Engagement Letters

The main tax and accounting bodies have issued new guidance on letters of engagement for tax practitioners, following a major redrafting exercise. They are confident that the updated guidance and engagement letter will be a practical and helpful tool for tax practitioners and their clients. The new guidance is designed to be user-friendly and can easily be adapted by smaller practitioners.

The working group adopted a three-step approach:

* The letter of engagement which identifies the client and whose instructions will be accepted when, for example, acting for a couple, a family, a group or a partnership. It also summarises the basis on which fees will be charged, including any estimate or fee quote and who is responsible for fees.
* A schedule which sets out the practitioner's standard terms and conditions.
* Further schedules which detail the nature and scope of the services to be carried out and the responsibilities of each party. The schedules of service cover the most common recurring compliance work carried out by our members: personal tax for individuals, sole traders and couples; trusts and estates; partnerships; limited liability partnerships; corporation tax; payroll services; benefits in kind returns and payments of Class 1A NIC; VAT and other indirect taxes. A schedule for tax credit work will follow. There are also two schedules for non–recurring services: HMRC enquiries and ad hoc tax advice.

Practitioners should not need to replace their existing engagement letters immediately. However they are encouraged to review them annually and update as appropriate. Where practitioners use the engagement letter and schedules developed by the joint bodies they should adapt them to suit their practice.

The guidance and engagement letters are available at www.theiit.org.uk.

Case Notes

Leisure Pass Group Ltd v HMRC

High Court; 11 September 2008

The appellant sells a pass which entitles the holder to free entry to a range of attractions in London. Each attraction may be visited only once. The Tribunal held that this was not a face-value voucher for VAT purposes and the High Court has now upheld that ruling. It was essential that a face-value voucher had a monetary limit which the holder could exhaust. This restriction did not apply to the London Pass.

HMRC v Royal Bank of Scotland plc

Court of Session; 21 August 2008

Lombard is an asset finance company in the RBS VAT group. It purchases assets and sells them to customers on hire-purchase terms. For many years it recovered 15 per cent of the VAT on its overheads, based on a method agreed at industry level. It proposed that this method was not fair and reasonable and the VAT Tribunal agreed. It proposed that since each transaction consisted of two elements, one taxable and one exempt, it was fair and reasonable for it to recover 50 per cent of its overhead VAT. The Tribunal noted that HMRC had not proposed any alternative to this method, so it had to decide whether it was fair and reasonable. It decided that it was fair and reasonable and so allowed RBS's appeal.

HMRC's appeal against the VAT Tribunal's decision has now been allowed by the Inner House of the Court of Session. The VAT Tribunal had not based its verdict on any facts disclosed in its decision, nor had it explained why it considered the proposed method fair and reasonable.

The matter must therefore be left for the parties to negotiate afresh, potentially followed by another Tribunal appeal if a fair and reasonable method cannot be agreed.

The Court indicated its view that Lombard's accounting system ought to be able to disclose how overheads are allocated. However, Lombard retorts that since the distinction between taxable and exempt activities is an artificial construct for tax purposes only, it is not reflected in its practical accounting method. HMRC's current publicly stated view is that all overheads incurred by businesses such as Lombard are related to exempt supplies only but it did not seek to justify that approach in shooting down the Tribunal's decision in this case.

The British Association for Shooting and Conservation Ltd

Tribunal decision 20739

BASC sought to exempt its supplies of membership services by claiming they were of a political, philanthropic or civic nature (see Value Added Tax Act 1994, Schedule 9, Group 9, Item 1(e) and Sixth VAT Directive, Article 13.A.1(l)); alternatively BASC claimed that it supplies services closely linked to sport (see Schedule 9, Group 10, Item 3 and Article 13.A.1(m)).

The Tribunal found that BASC's main object is the promotion of the interests of its members insofar as they take part in sporting shooting. However, the Tribunal was satisfied that a substantial subordinate object of BASC is to promote countryside conservation (whether or not to the direct benefit of its members).

Item 1(e) states that exemption applies to 'a body which has objects which are in the public domain' and are of a political, etc, nature. BASC sought to argue that Item 1(e) does not require the public objects to be the body's main objects for exemption to apply, just that they be objects of the body, such as its conservation and other activities for the public benefit. The Tribunal disagreed. It took Item 1 to require that 'the primary object or objects of the organisation must fall within one or more of the categories listed'. Here BASC's main object was promoting its members' interests, not conservation. Thus it would only qualify for exemption if that object were considered to be of a political, philanthropic or civic nature. The Tribunal decided that it was not.

In terms of the sporting services exemption the Tribunal held that the services must be closely linked to participation in sport. BASC once again did not qualify: it did not supply sporting facilities, just support for its members. It said:

'None of BASC's supplies is in that category: it does not provide to its members the land on which they may shoot, the game they may shoot at or the guns with which they may shoot it. All it can be said to do is make it more likely that the right to shoot is preserved and the facilities for doing so survive.'

The 2008 Indirect Taxes Conference

The 2008 Indirect Taxes Conference boasted a structural innovation that prevented me from providing a complete overview: in the morning proceedings were divided into a Customs Conference and a VAT Conference, the former chaired by Phil Challen and the latter by Institute President Michael Conlon. Topics covered in the Customs Chamber were: the Authorised Economic Operator Scheme; the *FG Wilson* case on the consequences of errors in using Customs Procedure Codes; and risk factors in the preferential and non-preferential origin rules. While those talks were being given the VAT Chamber enjoyed presentations on: VAT avoidance; business promotion schemes; and VAT and property.

Most delegates will have been drawn to one or the other naturally through their main work responsibilities but for the generally-interested visitor there were hard decisions to make. In the event I thought I was going in to hear Phil's introduction and found I was learning about the AEO scheme; later I expected to go back and hear Phil's talk on the origin rules and found myself boxed in and listening therefore to David Goy on VAT and property. What I heard was excellent, so whilst apologies are due to those I missed, I am grateful for my largely random selection also.

Customs

Mark Corby, of BAE Systems, gave a fascinating insight into the practicalities of seeking to acquire AEO status. He gave two telling reasons why businesses should think seriously about pursuing AEO: that there will inevitably be a two-tier system in the future, with those boasting AEO status finding their lives easier (maybe cheaper too) than those without; and that there is nothing required to achieve AEO status that businesses should not already be doing. Whilst take-up has been slow, it can therefore be expected to increase as those two factors become more widely appreciated. Mark has written an article version of his talk, which is published later in this issue of *Indirect TaxVoice*.

Giles Salmond, of Deloitte, explained the background to the *FG Wilson* case and noted that because it has been referred to Europe it will be some time in reaching a resolution. I did not hear this talk but its subject matter does touch on the themes I drew from the day: some would describe the *FG Wilson* case as an example of HMRC relying on the letter of the law in sharp distinction to its spirit; another description might be that HMRC is loath to accept that a taxpayer can make an innocent error.

Phil Challen, of GE Corporate, was due to lay down the risks associated with the origin rules and I assume that he did so with his usual clarity and humour.

VAT

Richard Woolich, of DLA Piper, considered the state of VAT avoidance post *Halifax* and wondered whether it is possible to draw a line between what is abusive and what is not. One of his conclusions was that judges will bend over backwards to prevent non-taxation or potential distortions and I expect we can all agree with that in principle. He also predicted an increase in litigation and ventured that sensible planning is still possible. However, the current litigation that has not yet come to a definitive conclusion – *Weald Leasing*, *WHA* and *RBS Deutschland* for example – may alter the landscape significantly.

Edmund King, of Essex Court Chambers, discussed business promotion schemes in detail but with admirable clarity and wit. He made the most telling point that although *Kuwait Petroleum* apparently infringes the principle of neutrality, HMRC is keen to rely on it to show that in a case such as *Loyalty Management* there is a departure from established principle and that the Court of Appeal's decision must therefore be wrong. To flout the principle of neutrality suggests that HMRC is only going to be satisfied where there is double taxation and that single taxation is seen as some sort of abuse. Once again the suspicion hung in the air that HMRC is more interested in revenue-raising than objective fairness.

David Goy, of Grays Inn Chambers, looked at the rewritten Schedule 10 and raised another concern which resonated with other speakers: there is simply too much uncertainty about this new legislation. That this recurred throughout the day may be explained by a trend towards non-specific legislation that is applied in practice subject to HMRC interpretation. Whether that is acceptable is probably a matter for the constitutional lawyer but it is not popular with practising advisers.

Combined

After lunch the conference combined to hear **Michael Conlon**, of Pump Court Tax Chambers, give his annual case law update. The first area he

Chris Reece covers the Institute's 2008 Conference. A version of this article has also been published in The Tax Journal

covered was 'taxable person and supply'. Michael echoed the thoughts of Edmund King in noting that whilst HMRC had success in *Weight Watchers* by arguing for a single, indivisible supply under the 'artificial to split' test, the same principle worked in the taxpayer's favour in *Birkdale School*. Yet it is not a matter of unanimity that those cases were correctly decided.

Michael's second topic was 'reliefs' and he helpfully contrasted and compared *Horizon College* with *Robert Gordon University*. 'Input tax' was the heading for discussion of *Gracechurch Management* and *Uudenkaupungin Kaupunki* and 'reclaims' for *Fleming and Condé Nast* and *Midlands Co-op*.

I was interested to hear Michael suggest that the last of those cases is not authority for automatic transferability of rights to reclaim VAT: there must either be a scheme laid down (possibly by statute) under which rights and obligations are transferred or the issue must be dealt with specifically in the documentation; mere purchase of a business might not be sufficient. However, Michael did not go so far as to agree with HMRC's claim that *Midlands Co-op* is peculiar to its facts and only applies to transfers of industrial and provident societies.

Mike Lambourne, of Ernst & Young, was a late replacement for Peter Jenkins, who was going to talk about 'The VAT Package'. Mike deputised seamlessly and whilst Peter was missed, that was no reflection on Mike's excellent performance. Essentially 'The VAT Package' brings a rolling programme of changes to the place of supply rules and there are consequent effects on refunds of VAT paid in other Member States. Mike very fairly applauded the simplifications the changes will bring while pointing out the complications it will cause too. If readers are wondering whether this is just a deckchair-rearrangement exercise, they might like to ponder that those receiving supplies from, say, India which are currently VAT-free, will have to apply the reverse charge in future. Enough said. However, Mike's recurring theme was that there are still too many areas of uncertainty with implementation commencing in not much more than a year.

Sir Stephen Oliver, President of the VAT and Duties Tribunals (and Presiding Special Commissioner) talked about the new Tribunals system. It is an indication of the fluidity of the situation that the proposals had changed significantly between when Sir Stephen wrote his conference notes and the day of the event. Appeals will now be allocated to one of four 'tracks': 'paper' (heard on papers only); 'basic' (straightforward appeals on simple matters); 'standard' (almost all the rest); and 'complex' (which speaks for itself).

The costs position has also changed, in that barring unreasonable behaviour costs will not be awarded to either party, except in complex cases, where costs will apply unless the appellant opts out.

Consultation proceeds and yet the new system will commence in April 2009. Once again uncertainty is sure to abound, at least for a while. Sir Stephen gave one example of a proposed procedural rule with which he does not agree (where HMRC fails to comply with a direction it cannot lose the case – the appeal cannot simply be allowed – but may be ordered to withdraw from proceedings, which Sir Stephen considers practically difficult) and there must be many more areas of concern for those who are unfamiliar with the detailed workings of the system. It is fortunate that the changes are generally welcomed, which will make the teething troubles easier to bear (though not for those who suffer injustice, of course).

The last presentation combined **Rachel Button**, of HMRC, with **Robert Maas**, of Blackstone Franks, discussing the new HMRC powers. Rachel took first turn and stressed that as far as HMRC was concerned safeguards are more important than powers and deterrents. This stunned the audience to such an extent that Rachel's entirely genuine belief that the new system will be fair was not challenged. Robert contended himself with a short discussion of what might be considered a 'prompted' or 'unprompted' disclosure in a variety of practical situations, plus the expected comments on uncertainty.

One issue that was tactfully skirted, perhaps in favour of good relations, was the question whether it is possible for a mistake to be made while taking reasonable care. Rachel insisted that HMRC staff are being taught that people do make mistakes but that is not the issue, frankly. If a trader discovers an error in his books he will know already whether it was deliberate or not. Let us assume not. He will then have to decide whether to disclose that error and will almost certainly not do so, because he will believe that he has taken reasonable care – it would be against human nature to think otherwise where the error was not deliberate or reckless. HMRC will on discovery immediately be considering an undisclosed careless error, which attracts a minimum 15 per cent penalty (it is also human nature for the discoverer of an error to assume that it could not have been made without carelessness at least). Let us hope that HMRC's next step will be to consider whether a suspended penalty would be appropriate, rather than whether the penalty should be as high as 30 per cent. This at least will give the parties a chance to discuss the cause of the error, which may lead to a genuine consideration of whether reasonable care was taken.

Organisation

A final word about the conference as a whole. The structural change to a split morning was achieved seamlessly and as far as I was aware the whole day proceeded without confusion or delay. Thanks must therefore go to Institute Chairman Bob Davies, Institute Secretary General Terry Davies and administrator Cindy Farmer.

Death Knell for Parking Claims?

On 16 September 2008 the European Court of Justice delivered its judgment in *Isle of Wight Council and others* [C-288/07]. As regular readers will recall, this case concerns whether the provision of off-street parking by a local authority can be treated as a 'statutory activity' undertaken other than in the course or furtherance of business and so exist outside the scope of VAT.

The Isle of Wight Council, together with three other 'handpicked' local authorities, chosen as a representative cross-sample of all UK authorities, are pursuing this argument in what is, in effect, a test case.

To succeed, they must show that:

* they provide off-street parking under a special legal regime not applicable to private sector providers of similar services, and
* non-VATable treatment would not lead to a significant distortion of competition.

These are broadly the tests laid down in the first two sub-paragraphs of Article 4(5) of the EC 6th VAT Directive and now replicated in Article 13(1) of the EC Principal VAT Directive.

As reported previously, as long ago as 2004 the VAT Tribunal (decision 18,557) accepted that local authorities provide off-street parking under a special legal regime – principally the Road Traffic Regulation Act 1994 and similar traffic management powers – and this was accepted by HMRC. Thus the case now rests on whether or not a significant distortion of competition would be created by treating local authority off-street parking provision as non-VATable.

In 2006, at a second hearing, the Tribunal (decision 19,427) ruled that it would not but HMRC, not surprisingly given the substantial amounts at stake, appealed to the High Court [2008] STC 614, which, in February 2007, referred three questions to the ECJ:

1. Is the expression 'distortion of competition' to be ascertained on a public body by public body basis, such that it should be determined by reference to the area or areas where the particular body in question provides off-street parking, or by reference to the totality of the national territory of the Member State?

2. What is meant by the expression 'would lead to'; in particular, what degree of probability or level of certainty is required for that condition to be satisfied?

3. What is meant by the word 'significant'; in particular, does 'significant' mean an effect on competition that is more than trivial or de-minimis, a material effect or an exceptional effect?

The ECJ judgment

As anticipated, the Court has broadly followed the Opinion of the Advocate-General (Poiares Maduro) as reported in the July 2008 edition of *Indirect TaxVoice*. The ECJ has thus ruled to the effect that:

1. in determining whether treating an activity undertaken by a public body – such as a local authority providing off-street parking – as outside the scope of VAT would create a significant distortion of competition with the private sector, regard must be had to the activity as a whole across the whole of the UK and not just the local market conditions affecting any one body

2. in considering whether a significant distortion of competition would be created, regard must be had to both actual extant competition and potential competition; this is not unexpected, it being a well-known concept of competition law that 'barriers to entry' must also be regarded as potentially distortive to competition; the only caveat in this respect is that the ECJ has echoed Advocate-General Kokott's Opinion in *Hutchinson 3G UK Ltd and others* C-369/04 that the possibility of such competition must be real and genuine, by reference to objective evidence or analysis of the contemporaneous market, and not purely hypothetical

3. in a slight deviation from the Opinion, the ECJ has ruled that 'significant' in this context means any distortion of competition that is not negligible. This is disappointing, as the Advocate-General had opined that it should mean an effect that is 'out of the ordinary'.

The broad thrust of the reasoning of the ECJ is very much along the lines of the Advocate-General's Opinion, in that the second and third sub-paragraphs of Article 4(5) (now Article 13(1)) broadly seek to achieve the same ends – the avoidance of distortions of competition between the public and private sector – and so should be interpreted in the same way.

Given that the third sub-paragraph defines, by reference to Annex D (now Annex I of the Principal VAT Directive), a schedule of activities which must always be treated as within the scope of VAT, even when undertaken by public bodies, it follows, according to the Court, that the second sub-paragraph must be interpreted similarly and regard

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had to the activity itself, rather than the local market, when determining whether or not a significant distortion of competition would arise.

As alluded to, the ECJ – like the Advocate-General – justifies this approach on the ground that both the second and third sub-paragraphs seek to avoid distortions of competition. The view of the Court is that the third sub-paragraph – and Annex D – lays down those activities deemed likely always to create such a distortion throughout the EU, whereas the second sub-paragraph provides individual Member States with a 'sweeping up' power to determine which other activities, by reference to the situation in the Member State itself, might also lead to distortions of competition.

There clearly are private sector providers of off-street parking, ipso facto there clearly is competition, ipso facto that competition is clearly significantly distorted. More considered opinion is that it may not be quite that clear cut

And, as the third sub-paragraph deems those activities listed in Annex D to be always within the scope of VAT when undertaken by a public body 'unless carried out on such a small scale as to be negligible', it follows, according to the ECJ, that 'significant' in the second sub-paragraph must be interpreted consistently therewith and so mean 'not negligible'.

One point that is of relevance, however, is that the ECJ does not appear to have adopted the Advocate-General's Opinion that the second sub-paragraph has the sole purpose of determining which activities undertaken by public bodies should be subject to VAT, such that concepts of EU competition law are not relevant thereto. Thus it appears that reference to competition law principles is permissible when determining whether or not a significant distortion of competition would arise, albeit that that must be judged on an activity-wide national basis rather than by reference to the local market.

Fiscal neutrality

The underlying theme of the judgment, as anticipated, is that the fundamental EU VAT law principle of fiscal neutrality must be observed – that is, that comparable activities undertaken by different entities must not be treated differently for VAT purposes solely on the basis of the nature or status of the undertaker.

Whilst there are, of course, some exceptions to this concept – notably in the not-for-profit sector – the ECJ seems now to be suggesting that these are very much the exception and apply only where explicitly provided for in specific circumstances; there is thus no wide-reaching caveat of the sort argued for by the councils which applies to public bodies generally.

Indeed the judgment appears to mark a signal shift of emphasis whereby, rather than public bodies generally being assumed to fall outwith the scope of VAT, other than in circumstances where they demonstrably compete with the private sector, they must now be presumed to be within the scope of VAT unless the strict criteria for exclusion are met. And, as Article 4(5) – now Article 13(1) – is a derogation from the norm, that all economic activities are within the scope of VAT, those criteria must be construed narrowly.

Legal certainty

The Court also took the view that the foregoing is the only answer which adequately preserves the principle of legal certainty, the principle that EU VAT law must be certain and its application clearly understood and foreseeable by those subject to it, the more so were significant financial consequences to result otherwise.

Echoing the Advocate-General's Opinion, the ECJ took the view that this principle would be seriously undermined were an ongoing contemporaneous case-by-case analysis of the state of competition in each relevant local market for parking necessary.

Indeed the Court noted that such local markets would invariably not be coterminous with local authority boundaries, that any one authority providing off-street parking may well have more than one local market therefor and that, conversely, the local market for parking in other cases may straddle local authority boundaries.

Thus adopting an activity-wide national basis avoids placing an onerous administrative burden on the tax authorities, with consequent uncertainty and potential for recurring dispute.

Implications

So what does it all mean for the Isle of Wight and its co-appellants (and indeed for the other 130 or so authorities with claims standing behind the case)?

Some commentators have suggested that the judgment signals the 'death knell' for the Isle of Wight's case; looking at the position nationwide, there clearly are private sector providers of off-street parking, ipso facto there clearly is competition, ipso facto that competition is clearly significantly distorted.

In fact more considered opinion is that it may not be quite that clear cut. The High Court now has to consider the position in the light of the ECJ's judgment but there may yet be some – albeit perhaps faint(!) – hope.

It is, for example, established case law that it is for HMRC to demonstrate that a significant distortion of competition would arise and not for the taxpayer to disprove this (proving a negative always

being a near impossibility). Thus HMRC will be required to show, by reference to objective economic analysis, how competition for off-street parking would be significantly distorted on a nationwide basis if local authorities were to be permitted to treat such as non-VATable. Given the notorious inelasticity of supply and demand for parking and that the distortion of competition caused must be solely as a result of the differing VAT treatment, this may not be an easy task.

And what of what a colleague called the 'Derry Dilemma'? If fiscal neutrality is the overarching criterion that must be met, why limit consideration as to whether competition would be significantly distorted to just the national market within the UK? Surely, given the 'Single Market' of the EU, such consideration should be on the basis of the activity as undertaken EU-wide. Otherwise the 'Derry Dilemma' becomes relevant: treating local authority provision of off-street parking in Londonderry might conceivable create no significant distortion of competition within the UK but it might severely disadvantage private sector car park operators just across the border in the Republic of Ireland.

On the whole, however, majority opinion is now erring on the side of HMRC in this case and that the chances of the Isle of Wight succeeding with its arguments are slim.

Other points arising

There are two further important points that arise out of the ECJ's judgment.

Firstly, whilst not forming part of the questions referred by the High Court, the ECJ – reportedly prompted by the European Commission and echoing the Advocate-General's Opinion in this respect – seriously questioned whether local authority off-street parking is provided under a special legal regime, a prerequisite of non-VATable treatment.

Although this was established as a matter of fact by the first VAT Tribunal in 2004 and has, to date, been accepted by HMRC, there is without doubt a very broad hint from the ECJ that the High Court should reconsider the point. This could, therefore, result in the case being referred back to the Tribunal (for a second time!) in order for the Tribunal to reconsider its decision on this point.

This may thus lead to the reopening of this aspect of the case which, from a local authority perspective, would be most disappointing, as not only was the point understood to have been resolved but subsequent case law was felt to have moved the debate on: notably the Court of Session decision in *Edinburgh Telford College* [2006] STC 1291 to the effect that when determining the existence of a special legal regime, cognisance must be had of the wider statutory and regulatory environment within which the public body undertakes the activity in question and not just those specific legal provisions expressly governing that activity.

Certainly within the local authority community, there remains no doubt that, notwithstanding the ECJ's comments, a special legal regime does exist to govern the provision of off-street parking.

Secondly, given the emphasis on fiscal neutrality as the decisive factor, even were the High Court to find in favour of the Isle of Wight, there might well then be a litigative response from the private sector.

The major private sector car park operators are known to already be in discussions with HMRC on this subject and their ire will clearly be aroused should the Court find for the Isle of Wight. And in

> *The major private sector car park operators are already in discussions with HMRC on this subject and their ire will clearly be aroused should the Court find for the Isle of Wight.* Rank *suggests they would have a good case.*

that event another recent case on fiscal neutrality, *Rank Group Ltd* (decision 20,777), suggests they would have a good case.

In Rank the VAT Tribunal suggested that, in order to demonstrate a breach of fiscal neutrality, it is not necessary for the aggrieved party to undertake a detailed economic analysis – as would be required to show a distortion of competition – but merely to show that the aggrieved party undertakes comparable activities to those of its perceived competitor, which benefits from the alleged advantageous treatment.

And there is ECJ 'history' on this point too: in *Feuerbestattungsverein Halle eV* C-430/04 the ECJ ruled that an aggrieved private sector body, which believes it is in competition with a public body able to treat its 'competing' activities as non-VATable, may rely on the second sub-paragraph of Article 4(5) – now Article 13(1) – to cite the creation of a significant distortion of competition in order to deny the public body non-VATable treatment in pursuit of fiscal neutrality.

Conclusion (for now!)

The High Court is expected to reconvene late this year or early next with a judgment then expected no later than early spring 2009.

Whether there is then a further appeal to the Court of Appeal by the losing party (or indeed the case is referred back to the Tribunal as alluded to above), so dragging the case on longer, remains to be seen. Some commentators think a further appeal is almost certain but others regard the ECJ judgment as being sufficiently robust to preclude any real likelihood of a higher appeal.

In conclusion, then, whilst the lady that comes onto the stage at the end of the show may not yet actually be singing, she certainly has the mike in her hands ...

AEO Process in Practice

by Mark Corby, a Customs & Trade Compliance Manager who is currently undergoing the AEO application experience in a large multinational

AEO is the EU response to worldwide security demands post-9/11. In brief, it is Supply Chain Security. Such systems are springing up worldwide. They typically look like AEO or the earlier US model, C-TPAT (Customs-Trade Partnership Against Terrorism). All are based on the World Customs Organisation SAFE model of 2005 (known as the 'SAFE Framework', or more fully as 'The Framework of Standards to Secure and Facilitate Global Trade'; the 2007 version has several updates). Such schemes will proliferate and they will be here for good.

AEO comes in three 'flavours':

* Customs Simplifications. This has the least criteria. It covers only fiscal controls over simplified procedures such as CFSP (Customs Freight Simplified Procedures, which allow authorised traders to gain accelerated removal or release of most third-country imports by making a simplified declaration containing the minimum of details at the frontier). It is an EU add-on to WCO SAFE and is only recognised within the EU.

* Safety & Security. This meets the criteria of WCO SAFE.

* Combined. This comprises the two systems and thus controls safety, security and fiscal issues. This should be the default choice of any applicant trading outside the EU.

AEO applications commenced officially from January 2008. Uptake has been far short of HMRC's expectations. A more rapid uptake might be expected when world markets improve and the scheme itself becomes more widely known. This creates resource implications for HMRC and trade.

The broad AEO process comprises:

* trader self-assessment against the published AEO criteria
* formal application once satisfied
* HMRC audit
* authorisation.

What are the implications of AEO?

So why is AEO of interest to an indirect tax audience?

It controls indirect tax issues. Classification and duty rate assessment, operation of duty suspension regimes and the like as well as valuation, origin etc. This is all familiar 'customs' fare.

AEO offers HMRC new methodologies and standards to work to. This is regardless of whether a company applies for AEO or not. We have a new de facto audit standard and approach for looking at company activity. At present it mainly impacts in the immediate 'customs' area. Sooner or later it will spread to other areas.

This latter point drives some clear implications for traders.

You get better visibility and control of your supply chain as an AEO. Equally HMRC gets a better visibility of what you're doing. If you don't do it right, or don't apply, then HMRC will have a better view of your complete supply chains than you do. Are you able to deal with this?

HMRC has already stated that it will use AEO standards in non-AEO areas. IPR is first.

HMRC will – directly or indirectly – make life more difficult for non-AEOs. Some or all current freely-available benefits will, sooner or later, be linked to AEO status.

Are there any benefits?

So what benefits are to be had from holding AEO status? This has always been a sticking point for both sides. You might identify the following benefits in your business. Few involve immediate cash benefit. Most are best described as non-disincentives.

You should always check that you continue to see the benefits of AEO for the particular circumstances of your company.

* Brand Reputation. 9/11 is the ostensible driver for AEO. Consider what happens if your company name is anywhere near a 9/11-like incident. What would that do for your business? Consider what became of Pan-Am six months after the Lockerbie incident.

* 9/11 drives aspects of corporate social responsibility. This is an increasingly important issue for corporations in particular.

* You need to keep up with the competition. AEO will become like ISO90001 – you're not credible without it. Early AEO applicants can place demands on their partners rather than have them placed by those partners. AEO is a differentiator. US companies in particular may well prefer an AEO partner over a non-AEO partner. It may even render you ineligible to bid on business if you do not have it.

* How critical is on-time delivery and lean inventory to you? Anything that puts a delay in international shipping – for example, not holding AEO status – means you add delay or inventory into your business somewhere. It all has a cost.

* Mutual Recognition. Such schemes will proliferate around the world. Holders of AEO authorisation might reasonably expect preferential treatment of their shipments where such schemes hold sway. Realisation of that may be more difficult to achieve. It is certainly the desired result by all players.

* Any future amendments to EU Legislation, or elsewhere, will certainly have AEO status in mind.

* AEO application acts as a customs health check. Under certain (widely applicable) circum-

stances there is nothing in AEO that you should not already be doing. This is not widely appreciated.

* AEO forces you to look at your activity. This is one of the few areas of possible financial benefit. This is achievable in classification, valuation, preference, operations of regimes, etc.

* There may be increased freight costs for non-AEO shippers. If a non-AEO shipment holds up a consolidation of AEO cargo will those cargoes ever be carried together again? There is a real chance of two-tier services evolving. As an AEO holder then any carrier should have to do less with your cargo and the associated data. Is that reflected in your freight rates?

* Other accreditations should make AEO authorisation simpler. ISO9001, Department for Transport Air Cargo Security Regulated Agent or Known Shipper status should all be accredited (at the time of writing only Regulated Agent status is recognised by AEO but holding Known Shipper status does mean you meet the requirement where there is a direct correlation between the two regimes). Equally, holding AEO status means that some accreditations should be more readily obtainable – for example, ISO28000 (Specification for security management systems for the supply chain).

* AEO is a visible badge of compliance. It protects against enhanced HMRC visibility of your activity. In today's compliance culture, is it a bad thing to deliberately raise your profile by implementing AEO? What does having AEO say about your company? More importantly, what does not having AEO say? Do you care about compliance, security, safety – or not? Who gets that message – HMRC, your customer, your competition, your market?

Underlying expectations

You need to have the following items in hand or you may as well not bother applying.

* Clear corporate governance and a clear bottom-to-top hierarchy and management line. This cannot be stressed enough. The hierarchy needs to be as flat as possible.

* The main board will need to be aware of AEO. They need to accept the ultimate responsibility for it. There should be a boardroom champion for your AEO project. It's difficult to see how you can succeed without one.

* All levels must understand the broad issues and responsibilities. Bear in mind the very basic customs tenet that 'A company may outsource all its international trade activity but can never outsource the compliance requirement'.

* Middle management must understand the detail and implications of AEO and customs and international trade (CIT). More specifically: the risks in getting it wrong. Therefore there is an expectation of a minimum level of in-house expertise in customs matters.

* Operational staff will need to understand the requirement. They need to be involved in the process. In AEO, as in most customs matter, the devil is in the detail. The detail typically lies at the bottom of an organisation. Ignore it at your peril.

* AEO carries a mandated minimum level of documented procedures. In reality you will need to document just about all your customs activity. This will be at both strategic and detailed operational levels. HMRC takes the simple view that there can be no proper controls without written instructions, processes or seat notes.

As far as possible apply the 'KISS' principle: 'Keep It Simple, Stupid'. Simple is not the same as unsophisticated. The simpler the process, the easier it is to implement, train to, maintain and audit. There is less to go wrong.

* You need levels of security appropriate to the size of your business and/or facility. Whether the customs response will be appropriate may be something to argue during the audit. Smaller companies, provided that they have adequate controls, should not need the same controls as a complex multinational enterprise (MNE). Equally, large MNEs should not be expected to meet every damn-fool requirement that might be levelled at them, because they're presumed to have limitless resources. There is a fine line to tread throughout. On both sides.

* Can you demonstrate confidence in your customs operations? Have you visibly addressed any issues and are you correct?

* Do you carry out regular self-audit? Are your customs activities included in your QA audit plans? They will need to be.

Approach to the AEO audit?

As far as possible apply the 'KISS' principle: 'Keep It Simple, Stupid'. Simple is not the same as unsophisticated. The simpler the process, the easier it is to implement, train to, maintain and audit. There is less to go wrong.

* You need to engage all levels and all functions within your company.

* You should be open and honest – internally and externally. Don't bluff. If you don't know or don't understand, ask. Get it sorted now. Bear in mind client privilege, though that may be best treated as a breathing space.

* Remember that making an error – even a serious one – is not necessarily a problem. Failing to address the cause and make adjustment is.

* Put your point across to HMRC if you disagree or have a particular stance on any issues. You should expect a reasonable and proportionate response to your business activity. Remember that

the underlying thrust should always be security – not bureaucracy.

* You can push back at HMRC if you feel justified and can back up your arguments.

* There is a desire to see detailed customs procedures regardless of the scale of operations. If you can provide them, then fine. If not, ensure they are really needed. Ensure that procedures supplied are actually read by HMRC. Refer to the procedure in conversation and check. If HMRC officers are demanding written procedures it seems only fair that they read and understand them.

AEO is simple in concept, extremely complex in implementation. The issues arise from the difficulty in interpreting the regime in terms of your business.

* You need to know what parts of AEO are immovable. They are clearly flagged in the guidance.

* You will have an opportunity to make necessary changes. If there issues requiring resolution you will have the time to put them right. You set the pace of the audit.

AEO Audit in the UK

Customs will expect you to understand your legal obligations at all appropriate levels. In some cases these will be general. For Customs Managers, though, the requirement will be detailed.

Customs may well include trained QA Auditors. They will be familiar with process audit. More importantly they will be well aware of the implications if a process is wrong or missing. For large businesses HMRC will certainly include the Central Audit function.

The transactional audit is based on HMRC's own MSS (Management Support System) data. This gives all the essential data on all imports and exports against a given VAT registration and TURN number (or EORI (Economic Operator Registration & Identification) Scheme number, once introduced). Ensure you have the same data and self-audit against it. There will inevitably be discrepancies but there should be no significant gaps. You should analyse and deal with those gaps. More importantly, MSS data should be no surprise to you when it is received.

HMRC will have limited appreciation of commercial drivers – but it is not non-existent.

AEO is different for each company, even between parts of the company. However, common procedures should only need reviewing once. Gap analysis only should be needed on the differences between parts of the business.

You need to demonstrate how you control your agents, forwarders and brokers. Your contracts must cover customs compliance KPIs, errors and omissions and allocation of responsibility. Sidestep agent representation issues by making non-compliance a breach of contract. Experience suggests most such contracts only deal with service level and cost. This is no longer sufficient.

Agents need to ensure they have done everything they can to obtain correct data. They should confirm standing data of traders and check every transaction against that standing data. Traders should expect this approach from agents.

HMRC has a clear preference for ERP-based or bought-in systems to control customs matters. HMRC's simple view is the more manual keying, the greater the risk of error. If you don't have such systems, your procedures need to be more rigorous.

Any in-house operation of customs regimes will be rigorously examined, by transaction and procedure. If you have successfully passed a customs regime audit in the past three years, any (detailed) audit should be unnecessary.

The management line will be checked. HMRC will interview key staff in all functions. A basic understanding of customs activity is expected at all levels.

Your HR people will be interviewed on staff background checking. The expectation is that full references are taken up for all staff. These must go back five years, with no unexplained gaps greater than two weeks. There are several data-protection issues here and it is the procedure under investigation, not individual results. It may be suggested that only staff in critical areas need the full approach if it is not your usual requirement.

Contracts and agency agreements are critical:

* The staff checking requirement on you must also be passed on. Cleaners, guards, vending machine/water suppliers, etc, are included, as are any on-site contractors.

* You must also consider your contracts with suppliers, customers, consultants and the like. All should be amended or drawn up with security requirements in mind. Consider using questionnaires and delegated authority signoff for suppliers.

* Clear contracts are essential for anyone who makes customs declarations on your behalf.

Breach of contract must be pursued.

Security

Physical security is a potentially large cost. It is also utterly dependent upon individual circumstances. HMRC will expect the highest level of security to be applied by everyone, all the time. This may not be necessary and you should consider the following points:

* Have you fire-walled the business functions?

* Who has access to your export cargo after packing? Limit access and use escorted access more. Challenge people – and reward successful challenges by your staff. Test the system and use incentives for that as well.

⁎ Operate a need to know regime within sales, import/export, packing, manufacturing activities, etc. This applies to records and physical product/area. It's no use limiting knowledge of how, when and where goods will be shipped if the records are open to all.

⁎ What are your access controls like? Smaller companies should need less stringent controls above a minimum standard. Good practices are better than relying on technology without proper controls.

⁎ Operate good basic housekeeping. Keep doors shut and locked – all the time

Other risks you might consider

What is the awareness of respective responsibilities between supply chain partners?

⁎ Suppliers, customers, hauliers, forwarders.

⁎ How far can any partner see into another's business to assure security?

⁎ What happens if there is a failure to address the issue at the highest levels amongst other supply chain partners?

Incoterms:

⁎ by selecting any Incoterm, one or other party has less control – ergo less security control

⁎ Incoterms were never designed with security responsibility in mind.

AEOs will become a target for the unlawful by virtue of the relaxed controls once approved. Therefore they have to maintain rigorous standards. However, no regular customs audit is proposed, unlike annual aviation security revalidation. Can your company meet that commitment?

The current terrorist threat to the UK is expected to last a generation (per Dame Eliza Manningham-Buller, then Head of MI5, November 2006). Are companies able to make that acceptance and commitment?

How companies will fail

Here are some bullet points of potential pitfalls. It is worth noting that many of these do not just apply to AEO.

⁎ Senior management may lack understanding of the issues.

⁎ Do senior management specifically commit to customs compliance?

⁎ Have you created an ethical and compliant culture and organisation?

⁎ Is your compliance organisation able to deliver?

⁎ Do you employ the right people, with expertise?

⁎ Do not confuse logistics with CIT. Be clear in your company what you mean by both.

⁎ Do you learn from mistakes and address root causes?

⁎ Do you actively engage with HMRC, professionally?

⁎ Do appropriate organisational levels accept appropriate responsibility?

⁎ Is there a flow of CIT knowledge throughout the company?

⁎ Is everything Kept Simple?

⁎ Do you maintain appropriate checks and balances?

⁎ Do you include CIT compliance in your contracts?

⁎ How do you address and report potential non-compliance?

⁎ Do you have the right people at the right level?

What else is out there?

A whole host of related initiatives are coming into force or proposed. A few are shown below. They all have issues and implications but are not further discussed here.

⁎ The EU 'Pre-Arrival, Pre-Departure' proposals for trade data capture prior to import or export.

⁎ The US '10+2' proposals for trade data capture prior to import or export.

⁎ US proposals for 100% sea freight scanning prior to loading for the USA. This links to US proposals and law such as HR1, SAFE ports, C-TPAT and the Container Security Initiative.

⁎ A plethora of AEO or C-TPAT look-alike schemes across the world including in China, Japan, Australia, Canada, New Zealand, Jordan, India and Brazil.

⁎ UK Customs, EU Customs and the World Customs Organisation are doing some navel-gazing and contemplating their future role. All three have published documents addressing their thoughts, thus inviting comments.

Conclusion

AEO is simple in concept, extremely complex in implementation. The issues arise from the difficulty in interpreting the regime in terms of your business. As such it is less strange than it first appears. This dilemma is fairly common across all customs activity.

If nothing else, AEO forces compliance – specifically customs compliance – far higher up the agenda. AEO can be regarded as the most significant development in Supply Chain for some years. It will remain high-profile in the medium term. Longer term, the issues are not going to go away. These visibility and control systems offer so much to HMRC. They will grow more complex, more intrusive and commonplace.

In the background is the need for trade facilitation. Facilitation and compliance are regarded as two sides of the same coin. It may be better to view them as two halves of the same side of the coin. On the flip side lie non-compliance, delay, cost, illegality. The next debate must surely be about how compliant traders – AEO authorised traders – obtain the maximum facilitation from their more trusted status. That debate is just starting.

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