposals themselves I suggest are not excessive. Neither are the penalties too severe. Indeed, the object of the legislation is to change behaviour so that those who do not at present disclose schemes will do so.

The measures are proportional to the problem revenue departments face in dealing with avoidance. The "offence" is failure to disclose a notifiable scheme – the fact that the business challenges the scheme and ultimately succeeds is, as a matter of pure law, nothing to the point – although one would think that mitigation or a defence of reasonable excuse could be mounted.

Why not outlaw the schemes themselves? In many cases we do that. Earlier I mentioned the changes to the TOGC rules in respect of property transfers. Other changes are proposed to the grouping rules to ensure that corporate structures are not put in place which distort the tax position of the companies in question. Could we implement a GAAR (general anti-avoidance rule)? We probably could but we have decided to await the judgement in the *Halifax* case to see what the ECJ says about such rules.

The reason for approaching the avoidance problem in the way we have is that it is a step along the way to providing a policy solution to an operational problem. It will begin to give us the information to challenge the scheme – either by legislation or by litigation.