HM Customs and Excise: Countering VAT Avoidance
This report has been prepared under Section 6 of the National Audit Act, 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

John Bourn
Comptroller and Auditor General

National Audit Office
4 September 1992

The Comptroller and Auditor General is the head of the National Audit Office employing some 900 staff. He, and the NAO, are totally independent of Government. He certifies the accounts of all Government departments and a wide range of other public sector bodies; and he has statutory authority to report to Parliament on the economy, efficiency and effectiveness with which departments and other bodies have used their resources.
# Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Summary and conclusions</td>
<td>1</td>
</tr>
<tr>
<td>Part 1: Introduction</td>
<td>6</td>
</tr>
<tr>
<td>Part 2: Identifying and evaluating avoidance</td>
<td>10</td>
</tr>
<tr>
<td>Part 3: Countering avoidance</td>
<td>19</td>
</tr>
</tbody>
</table>

## Appendices

A. The Taxpayer's Charter                                      | 26   |
B. Representative bodies involved with VAT or similar tax systems with whom the National Audit Office had discussions | 27   |
C. Examples of Avoidance Schemes                              | 28   |
Summary and conclusions

1 It is a basic principle of taxation that taxpayers have the right to arrange their affairs so as to minimise their tax liability. However, case law has ruled as legally ineffective certain contrived arrangements which involve little or no business purpose other than the avoidance of tax.

2 For a number of years Customs and Excise have been aware that an increasing number of businesses, in particular the larger taxpayers, obtain tax benefits through measures which have little or no commercial purpose other than to avoid VAT. The Department consider it important to take appropriate counteraction to ensure that other traders are not placed at a competitive disadvantage and to safeguard the revenue. Otherwise the equity principle which is fundamental to United Kingdom tax law would be distorted and the overall integrity of the tax would be undermined.

3 The Department therefore aim to maintain the VAT revenue base by identifying and countering unacceptable avoidance using their existing powers under the legislation or by seeking changes in the law. The Department estimate that, over the past seven years, legislative measures to counter avoidance have resulted in the collection of nearly £500 million a year in additional tax.

4 But tax avoidance issues are not clear cut. A grey area exists between avoidance (which in principle is legal) and evasion (which is illegal). Tax avoidance also differs from tax mitigation. Both are within the strict letter of the law but avoidance may be considered to be outside the spirit of the law. But, again, the dividing line is not easily defined.

5 Avoidance involves complex issues and the position is constantly changing. A policy change in the United Kingdom, or a ruling from the European Commission or European Court of Justice, can easily result in today’s unacceptable avoidance becoming tomorrow’s acceptable tax mitigation, and vice versa.

6 Given this dynamic environment, the Department’s approach to countering avoidance is essentially pragmatic, and recognises that no tax system can ever be expected to achieve a 100 per cent collection rate. The Department are constrained, first, by the level of resources which the Government thinks it proper to devote to tax collection and, second, by the need to avoid imposing disproportionately heavy burdens on businesses, either through onerous accounting procedures or by insisting on a higher degree of accuracy than would normally be regarded as satisfactory, judged against responsible commercial standards. There are also external constraints arising, for example, from European Community directives.

7 Against this background, the National Audit Office examined the Department’s arrangements for identifying, evaluating and countering VAT avoidance. The main findings of the examination are set out below together with suggestions for further action.
HM CUSTOMS AND EXCISE: COUNTERING VAT AVOIDANCE

(a) As part of their obligations under the Taxpayer's Charter, the Department should provide broad guidance to traders on what constitutes unacceptable avoidance, how it differs from tax mitigation, and their approach to the issues involved.

The Department operate on the basis that there is a distinction between tax avoidance and tax mitigation. However, there is no definition in legislation or elsewhere of tax avoidance or tax mitigation or how they differ. Nor have the Department issued guidance to traders on what practices they class as avoidance — and would therefore seek to counter — and what practices they accept as tax mitigation (paragraphs 2.1 to 2.4).

Representatives of the trading community consider that the Department should make clear where they draw the line between tax avoidance and tax mitigation. At present, traders risk falling foul of the Department, often at considerable cost, when they may genuinely have believed the arrangement of their VAT affairs to be acceptable. In a written submission to the National Audit Office, the Institute of Taxation characterised the hallmarks of avoidance, and the Department have agreed to use these as the basis from which to formulate suitable guidance (paragraphs 2.5 to 2.9).

(b) Better training and guidance to the Department's staff would help ensure that tax avoidance schemes are recognised at an early stage and effective counteraction taken.

VAT control staff rely on experience and intuition and until now have not received formal training in recognising and dealing with avoidance, even though a need for better training was recognised in internal reviews in 1985 and 1991. However, the Department have decided to extend their basic VAT training to include far greater instruction in VAT law for selected local staff. This should help to make staff more aware of potential avoidance schemes and equip them with the knowledge and skills to deal more effectively with legitimate tax mitigation questions raised by traders. There may be useful lessons to be learned from Inland Revenue practice in this area, whilst recognising their different operating circumstances and priorities and that direct tax avoidance is more prevalent than VAT avoidance (paragraphs 2.11 to 2.15).

Information on identified avoidance is regularly publicised to staff in specialist newsletters and features in local and regional seminars conducted by headquarters staff. However, the National Audit Office noted that avoidance was directly referred to only twice in the 35 or so volumes of Departmental instructions relating to VAT. Avoidance is not defined and there are no general instructions as to what action staff should take if avoidance is suspected. Again, there may be lessons to be drawn from the Inland Revenue's internal guidance to their staff (paragraphs 2.16 and 2.17).

(c) Better information and analysis is needed on the significance and incidence of different types of avoidance if the Department are to take more effective counteraction.

Consultants employed by the National Audit Office identified 28 significant avoidance schemes. The Department confirmed that they were fully aware of each of the schemes and, for some, had been so since the inception of the
HM CUSTOMS AND EXCISE: COUNTERING VAT AVOIDANCE

tax. Ten had been successfully closed off by legislation and the remainder continued to be tackled as individual cases arose (paragraphs 2.20 to 2.33 and Table 2).

The Department evaluate identified avoidance schemes and decide whether to take counteraction according to the amount of tax lost or at risk; the number of traders involved; the effect of the scheme on the equity and integrity of the tax; and the impact of countermeasures on compliance and administration costs. However, these criteria are not set out in standing instructions, nor are they applied consistently and systematically. Departmental assessments of the tax at risk from avoidance and the number of traders involved are generally speculative (paragraphs 2.34 to 2.36 and Table 3).

The Department could improve their identification and evaluation of avoidance in a number of ways. More use should be made of surveys to help establish the tax at risk and number of traders involved. Information on traders’ business structures should be recorded on the VAT computer system, since most avoidance schemes involve traders having structured their business affairs in a particular manner to minimise the VAT payable. And the Department’s own professional accountants should be given a larger role in identifying and evaluating avoidance (paragraphs 2.41 and 2.47).

(d) In general, the Department make full use of their existing legal powers to counter avoidance; and they do so with due care and with close regard to the impact on businesses. But they must continue to monitor the position closely to ensure that taxpayers are assessed for tax only when it is fully justified, and that taxpayers are treated fairly and consistently.

The Department can use their existing legal powers to counter avoidance in two ways. First, they can issue a notice of direction in certain specific circumstances requiring a trader to arrange his or her affairs in a particular way. Second, they can issue an assessment for the amount of tax considered to have been avoided. Assessments are issued only when the Department consider in their best judgement that their interpretation of the law is correct and that such action is essential if equity, fair competition and the integrity of the tax are not to be undermined. Notices of direction and assessments are subject to appeal by traders to a VAT Tribunal (paragraphs 3.1 to 3.7).

Issuing an assessment is an effective means of countering avoidance. But there are dangers, particularly where a trader genuinely considers that he or she is acting reasonably and within the legislation but nevertheless feels obliged to accept the assessment on cost or other grounds. One representative body told the National Audit Office that traders whose assessed tax could be passed on to their customers to become the customer’s reclaimable input tax would, irrespective of the circumstances which led to the assessment being raised, generally be advised to pay rather than incur legal expenses at Tribunal. Similarly, some traders would pay rather than risk the adverse publicity which could result from a case going to Court (paragraphs 3.8 to 3.11).
The Department told the National Audit Office that they carefully weighed up the strengths and weaknesses of the arguments involved, and potential costs, before taking action in individual cases. Assessments were only issued in avoidance cases where senior line management and headquarters were satisfied, on their best judgement, that there had been an underdeclaration and that basic principles of the tax had been breached (paragraph 3.9).

(c) In borderline cases the Department should take early action to remove unnecessary uncertainty about the law, either by accepting that such cases are tax mitigation or by seeking to have the law changed.

There were some isolated instances where the issue of an assessment in avoidance cases appears to have been counterproductive. In one major test case lost by the Department, the publicity generated served only to highlight the type of avoidance without curtailing it. The law was eventually changed, but only after some nine years had elapsed (paragraph 3.10).

(f) A specialist VAT avoidance team would provide a central co-ordinating point for all avoidance matters. In each local VAT office an officer should be given specific responsibility for avoidance control at local level and for monitoring fairness and consistency in local procedures and practice.

The Department’s pragmatic approach allows them to tailor their actions to current needs and circumstances; but there is a risk that this approach is applied piecemeal and lacks the predictability and consistency that traders would like to see. Each policy branch at headquarters is responsible for its own work on avoidance and local offices submit cases to the branch with particular responsibility for the area of the tax affected. Although a designated headquarters branch is responsible for co-ordinating the Department’s efforts in this area, the branch’s objectives are not defined, and systems for ensuring that all cases are referred to it have not been established (paragraphs 3.23 to 3.26).

Whilst it is to be expected that the Inland Revenue would have more specialist staff assigned to avoidance work, Customs and Excise could improve their effectiveness if they too had a specialist team at headquarters with a more clearly defined role to co-ordinate, monitor and evaluate countermeasures. Better co-ordination and control at local level would also be assisted by channelling all avoidance matters through a designated member of staff in each local VAT office. The cost of these changes should be small and more than offset by the extra revenue generated from earlier identification and counteraction (paragraphs 3.27 to 3.32).

(g) If their plans to delegate more decision-making to local offices are to succeed, the Department need to take positive steps to ensure that traders are treated consistently as between one local office and another.

The Department intend giving increased responsibility to staff in their local VAT offices around the country. Business representatives are concerned that the proposed changes will result in greater uncertainty and less consistency in Departmental rulings. The Department recognise these fears and concerns, and intend to consult business representatives about the implications of the proposed changes (paragraphs 3.33 and 3.34).
Nevertheless, there are clear risks that traders may not be treated consistently between one local office and another. To prevent potential problems, the Department need to establish a clear framework for delegation, with adequate guidance and training for the staff involved. And they need to monitor the work of their local offices to ensure that traders are treated consistently in practice. The Department confirmed that they already have such measures planned (paragraph 3.35).

(h) **Better information and analysis is needed to establish the effectiveness of measures taken to counteract avoidance, and to help target areas and issues for continuing attention.**

Departmental monitoring of the effectiveness of countermeasures needs to be developed further and made more systematic. The effectiveness of counteraction by assessment is not measured at all. Changes in legislation are generally monitored for two years, but the National Audit Office found that the information collected was rarely analysed to determine how far or how permanently the overall incidence of a particular type of avoidance had declined or the extent to which the overall tax collected had increased (paragraph 3.37).

Better monitoring could be achieved through fairly straightforward improvements to the Department’s management information systems; but this will be cost-effective only when the main computer systems are replaced over the next five years. It would then be possible for the Department to obtain broad estimates of the incidence of and revenue at risk from a particular avoidance scheme before and after it is addressed. Such analysis would indicate which are the most effective methods of redress and which areas require legislative change, and it would enable more effective targeting of issues and cases to pursue (paragraphs 3.38 to 3.40).

**Overall conclusions**

Nearly all significant avoidance schemes countered over the years have come to light as a result of the vigilance of the Department’s VAT control staff. And the Department consider that their total countermesures to date are containing the avoidance problem. Nevertheless, the National Audit Office consider that a more consistent and targeted approach would provide further benefits. The Department could do more to provide guidance to traders on what constitutes unacceptable avoidance and how it differs from tax mitigation, thereby reducing the uncertainties surrounding the subject. And within the external constraints under which they operate, more could be done to improve their own methods for identifying, evaluating and countering avoidance.
Part 1: Introduction

1.1 Tax avoidance is as old as taxation itself. A basic principle of taxation is that every taxpayer has the right to arrange his or her affairs so as to minimise his or her tax liability. The Taxpayer's Charter (Appendix A) recognises that taxpayers are expected to pay only what is due under the law.

1.2 There is a basic distinction between tax avoidance, which in principle is legal, and tax evasion, which is illegal. But the dividing line is not clear-cut. Since the late 1960s the growth of tax avoidance and the emergence of a dedicated tax avoidance industry has been characterised by the marketing of schemes designed specifically and solely to exploit loopholes in tax law to an extent never envisaged when the relevant legislation was approved by Parliament. And recent case law has ruled as legally ineffective a number of contrived arrangements which involved little or no business purpose other than to avoid tax. So the scope for avoidance too may be circumscribed.

1.3 In recent years Value Added Tax (VAT), because of its size and complexity and the growing wealth of governing EC and domestic legislation, has become increasingly prone to avoidance devices. Customs and Excise are aware that an increasing number of businesses, in particular the larger taxpayers, seek to obtain tax benefits through measures which have little or no business purpose other than to avoid VAT. The Department consider that it is important to take appropriate counteraction to prevent other traders being placed at a competitive disadvantage and to safeguard the revenue. Otherwise the equity principle which is fundamental to United Kingdom tax law would be distorted and the overall integrity of the tax would be undermined.

Objectives and priorities

1.4 Increasing their efficiency and effectiveness in collecting VAT is one of the Department's top priorities. They aim to maintain the VAT revenue base not only by increasing compliance overall and preventing evasion but also by identifying and countering contrived or artificial avoidance. More specific objectives are, for example, to ensure awareness of tax avoidance schemes at an early stage; to make proposals for dealing with such schemes; and to alert different divisions within the Department to the scope for and risk of avoidance and to assist in identifying solutions.

1.5 Nevertheless, no tax system can ever be expected to achieve a 100 per cent collection rate. The Department are constrained, first, by the level of resources which the Government thinks it proper to devote to tax collection and, second, by the need to avoid imposing unacceptably heavy compliance burdens on businesses, either through onerous accounting procedures or by insisting on a higher degree of accuracy than would normally be regarded as satisfactory, judged against responsible commercial standards. There are also external constraints on the scope for anti-avoidance measures, notably the European Community Sixth Directive on VAT which makes some VAT avoidance devices legal, regardless of any provisions of UK law.

1.6 If the tax system is to work effectively, there has to be a degree of give and take between the Department and taxpayers. In the area of tax avoidance, the Department need to assure themselves that they have the capacity to pick up major avoidance schemes. But they do not regard it as part of their business to try to find ways of undermining reasonable arrangements which a trader may have made to mitigate his or her tax liabilities.

1.7 The Department's main efforts on VAT avoidance are channelled through their programme of VAT control visits to registered traders and the dissemination of information to their staff on detected cases and VAT Tribunal decisions. Although VAT control visits are primarily directed at protecting the expected yield from the tax, they are also the main means of identifying questionable avoidance schemes. In 1991–92,
HM CUSTOMS AND EXCISE: COUNTERING VAT AVOIDANCE

The Department made 426,000 visits to registered traders at a cost of £127 million. As a result, they discovered £1.5 billion in additional tax. The Department do not have any information on how much of this extra revenue came from countering avoidance devices. However, they estimate that legislative measures to counter avoidance over the past seven years have resulted in the collection of nearly £500 million a year in additional tax.

The operation of VAT

1.8 VAT is charged on a wide range of home-produced and imported goods and services. There are two rates—standard (currently 17½ per cent) and zero—and a number of exemptions. In 1991–92, net VAT receipts to the Exchequer totalled £36 billion, representing 25 per cent of the total revenue from central government taxation.

1.9 VAT is assessed by, and collected from, those registered businesses which produce, sell or otherwise provide taxable goods and services. It is charged at every stage in the process of production, manufacture and distribution. Each business pays VAT on the goods and services it purchases for its business. This is known as input tax and as a general rule may be reclaimed from the Department if it relates to a taxable output. When the business supplies taxable goods and services it is obliged to charge VAT on their value. This is known as output tax and is normally passed on to the customer in the selling price.

1.10 Generally, each quarter the business has to collate all its output tax and reclaimable input tax and make a return to the Department. If output tax exceeds input tax, the business has to pay over the difference; if input tax is more than output tax, the business claims back the difference. Businesses which regularly pay VAT are known as payment traders; those which regularly reclaim VAT are known as repayment traders. Special accounting schemes apply to retailers. Where a business regularly claims tax back, returns may be made on a monthly basis. From Autumn 1992, the 1,600 largest payment traders (those which paid more than £2 million VAT a year) were required to pay tax monthly on account against quarterly returns.

1.11 A trader with a turnover of £36,600 or more a year in taxable goods and services is legally required to be registered by HM Customs and Excise for VAT purposes. Traders with a turnover below the registration threshold may seek voluntary registration. Currently some 1.7 million businesses are registered for VAT of which 0.3 million (17 per cent) are repayment traders. In 1991–92, the Department collected £61 billion in VAT and repaid £25 billion. Four per cent of traders accounted for more than 45 per cent of the domestic net tax paid (Figure 1). In the Department’s experience it is generally only the largest traders which are in a position to devise elaborate schemes to reduce their liability to VAT, and have the incentive to do so.

Tax reliefs and exemptions

1.12 A number of VAT reliefs and exemptions have been introduced over the years, primarily for reasons of economic or social policy. The most significant are:

(a) Certain kinds of goods and services (for example, foodstuffs, children’s clothing and public transport) are zero-rated. The trader is not liable for any output tax and the associated input tax is recoverable. Some 21 per cent of consumers expenditure in the United Kingdom is currently on zero-rated items.

(b) A further 22 per cent of consumers’ expenditure is exempt from VAT. Exemptions include most insurance and banking services, health and postal charges. Businesses dealing in wholly exempt supplies generally cannot recover any input tax. In effect the VAT “sticks” with the business. Many businesses are involved in a mixture of exempt and taxable (standard or zero-rated) supplies. The Department have devised special rules on input tax recovery for the estimated 10,000 traders in this category who are designated as partly exempt.

(c) Traders with a turnover below the registration threshold of £36,600 are not required to register for VAT. This provision is primarily aimed at relieving the administrative burden of the tax on smaller traders and the Department. Unregistered traders do not have to
account for output tax and cannot recover input tax.

(d) The United Kingdom's largest businesses often comprise not one but a group of legal entities. Provided certain criteria are met, the Department allow a single group registration for these large businesses to avoid the need to charge VAT on transactions between the companies in the VAT group.

1.13 The Department estimate that the total value of these VAT reliefs and exemptions amounted to over £30 billion in 1991-92 (Table 1). In their experience the greatest scope for tax avoidance lies within the coverage and machinery of these provisions.

The value of the main tax reliefs and exemptions given on VAT amounted to over £30 billion in 1991-92.

Scope of the National Audit Office examination

1.14 The National Audit Office examined how Customs and Excise identify and evaluate VAT avoidance (Part 2 of this Report) and respond to identified VAT avoidance schemes (Part 3). The examination did not cover the Department's arrangements for dealing with...
traders who, by acts of omission or commission, evade VAT.

1.15 The National Audit Office reviewed all significant categories of tax avoidance identified by the Department. This involved visits to Customs and Excise headquarters and a selection of local VAT offices. Customs and Excise practice on countering avoidance was compared where appropriate with that of the Inland Revenue, whilst recognising certain important differences. To gain a broader view, the National Audit Office also discussed the main issues on VAT avoidance with a number of external bodies, including those representing VAT businesses and their advisers (Appendix B). Specialist VAT consultants were employed to assist in the identification and evaluation of avoidance schemes.

1.16 The Report is illustrated, at Appendix C, with examples of avoidance schemes under examination or already tackled by the Department.
Part 2: Identifying and evaluating avoidance

2.1 As already noted, there is a difficult dividing line between tax mitigation and avoidance on the one hand, and evasion on the other (Figure 2). Tax mitigation involves a proper and provident ordering of a taxpayer’s affairs in such a way as to minimise tax liability. Tax evasion, at the other extreme, involves a disregard of legal obligations, with or without fraudulent intent on the taxpayer’s part.

2.2 In between the two lies tax avoidance. Though avoidance is in principle legal, the concept of unacceptable avoidance grew largely out of the Courts’ response to a growing tax avoidance industry in the 1980s. As Lord Templeman said in an address to the Institute of Fiscal Studies in 1985.

“While tax avoidance is not, by definition, an illegal activity, a tax avoidance industry of the scale that developed in the 1970s had to be destroyed. The origins of the new approach by the Courts had to be seen as a reaction to the growth and activities of this industry. An industry of that nature and size had the capacity to make very considerable inroads into Government revenues and essentially created two nations of taxpayer; those ‘in the know’ with the financial resources enabling them to use the artificial devices on offer to avoid tax altogether and those to whom, through lack of knowledge or resources, such opportunities were not open.”

2.3 In considering whether to take action to challenge particular VAT arrangements, Customs and Excise draw a distinction between tax mitigation, which is within both the letter and spirit of the law, and avoidance which - though within the strict letter of the law - is not within its intention. These are issues which as well as involving

Figure 2: Tax mitigation, avoidance and evasion

Avoidance may be considered as part of a continuum running from tax mitigation to serious fraud. The diagram does not reflect the revenue or number of traders involved.
complex technical matters also go to the heart of the fairness and equity with which the Department apply the law and exercise their statutory powers. This part of the Report examines what the Department have done to distinguish unacceptable avoidance from legitimate tax mitigation and how they identify and evaluate VAT avoidance schemes.

Defining avoidance

2.4 There is no definition in legislation or elsewhere of tax avoidance or tax mitigation or how they differ from each other. Nor have the Department issued general guidance to their own staff or to traders on what practices they accept as tax mitigation and what practices they regard as unacceptable avoidance, and would therefore seek to counter.

2.5 The National Audit Office discussed the distinction between tax mitigation and avoidance with tax practitioners and various bodies representing taxpayers. There was general agreement that certain practices were designed to secure tax benefits in a manner which undermined the intention of the law and the integrity of the tax. There was, however, no consensus on a suitable label for these practices. In general, most tax advisers recognised "tax mitigation" as encompassing every lawful practice designed to secure a tax benefit.

2.6 Under the Taxpayer's Charter, registered traders and their advisers are entitled to expect certainty from the law, consistently and impartially applied by the Department. Representatives of taxpayers and their advisers told the National Audit Office that the Department should issue public statements making it clear where they draw the line between tax mitigation and unacceptable tax avoidance. Unless this is done, a registered trader risks falling foul of complex legislation and the Department's application of their statutory powers, often at considerable cost, when the trader may genuinely have believed that arranging his or her VAT affairs in a particular way would be acceptable to the Department.

2.7 In a written submission to the National Audit Office, the Institute of Taxation characterised avoidance schemes as arrangements which:

(a) are by their nature designed to avoid or reduce liability to the tax;

(b) are brought into existence solely with that end in mind and not with a view to achieving some other commercial purpose of the business, even though they might be carried out in an overall commercial context; and

(c) can be recognised (even if not described in advance) as outside the broad intention of the legislation.

2.8 The Department consider that it would be inappropriate for them to produce any rigid definitions of avoidance. Avoidance is dynamic in nature and what the Department produce today may be ineffective in countering novel avoidance devices tomorrow. Nevertheless, the Department accept that, under the Taxpayer's Charter, they should provide guidance to traders on what constitutes avoidance and how it differs from tax mitigation. They have therefore agreed to issue a policy statement to traders in the form of a business brief which would:

- make clear their view that avoidance is unacceptable and may be challenged
- detail the hallmarks of avoidance practices
- provide examples of avoidance schemes which have been or may be countered
- refer to other Departmental publications which explain how traders are meant to arrange their affairs in order to comply with the law

2.9 The Department also accept that they need to provide similar guidance to their own staff, so as to ensure fair and consistent treatment of often complex and difficult cases. They have agreed to use the avoidance hallmarks identified by the Institute of Taxation as a basis for formulating their business brief to traders and internal guidance for their own staff.

Identifying avoidance

2.10 The Department identify avoidance schemes they may wish to challenge:

- during inspection visits by VAT control staff
HM CUSTOMS AND EXCISE: COUNTERING VAT AVOIDANCE

- through information supplied by taxpayers about other traders whom they consider are using avoidance schemes which place them at a competitive disadvantage
- through approaches by tax advisers asking for advice in hypothetical and real situations.

Nearly all avoidance schemes are identified through the work of the Department's VAT control staff.

Training

2.11 VAT control officers do not receive formal training in how to recognise avoidance; they rely essentially on experience and intuition. Though a nine-month basic VAT training course for new entrants includes instruction on awareness of VAT fraud, this does not directly address avoidance. Nor does a range of other more specialist and advanced courses for staff and managers. In contrast, in the Inland Revenue tax avoidance is comprehensively covered following the full training programmes for tax inspectors.

2.12 The importance of more training in avoidance matters, and the key role of VAT control officers was acknowledged by the Department in a 1985 internal report. The report recognised that control officers should be given sufficient time, incentive and, most importantly, training to meet this challenge. However, this did not form the basis of a formal recommendation and was consequently not acted upon. However, in a further Departmental review in 1991, the need for better written guidance and training in all VAT technical and liability matters (including avoidance) was again acknowledged, and recommendations for future improvement made. An implementation programme is in its early stages and is planned for completion within four years.

2.13 Most avoidance schemes take advantage of gaps or ambiguities in the law. In implementing the 1991 review, the Department's main thrust will be to provide local officers with clearer, more accurate, more up-to-date and more easily accessed guidance on VAT law, trade practices and Departmental policy. The Department are also extending their basic VAT training to include far greater instruction in VAT legislation for selected local staff. The intention is to equip those local staff who most need it with the knowledge and skills to analyse and discuss the legality of VAT arrangements when these are disputed with a trader. As well as heightening these officers' awareness of potential avoidance this would also equip them to deal more effectively with questions of legitimate tax mitigation.

2.14 The National Audit Office recognise that targeted avoidance training is inappropriate for new entrants because of the nature and complexity of the subject. And there are good reasons why the Inland Revenue's approach to training staff in more detailed avoidance matters should be more comprehensive than might be appropriate for Customs and Excise. Complex legislation has resulted in avoidance always being a problem for the Inland Revenue. Moreover, a mass of specific anti-avoidance legislation was introduced to counter particular schemes in the 1970s and 1980s and this has further widened opportunities for manipulation. In addition, most direct taxation is not circumscribed by EC legislation (which limits the scope for anti-avoidance measures on VAT).

2.15 Although VAT avoidance is probably not on anything like the scale of direct tax avoidance, the National Audit Office consider that Customs and Excise could benefit from examining the training practices of the Inland Revenue. In particular, VAT training for managers (Higher Executive Officer and above) could include appropriate tuition on recognising different kinds of avoidance, supplemented by the local and regional seminars targeted at frontline control staff already used by the Department.

Guidance

2.16 Information on identified avoidance cases is regularly publicised to staff in specialist newsletters. However, the National Audit Office noted that avoidance was directly referred to only twice in the 35 or so volumes of Departmental instructions relating to VAT. These instructions are the primary reference point for all VAT control staff and detail the action required in all
aspects of VAT from registration procedures through to control notes for specific types of trader. But avoidance is not defined and there are no general instructions as to what action should be taken if avoidance is suspected. On the other hand, references to evasion feature repeatedly throughout the instructions and an entire section is devoted to it.

2.17 Given the continuing need to check the growth of avoidance schemes, there would be substantial benefits in the Department developing standardized, permanent instructions on avoidance, kept regularly up to date. Such instructions could cover:

(a) the hallmarks of avoidance and how it differs from tax mitigation;
(b) guidance on specific avoidance and tax mitigation schemes likely to be used by different types of trader;
(c) counteraction measures and procedures; and
(d) the safeguards needed to ensure fair and consistent treatment of traders, including the handling of cases under challenge.

Again there may be lessons to be drawn from the Inland Revenue’s internal guidance to their staff.

Motivation

2.18 Recognizing and pursuing avoidance does not receive high priority in competition with the heavy volume of other VAT work. VAT control officers interviewed by the National Audit Office said that they were under considerable pressure to maintain visit levels and to detect underdeclarations of tax attributable mainly to evasion. This pressure influenced local objectives and targets and, despite acknowledged previous successes, was at times a disincentive to control staff pursuing possible cases of tax avoidance. Avoidance cases often took a long time and hard work to resolve, no additional tax was immediately collectable and staff felt that there was often little recognition of the individual officer’s efforts.

Types of VAT avoidance

2.19 Traders will generally seek to organize their affairs or transactions in a manner which secures them the greatest tax advantage. This may be through:

(a) increased recovery of input tax;
(b) reduced liability to output tax; or
(c) improved cash flow.

The first two benefit traders by reducing the amount of tax they have to pay, with the obvious disadvantage to the Exchequer of reducing the overall VAT collected. The third defers payment of VAT, which benefits the trader’s cashflow but results in a financial cost for the Exchequer.

2.20 Within these broad categories the Department have over the years encountered many different varieties of avoidance schemes. However, general themes have emerged and most schemes can be placed in one of seven categories (Table 2). Consultants employed by the National Audit Office identified within these categories 28 significant avoidance schemes. The Department confirmed that they were fully aware of each of these schemes and, for some, had known about them since the inception of the tax. Ten schemes had been closed off by legislation; and the remainder continued to be tackled as individual cases arose. Examples of each of the different categories of avoidance are given in the Case Studies at Appendix C.

Category 1 — Registration

2.21 The most common avoidance device in this category is disaggregation, that is, the artificial fragmentation of business activities to avoid registration for VAT. There are two main methods of disaggregation:

(a) interposing self-employed persons between the business and the consumer (for example, a hairdressing business which rents its salon chairs to individual self-employed stylists); and
(b) splitting the business into two or more legal entities (for example, a launderette operating as seven companies, one for each day of the week, to bring each company’s turnover below the registration threshold).
Although this form of avoidance is most commonly practised by small businesses (Case Study 1), there have been cases where large companies have hived off one or more business activity in this manner.

2.22 By the early 1980s, the Department were concerned that disaggregation had become widespread and was costing some £15 million to £20 million a year. Disaggregation packages for avoiding VAT were being openly advertised. The Finance Act 1986 gave the Department powers to counteract disaggregation in certain circumstances by allowing them to direct that a trader should be treated as a single business for VAT registration purposes. Since that time the number of cases has generally been declining. However, the Department have been alert to the risk that the increase in the registration threshold from £25,400 to £35,000 in 1991 (uplifted in line with inflation to £36,600 in 1992) may have provided a new incentive for this type of avoidance. Once the increases have bedded in, they intend to evaluate the impact of the higher threshold on the extent of disaggregation.

Category 2 - Tax points and VAT payment periods

2.23 Traders may obtain a cash flow advantage by altering the date of the supply of goods or services (the tax point) or the date on which tax is due to be paid or repaid (the VAT payment period). For example, a manufacturing company which exports part or all of its products might channel its exports through an associated export company, rather than exporting directly to its overseas customers. The output tax due from the manufacturing company for the goods sold to the export company is payable to the Department at the end of three months. But the export company, being a repayment trader, can reclaim the corresponding input tax on the same goods each month. Without the intermediary export company, the manufacturing company would have had to wait three months before reclaiming input tax (Case Study 2). A similar benefit can flow from careful timing of supplies between associated companies with the same VAT period but different dates for submitting returns.

2.24 Pre-payment (advancing the tax point) for a future supply, particularly where the VAT rate for goods or services is due to increase, can also provide traders with a significant cash flow advantage. Traders normally have advance notice of an increase in the VAT rate for particular goods or services which enables retail businesses supplying goods and services to adjust their prices. For supplies normally invoiced between businesses, the advance notice of an increase in the rate of tax or a change from zero-rating or exemption to standard-rating gives the opportunity to alter tax points. This can be done by raising invoices or receiving payment within the notice period in respect of goods to be delivered after the date of the rate or liability change.

2.25 These pre-invoice or pre-payment arrangements are entirely lawful. However, the question of avoidance can arise where pre-payments appear to exist only on paper or are circuitous and do not involve money changing hands (Case Study 3). In 1991, the Department estimated that cash flow avoidance schemes operated by the largest traders could be costing the Exchequer £100 million a year. The changes to monthly payment on account for the largest taxpayers from Autumn 1992 (paragraph 1.10) should significantly reduce the scope for this type of avoidance.

Category 3 — Business and non-business use

2.26 A registered trader may only recover as input tax the VAT charged on items purchased in the course of business. However, some traders try to recover the tax paid on items which the Department consider have been purchased, wholly or in part, for private or other non-business use (Case Study 4). This category of avoidance is presenting increasing problems for the Department. Although they have not estimated the overall incidence of cases of this type, or the revenue at risk, they consider that the amounts involved could be substantial.

Category 4 — Mixed supplies

2.27 Certain goods and services make up a single, indivisible supply. They are treated by the Department as standard-rated even though

---

* A recent ruling by the European Court of Justice (the Lennartz case) could result in the Department having to change their policy whereby input tax recovery is apportioned according to the amount of business to non-business use. However, whilst the change will mean that traders will be able to recover input tax in full, output tax will become chargeable on private use and the Department consider that this will still present scope for avoidance.
certain elements, if supplied separately, would be zero-rated or exempt. For example, the Department treat television rentals as a single standard-rated supply. However, some traders have recently begun to split television rentals into two supplies: rental which is taxable and insurance which is exempt (Case Study 5). This is a relatively new type of avoidance and the Department are concerned that, unless countered, the practice could become widespread, and extend to a wider range and diversity of rented goods and services. Even where such mixed supplies are divisible for tax purposes, traders may attempt to attribute a higher value to the element which is exempt than the Department consider justified, with the aim of securing a reduction in chargeable output tax.

Category 5 — Land and property

In April 1989, in a complex package of legislative changes, certain building and land transactions, which had previously been zero-rated, became standard-rated and others became exempt. In addition, from August 1989, traders have been able to exercise an “option to tax”, that is, to decide whether or not they wish certain exempt building and land transactions to be subject to standard-rated VAT. If they choose the option to tax, they are then able to make input tax deductions for which they were not previously eligible. Despite the legislation being drafted in a manner designed to curb attempted avoidance, the Department are concerned that a number of loopholes are already being exploited by certain traders and their advisers (Case Study 6). The Department have not yet evaluated the incidence of this category of avoidance and the overall tax at risk.

Category 6 — Zero-rated exports of services

This category includes cases where securities are sold to someone in the United Kingdom via an intermediary abroad. If securities are sold direct to the person in this country, they are classed as exempt — because they are financial transactions — and input tax is not recoverable. However, by first exporting the securities, their status alters from exempt to taxable zero-rated supplies (since exports are zero-rated). Thus, input tax becomes recoverable (Case Study 7). This type of avoidance is relatively new and the Department have unearthed only a few cases to date. They are, however, monitoring the situation.

Category 7 — Partial exemption

A partly exempt trader is one who makes both taxable and exempt supplies. In 1985, a Departmental report on VAT avoidance concluded that, apart from disaggregation, the arrangements for partial exemption represented the largest area for avoidance. Some 10,000 traders are classed as partly exempt. Of these, 1,400 (mainly the largest traders) have a group registration.

Under the VAT rules, a partly exempt trader generally has to agree with the Department a fair and reasonable method for identifying recoverable input tax. Input tax which is clearly and directly attributable, wholly or in part, to exempt supplies cannot be recovered: input tax directly attributable to taxable supplies can be recovered in full. Any residual tax, for example, on general overheads (and amounts here can be considerable) is attributed by a method agreed with the Department. This is normally based on the proportion by value of taxable to exempt outputs.

Methods to establish the input tax recovery rate for partly exempt businesses can be detailed and complex. The Department have noted instances where distortions have been introduced into the agreed method and inflated the rate of input tax recovery. This can be achieved either by increasing the value of taxable supplies or by decreasing the value of exempt supplies (Case Study 8).

In 1987, new measures were introduced in the Finance Act to tighten up the partial exemption rules. At that time the tax at risk was estimated by the Department to be in the region of £400 million a year. In all, nine identified loopholes were closed by the legislation. The countermeasures included a provision to prevent grouped companies which were partly exempt from recovering input tax on capital goods by moving companies in and out of the group registration (Case Study 9). Despite the changes to the partial exemption rules, the Department were concerned that some avoidance still occurred in this area. After an internal review of the changes made in 1987, amended regulations were made in March 1992 to close the remaining loopholes. However, they have not evaluated the incidence of avoidance and tax at risk beyond 1989 and therefore do not know how
Table 2: Categories of avoidance

<table>
<thead>
<tr>
<th>Category</th>
<th>Main tax benefit</th>
<th>Revenue at risk (£m p.a.)</th>
<th>Case Study (Appendix C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Registration</td>
<td>Reduced output tax</td>
<td>16-20</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(up to 1986)</td>
<td></td>
</tr>
<tr>
<td>2. Tax points and VAT payment</td>
<td>Cash flow enhancement; reduced output tax</td>
<td>100</td>
<td>2/3</td>
</tr>
<tr>
<td>periods</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Business and non-business</td>
<td>Increased recovery of input tax</td>
<td>not known</td>
<td>4</td>
</tr>
<tr>
<td>use</td>
<td>Reduced output tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Mixed supplies</td>
<td>Reduced output tax</td>
<td>not known</td>
<td>5</td>
</tr>
<tr>
<td>5. Land and property</td>
<td>Increased recovery of input tax</td>
<td>not known</td>
<td>6</td>
</tr>
<tr>
<td>6. Zero-rated exports of services</td>
<td>Increased recovery of input tax</td>
<td>not known</td>
<td>7</td>
</tr>
<tr>
<td>7. Partial exemption</td>
<td>Increased recovery of input tax</td>
<td>400</td>
<td>8/9</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(up to 1997)</td>
<td></td>
</tr>
</tbody>
</table>

Source: HM Customs and Excise.

Most VAT avoidance schemes can be placed in one of seven categories.

Far the 1987 measures have been successful in reducing the £400 million tax estimated to be at risk each year.

Evaluating the extent of avoidance and need for action

2.34 The Department use the following criteria to evaluate avoidance schemes and decide whether to take counteraction:

(a) the amount of tax being lost or at risk;
(b) the number of traders involved;
(c) the effect of the scheme on the equity and integrity of the tax; and
(d) the impact of possible countermeasures on the costs of compliance for businesses, particularly small traders, and on the cost-effective administration and collection of the tax.

2.35 These criteria are not set out in standing instructions to staff, and the National Audit Office examined how far the criteria are applied consistently and systematically across the Department in relation to each of the seven categories of avoidance. Table 3 shows that the amount of tax lost or at risk has been evaluated for less than half the categories; the number of traders involved has not been estimated for any category; the effect on equity and integrity of the tax has not been evaluated for two categories; and the impact of possible countermeasures has been considered for only two categories.

2.36 The National Audit Office noted that Departmental assessments of tax at risk from avoidance and the numbers of traders involved were generally speculative. For example, the two most significant instances of legislative change were the disaggregation powers given in 1986 (paragraph 2.22) and the partial exemption changes of 1987 (paragraph 2.33). The first was expected by the Department to net an extra £15 to £20 million a year, and the second some £400 million a year. In the event the actual revenue protected may have been very much less than forecast.

2.37 A recent Departmental analysis showed that between October 1986 and June 1989 an estimated £1.9 million was raised in pursuing disaggregation cases. In the year to March 1991 the figure fell to around £0.5 million.

2.38 After the 1987 changes, the Department collected data for partly exempt businesses from local VAT offices. However, information

Table 3: Application of evaluative criteria to identified avoidance categories

<table>
<thead>
<tr>
<th>Evaluative criteria</th>
<th>Tax lost or at risk</th>
<th>Number of traders involved</th>
<th>Effect on equity and integrity of tax</th>
<th>Impact of possible countermeasures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax points and payment periods</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Business and non-business use</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Mixed supplies</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Land and property</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Zero-rated exports of services</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Partial exemption</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

The Department have not applied the evaluative criteria consistently and systematically in relation to each of the seven categories of avoidance.
was received from only 60 per cent of offices (covering 199 traders). The Department have not evaluated this information nor did they ascertain why the remaining local VAT offices did not respond. The National Audit Office analysed the data and concluded that the revenue increased by only £15 million in the first year, and by £7 million in the first six months of the following year. Information was not available beyond two years after the changes.

2.39 The Department have not analysed why the additional revenue collected has fallen so far short of their original estimates. However, they told the National Audit Office that most of the 1987 changes were of a preventive nature and there were no figures available to quantify the preventive effect. The tax outturn in the years immediately following the changes exceeded their forecasts by more than £400 million but the Department acknowledge that this could be the result of factors other than the partial exemption changes.

2.40 There are obvious difficulties in accurately evaluating the incidence of avoidance and the tax at risk, since avoidance is complex and changing and there is a lack of reliable information in certain areas. For example, with cases of disaggregation, the Department have no means of accurately determining the number of businesses trading below the registration threshold. More generally, the interval between VAT control visits to small-to medium-sized businesses may run to several years. So a registered trader could, for example, be enjoying a tax-free benefit on an item purchased essentially for private use for a considerable period with little likelihood that it would quickly be discovered by the Department. However, Customs and Excise regard this as an acceptable risk.

2.41 Nevertheless, there is scope for the Department to improve their effectiveness in this area. The results of a recent survey amongst control officers on the incidence and revenue impact of cash flow avoidance schemes (paragraph 2.23) showed that £100 million a year in interest was being lost to the Exchequer through schemes being operated by the very largest traders. More use of surveys of this nature would help to pinpoint key areas of risk, strengthen the Department’s evaluation of avoidance, and inform decisions on appropriate countermeasures.

Better management information

2.42 The VAT central computer system allocates registered traders to a particular trade classification, and the database includes details of turnover, returns made and assessments issued for underdeclared tax. But, with the exception of partly exempt traders, the Department do not record details of the structural characteristics of particular businesses except in manual records at each local VAT office. This means that a central overview of trends in business structures cannot easily be undertaken.

2.43 Most avoidance schemes involve traders structuring their business affairs in a particular manner to minimise the VAT payable. The National Audit Office consider that the Department should therefore re-examine the scope for recording details of traders’ business structures on their central computer. This could, in particular, include:

- businesses with trading or dormant associated companies, whether or not group-registered, in the United Kingdom and off-shore
- businesses with overseas markets whose structure alters in any unusual manner, in particular after completion of the Single European Market.

2.44 Details of business structure could be recorded along with the other information on the VAT computer, either on registration or after the first or subsequent control visits. In this way, if an avoidance scheme is suspected of being on the increase, its likely incidence and the potential total tax at risk could more accurately be estimated.

2.45 As part of an internal review of VAT administration, the Department are currently considering what improvements might be made to the allocation of traders to trade classifications. In addition, the current VAT computer system is due to be replaced within a five-year timetable. It should therefore be possible for the Department to build requirements for additional information and analysis into the new system at little extra cost.
Use of professional accountants for evaluating avoidance

2.46 Stemming from an internal review in 1986, the Department recruited a small number of professional accountants. There are now 18 with a further 15 in training and most of them are deployed on a regional basis serving the Department's local office network. Their role is to provide:

(a) professional back-up to VAT officers during control visits; and
(b) specialist support and professional advice to local management in areas such as:
   (i) financial forecasting and planning;
   (ii) systems examination and design;
   (iii) management information and development of performance measures;
   (iv) training.

2.47 The accountants interviewed by the National Audit Office said that their role was still evolving but they considered that they could make a useful contribution to identifying and evaluating avoidance. As well as accompanying VAT officers on visits to the larger and more complex traders where significant avoidance schemes might be operating, which they are already beginning to do, the accountants could also assist in developing management information systems aimed at establishing the incidence of avoidance and the tax at risk. As a base line, they might compare the actual receipts with the potential yield from particular groups of traders. In the longer term this could develop into a nationally-based system.
Part 3: Countering avoidance

3.1 Customs and Excise counter avoidance by using existing legal powers or by seeking a change in the law. This part of the Report examines the measures used; considers the constraints the Department face in practice; and assesses how the Department monitor the effectiveness of their actions.

Use of existing powers

3.2 The Department have two main legal powers: first, to issue a notice of direction in certain specific circumstances, requiring the trader to arrange his or her affairs in a particular way; and second, to issue an assessment for the amount of tax they consider has been avoided. Directions and assessments are issued by local staff, usually after consultation with line management and the appropriate headquarters policy branch. Both procedures are subject to appeal by traders to a VAT Tribunal, a special court which exercises limited judicial functions under powers conferred by Act of Parliament and provides a relatively informal and inexpensive means of settling disputes.

Issuing directions

3.3 Directions are issued mainly where the Department consider that a business has been deliberately split into a number of independent parts solely to avoid tax (paragraphs 2.21 and 2.22). Since 1989, the Department have examined 582 cases where they suspected artificial disaggregation. They issued notices of direction in 19% cases (33 per cent) but they do not have any information on how many of these notices of direction were challenged at Tribunal or with what success.

3.4 A National Audit Office analysis of disaggregation cases taken to Tribunal showed that the Department won 75 per cent. Cases were won by the Department where the Tribunal accepted that the independent parts of the business were genuinely the responsibility of different persons.

Issuing assessments

3.5 Each trader is responsible for assessing his or her liability to VAT and making a return to the Department. However, the Department can issue their own assessment if a trader fails to submit a return or if they consider a return is incorrect. Powers to issue assessments are vested in the 1977 EC Sixth Directive and the VAT Act 1983. In 1991–92, the Department issued some 213,000 assessments for £1,428 million but they have no information on how many of those related to avoidance.

3.6 In avoidance cases, Customs and Excise policy is to issue assessments only when they consider that the arrangement of a trader’s business affairs in a particular way runs counter to the Department’s interpretation of statute; is intended primarily or solely for the purpose of avoiding VAT; and, if the trader appeals, the Tribunal will uphold the assessment. The Department usually issue assessments in avoidance cases as a last resort when they are convinced that their interpretation of the law is correct and that to act in this way is essential if equity, fair competition and the integrity of the tax are not to be undermined.

3.7 Over the years, the Department have not systematically and in a unified manner analysed all cases taken to Tribunal to identify trends. To identify those that related to avoidance, the National Audit Office therefore examined details of all VAT Tribunal hearings since the inception of the tax. This analysis established that 307 cases (fewer than two per cent) related to avoidance and, of these, the Department were successful in 196 cases (64 per cent). More than 75 per cent of the avoidance cases heard at Tribunal since 1973 related to questions on business and non-business use or on registration arrangements (Figure 3).
3.8 Only 307 avoidance cases have been heard at Tribunal since the inception of the tax more than 20 years ago. However, in looking at the overall impact of Departmental assessments these figures must be interpreted with some caution, since there is no information available on the number of assessments issued in cases of avoidance which are accepted, without appeal, by traders. The Institute of Chartered Accountants in England and Wales told the National Audit Office that traders whose assessed tax could be passed on to their customers to become the customer’s reclaimable input tax would, irrespective of the circumstances which led to the assessment being raised, generally be advised to pay rather than incur legal expenses at Tribunal. Similarly some traders would pay the amounts assessed rather than risk the adverse publicity which could result from a case going to Court. Of the 28 significant avoidance schemes identified by the National Audit Office’s consultants, eight were successfully countered by the Department’s use of their powers to raise assessments.

3.9 The Department told the National Audit Office that they carefully weighed up the strengths and weaknesses of the arguments involved, and potential costs, before taking action in individual cases. Assessments were only issued in avoidance cases, where senior line management and headquarters were satisfied, on their best judgement, that there had been an underdeclaration and that basic principles of the tax had been breached.

3.10 Nevertheless, some isolated instances were noted where issuing assessments appeared to have been counterproductive. In one major test case lost by the Department, the publicity surrounding the Tribunal and subsequent hearings served only to highlight the scope for avoidance without curtailing it (Case Study 2). In cases such as these the better course, with hindsight, would have been for the Department either to have accepted, at an early stage, that the scheme constituted legitimate tax mitigation or to have sought a change in the law. In general terms the advantage would seem to lie with taking early action to remove unnecessary uncertainty about the law. In the example quoted, the law was eventually changed some nine years after the avoidance scheme was first identified.

3.11 On the evidence available it can be argued that issuing assessments is an effective means of combating avoidance, particularly when large amounts of tax are at stake. Nevertheless, there are dangers in issuing assessments in borderline cases, with the risk that a trader who considers he or she is in the right may nevertheless feel obliged to
accept the assessment on cost or other grounds. This makes it important for the Department to continue to monitor the position closely, to ensure that staff receive relevant training and guidance, to exercise careful oversight of staff, and generally to ensure that taxpayers are challenged in this manner only in cases where it is fully justified.

Changing the law

3.12 The Department's other main approach to countering avoidance is to seek changes in the law. Changes can be made either to the primary legislation in the VAT Act 1983, as amended by subsequent Finance Acts, or to subordinate legislation (including certain specific Public Notices which have the force of law). The main anti-avoidance provisions introduced in the Finance Act 1987 to the rules under which partly exempt businesses recover input tax (paragraph 2.33). The changes removed much of the scope for traders to increase recovery of input tax, for example, by including high value transactions outside the scope of normal day-to-day business so as to alter the proportion of their taxable to exempt supplies.

3.14 In the Finance Act 1987, the Department relinquished their powers to direct a partly exempt trader to use a particular method for calculating the amount of input tax to be recovered. They now believe that this has led to the partial exemption rules again being used by traders to increase recovery of input tax. The Department estimate that as a result one group of traders has recovered some £60 million in additional input tax. Following a recent review, however, new powers were granted to the Department in March 1992 to direct the use of an input tax recovery method which is fair and reasonable to both sides.

Table 4: Anti-avoidance provisions in Finance Acts 1986 to 1992

<table>
<thead>
<tr>
<th>Finance Act</th>
<th>Clause No</th>
<th>Detail</th>
<th>Predicted saving</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>9</td>
<td>Scales for amounts of tax to be accounted for on private motoring</td>
<td>£40m a year</td>
</tr>
<tr>
<td></td>
<td>10</td>
<td>Artificial disaggregation of companies to avoid registration</td>
<td>about £15m-£20m a year</td>
</tr>
<tr>
<td></td>
<td>11</td>
<td>Reduced VAT not to apply on hotel black bookings made by travel agents</td>
<td>£12m a year</td>
</tr>
<tr>
<td>1987</td>
<td>12</td>
<td>New input tax rules for partly exempt traders</td>
<td>£200m in 1987-88</td>
</tr>
<tr>
<td></td>
<td>15</td>
<td>Taxation of acquisition of assets by partly exempt traders</td>
<td>£400m in 1986-89 and each year thereafter</td>
</tr>
<tr>
<td></td>
<td>17</td>
<td>Commissioners to decide value of supplies between connected persons</td>
<td>£100m in 1988-89 (part of £200m above)</td>
</tr>
<tr>
<td></td>
<td>19</td>
<td>Reverse charge to be made by exempt traders on services from abroad</td>
<td>£5m in 1988-89 (part of £400m above)</td>
</tr>
<tr>
<td></td>
<td>21</td>
<td>Commissioners' powers to invalidate registrations of traders ineligible to register</td>
<td>about £5m a year</td>
</tr>
<tr>
<td>1988</td>
<td>13</td>
<td>Power to assess on underdeclarations on self billing invoices</td>
<td>not known (minimal)</td>
</tr>
<tr>
<td></td>
<td>24</td>
<td>Input tax on self supply by partly exempt traders</td>
<td>£5m a year</td>
</tr>
<tr>
<td>1989</td>
<td>17</td>
<td>Gifts or loans of land (to prevent partly exempt traders obtaining tax free land, etc)</td>
<td>not evaluated (to close potential loophole)</td>
</tr>
<tr>
<td></td>
<td>24</td>
<td>Input tax on self supply by partly exempt traders</td>
<td>not evaluated (to close potential loophole)</td>
</tr>
<tr>
<td>1990</td>
<td>None</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>None</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>None</td>
<td>None</td>
<td></td>
</tr>
</tbody>
</table>

Source: HM Customs and Excise.
Note: Departmental estimates of predicted savings are speculative.
3.15 In 1990, the Department introduced the Capital Goods Scheme\(^1\) in accordance with the EC Sixth Directive and took a novel approach to counteracting potential avoidance. To contain traders' compliance costs, the Department opted for a simple scheme but at the same time advised the largest firms of tax practitioners that, if the scheme were manipulated, a more complex, and costly, regime would be introduced. The Department are monitoring the situation.

3.16 The continuing difficulties with the 1987 changes to the partial exemption rules demonstrate how seeking to counter avoidance by changing the law can cause additional problems. And a change in the law may create the potential for further loopholes, particularly if the legislation adds to the complexity of VAT. Nevertheless, of the 28 significant avoidance schemes identified by the National Audit Office's consultants, 10 were successfully countered by amended legislation.

External constraints

3.17 A number of external constraints may prevent the Department from taking countermeasures against identified avoidance schemes:

(a) the finite level of resources available to administer the tax;

(b) case law established over the years by VAT Tribunals, higher Courts and the European Court of Justice;

(c) EC Directives, in particular the Sixth Directive;

(d) the disproportionately large burden which countermeasures may place on small businesses, who may not have been engaged in the avoidance practice being addressed; and

(e) lack of space in the Finance Bill and wider political imperatives.

3.18 The Department need to target their resources on the areas which they consider present the highest revenue risk. This may mean that the Department will not always be able to give anti-avoidance work first priority.

\(^1\) The Capital Goods scheme requires the initial deduction of input tax on computer equipment, land and buildings to be adjusted over a period of years if there is a change in their taxable use.

Case law

3.19 Over the years, the Courts have introduced a number of objective and subjective tests into avoidance cases brought before them. One of the most recent and significant of these is the "business motivation" test which has been applied to cases involving the distinction between business and non-business use (Case Study 4). In effect, cases are often decided on the basis of what was in the trader's mind when he or she decided to take a particular course of action. The subjective nature of the test and lack of hard evidence create obvious problems for the Department in deciding whether to pursue a particular case and in judging the likely reaction of the Courts. The most significant case law relates to direct tax avoidance, not VAT, and the Department have been unsuccessful in having certain tenets established by the Courts on direct taxation applied to cases of VAT avoidance.

EC Sixth Directive

3.20 The fundamental principles of VAT law in the European Community are contained in the 1977 EC Sixth Directive. EC law takes precedence over United Kingdom legislation. In some types of avoidance, particularly certain cases arising in the tax point and payment period category (paragraphs 2.23 to 2.25) the trader's action is permitted under the Sixth Directive. In other cases, such as those involving business and non-business use, action to amend United Kingdom law to counter avoidance cannot be taken as it would bring United Kingdom legislation into conflict with the Sixth Directive.

The Finance Bill

3.21 The annual Finance Bill is a complicated, technical Bill and Treasury Ministers generally strive to keep it as short and uncomplicated as possible to ensure its speedy progress through Parliament. When space is tight, as it usually is, provisions to tighten avoidance rules can find themselves squeezed out along with many others. Ministers are also concerned to avoid complicating the tax by taking repeated bites at the anti-avoidance cherry; the balance of advantage may often be in favour of waiting to see how a particular situation develops and then legislating to achieve a comprehensive solution.
Burdens on business

3.22 The Taxpayer's Charter requires the Department to minimise taxpayers' costs of complying with the law. Therefore, in countering avoidance, the Department have to be particularly careful that the countermeasures do not add significantly to the compliance costs of traders, particularly small businesses. It is generally the larger businesses which benefit most from avoidance schemes and the smaller traders who incur disproportionately increased costs as a result of any countermeasures introduced. For reasons of equity and fair competition the Department therefore have to strike a careful balance between the need to counter avoidance where the tax advantages accrue solely to big business, and the need to contain compliance costs, particularly where these disproportionately affect small traders.

The Department's approach to countering avoidance

3.23 Avoidance is complex and constantly changing, and it varies according to specific factors such as the liability to tax of an individual trader's particular supply and more general factors such as changes in the current standard rate of VAT. The complexity of the situation means that the liability of an individual trader's particular supply, or the acceptability of a trader's arrangement of his or her affairs for VAT purposes may not be clear cut. A policy change in the United Kingdom or a ruling from the European Commission or European Court of Justice can easily result in today's avoidance becoming tomorrow's tax mitigation, and vice versa.

3.24 Given this dynamic environment and the constraints under which they operate, the Department's approach to countering avoidance is essentially pragmatic. Each case is judged on its merits and individual instances are challenged only when the incidence of avoidance or revenue at risk is considered to be sufficiently large to justify counteraction. They consider that their total countermeasures to date are containing the avoidance problem.

3.25 The Department's pragmatic approach allows them to tailor their actions to current needs and circumstances; but there is a risk that this approach to countering avoidance is applied piecemeal and lacks the predictability and consistency that traders would like to see. The Department currently address avoidance in the context of the specific area of the tax affected and not as a single coherent subject, applied across the regions, as they do with fraud. Each headquarters policy branch is responsible for its own work on avoidance and local offices submit cases to the headquarters branch with particular responsibility for the area of tax affected.

3.26 Although a designated headquarters branch is responsible for co-ordinating the Department's efforts in this area, the branch's objectives are not defined, and systems for ensuring that all cases are referred to it have not been established. The branch currently has three staff assigned part-time to avoidance work: a Principal (0.1 man-years); two Senior Executive Officers (0.5 man-years); and a Higher Executive Officer (0.75 man-years).

3.27 In contrast, the Inland Revenue have set up a number of sections which specialise in identifying, evaluating and countering avoidance:

- **Special Offices** investigate a variety of difficult or complex cases of evasion (other than serious fraud), avoidance and non-compliance (170 staff in 10 offices);
- **Special Investigation Section** counters major corporate avoidance, together with artificial avoidance schemes generally (33 staff);
- **International Division** has specialists who concentrate on countering avoidance with an international dimension (16 staff).

3.28 As previously noted, such comparisons have to be approached with care, since avoidance is more prevalent in direct taxation than VAT and it is natural for the Inland Revenue to have many more specialist staff assigned to this work. Customs and Excise already have extensive resources dedicated to tackling evasion. However, the National Audit Office consider that there would be benefits, for Customs and Excise and for traders, from setting up a specialist avoidance team to act as a central reference and co-ordinating point for all avoidance matters.
3.29 A specialist avoidance team could, for example, review submissions from control staff and identify any general themes or common issues before referring cases to the appropriate policy branch. They could also monitor the responses from branches to ensure they are timely and consistent. To improve customer service the Department could also set target response times for the team to deal with queries from control staff and from traders and their advisers. Once an avoidance scheme had been identified, the specialist avoidance team could assume responsibility for evaluating its impact and the need for any countermeasures. And the team could monitor the effectiveness of the countermeasures taken. The additional staff costs involved should be more than offset by the extra revenue generated from earlier identification and counteraction of avoidance schemes, with benefits also to traders in speedier and more consistent handling of VAT issues, and better advice.

3.30 The 1991 internal review of VAT administration acknowledged weaknesses in the Department's approach to avoidance. The review concluded that the Department's VAT Administration Directorate was aware of tax avoidance schemes and how they worked but had little scope within its present structure to devote resources to this important risk area or to adopt a uniform approach to the issues arising. The Department have accepted the review's recommendation that VAT avoidance should be dealt with as a single, coherent subject within one headquarters division. A team has been set up to develop a co-ordinated approach, and will be taking this recommendation forward over the next four years.

Role of local control staff

3.31 Work on avoidance in local offices could also benefit from a more systematic approach. In 1987, the Department established a post in each local VAT office for channelling information on partial exemption to and from VAT control staff. These posts are filled by operational staff who carry out this work in addition to their normal duties. Building on this work would involve giving such posts a specific responsibility for dealing with avoidance issues at local level and channelling all avoidance queries through them. They could evaluate training needs; ensure that key queries and issues arising are passed to headquarters; provide a local source of avoidance expertise; and enable patterns and trends of avoidance across the trader population to be identified and analysed.

3.32 Enhancing the role of these staff in such ways would raise the local profile of avoidance, keep individual officers better informed on potential risks and help managers in planning the optimum allocation of resources as between avoidance and other tasks. The staff involved are already in post and few additional resources would be required since most local VAT offices deal with only a handful of avoidance cases each year.

Delegation to local offices

3.33 Under the "Next Steps" initiative, Customs and Excise have established 30 Executive Units to carry out the bulk of the Department's operational and service functions. The Head of each Unit has been given new freedoms to manage and innovate, and will be more accountable for planning and performance. Individual members of staff have been given more scope to use their initiative and expertise. Unit managers are being encouraged to develop programmes and generate ideas from staff for improving service to the public. Twenty of these Units embrace the Department's national network of 91 local VAT offices.

3.34 In keeping with this initiative, the Department intend giving increased responsibility to staff in local VAT offices around the country. They recognise that it will be important to ensure that Unit managers, with appropriate headquarters guidance, strike the right balance in tackling avoidance and that there is consistency in approach and in decisions affecting taxpayers. However, representatives of the trading community and their advisers told the National Audit Office that they were concerned that the proposed changes would result in greater uncertainty and less consistency in rulings on tax mitigation and avoidance. The Department intend to allay these fears by consulting representatives of business and the tax advisory professions about the commercial, industrial and accounting implications of the proposed and other future changes to VAT and its administration.
3.35 Nevertheless, there are clear risks that traders may not be treated consistently as between one local office and another. The Department therefore need to establish a clear framework for delegating the work, with appropriate targets and adequate guidance and training for the staff involved. They will also need to ensure that the work of local offices is adequately monitored to ensure that traders are treated consistently in practice. This monitoring role could fall to the specialist avoidance team proposed in paragraph 3.28.

Experience in other countries

3.36 Stemming from their recent internal review, the Department intend, where relevant and possible, to research practice on countering VAT avoidance in other Member States of the European Community. Towards the end of 1991, the European Commission completed a study of the effectiveness of VAT collection systems in Member States, including a brief examination of the steps taken to counter avoidance. The Commission’s report recommended that individual Member States should develop selective audit methods for large traders, focusing on tax avoidance. The Department accepted this recommendation but pointed out that these measures were already in place in the United Kingdom.

Monitoring the effectiveness of countermeasures

3.37 In the National Audit Office’s view the Department’s arrangements for monitoring the effectiveness of the measures taken to counteract avoidance need to be developed further and made more systematic. The effectiveness of countering avoidance by issuing assessments and pursuing matters through the Courts is not measured at all. Changes in legislation are generally monitored for two years, with headquarters asking local VAT offices to submit periodic returns showing the number of traders affected by the change and the additional revenue recovered; but, the National Audit Office found that this information was rarely analysed to determine how far or how permanently the overall incidence of a particular type of avoidance had declined or the extent to which the overall tax collected had increased.

3.36 When information on assessments is entered into the central VAT computer, a “reason code” is used to denote the type of error made by the trader. However, none of the codes are necessarily indicative of avoidance. The National Audit Office consider that the Department should establish an additional computer classification for such assessments so as to provide the information and analysis to help determine how cost-effective assessments are in tackling avoidance.

3.39 The Department have concluded that changing the present system to provide better information and analysis would not be cost-effective. However, the current VAT computer system is due to be replaced over the next five years, and it should be possible at that time for the Department to build requirements for extra information into the new system with little additional cost. Detailed monitoring over time of the detected incidence of avoidance and revenue at risk, together with costs and success rates at Tribunal, would then provide the Department with a good basis for measuring the effectiveness of counteraction by assessment and litigation. The analysis would help to identify the most effective methods of redress and those areas which require legislative change, and it would enable more effective targeting of issues and cases to pursue.

3.40 The Department also need a more systematic approach to monitoring the impact of legislative change. The types of avoidance which can only be dealt with by legislative change are generally practised by the largest traders. The Department invariably assign dedicated VAT control staff to such traders. Using the knowledge and experience of those staff, it should be possible for the Department to obtain broad estimates of the incidence of, and revenue at risk from a particular avoidance scheme, before and after it is addressed by legislation, using surveys of the type discussed in paragraph 2.41.
Appendix A
The Taxpayer’s Charter

You are entitled to expect HM Customs and Excise

To be fair
- by settling your tax affairs impartially
- by expecting you to pay only what is due under the law
- by treating everyone with equal fairness

To help you
- to get your tax affairs right
- to understand your rights and obligations
- by providing clear leaflets and forms
- by giving you information and assistance at our enquiry offices
- by being courteous at all times

To provide an efficient service
- by settling your tax affairs promptly and accurately
- by keeping your private affairs strictly confidential
- by using the information you give us only as allowed by the law
- by keeping to a minimum your costs of complying with the law
- by keeping our costs down

To be accountable for what we do
- by setting standards for ourselves and publishing how well we live up to them

If you are not satisfied
- we will tell you exactly how to complain
- you can ask for your tax affairs to be looked at again
- you can appeal to an independent tribunal
- your MP can refer your complaint to the Ombudsman

In return, we need you
- to be honest
- to give us accurate information
- to pay your tax on time
Appendix B
Representative bodies involved with VAT or similar tax systems with whom the National Audit Office had discussions

In the United Kingdom
- The Association of British Chambers of Commerce
- The Federation of Small Businesses
- The Institute of Chartered Accountants in England and Wales
- The Institute of Chartered Accountants of Scotland
- The Institute of Taxation
- The Law Society for England and Wales
- The Law Society of Scotland
- The Scottish Chambers of Commerce
- The VAT Practitioners Group

Overseas
- The European Commission
- Canada: Revenue Canada
- Ireland: The Revenue Commissioners
- New Zealand: Inland Revenue
Appendix C
Examples of Avoidance Schemes

Case Study 1

Category: Registration

1. During a control visit to a public house in February 1988, a VAT officer found that the publican,
   although registered for VAT, did not account for output tax estimated at £1,200 a year on bar meals and
   snacks. The publican maintained that the catering provided by his wife was a separate business and that as
   the turnover on catering was below the VAT threshold there was no need to account for VAT. However,
   examination of the business records led the VAT officer to conclude that the husband and wife should be
   treated as a single taxable person. Following a submission to headquarters, a notice of direction to this effect
   was issued by the Department in July 1988.

2. The trader appealed, but at the hearing in January 1989 the Tribunal upheld the direction on the
   grounds that the catering had been treated as a separate business solely to avoid VAT.

Case Study 2

Category: Tax points and VAT payment periods

1. In 1980, a large international group set up an export company through which all of its sales to overseas
   markets were ostensibly channelled. Most exports are zero-rated and the export company therefore applied
   to receive regular monthly repayments of VAT from the Department.

2. Although the group claimed that all exports were channelled through the export company, in reality
   each company within the group was dealing with its own exports and invoicing overseas customers direct.
   The export company's records were simply a monthly collation of all the group's exports. If the export
   company had not existed, the group would have been forced to recover input tax by setting it off against
   output tax every quarter. Thus, by using the export company, the group was able to reclaim input tax some
   two months earlier than it would otherwise have been able to do.

3. In 1989, the Department advised the group that they considered the group's exports to be supplied not to
   the export company but direct to the overseas customers. The Department estimated that the avoidance
   scheme was earning the group up to £70,000 a month in interest.

4. Concerned that the practice could become widespread, the Department withheld repayment of input tax
   of £3 million in February 1989. A subsequent appeal by the group in July of that year was dismissed at
   Tribunal. However, in May 1990, the High Court reversed the Tribunal decision and, later that year, the
   Department were forced to make a substantial out of court settlement to the group.
Case Study 3

Category: Tax points and VAT payment periods

1. In March 1984, the Government announced that construction work would change from being zero-rated to being standard-rated from 31 May that year. Work already in progress at the time of the change would remain zero-rated provided the customer agreed to pay for the whole job before 1 June 1984.

2. Realising the potential advantage to be gained, a construction company issued invoices in May 1984 totalling just over £15 million for work it had in progress for an associated company. Both companies were wholly-owned subsidiaries of a third company (the parent company).

3. On 25 May 1984, the parent company paid a cheque for £15 million to the associated company. The associated company then paid a cheque for the same amount to the construction company which, in turn, issued a cheque for £15 million to the parent company. This "money-go-round" was discovered by a VAT control officer during an inspection visit. In March 1987, following advice from headquarters, the officer issued an assessment of £2.25 million for payment of 15 per cent VAT on the £15 million transaction.

4. The trader appealed to the VAT Tribunal contending that the work was zero-rated because the supply legitimately took place on 25 May. In September 1989, the Tribunal found in favour of the trader on the grounds that the payments were genuinely intended to pay the construction company for work to be carried out at a later date and were not payments which had no other purpose than tax avoidance.

Case Study 4

Category: Business and non-business use

1. In early 1984, whilst inspecting the records of a manufacturing company, a VAT officer found that input tax had been reclaimed on the training and upkeep of a racehorse. Following consultation with headquarters, the officer issued an assessment for £5,000 covering the input tax involved.

2. In November 1984, the company appealed to Tribunal contending that it purchased the racehorse for business promotion purposes. Giving evidence, the director said that this was his sole objective in authorising business expenditure on the animal. In dismissing the appeal, the Tribunal held that it was entitled to reject what the director claimed to be in his mind when he bought the horse (he was also known to be a racing fan). Instead, the Tribunal decided on the basis of what the average businessman would have decided to do in the same situation. In coming to its decision, the Tribunal effectively overturned established case law—normally the deciding factor in cases such as these is a "business motive" test (that is, what was in the appellant's mind when he or she decided to take the particular course of action).

3. The trader appealed to the High Court. In March 1987, the High Court allowed the appeal, holding that the Tribunal must not substitute the test of what the average businessman would do for what was in the mind of the witness at the time of authorising expenditure.
Case Study 5

Category: Mixed supplies

1. The Department treat television rentals as a single standard-rated supply. However, two companies engaged in this business have recently begun to split the rental into two supplies: rental (taxable) and insurance (exempt).

2. The companies are now arranging for all new customers to be placed on mixed supply contracts and, where possible, existing customer agreements are being redrawn. Both companies have been licensed by the Department of Trade and Industry to carry on insurance business.

3. The companies claim that the insurance element of the rental charge relates to keeping the set serviced and repaired. However, the Department consider that service and repair work is the responsibility of the rental company rather than the customer; the customer's responsibility is limited to loss by theft or fire (covered by normal household insurance). In late 1991, the Department therefore assessed one of the companies for £14 million in over-recovered input tax. The trader has appealed to Tribunal but the case has yet to be heard.

Case Study 6

Category: Land and property

1. In 1991, a banking group were able to maximise their recovery of input tax on the purchase of a new office building as a result of loopholes in the rules governing partial exemption and the capital goods scheme.

2. The banking group included a banking company which was to use the building for tax-exempt banking and a property management company which looked after the bank's portfolio of buildings. The property management company purchased the new building and leased it on a 10-year lease to a subsidiary company, outside the group, engaged in taxable property leasing. The property management company opted to tax the leasing supply to the subsidiary company and was therefore able to recover in full the £1.2 million input tax incurred on the purchase of the building. The subsidiary company sub-leased the new building to the banking company for a similar period of 10 years. The subsidiary company also opted to tax the rents charged to the banking company and was thus able to recover the input tax on the rents charged to it by the property management company.

3. Under the partial exemption rules, the banking company’s input tax recovery rate is restricted to around 20 per cent. However, under the capital goods scheme, this 20 per cent restriction on input tax recovery is limited to the 10-year rental period. At the end of the 10-year period, the property management company will be able to re-lease or sell the freehold of the building to the banking company without incurring further VAT since intra-group supplies are disregarded for VAT purposes. By this arrangement the banking group will be able to obtain full recovery of input tax on the purchase of the new building, apart from the input tax on 10 years of rental charges. If the bank had not entered into this lease and lease-back arrangement they would have lost some 80 per cent of the VAT charged to them when they acquired the building.
Case Study 7

Category: Zero rated exports of services

1. In 1990, a large company wished to raise capital by way of a share issue. The sale of shares is exempt from VAT if made to a person in a European Community country; otherwise it is zero-rated. Input tax may be recovered from the Department for zero-rated supplies but not for exempt supplies.

2. The shares were to be taken up mainly by persons in the United Kingdom, which meant that the transactions would be exempt and input tax paid by the company would not be recoverable. So instead the trader first sold the shares to an off-shore company in the Channel Islands (which is outside the European Community), and since the transactions were then zero-rated this allowed for full recovery of input tax on the costs incurred in the issue. There was no VAT charge on re-importation of the shares.

Case Study 8

Category: Partial exemption

1. A business making both taxable and exempt sales is classed as partly exempt. The business may recover input tax on the taxable element but not on the exempt element. The partial exemption rules allow for the attribution of input tax which is clearly identifiable to taxable (recoverable) and exempt (non-recoverable) sales. Any residual input tax (for example, on general overheads) is then apportioned to determine the recoverable percentage. For certain traders the Department have agreed a special method for calculating the recovery rate because of the large amount of residual input tax involved. In the interests of fairness, the method is meant to preclude high value transactions outside normal day-to-day business which could distort the calculation.

2. In May 1999, a local VAT officer issued an assessment on a bank for some £4 million in overclaimed input tax. The assessment was in respect of third world debts totalling around £110 million which the bank had disposed of mainly as zero-rated transactions in the mid-1980s. The bank reclaimed input tax but the VAT control officer considered that the transactions were distortive and input tax should therefore be disallowed.

3. In January 1991, the trader appealed. The appeal was upheld by the Tribunal on the grounds that the wording of the special method agreement did not specifically preclude the particular transactions involved.

4. Later in 1991, individual methods for the clearing banks were withdrawn and the Department are currently re-negotiating the central agreement. The Department estimate that the loss to the Exchequer from the loophole was some £15 million to £20 million a year from 1986 to 1990. New regulations in 1992 have given the Department new powers to direct the use of an input tax recovery method which is fair and reasonable to both sides.
Case Study 9

Category: Partial exemption

1. In late 1986, a bank wished to install expensive new computer equipment. To obtain full recovery of the input tax of around £72,000 on the purchase, the equipment was bought by a wholly-owned subsidiary, registered outside the VAT group, which then made taxable leasing supplies of the computers to the user companies in the group. After a short time the bank applied to include the leasing company in the VAT group since intra-group supplies are disregarded for VAT purposes.

2. The Department refused the grouping application. So as not to lose the tax benefit, the bank sought to achieve its objective by another route. On 31 March 1987, it transferred the leasing business as a going concern to one of the companies in the group, avoiding a further estimated £78,000 VAT. Under the rules then in place, the transfer of a business as a going concern was permissible without prior approval by the Department and was not regarded as a supply for VAT purposes. Once transferred, the leasing supplies became disregarded for VAT as intra-group transactions.

3. During a VAT control visit in August 1987, the VAT officer recognised that, by judicious timing, the trader had managed to exploit a loophole which had been closed by legislative changes introduced by the Finance Act only four months before the visit. The officer submitted the case to headquarters for advice and it was decided to assess the trader for over-recovery of input tax of £48,000. The bank appealed and the appeal was upheld at Tribunal in July 1989.