HM Revenue & Customs

VAT: deductions relating to foreign branches

Who is likely to be affected?

Financial institutions such as banks and insurers with establishments both within and outside the UK.

General description of the measure

The measure will result in an amendment to the VAT Regulations 1995 (SI 1995/2518) (the VAT Regulations), and will mean that supplies made by foreign branches can no longer be taken into account when calculating how much VAT incurred on overhead costs can be deducted by partly exempt businesses in the UK.

Policy objective

This measure will simplify the tax system and make it fairer by mitigating the risk that some partly exempt businesses could artificially increase the amount of input tax that they are entitled to deduct. It also implements a 2013 decision of the Court of Justice of the European Union (CJEU) (*Credit Lyonnais*).

Background to the measure

Some services, including financial services, are exempt from VAT. This means these services are not taxable for VAT purposes and there is no right to deduct VAT on related costs. A business providing exempt services to customers within the UK and the EU cannot therefore deduct VAT incurred by it on costs related to the provision of these exempt services. However, exempt financial services provided to customers outside the EU are treated as taxable for the purposes of input tax deduction and so the related VAT on costs may be deducted. A business that makes both taxable and exempt supplies has to work out what proportion of VAT on its costs can be deducted. The calculation for this is known as a partial exemption method.

Up to now, UK law has allowed UK partly exempt businesses to recover VAT on overhead costs used to support foreign branches by reference to supplies made by those branches. This does carry the risk that a business could artificially increase the amount of input tax it is entitled to deduct by over-allocating overhead costs to its non-EU foreign branches.

In *Credit Lyonnais* the CJEU found that the VAT Directive could not be interpreted so as to allow a company to take into account the turnover of its EU or non-EU foreign branches when calculating how much input tax it can deduct in the Member State where it has its principal establishment.

Implementing this decision in the UK means that UK 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 HM Revenue & Customs (HMRC). This will simplify the calculation for businesses and also mitigate the risk of some businesses manipulating the amount of VAT they can recover.

This measure was announced at Budget 2015.

Detailed proposal

Operative date

It is intended that this measure will have effect on and after 1 August 2015 but, where 31 July 2015 falls within the VAT longer period of accounting for a business, it will not have effect until the first day of the next longer period that applies to that business.

Current law

The VAT Regulations contain the legislation for partial exemption.

- Regulation 99(3) – (7) sets out how the longer period is to be determined
- partly exempt taxpayers must calculate the amount of VAT that they are entitled to recover under Regulation 101 (the standard method) unless the Commissioners agree that they should apply an alternative special method pursuant to Regulation 102 and Regulation 103 (attribution of input tax to foreign and specified supplies)
- Regulation 101(8)(b) provides for deduction of input tax on overheads in relation to foreign branches to be made according to use within the standard method of deduction
- Regulation 102(2) excludes the value of certain supplies from being included in a special method calculation for deducting VAT on overheads
- Regulation 103 provides for a use based calculation for deduction of input tax relating to foreign and specified supplies under a special method

Proposed revisions

- 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 also 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 overheads used to support activities of the foreign establishments of a business can only be calculated by reference to supplies made by that business's UK establishments

It is intended that the VAT Regulations will be amended by secondary legislation.

Summary of impacts

Exchequer impact (£m)	2015-16	2016-17	2017-18	2018-19	2019-20
	+25	+95	+90	+85	+90
	These figures are set out in Table 2.1 of Budget 2015 and have been certified by the Office for Budget Responsibility. More details can be found in the policy costings document published alongside Budget 2015.				
Economic impact	The measure is not expected to have any significant economic impacts.				
Impact on individuals, households and families	There is no impact on individuals, households or families because the changes only affect partly exempt businesses.				

Equalities impacts	The measure is not expected to have any impact on any equalities group.
Impact on business including civil society organisations	This measure is expected to have a negligible impact on partly exempt businesses who make supplies from branches outside the UK. There are likely to be one-off costs for approximately 150 banks and insurers who will need to amend current partial exemption calculations. The increased simplicity is expected to create negligible ongoing administrative savings for businesses.
Operational impact (£m) (HMRC or other)	The measure will initially cause an additional administrative burden to HMRC because HMRC compliance officers will have to spend longer assuring partial exemption calculations, but the cost of this will be negligible. The increased simplicity should reduce the overall burden in the longer term.
Other impacts	Small and micro business assessment: the impact on small and micro insurance companies with branches both within the EU and outside is likely to be negligible. Other impacts have been considered and none have been identified.

Monitoring and evaluation

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

Further advice

If you have any questions about this change, please contact Karen Pittis on 03000 585720 (email: karen.pittis@hmrc.gsi.gov.uk).