Explanatory Memorandum to

The Value Added Tax (Amendment) (No.X) Regulations

2015 No. [XXXX]

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

Regulations 101, 102 and 103 of the Value Added Tax Regulations 1995 (SI 1995/2518; 'the 1995 Regulations') set out how the input tax incurred on the overheads of partly exempt businesses is to be attributed to taxable supplies so as to calculate the proportion of input tax they are entitled to deduct in each prescribed accounting period. This instrument amends these regulations so that a partly exempt business can no longer take into account supplies made from branches outside the UK when calculating how much input tax may be deducted.

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

None.

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. A business that makes taxable supplies can deduct the VAT that it incurs on related costs. A business making exempt supplies, such as the supply of financial services, does not charge VAT on these supplies and cannot deduct VAT on related costs.

4.2 Section 26(2)(c) of the Act gives an entitlement to businesses to deduct VAT incurred on costs related to such supplies made outside the United Kingdom and such exempt supplies as the Treasury may by order specify. This is the vires for the Value Added Tax (Input Tax) (Specified Supplies) Order 1999 (SI 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 to a person who belongs outside the member States , thus giving businesses making these specified supplies an entitlement to deduct VAT incurred on costs related to these supplies. This means that for the purpose of deduction these specified supplies are treated as if they are taxable.

4.3 A business that makes both taxable supplies (including a business that makes supplies of specified financial services outside the EU) and exempt supplies is partly exempt and has to work out what proportion of VAT on its overhead costs can be deducted. The calculation for this is known as a partial exemption method and the 1995 Regulations contain the secondary law on partial exemption.

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 that they should apply 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 supplies made by foreign branches to be taken into account when calculating how much VAT may be deducted on overhead costs incurred in the UK and used to support the activities of those branches. The Court of Justice of the European Union (CJEU) has confirmed (in its decision in Credit Lyonnais C-388/11) that this is not permitted by the Principal VAT Directive (2006//112/EC; 'the Principal VAT Directive (PVD)').

4.6 This instrument will amend the 1995 Regulations so that supplies made by foreign branches may no longer be taken into account in partial exemption calculations.

- Regulation 101 will be amended to make it clear that supplies made from establishments outside the UK cannot be taken into account by businesses using the standard method

- Regulation 102(2) will be amended to exclude supplies made from a foreign establishment from being included in a special method

- changes to regulation 103 will restrict the use based calculation for foreign and specified supplies to supplies that are made from establishments within the UK

- these amendments will mean that deduction of input tax on overhead costs used to support the activities of the foreign establishments of a business can only be calculated by reference to supplies made by that business's UK establishments

4.7 The 'longer period' (otherwise known as prescribed accounting period/partial exemption tax year) is set out in regulation 99(3) – (7) and determines the period in which recoverable VAT is to be calculated.

4.8 Businesses are required to implement these changes from the beginning of their next longer period falling on or after 1 August 2015.

5. Territorial Extent and Application

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

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 There is a risk that some businesses could use partial exemption legislation to manipulate the amount of VAT that they recover by not taking a balanced approach in allocating costs across their EU and non-EU branch network.

7.3 In Credit Lyonnais the CJEU decided that the PVD 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.

7.4 This instrument amends the 1995 Regulations and will mean businesses will not be able to take into account supplies made by foreign branches when carrying out their partial exemption calculations irrespective of any special method agreed with HMRC. Going forward deduction of input tax on overheads used to support activities made by the overseas establishments of a business will be calculated by reference to supplies made by the principal establishment in the UK.

7.5 Businesses will not have to implement the changes until the beginning of their next longer period that starts on or after 1st August 2015. This means they will not have to operate more than one partial exemption method during one longer period.

7.6 These changes will mitigate the risk that some businesses are able to deduct more VAT than they are entitled to. They will also implement the Credit Lyonnais decision and simplify the partial exemption calculation for businesses

Consolidation

7.7 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

In accordance with the Tax Consultation Framework, this instrument was published in draft immediately after announcement for a 12 week consultation. (Outcome of consultation to be confirmed).

9. Guidance

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

10. Impact

10.1 This instrument will mainly affect financial institutions such as banks and insurance companies who have an overseas branch network. There are likely to be one-off costs for businesses who will need to amend their current partial exemption calculation and the input tax that some businesses can deduct will be decreased. The increased simplicity is expected to create ongoing administrative savings for businesses. The impact on charities and voluntary bodies is negligible.

10.2 The impact on the public sector will be negligible as this relates to businesses.

10.3 A Tax Information and Impact Note covering this instrument will be published on the GOV.UK website.

11. Regulating small business

This instrument applies to small business, however it is not likely to affect small businesses as they are unlikely to have foreign branches.

12. Monitoring and review

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

13. Contact

Karen Pittis at HMRC Telephone: 03000 585720 or email: karen.pittis@hmrc.gsi.gov.uk can answer any queries regarding the instrument.