



HM Revenue
& Customs

Simplification of Partial Exemption & Capital Goods Scheme

Call for evidence

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1. Introduction

- 1.1 At Spring Statement 2019, the government announced that it would launch a call for evidence exploring ways to improve the operation of Partial Exemption (PE) and the Capital Goods Scheme (CGS), following the findings of the 2017 Office of Tax Simplification (OTS) VAT review.
- 1.2 The government wants UK businesses to operate in the best possible environment to ensure that they remain both productive and competitive. The government also wants the tax system to be efficient and effective.
- 1.3 While it is important businesses comply with their tax obligations, the government recognises that the tax system should not inhibit productivity or prevent fair competition.
- 1.4 This call for evidence focusses on PE and the CGS. These are two areas of VAT which can involve a significant amount of administration for businesses, with complex calculations often being required for some businesses to determine the amount of input tax that they are entitled to recover.

What the OTS have said on simplification

- 1.5 In November 2017, the Office of Tax Simplification (OTS) published its report, 'Value Added Tax: Routes to Simplification' which made recommendations on the operation of various aspects of VAT, including PE and the CGS.
- 1.6 The OTS highlighted that the processes involved for PE and the CGS are not as efficient as they could be. It suggested that HMRC should consider reforms to the PE regime with the aim of simplifying its application. The OTS also identified issues with the current CGS regime, highlighting that the time and administration required can sometimes be significant only to result in a relatively small adjustment.
- 1.7 The government is taking the opportunity to review the PE and the CGS regimes, focussing on potential simplifications whilst ensuring that VAT continues to be collected in an efficient way. VAT raises a significant amount of revenue and plays an important part in funding the government's public spending priorities. Therefore when considering any changes the government will also need to factor in any impacts on revenue.
- 1.8 This call for evidence is an opportunity for business to share their views on PE and CGS and potential simplification.

1.9 The call for evidence is split into three sections:

- The first section looks at the process for applying PE Special Methods (PESMs) and the possible ways in which this might be improved to reduce burdens for taxpayers and HMRC alike
- The second section explores how the current PE de minimis limit could be changed to aid simplification
- The third section considers possible policy solutions to issues caused by the CGS.

2. Partial Exemption

- 2.2. VAT registered businesses must charge VAT on all the taxable goods and services that they supply (output tax). They may also recover the VAT that has been incurred on the goods and services they have purchased (input tax) in the course of making those supplies.
- 2.3. Businesses making exempt supplies do not have to charge any VAT on the supplies they make, but cannot recover any of the VAT incurred.
- 2.4. Some businesses make both taxable and exempt supplies ('partial exemption') and incur input tax that cannot be attributed directly to either taxable or exempt supplies. This input tax is called residual input tax and a calculation must be performed to determine how much of this is recoverable.
- 2.5. There are various goods and services which are VAT exempt, such as financial services, healthcare, gambling, education and insurance, but businesses making such supplies will very often also make taxable supplies. One example of such a 'partly exempt' business would be a casino supplying exempt gambling services that also has an on-site restaurant that makes standard-rated supplies of food.
- 2.6. The OTS noted in its VAT review that the many, often complex issues of PE usually revolve around one basic question: what 'fair and reasonable method' can be used to establish how much of the residual input tax can be recovered?
- 2.7. There are two types of methods that are available to carry out this calculation. The default position is to use the standard method which uses turnover to calculate the recoverable input tax. However, if this does not give a fair and reasonable result a PESM can be proposed. There are several scenarios where the standard method could fail: for example, if different supplies use the same costs but in different ways or if high value supplies are made but with only a slight use of residual inputs. A PESM will reflect the specific activities of the business and in some cases can be very complex. Whatever method is used, it must be fair and reasonable.
- 2.8. At present where a business requires a PESM, it must submit a proposal with a signed declaration that the proposal is, in its view, fair and reasonable. This proposal will be reviewed by HMRC and approval given for its use following checks on the proposed method. In some cases the review of the proposed method can take years before approval is given. This approval process can be burdensome for both HMRC and customers. The government is launching this call for evidence to gather evidence on how the current administration of PESMs impacts businesses and to seek ways in which it can be simplified and improved. The government welcomes suggestions not limited to what is discussed in the following section.

Partial Exemption Special Methods

- 2.9 Removing the requirement for taxpayers to negotiate and obtain approval from HMRC to use a PESM could be an effective VAT simplification.
- 2.10. This could simplify and speed up the process of applying a PESM as the need for time consuming negotiations would no longer be there. A declaration would still be required that the business believed the PESM to be fair and reasonable.
- 2.11. At present, a business is required to take reasonable care in arriving at the proposed PESM, before submitting it with the declaration. By removing the approval process, the declaration would hold greater importance. HMRC could review the PESM at any time and bring its operation to an end and potentially apply penalties for misuse if appropriate. This is because any VAT error is subject to a review under the current penalties regime and can result in the issue of a penalty if certain criteria are met.
- 2.12. Removing the requirement to seek prior approval before applying a PESM is likely to significantly reduce the burden both on businesses and HMRC in terms of time and resource, particularly in relation to the negotiation of a final agreed PESM. However, this lack of approval could also create uncertainty. For example, it could lead to businesses hiring potentially expensive advisors or spending a disproportionate amount of time on trying to ensure the PESM is robust.
- 2.13. The ability to apply a PESM without agreeing it with HMRC could be particularly beneficial for growing businesses who can readily update their method and reduce the need to recalculate the amount of VAT that they can recover. It would also remove the “contractual” nature of PESMs which would give businesses the flexibility to make changes in real time.
- 2.14. On the other hand, removing this requirement could restrict transparency between HMRC and the customer – it might be harder to assess whether a method in place is fair and reasonable. Without HMRC insight into the process, it may increase the potential for methods to be used which are not fair and reasonable, resulting in a situation where HMRC assess liabilities and potentially issue penalties. However, the greater use, and more detailed application, of sectoral frameworks (which provide a good basis for particular sectors to establish a method) could go some way to alleviating this concern. Frameworks are additional guidance for specific sectors of the UK economy and have been put together with the involvement of the sector’s representative bodies. The purpose of these is for a business to be able to submit a PESM that is fair and consistent that can be approved with minimum discussion.
- 2.15. The government recognises that reforming the operation of PESMs is an area that will attract a lot of interest. As such, we are keen to hear any other ways that this

regime could be simplified and will be interested to learn the experiences of business in getting PESMs approved, in terms of what works well and what doesn't.

Questions

1. Does your business use a PESH? If so, what was your experience in getting the PESH approved?
2. How long did the approval process take?
3. Do you find the administration involved with PESHs challenging?
4. Would allowing businesses to apply PESHs without seeking approval improve the system? Please give reasons for your answer.
5. Would there be issues created by removing the requirement to seek approval of a PESH?
6. Would an increased focus on the use of sectoral frameworks be of benefit, particularly if approvals were removed?
7. Do you have other suggestions to improve or simplify the application of the PE regime?
8. Do you have other suggestions on how the way in which HMRC interacts with partly exempt businesses could be improved?

3. De Minimis

- 3.1 In the OTS report on simplifying VAT, it noted that businesses with input tax attributable to exempt supplies cannot generally reclaim it. However, EU legislation allows member states to ignore insignificant amounts of input tax relating to exempt supplies.
- 3.2 In the UK we apply this simplification. Where exempt input tax incurred by a business is insignificant it can treat that exempt tax as if it were taxable input tax and recover it in full if its total value is less than a prescribed amount. An amount that is insignificant is known as 'de minimis' and is set out in law for PE purposes.
- 3.3 Businesses that engaged with the OTS review welcomed simplification of this regime as it would benefit small businesses that have to carry out this calculation and, due to the current de minimis limit, would otherwise have to use a PESM.
- 3.4 A business can be treated as fully taxable in any VAT period (this is not always the standard three months) if the total value of its exempt input tax is not more than:
- £625 per month on average; and
 - Half of its total input tax in the relevant period.
- 3.5 For some businesses, every time a VAT return is due, this calculation must be carried out to determine whether the exempt input tax is recoverable.
- 3.6 In 2010 the PE de minimis was simplified by introducing two new tests that did not rely on the businesses performing a PE calculation. Businesses could instead use readily available accounting information to quickly assess whether they qualified as de minimis under Test 1 or, if they failed Test 1, under Test 2. Only those businesses that failed Test 1 and Test 2 would be required to perform a full partial exemption calculation.
- 3.7 Test 1: Total input tax incurred is no more than £625 per month on average and the value of exempt supplies is no more than 50% of the value of all supplies.
- 3.8 Test 2: Total input tax incurred less input tax directly attributable to taxable supplies is no more than £625 per month on average and the value of exempt supplies is no more than 50% of the value of all supplies. However, in practice it seems that most businesses are not making use of this simplification.
- 3.9 This call for evidence outlines two other possible options for reforming the de minimis test: increasing the threshold and removing the de minimis test entirely. However, the government would welcome other ideas on how the current operation of the PE de minimis test could be improved.

Increasing the de minimis limit

- 3.10 The current PE de minimis limit of £625 has not been increased since its introduction in 1994. It was suggested in the OTS report that the government should consider increasing the de minimis limit as well as exploring alternative ways of simplifying the processes for businesses incurring insignificant amounts of input tax.
- 3.11 An increase to the de minimis limit could mean that more small businesses fall under the de minimis limit. These businesses would be able to treat a higher amount of input tax relating to exempt supplies as insignificant and therefore recover their total input tax in full.
- 3.12 However, an increased de minimis limit would not remove the obligation for businesses to carry out this calculation so may not be a simplification.

Questions

9. What is your experience of carrying out the de minimis test?
10. What would the advantages and disadvantages of increasing the de minimis threshold be to business?
11. Are you aware of the existing simplification, and do you make use of it?

Removal of the de minimis limit

- 3.10 Some VAT jurisdictions, such as Germany, do not have a de minimis limit. As a result, input tax relating to exempt supplies is disallowed in full, regardless of whether it counts as insignificant. While the de minimis test requires a calculation to be made, taking up time and resources for businesses, it does allow for full recovery of input tax when the taxpayer qualifies. The question here is whether the opportunity cost of spending the time on the calculation is worth the benefit.
- 3.11 The main benefit to the removal of the de minimis limit is that it would ensure a single calculation for all businesses, rather than requiring two stages for some because of the need to establish whether a business is de minimis. However, it would mean that many small businesses would not be able to benefit from the option to treat themselves as fully taxable for the VAT period.
- 3.12 It is worth noting that those businesses whose activities mean they are clearly above the de minimis threshold are not required to complete the de minimis test. Similarly, those businesses whose activities may qualify as fully taxable as a result of the de minimis test, but determine the test is too burdensome, are not required to complete the de minimis test. In both cases, such businesses will only need to apply the full PE calculation.
- 3.13 The de minimis test as well as the simplified tests introduced in 2010 all rely on a monetary limit (within a two-part test) for determining 'insignificant' tax. The government would be interested in businesses' views on other ways of determining 'insignificant'.

Questions

12. What would be the advantages and disadvantages of removing the de minimis test?
13. Do you have other suggestions to improve or simplify the application of the de minimis regime?
14. Do you have any suggestions on how to determine what can be considered as 'insignificant' that would be different to the current de minimis tests?

4. The Capital Goods Scheme

- 4.1 The CGS provides for adjustments to be made over time to the initial VAT recovery relating to purchases of certain capital items, recognising the longer working life such assets have. The recovery of the VAT incurred on such assets is only made once – in the year of purchase. If, during the life of the CGS, there is any change in the proportion of taxable use then businesses must make an adjustment to their input tax recovery to take account of this.
- 4.2 A business can reclaim more if the proportion of its taxable supplies increases, but it will have to repay some if it decreases. The CGS reflects the proportion of taxable use against exempt and non-business use, whereas PE only considers taxable and exempt use.
- 4.3 The CGS applies to specific assets over a certain value. These are:

	VAT exclusive value of:
Land, buildings and civil engineering work Alterations, extensions, annexes and refurbishments.	£250,000 or more
Computers and computer equipment	£50,000 or more
Aircraft, ships, boats or other vessels	£50,000 or more

- 4.4 An adjustment period is the time over which a business reviews the extent to which a capital item is used in making taxable supplies. The adjustment period is known as an interval. There are 5 intervals for computers, ships and aircrafts and for all other capital items there are 10. An interval is normally a year and is aligned with the business' PE tax year.
- 4.5 The government recognises that administering the CGS can sometimes be burdensome. It is also likely that businesses will sometimes employ external advisors to oversee the CGS adjustments.
- 4.6 Several options have been identified that may simplify the application of the CGS and ease the administrative burden on CGS users. For example, this call for evidence considers the benefits of raising the current threshold for land and property and changing the duration of CGS intervals. Another option could be to remove computers from the CGS, as you are unlikely to encounter a single computer costing £50,000 or more given recent technological advances.
- 4.7 However, this call for evidence is not limited in scope to these options for reform. If there are any other areas of the CGS that could be improved, the government would be interested in hearing how this could be achieved.

CGS Thresholds

- 4.8 The current threshold for land and buildings is £250,000 and has not been changed since the CGS was introduced in 1990. Since this threshold was introduced, the value of commercial property has increased. As such, there has been a significant increase in the number of businesses who must comply with the scheme. Increasing the threshold is likely to remove many businesses from the CGS, although currently we cannot quantify the number. This would simplify VAT administration for these businesses, as it would remove the need for the complex and time-consuming calculations for land and building assets that may be smaller in nature. However, it could disproportionately impact smaller businesses who wish to be able to use the CGS to adjust for input tax over the life of the capital item.
- 4.9 Another factor to consider is regional variation in property prices. For example, businesses with property assets in London and the South East are much more likely to be caught by the CGS than in other areas. An increase to the land and property threshold may therefore not be equally distributed throughout the UK.
- 4.10 Alterations, extensions, annexes and refurbishments to land and property and civil engineering works currently have the same threshold of £250,000. If the threshold is raised for land and property itself another consideration is whether the threshold for these capital items should also be raised or remain the same.
- 4.11 One point worth considering is that the CGS prevents a business from recovering their input tax in full in year 1 and then using the asset for non-business or exempt activity soon after. This key function of the CGS helps to ensure a fair, competitive environment for UK businesses to operate in.

Questions

15. What is your experience of the CGS?
16. How much time and resource do you allocate to carrying out CGS calculations? Does this have an impact on your business?
17. To what extent does the CGS help to prevent cases of tax avoidance and unfair competition?
18. What would be the advantages and disadvantages of increasing the threshold for land and property for businesses?
19. Would there be any other issues involved with increasing the land and property threshold?
20. If the threshold for land and property is increased, do you think we should consider having a different threshold for alterations, extensions, annexes and refurbishments, (i.e. retain the current threshold) or would this increase complexity?
21. Are there other ways in which the CGS can be improved?

Categories

- 4.12 Computers are included within the CGS if their VAT-bearing costs exceed £50,000. This threshold is considered to be high in today's environment as, following technological advances, computer equipment rarely costs more than £50,000.
- 4.13 The 2017 OTS review suggested reviewing this category with the possibility of removing computers from the CGS altogether.
- 4.14 Removing computers from the CGS could potentially remove a number of businesses from the scheme, reducing their CGS-induced administrative burden. However, the number of such businesses is likely to be low.
- 4.15 We must also consider how removing this category could impact future technological developments. If a piece of computer hardware is developed that costs more than £50,000, it would not fall within the CGS and the owner would be unable to adjust their input tax recovery.
- 4.16 Furthermore, it is worth considering whether the scope of this option to reform the CGS would actually simplify the tax system for enough businesses to justify the change. The scope of the benefit of this could be questionable, if there are very few pieces of computer hardware which have a VAT-bearing cost greater than the £50,000 threshold already.

Questions

- 22. Do you have experience of computers being included in the CGS?
- 23. Would removing computers from the CGS be a simplification for business?

Intervals

- 4.17 Under current EU law the minimum number of intervals for a capital goods scheme calculation is five annual periods. In the case of immovable property, it can be up to 20 years. In the UK, land and property assets that fall within the CGS are liable to CGS adjustments for 10 intervals, while aircraft, boats and other vessels and computers must calculate adjustments for 5 intervals.
- 4.18 One option to simplify the CGS would be for the number of intervals for immovable property to be changed, either by reducing or increasing the number of intervals.
- 4.19 If the number of intervals were reduced this would potentially reduce the administrative burden for CGS users over the life of the asset. Conversely, if the number of intervals were increased, there would be more CGS calculations required over the life of the asset. There is a risk that any change in the number of calculations could lead to errors being made.

Questions

24. What do you think of the current interval length?
25. Would a change in the number of intervals help businesses with their administration of VAT? Why?

5. Other possible areas to review

- 5.1 This call for evidence has highlighted important areas of potential simplification of the PE and the CGS regimes, and details those that appear to be the most viable in the near future.
- 5.2 However, we do not wish the evidence collated to be limited in its scope to the options within this call for evidence, and are keen to utilise as much as possible the experience of business in taking forward potential changes to the scheme. For example, it may be that Making Tax Digital has the potential to streamline the operation of both PE and the CGS.
- 5.3 The government also recognises that the operation of PE and the CGS varies across other EU member states and would welcome thoughts from businesses with experience of dealing in other countries on how the UK rules compare. For example, it would be good to know if there are methods used in other countries that could benefit UK businesses if adopted here.
- 5.4 We would therefore welcome any other suggestions to aid simplification of PE and the CGS to ensure that UK businesses operate in the best possible environment.

Questions

26. Do you have other suggestions to improve and simplify the application of the PE and CGS regime?
27. Do you have any experience of the operation of PE and the CGS in other countries? How does the UK compare?
28. Do you have any other comments?

6. Summary of call for evidence questions

Partial Exemption Special Methods

1. Does your business use a PESH? If so, what was your experience in getting the PESH approved?
2. How long did the approval process take?
3. Do you find the administration involved with PESHs challenging?
4. Would allowing businesses to apply PESHs without seeking approval improve the system? Please give reasons for your answer.
5. Would there be issues created by removing the requirement to seek approval of a PESH?
6. Would an increased focus on the use of sectoral frameworks be of benefit, particularly if approvals were removed?
7. Do you have other suggestions to improve or simplify the application of the PE regime?
8. Do you have other suggestions on how the way in which HMRC interacts with partly exempt businesses could be improved?

Increasing the de minimis limit

9. What is your experience of carrying out the de minimis test?
10. What would the advantages and disadvantages of increasing the de minimis threshold be to business?
11. Are you aware of the existing simplification, and do you make use of it?

Removal of the de minimis limit

12. What would be the advantages and disadvantages of removing the de minimis test?
13. Do you have other suggestions to improve or simplify the application of the de minimis regime?
14. Do you have any suggestions on how to determine what can be considered as 'insignificant' that would be different to the current de minimis tests?

CGS Thresholds

15. What is your experience of the CGS?
16. How much time and resource do you allocate to carrying out CGS calculations? Does this have an impact on your business?
17. To what extent does the CGS help to prevent cases of tax avoidance and unfair competition?
18. What would be the advantages and disadvantages of increasing the threshold for land and property businesses?
19. Would there be any other issues involved with increasing the land and property threshold?
20. If the threshold for land and property is increased, do you think we should consider having a different threshold for alterations, extensions, annexes and refurbishments, (i.e. retain the current threshold) or would it increase complexity?
21. Are there other ways in which the CGS can be improved?

Categories

22. Do you have experience of computers being included in the CGS?

23. Would removing computers from the CGS be a simplification for business?

Intervals

24. What do you think of the current interval length?

25. Would a change in the number of intervals help businesses with their administration of VAT? Why?

Other possible areas to review

26. Do you have other suggestions to improve and simplify the application of the PE and CGS regime?

27. Do you have any experience of the operation of PE and the CGS in other countries? How does the UK compare?

28. Do you have any other comments?

7. The consultation process

This consultation is being conducted in line with the Tax Consultation Framework. There are 5 stages to tax policy development:

- Stage 1 Setting out objectives and identifying options.
- Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.
- Stage 3 Drafting legislation to effect the proposed change.
- Stage 4 Implementing and monitoring the change.
- Stage 5 Reviewing and evaluating the change.

This consultation is taking place during stage 1 of the process. The purpose of the consultation is to seek views on the policy design and any suitable possible alternatives, before consulting later on a specific proposal for reform.

How to respond

A summary of the questions in this consultation is included at chapter 6.

Responses should be sent by 26 September 2019, by email to: operation.ofPE@hmrc.gsi.gov.uk or by post to:

Manvir Sagoo
HM Revenue and Customs
Deductions and Financial Services Team
9th Floor
10 South Colonnade
London E14 4PU

Please do not send consultation responses to the Consultation Coordinator.

Paper copies of this document or copies in Welsh and alternative formats (large print, audio and Braille) may be obtained free of charge from the above address. This document can also be [accessed on GOV.UK](#). All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 2018, General Data Protection Regulation (GDPR) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Revenue and Customs.

Consultation Privacy Notice

This notice sets out how we will use your personal data, and your rights. It is made under Articles 13 and/or 14 of the General Data Protection Regulation.

Your Data

The data

We will process the following personal data:

Name
Email address
Postal address
Phone number
Job title

Purpose

The purpose(s) for which we are processing your personal data is for the call for evidence on the simplification of Partial Exemption & Capital Goods Scheme.

Legal basis of processing

The legal basis for processing your personal data is that the processing is necessary for the exercise of a function of a government department.

Recipients

Your personal data will be shared by HM Revenue and Customs with HM Treasury.

Retention

Your personal data will be kept by us for six years and will then be deleted.

Your Rights

- You have the right to request information about how your personal data are processed, and to request a copy of that personal data.
- You have the right to request that any inaccuracies in your personal data are rectified without delay.
- You have the right to request that any incomplete personal data are completed, including by means of a supplementary statement.
- You have the right to request that your personal data are erased if there is no longer a justification for them to be processed.
- You have the right in certain circumstances (for example, where accuracy is contested) to request that the processing of your personal data is restricted.

Complaints

If you consider that your personal data has been misused or mishandled, you may make a complaint to the Information Commissioner, who is an independent regulator. The Information Commissioner can be contacted at:

Information Commissioner's Office
Wycliffe House
Water Lane
Wilmslow
Cheshire
SK9 5AF
0303 123 1113
casework@ico.org.uk

Any complaint to the Information Commissioner is without prejudice to your right to seek redress through the courts.

Contact details

The data controller for your personal data is HM Revenue and Customs. The contact details for the data controller are:

HMRC
100 Parliament Street
Westminster
London SW1A 2BQ

The contact details for HMRC's Data Protection Officer are:

The Data Protection Officer
HM Revenue and Customs
7th Floor, 10 South Colonnade
Canary Wharf, London E14 4PU
advice.dpa@hmrc.gsi.gov.uk

Consultation Principles

This call for evidence is being run in accordance with the government's Consultation Principles.

The Consultation Principles are available on the Cabinet Office website:

<http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance>

If you have any comments or complaints about the consultation process please contact:

John Pay, Consultation Coordinator, Budget Team, HM Revenue and Customs, 100 Parliament Street, London, SW1A 2BQ.

Email: <mailto:hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk>

Please do not send responses to the consultation to this address.