Simplification of Partial Exemption and the Capital Goods Scheme

Response to the Call for Evidence by the Charity Tax Group

26 September 2019

Introduction

1. The Charity Tax Group (CTG) has over 700 members of all sizes representing all types of charitable activity. The organisation was set up in 1982 to make representations to Government on charity taxation and it has since become the leading voice for the sector on this issue.

2. We welcome the opportunity to respond to this Call for Evidence ('CfE') and we were grateful for the opportunity to meet officials to discuss our feedback on 19 September 2019.

3. We note that the CfE posits several questions, split between three sections. As a representative and campaigning body, only certain of these are relevant to our concerns. We also note that the CfE appears to invite more general comments and we have therefore taken the option of providing these more general comments rather than seeking to match comments to particular questions.

What is meant by 'simplification'?

4. We do not think that 'simplification' equates with 'reducing the number of rules'. One of the greatest causes of complexity and difficulty is uncertainty created by incomplete frameworks and vague principles. It is often the case that a greater range of rules, options, or requirements, gives reassurance and thus makes life simpler.

5. Charities, in particular, commonly face the highest levels of interpretative uncertainty alongside basic complexity. If they were equipped with more detailed rules, this would often allow them to get further into an issue before calling for specialist or legal advice. Many small charities have inherently complex VAT positions and the least resources to afford specialist help. These organisations seek certainty rather than brevity. Our comments are based on this basic philosophy.

Preliminary remarks

6. We note that the CfE does not mention apportionment of purchase VAT to reflect partial non-business use (commonly referred to as B/NB apportionment). We also note that both the special method regime and capital goods scheme have provision for non-business adjustments. We have therefore presumed that the scope can automatically include non-business related aspects.

7. The CfE refers in places to EU law and to practice in other EU states. We see nothing there about the scope of any change that could be allowable when the restrictions of EU legislation (deriving from the Principal VAT Directive) are no longer applicable. Whilst we understand that the UK must conduct itself as a member until it no longer is one, and that there may be only little of practical value in ideas that are incompatible with the PVD, we feel that a major review of rules (a 'once in a decade' exercise)

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ought to entertain the wider scope that, in accordance with government policy, will be available either from 31 October, or from the UK exiting the EU acquis, which would only be two years away at most. We have therefore not limited ourselves to ideas that must stay within the PVD framework. We expect that you will be able to determine which ideas are PVD compatible, and which are not (or may not be).

Partial Exemption Special Methods

8. We would say that a discussion of special methods should entertain the possible reform of the standard method rules, since it is often the borderline between these which causes complications. Some of the suggestions the CfE makes for streamlining special methods could just as well be deployed as 'off the peg' sectoral standard methods. If the idea is to be able to create a system akin to 'automatic permission' for a sectoral special method, there is no real practical difference between this and a standard method.

9. We note that, in another context, the concept of 'automatic permission' (where making of an option to tax is in point) is counter-intuitive and puzzling. If such an 'automatic' consent is to be relied on, it ought to be binding on HMRC. That is, in practical terms, a standard method (as moderated by the need of the user to qualify as being within the stated sector).

10. In addition, we would argue that one of the 'easiest wins' in this respect would be to allow an organisation that clearly runs on activity centre lines, and which keeps its accounting data in that format, to use the current value of supplies standard method on a sector by sector basis (using the same figures, but only for each sector), whilst dealing with the ultimate overhead cost apportionment on an aggregated basis. This is one of the commonest reasons for the application of the 'standard method override'. It would be better if it was a standard method in itself.

11. We also believe that a standard method extension to include non-business apportionment, where a charity believes that the use of outside scope turnover is a fair proxy for non-business activity (which is not always the case, but sometimes is) should be allowed. Currently, the B/NB apportionment is not set out in rules, except where it is part of a negotiated special method. We think this creates an unwanted uncertainty for the relevant charities. We think it would be possible (post EU exit) to include the non-business turnover in a standard method as a choice.

12. We now turn to special method inception procedures *per se*. We agree with the view that the current system whereby the business provides a declaration of the fairness of the method when applying for it is not working. We are not convinced this can only be addressed by a change in the rules. The idea was that HMRC officers could rely on the certificate to help fast track approvals, and to give reassurance that, if it later became apparent that the declaration has been insincerely issued, the method would be void *ab initio*. In practice, officers have rarely accepted this principle, and have treated the declarations with considerable suspicion and scepticism. We believe, from the experience of both our charity members and our observer members, that this has been unjustified and ubiquitous. The solution could therefore be in a change of mindset from HMRC. That said, we are happy to comment on the two major proposed solutions: sectoral frameworks and certification without official approval. We have significant concerns with both, but also suggested solutions to those.

Sectoral Frameworks

13. We are strong supporters of this system as long as it is constructed so as to be fit for purpose. The obvious merit is that a charity which fits neatly into a set of pre-determined characteristics can choose to adopt a framework without the fear of HMRC challenging their position.

14. But this causes a similar but different problem to the one that is removed, which is the potential for dispute over whether a charity would conform to the sectoral stereotype. In particular, where charities are concerned, the concept of a single model of a charity is untenable, as the sector is so diverse. We are, of course, wholly aware that HMRC would provide different frameworks for different activities that happen to be charitable. There could be some for education, others for care, and others for fundraising charities, and so on. But where charities carry out more than one of these categories of operation, or are a singular blend of them, the prospects of being able to select from the frameworks begins to recede.

15. This is then replaced by a danger that the charity will nonetheless wish to shoehorn itself into one or other framework, but face HMRC challenge for having done so. Or HMRC may start trying to shoehorn charities into unsuitable frameworks, and resist requests for a bespoke arrangement.

16. To counter these threats, the frameworks would need to be very thoroughly worked through, with more detail as to their operation, rather than less. They would need to demonstrate various versions of arrangements, and how these iterations can be accommodated within the framework. Essentially, therefore, the frameworks would not prove to be simple in themselves, but, once selected in a suitable manner, can be operated by a charity in a confident and straightforward way. That conceptual complexity (or significant level of detail in the rules given) may not appear to foster 'simplification', but we feel that this is a more honest approach to simplifying the special method system, than merely reaching for a false vision of simplicity, by providing inadequate, flimsy, frameworks.

17. It follows that the frameworks would take considerable time and effort to compile, and would be a considerable investment of resources. The outcomes from this investment are potentially uncertain, and may prove disappointing. Unless undertaken with these points in mind, failure of this policy is likely.

18. We support the idea, but with the above warnings and caveats.

Certification/declaration, without more

19. Our first comment is to revert to the point that the original intended purpose of the 'fair & reasonable' declaration was to remove the need for the level of consideration that HMRC officers appear insistent on applying to each application. Your revised proposal would seek to replicate that original intention but apparently on the footing that the use of the method would be regarded as provisional, in the sense that HMRC can challenge its application on a fundamental basis, rather than merely because it decided that the issuer of the declaration was insincere.

20. Whilst we can see the attraction in allowing a tax payer to determine the position and then to defend it against HMRC scrutiny and challenge (since most VAT treatment works along those lines), we think that the burdens on HMRC would increase, uncertainty for the charity that adopted this approach would increase greatly, in a manner that would cause serious difficulty, and the general relationship between HMRC and the sector could deteriorate as a result. Charities are particularly vulnerable to the impact of such uncertainties. They often raise voluntary income to meet a significant expense, and are not able to carry reserves that inure them to the shock of an unexpected increase in that expense. Unlike most commercial operations, the likely financial scale of disputes with HMRC would tend to be more critical. Charities are usually susceptible to greater complexity in their VAT affairs, and have less funding to pay for professional help.

21. Even if HMRC was minded to introduce a choice to make declarations with no reassurance of acceptance of the method at the next assurance meeting, this should only be one choice, though we doubt it will prove a welcome one for most charities.

22. We therefore support continuation of the current arrangement where the method is agreed specifically with HMRC, subject to HMRC discovering a lack of sincerity on the part of the declarant who issues the fair & reasonable declaration. But we would urge HMRC to review its mindset when considering such applications so that the system can work as originally intended.

23. In pursuit of this we have the following further refinements to suggest to the existing approach:

    a. Where a single entity has agreed a method, and forms a VAT group because it needs to (or chooses to) transfer an existing activity to a controlled company, the agreed method should be automatically transferable to the group (and vice versa).
    b. Where a change in activities leads to a need for a change to the method, allow the change alone to be agreed as an addendum, and do not insist on a complete reappraisal of the method as a whole.
    c. Allow an element of 'future-proofing' in a method whereby the predicted activities are provided for in the arrangement, thus obviating the need to revert to HMRC in the event of these planned activities or changes coming into existence.
    d. Accept certification of the fairness of an overall schematic proposal, allowing detailed nuances to be dealt with as though covered by that declaration, without purporting to 'reject' the proposal (which gives an impression of hostility and intransigence) and the requirement to issue a new declaration.
    e. Provide HMRC officers with a discretion to allow an unagreed 'special method' to be allowed if it gives a fair result, and has erroneously been applied in the past, without the need for the method to trigger the override provisions to displace a less suitable standard method result.

24. In brief, the rigidities that have built up in the operation of the current system are a significant factor in why they do not work as they ought.

25. However, we also suggest consideration is given to a pure certification (without more) approach along the following lines, as an alternative that the taxpayer can select.

26. This would be for the tax payer to commission an external specialist review of their position by an acceptable qualified person/firm (such as chartered/certified accountant, lawyer, or chartered tax advisor), which gives rise to a detailed report which covers prescribed areas or 'questions' to ensure uniformity of approach and sufficient thoroughness. Assuming the external specialist is satisfied that the proposal is fair & reasonable, he then issues the report and a certificate attached to the proposal. The method proposal and certificate are lodged with HMRC for the sake of transparency, but not at that stage reviewed. However, if in the course of assurance, HMRC wishes to, it can call for a copy of the full report.

27. HMRC would then only be able to challenge any perceived lack of bona fides, or mandate a change from a current date (basically, under the special method override rule, or a variant of it).

28. We do not believe that this approach should replace the current one. It should be an alternative to it. If adopted by some (probably mainly larger) taxpayers, it would relieve the pressure on HMRC, and, for those that do not choose to pay for the above service, but to follow the traditional negotiation approach, that remains a valid option.

Initial allocation of expense invoices

29. The CfE focusses on the complexity of apportioning residual costs. In our experience the often overlooked complication of initial allocation of purchase invoices to the two (or three) directly attributable categories, that then leave the residue to be apportioned, is a burden and a source of potential error. Indeed, the financial scale of such an error is possibly more serious than many problems arising from the apportionment method for the 'pot'.

30. We therefore suggest a limited return to the former method under which all costs can be deemed to be 'pot' items, thus removing an entire plank of the partial exemption operation. However, this is only justifiable as a small business easement measure. We invite you to consider such a measure, setting, perhaps, a turnover limit that equates to the current cash accounting scheme. We have not developed any detail around this but would be happy to become involved in further focussed consideration. This should, of course, be a choice, not mandatory.

Use method

31. The current standard method provides for an initial 'use' method which is commonly applied where no turnover has yet been generated (or it is unrepresentative of intended use). This is a vital component of the current standard method. However, the rule is limited in application to costs incurred over the period of around one year.

32. The intention behind this provision is to allow apportionment to be based on intended use ratios. However, if the lead time for the relevant purchases are longer than the year or so that could apply, the taxpayer is forced to apply for a special method, or to rely on the standard method override (the application of which is somewhat capricious). It is common for the lead time to be considerably longer than one year. In fact, up to five years is perfectly normal. Even where a charity can apportion much of its expenditure on the basis of ongoing revenue streams, these often have no relationship with the

intended use of a capital asset. This arises commonly where a charity that has had to use rented buildings enters into a capital project to equip it with an owned charity building, following which its activities will be greatly expanded and potentially changed.

33. In such cases, it would be helpful if the 'use' rule was allowed to apply up to five years (and, as present, on a voluntary basis) for those costs where there is no relationship with the income generation of the taxpayer. This would apply irrespective of the override rules, and no special method would be required. We acknowledge that the deployment of 'use' has no safeguards as to HMRC's interpretation of this concept. However, in many cases the potential use values are fairly easy to apply, and could be drawn from concepts within sectoral frameworks.

Tax Year

34. At present the legislation mandates that the fiscal year be used as the taxpayer's tax year unless he applies for his own financial year to be substituted. In our experience, this is never refused. It would be easier to allow taxpayers to choose either approach without the need to apply, or report the decision, as long as the decision is adhered to for a reasonable time period. In our experience most charities would apply their own financial year as a matter of course.

***De minimis* limits**

35. The over-arching problem with the *de minimis* limits is that they involve work to be performed to determine whether they apply, and this is counter to the apparent intention that they are a simplification. The 2010 changes do provide some 'short cut' tests, but have had a contrary impact in that they appear to increase the complexity of the rules in aggregate, making *de minimis* appear even more daunting.

36. However, we think it would be defeatist to jettison *de minimis* in the way that certain continental tax authorities have chosen to do. We have some other suggestions.

37. First, and reflecting a post-EU scenario, we believe that the *de minimis* test ought to apply also to non-business activities. Currently, charities can sometimes find that they pass the *de minimis* test for partial exemption, only to be required to restrict VAT recovery as a result of non-business activity. This is frustrating and counterintuitive.

38. As regards simplifications, we believe that the following alternative *de minimis* tests should be considered: (Note, the following are framed as though non-business was not included, and are not available under the use based standard method):

    a. If the value of exempt turnover in the VAT year is below the VAT registration threshold, the *de minimis* rule applies (though not to costs that are subject to the CGS).
    b. If the value of exempt turnover is less than 10% of all turnover, the *de minimis* rule applies (though not to costs in the CGS).

39. Such outputs based rules are much easier to monitor and understand. They used to apply many years ago.

Capital Goods Scheme

40. The CGS arises commonly for many charities and creates an immense burden on these organisations. In particular, charities frequently enter CGS with expenditures that are disproportionately large compared with their ongoing scale of activities and their reserves. This can happen where a particular capital appeal has paid for construction or purchase of premises and/or equipment, and the VAT values are a significant factor in the affordability of the project.

41. Charities are aware that they can often benefit from the fact that the CGS exists, and there is unlikely to be much support for its abolition (which in any case you do not advocate). However, we welcome the intention behind HMRC's commentary to seek simplifications where they can be found. We do feel, however, that these are not easy to achieve.

Computer hardware

42. We support removal of computer hardware from the CGS. To be frank, the difference this will make will be utterly negligible, as single hardware purchases of £50k do not arise these days. This would simply be the case of removing otiose material from the statute book. It improves the look of the statute book without simplifying anyone's life.

Entry value

43. Charities sometimes purchase boats and aircraft for charitable activity, so we believe that any re-valorisation of the entry values ought to apply to these as well.

44. There are advantages and disadvantages to changing these. We acknowledge that charities may well find that there is a fiscal downside to any increase (since, as a general feature, taxable use of an asset often increases over the first ten years of its life). However, we believe, on balance, that some charities are having to perform record keeping which gives relatively little value to HMRC or to themselves, and simplification ought to be encouraged.

45. We would therefore support a doubling of the current entry values (£500k for property, and £100k for boats and aircraft). We have considered whether the property related value should be as high as £1m or more (which indexing might have justified) but feel that the possible adverse fiscal impact in some cases dissuades us from putting this forward as a simple threshold, so we would prefer £500k.

46. However, HMRC could consider allowing taxpayers to elect (for all assets perhaps) to use a £250K, £500k, £750k, or £1m threshold. Whilst this does not simplify the rules, it effectively allows the business to choose between a level of simplification and a level of fiscal accuracy. It also allows a small organisation (for which £250k might be a large sum) to choose fiscal accuracy, or, conversely, to seek the greatest simplification. Whilst we acknowledge that this means charities will need to consider professional advice, and that wider choice can lead to confusion, if the default entry level is set to

£500k, then many (perhaps most) would simply apply the default value, without such costs being incurred.

Length of adjustment period

39. We note the suggestion of potentially increasing this length. We do not see how that could be regarded as simplificatory. However, it does increase accuracy. It is a foible of the current CGS that the initial recovery percentage is disproportionate to the level of the subsequent yearly adjustments, which creates, in the sense of the time value of money, an in-built inaccuracy. The greater overall accuracy of a longer period is somewhat offset by this increased inaccuracy relating to the time value of the money. As there is no possible simplification, there are few attractions in this. We have never heard of a charity lamenting the overly short duration of CGS.

40. We might support an arrangement where the default minimum duration for land is 10 years, but that a taxpayer can opt (from no later than the second interval) for a longer period of say 15 or 20 years. We doubt many will opt for that. It could be attractive to property development/investment companies, which a small proportion of the charity population is engaged in.

41. We do not support a reduction in the adjustment period, since this reduces accuracy. It has at best a mild simplification impact, since carrying on a calculation that has already been set up is not as onerous as setting it up in the first place. We see no need to change the duration for boats and aircraft.

In period de minimis adjustment

42. This idea does not appear in HMRC's paper. The concept is that a CGS adjustment is only made if it exceeds a *de minimis* limit. The calculation on which that limit is based is the full CGS calculation. This means that most of the required work would still have to be done. The measure would be pointless.

43. We mention it as others may put it forward. In our view it should be rejected.

Regulation 111

44. This removes CGS costs from the pre-registration claim regime. We understand the reason for this, but the measure appears to go too wide. It should only exclude costs where the asset has come into use in a tax year that has finished prior to the registration date. The costs should be included in the pre-registration relief rule where the first use trigger point for the first interval has not yet been reached.

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