

Pre-Budget Report: the Rate Change

Readers will be aware that the standard rate of VAT changed to 15 per cent on 1 December 2008 and will revert to 17.5 per cent on 1 January 2010. But not all readers will be familiar with what that means in practical terms. We trust that the following extracts from HMRC publications will assist in everyone's understanding of the changes

Guidance – introduction

The VAT rate change in the Pre-Budget Report was accompanied by a variety of guidance. HMRC has asked the Institute of Indirect Taxation to create a link on its website to the publication 'A technical guide for businesses'. This link can be found at the home page www.theiit.org.uk. The following extracts give a flavour of the contents of that guide:

Section 1 is the introduction, which outlines the contents of the guide:

Reduction of the standard rate of VAT

In his Pre-Budget Report of 24 November 2008 the

Chancellor announced that the standard rate of VAT will be reduced to 15%.

New standard rate from 1 December 2008

The new standard rate of VAT, 15%, comes into effect on 1 December 2008.

Effect on businesses – what you need to do

This change affects any VAT-registered business that sells or purchases goods or services that are subject to the standard rate of VAT.

You should charge standard rate VAT at the new rate of 15% for any sales of standard-rated goods or services that take place on or after 1 December 2008.

Other rates of VAT are not affected

This change in the standard rate of VAT does not affect sales of goods or services that are charged at another rate of VAT. These are:

- * zero-rated – for example most foodstuffs, children's clothing or books
- * reduced-rated – for example children's car

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seats, domestic supplies of fuel and power, and

* exempt – for example education, health and financial services.

Businesses that only supply goods or services at other rates

If your business only supplies goods or services that are subject to one of the other rates of VAT (above) you do not have to change the rate of VAT that you charge.

All businesses – input tax

The rate of VAT on goods and services that your business purchases will be lower and as a result, your claims to input tax will be affected.

If you make a mistake in applying the new standard rate of VAT

HMRC wants to encourage and assist businesses as they make the changes necessary to deal with the change in the standard rate.

If a business discovers that it has made material mistakes, it should correct them through the normal voluntary disclosure process.

HMRC will however be operating a 'light touch' in terms of errors made in the first VAT return after the change (where the error relates to a change of rate issue). This means that in planning our audit work we will not target change of rate errors that are unlikely to lead to any material net revenue loss. And if we find errors which relate to a change of rate issue we will not seek an adjustment unless we have reason to suppose that there is an overall revenue loss.

In situations where HMRC do need to adjust (and issue an assessment) they will take into account the difficulties the business has faced in adjusting to the change in considering whether penalties apply. The light touch applies here as well.

Annex A [reproduced below] sets out the guidance HMRC compliance staff have on what 'light touch' means.

Using this guide

The last change to the standard rate of VAT took place in 1991 and we are aware that many businesses will not have experienced such a change.

This guide tells you in practical terms how to deal with and apply the change to the new standard rate of VAT from 1 December 2008, based on common questions we think you might have.

The guide is divided into a number of sections. You do not have to read it all but should only refer to those parts that affect your particular business:

Section 2 provides an overview of how sales generally should be treated after the change and provides information that might be of use to all businesses.

Section 3 gives a brief guide to businesses on how to deal with sales where you have received a payment or issued an invoice before 1 December 2008 for goods that will be provided (or services

delivered) on or after 1 December 2008.

Section 4 considers how retailers and other businesses that make mainly cash sales to non-business customers should deal with sales at the new rate.

Section 5 describes how VAT should be reclaimed on purchases.

Section 6 explains what changes need to be made to accounting systems following the reduction in the standard rate.

Section 7 explains what you need to do when completing your VAT return after the change.

Section 8 provides further advice for businesses in the following special VAT accounting schemes:

- * Agricultural Flat Rate Scheme
- * Annual Accounting
- * Cash Accounting
- * Flat Rate Scheme
- * Payment on Account Regime
- * Tour Operators' Margin Scheme.

Section 9 provides additional guidance for the following types of business:

- * barristers and advocates
- * clubs and associations
- * construction services
- * solicitors.

Section 10 considers the VAT arrangements for the following type of sales:

- * coin-operated machines
- * continuous supplies
- * hire purchase, conditional sale and credit sale
- * investment gold
- * property
- * royalties and similar payments
- * second-hand sales – margin scheme for second-hand goods, antiques, works of art and collectors' items
- * self-billing
- * goods in warehouse regimes (excise, customs or fiscal warehouses)
- * international trade.

Section 11 provides contact details for HMRC should you need further advice.

Annexes A-E give more detailed guidance on:

- * HMRC's approach to errors - the 'light touch'
- * time of supply
- * rules for sales spanning the change of rate
- * VAT payable on fuel scale charges following the change of rate
- * the new percentage rates for the Flat Rate Scheme.

Guidance – the 'light touch'

This is what HMRC has to say in Annex A: 'The light touch – guidance for HMRC staff':

What if businesses make mistakes implementing the change of rate (light touch)?

HMRC wants to encourage and assist businesses as they make the changes necessary to deal with the change in the standard rate.

Extracts from official HMRC and Ministerial guidance on the VAT rate change on 1 December 2008 and the reversion to a higher rate on 1 January 2010

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If a business discovers that it has made material mistakes, it should correct them through the normal voluntary disclosure process.

HMRC will however be operating a 'light touch' in terms of errors made in the first VAT return after the change (where the error relates to a change of rate issue). This means that in our audit plans we will not target change of rate errors that are unlikely to lead to any material net revenue loss. And if we find errors which relate to a change of rate issue we will not seek an adjustment unless we have reason to suppose that there is an overall revenue loss.

For example, consider a fully taxable business which supplies standard-rated goods to a fully taxable customer and incorrectly charges 17.5% rather than 15%. As the detailed guidance makes clear, the customer should treat only 15% of the tax exclusive (net) price as input tax. However, if the supplier has accounted for the full 17.5% there will be no overall loss of tax if the customer treats the full 17.5% as input tax. When auditing the purchaser, HMRC will assume that the supplier has followed the accounting documents unless there is good reason to suppose otherwise.

By contrast, consider a cash accounting business which makes a supply before the change in rate at 17.5% but gets paid after. Assuming that the customer has correctly paid and recovered 17.5% VAT, if the supplier only accounts for VAT at 15%, as the rate in place at the time of payment, there will have been an overall revenue loss. In this case, the supplier should have accounted for VAT at 17.5%, and if this error is discovered on auditing the supplier, HMRC will seek to adjust (issue an assessment) in the normal way.

In situations where HMRC do need to adjust (and issue an assessment) we will take into account the difficulties the business has faced in adjusting to the change in considering whether penalties apply. The light touch applies here as well.

Anti-forestalling

The Government is worried that businesses will seek to prolong artificially the effect of the 15 per cent rate at the expense of the returning 17.5 per cent rate.

The Financial Secretary to the Treasury, Stephen Timms, made the following Written Ministerial Statement on 25 November, the day after the PBR:

The Chancellor of the Exchequer yesterday announced as part of the Pre-Budget Report a temporary reduction in the standard rate of VAT to 15 per cent from 1 December 2008 to 1 January 2010 when the rate will return to 17.5 per cent.

This Government has taken these steps to provide further support for growth and incomes during the economic downturn. The Government's discretionary fiscal action will deliver support of around 1 per cent of GDP to the economy in total in 2009/10.

However, it is also important that the Government protects the public finances from artificial avoidance seeking to exploit the change in VAT rates where there is no current economic activity. Therefore, Finance Bill 2009 will contain anti-forestalling legislation to ensure that the VAT rate changes announced are fully effective. The Government will expose the draft legislation for comment as soon as possible.

Anti-forestalling legislation will apply from today to ensure that, in the circumstances set out below, supplies with a basic time of supply after a VAT rate increase takes effect will be subject to the rate of VAT in force at that time. The provisions are designed to prevent artificial forestalling whilst being straightforward for business to understand and operate and not affecting genuine commercial transactions. This legislation is not intended to catch the normal commercial activity of providing goods and services.

The anti-forestalling legislation will apply in the circumstances set out below where the supplier receives a prepayment for the goods or services or issues a VAT invoice in advance of the rate increase. It will also apply where, in advance of the rate increase, the supplier grants the customer an option or a right to obtain goods or services at a discount or free of charge after the rate increase takes effect.

The circumstances are that the customer cannot recover VAT in full on the supply and that:

- * the supplier and customer are connected parties; or
- * the supplier receives a prepayment, or grants the customer an option or a right, and the prepayment, or the acquisition of the option or right, is wholly or partly funded (directly or indirectly) by the supplier; or
- * a VAT invoice is issued by the supplier showing an amount any part of which is due more than six months after the date of the invoice.

The basic time of supply is normally when goods are delivered or made available, or when services are performed. For continuous supplies of goods or services, with consideration payable periodically or from time to time, the basic time of supply will be the end of the period to which a payment or invoice relates (for example, a billing period).

Although the anti-forestalling legislation will apply from today, any extra VAT arising from its operation will not become due until after Royal Assent of Finance Bill 2009. Until then, suppliers should continue to account for VAT as normal, applying the VAT rate at the time of the prepayment, VAT invoice issue or grant of the right or option.

The operation of the legislation will be kept under review to ensure that the provisions work as intended. Any additional or alternative anti-forestalling provisions included in Finance Bill 2009 will only take effect at the earliest from the date that they are announced.

Non-business Reverse

The European Court of Justice has recently handed down its judgment in *Kollektivavtalsstiftelsen TRR Trygghetsrådet v Skatteverket* Case C-291/07 (*TRR*), broadly following Advocate-General Mazák's Opinion that the reverse charge mechanism applies to the procurement of cross-border services by a VAT-registered entity even where those services are procured in connection with that entity's non-business activities.

Among implications noted by many observers are the impact this case may, therefore, have on services procured from a non-UK supplier by UK entities engaged in significant non-business activities, notably charities and the public sector.

TRR: the background

TRR is a Swedish foundation formed for the primary purpose of paying compensation to those made redundant and assisting such individuals to find new employment, together with advising employers in situations of over-staffing likely to lead to redundancies. TRR is funded in this respect by fees levied on employers, based on a proportion of earnings paid out to their employees. It was accepted that, in performing such functions, TRR is not engaged in a business activity. However, TRR also undertakes some minor, ancillary, business activities, mainly concerning advice on outsourcing, which represent some 5% of the foundation's overall activities.

At issue was TRR's procurement of services from a Danish consultant in connection with its core non-business activities. The Swedish tax authorities took the view that these consultancy services were subject to the reverse charge mechanism, a view with which TRR disagreed on the ground that it was not procuring the services for any business purpose.

Pertinently, the stance taken by TRR is exactly in accordance with UK law as currently drafted; section 8(1)(b) of the VAT Act 1994 applies the reverse charge mechanism only to the specified services when received by a UK person 'for the purposes of any business carried on by him'.

The ECJ's judgment

The gist of the ECJ's judgment is that, by dint of its 5% business activity, TRR is carrying out economic activities in Sweden, as defined by Article 9(1) of the EC Principal VAT Directive, and so is a taxable person for the purposes of EU VAT law.

Article 56(1) then treats the place of establishment of the customer as being the place of supply for VAT purposes where specified services are supplied to a taxable person located in a different

Member State from that of the supplier. Article 56(1)(c) refers to 'consultants, engineers ... lawyers, accountants, and other similar services ... and the providing of information', as was the case with TRR.

As an aside, it might be noted that Article 56(1)(e) covers banking, financial and insurance services, (f) the supply of staff, (i) telecommunication, and (k) electronically supplied services, for all of which cross-border procurement is increasingly likely in the modern world.

Finally, where Article 56(1) 'switches' the place of supply to where the customer is established, Article 196 then requires that customer, as a taxable person, to account for the VAT due on those services; this is the familiar reverse charge mechanism.

Against this legal framework the key point of the *TRR* judgement is that Article 56(1) services, when procured by a taxable person established in a different Member State from that of the supplier, are subject to the reverse charge mechanism; this applies regardless of the purpose for which those services are procured, Article 56(1) referring simply to 'taxable person' not 'taxable person acting as such'.

However, the 'normal' rules on VAT recovery then come into play in the customer's Member State such that, where the services are procured other than in connection with the carrying out of a business activity, the VAT declarable thereon under the reverse charge mechanism is irrecoverable.

As noted by the ECJ, this meets the principal objective of EU law in that VAT is paid on such services in the Member State where consumed and further meets the fundamental EU VAT law principles of simplicity and legal certainty, there being no obligation on the supplier in such circumstances to deduce whether the services are supplied in connection with the customer's business or non-business activities.

UK private sector: charities, etc

The consequences of the *TRR* case for private sector entities in the UK engaged in non-business activities, such as UK charities fulfilling their charitable objectives, are that when procuring Article 56(1) services from a supplier located in another Member State of the EU, if such charities also undertake a business activity, no matter how minor or insignificant that business activity, the reverse charge mechanism will apply with consequently irrecoverable VAT.

In fact this may not be as 'catastrophic' as imagined, given that such VAT incurred, regardless of where, is irrecoverable. Other than the administra-

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Taxation
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reverse
charge
mechanism
and services
procured by a
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the light of the
TRR case
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tive burden of recording and accounting for such VAT, it might actually be advantageous to 'suffer' 15% UK VAT rather than the higher VAT of some other Member States. Indeed, remember that, apart from Cyprus and Luxembourg, all other EU countries apply a higher standard rate of VAT than the UK. And, of the 'major' countries of Europe with which such an entity might be dealing, VAT in Germany and The Netherlands is 19%, France 19.6%, Italy and Portugal both 20%, Belgium 21%, Ireland (now) 21.5% and the Scandinavian countries generally 25%.

So the consequences for UK charities and other private sector entities engaged in non-business activities may not be so bad as perhaps anticipated.

Public sector bodies

As for public sector bodies, however, there is a significant complication.

Read in isolation there is no doubt that the *TRR* judgment implies that wherever Article 56(1) services are procured cross-border by a VAT-registered entity carrying out both business and non-business activities - such as a public body - those services are deemed to be supplied where the customer is established and so subject to the reverse charge, even if the services are procured for non-business purposes by, for example, a UK local authority in connection with its statutory non-business activities.

However, the judgment must be read in the context of the EU law provisions for which the Swedish Court sought clarification - that is, Article 56(1) of the EC Principal VAT Directive as now applicable. Most pertinently, as the ECJ noted, Article 56(1) merely states that the place of supply of the services specified is where the customer is established when such services are supplied cross-border to a taxable person.

The point in *TRR* was that *TRR* is a taxable person because, notwithstanding its prime non-business function as a charitable foundation, it does make some limited VATable supplies and so is registered for VAT in Sweden. And, in this context, as noted, the ECJ found that Article 56(1) is applicable wherever such cross-border services are supplied to a taxable person, not just to a taxable person when acting as such.

However, for public sector bodies Article 13(1) is also relevant.

Article 9(1) defines taxable person to mean 'any person who, independently, carries out ... any economic activity, whatever the purpose or result of that activity', which, given the wide interpretation of economic activity envisaged by the second sub-paragraph of Article 9(1), clearly encompasses the activities of a public body. However, Article 13(1) nevertheless provides that 'states, regional and local government authorities and other bodies governed by public law shall not be considered taxable persons in respect of the activities or trans-

actions in which they engage as public authorities ...' (emphasis added).

Thus a public sector body, such as a UK local authority, procuring Article 56(1) services from another Member State of the EU in connection with the performance of its statutory non-business activities is treated, for the purposes of EU VAT law, as not being a taxable person. And, if not a taxable person, it is arguable that Article 56(1) does not apply and such services are, therefore, subject to VAT in the supplier's Member State.

Article 56(1) v Article 13(1)

The key, then, from the perspective of public sector bodies, is whether Article 56(1) or Article 13(1) takes precedence; and in that respect, of course, there is much ECJ case law that no Article of the VAT Directives can be regarded as taking precedence over any other but that all must be read together.

It might thus only be possible to resolve this conundrum by determining what the 'basic provisions' of the VAT Directives are and which other provisions then operate as an exception thereto.

This may well need further ECJ litigation to resolve, though it is something touched upon by the ECJ in *Isle of Wight Council and others Case C-288/07*, which suggested that Article 13(1) should be interpreted as an exception to the general principle that VAT is a tax on supplies of all goods and services effected for consideration. As an exception, Article 13(1) must be construed narrowly and there is, therefore, a school of thought that it is indeed Article 56(1) that takes 'precedence', especially as that Article must be given a wide interpretation if transactions are not to escape VAT altogether.

On this argument, the fact that a UK local authority has correctly been registered for VAT by HMRC and issued with a UK VAT registration number in respect of its business activities, is sufficient to bring it within the ambit of the *TRR* judgment.

On the contra interpretation, however, Article 13(1) is clear-cut that a public body is not, when acting as such, a taxable person. On this interpretation, *TRR* may not actually change anything and the problems encountered now in procuring consultancy and similar services from elsewhere in the EU will remain.

Cross-border procurement

The real crux of this issue is that UK local authorities have the benefit of section 33 of the VAT Act 1994. This permits UK local authorities (and certain other specified public bodies, though not Government Departments or the NHS) to recover, in full, VAT incurred in connection with the undertaking of their statutory non-business activities. Thus UK VAT incurred by a local authority in procuring consultancy services and the like is fully recoverable. In fact this would be so even if such

services were subject to the reverse charge mechanism (as is indeed the case now with such services procured in respect of a local authority's business activities).

Were TRR to be extended to apply to public bodies acting under Article 13(1), the implications for UK local authorities would, therefore, be significantly advantageous.

This is not, however, presently the case, with UK local authorities increasingly encountering the problem of irrecoverable VAT when procuring services from other EU Member States.

Ironically, under EU procurement law (Directive 2004/18/EC implemented in the UK by the Public Contracts Regulations 2006), a local authority seeking to procure significant consultancy services, for example, is required to consider suppliers established throughout the EU. Yet, if a non-UK supplier is chosen, as most other Member States (seemingly correctly under EU VAT law) do not recognise such a public body as being a taxable person, that supplier will generally insist on charg-

ing its own domestic VAT, on the ground that Article 56(1) does not apply. And, of course, such 'foreign' VAT is irrecoverable – the 8th Directive refund procedure mirroring 'normal' VAT law in only applying to VAT incurred in connection with business activities. Whether or not TRR changes this interpretation remains to be seen.

Furthermore, there appears little in the so-called 'VAT package' – which greatly increases the range of cross-border services subject to the reverse charge mechanism with effect from 2010 – that addresses this particular anomaly, which thus seems likely to persist.

The proposed new Article 43(1), due to come into force on 1 January 2010, in fact does little more than spell out explicitly the situation found by implication by the ECJ in TRR, that 'a taxable person who also carries out activities ... that are not considered to be taxable supplies ... in accordance with Article 2(1) shall be regarded as a taxable person in respect of all services rendered to him'.

Security for Duty

The Modified Customs Code will potentially come into force some time in 2009, and cannot be delayed beyond 2011. This article discusses the impact of one particular aspect of this legislation – the requirement that any suspended customs duty must be the subject of security to guarantee the debt.

In March 2005 I wrote to the person at the European Commission who had penned the then draft revision of the Code, expressing disquiet at the impact on the cost of guarantees if the proposals were to stand. With the Modified Code now enacted (Regulation 450/2008), we have very similar provisions in force to those I objected to, so this article draws readers' attention to the potential impact of the new laws, which come fully into force within the next two years.

The relevant draft provisions

It seems to me that the following provisions are key:

- * Article 56(4) – extending guarantees to cover VAT and excise duties

- * Article 56(1) and (4) – extending the obligation of a guarantor so that it covers any liability arising out of a posteriori controls

- * Article 64 – if the amount of any guarantee appears inadequate to cover the obligations involved, the customs administration must require a larger guarantee

- * Article 65 – the guarantee can only be released when the customs debt it covers is extinguished, or when no further debt in respect of it can possibly arise

- * Article 68(2) – if a criminal act has occurred, any customs debt arising from that act can be recovered up to 10 years after the debt was incurred.

Discussion

I will now look at the meaning of Article 65 in the context of Article 56.

Article 65 is ambiguous, in that it allows for a guarantee to be released on the occurrence of two separate events that may occur up to 10 years apart. The question then arises whether the trigger for release of the guarantee occurs when the first event happens, or the second.

Article 65 reads as follows:

'1. The customs authorities shall release the guarantee immediately when the customs debt or liability for other charges is extinguished or can no longer arise.

'2. Where the customs debt or liability for other charges has been extinguished in part, or may arise only in respect of part, of the amount which has been secured, a corresponding part of the guarantee shall be released accordingly at the request of the person concerned, unless the amount involved does not justify such action.

'3. The Commission may, in accordance with the regulatory procedure referred to in Article 184(2), adopt measures for the implementation of this Article.'

Under Article 86(1)(a), the customs debt is extinguished when the duty in respect of it has been paid. So in respect of a deferment account covering a month's-worth of imports, guarantees in

Phil Challen exposes the potential hidden cost of future imports. Phil is a Fellow of the Institute, and over the last 20 years has split his time fairly evenly between Customs, the large accounting firms and latterly industry

respect of each import in January are apparently released on 15 February by the payments made to clear the deferment account. However, this interpretation does not sit well with the provisions of Articles 65(1) and 56(1) and (4), which make it clear that the guarantee is intended to cover duty liabilities arising out of a posteriori controls.

A posteriori controls can result in a customs debt arising up to 10 years after import. In fact, until 10 years have passed, it is impossible to say that no customs debt in respect of a movement can arise. However, if the debt were to have been extinguished as a result of the original payment of duty, the guarantee should have been released at that point. It is hard to see how the guarantee could still

It makes no sense to draft new legislation in the hope and expectation that it will be ignored in order to avoid its own damaging consequences

be open and available to cover the debt arising up to 10 years later.

If Article 65(1) is interpreted as meaning that the guarantee is released upon the first occurrence of one of the two possibilities, the guarantee will never be available to cover the outcome of a posteriori controls in accordance with Article 56. It therefore seems likely that Article 65 will be interpreted such that the guarantee is only released when the latter of the two possibilities comes to pass. This interpretation is consistent with the adoption of Article 65(2). Consequently, when a duty payment is made, only part of the guarantee can be released, with the guarantee being kept open until no further customs debt in respect of the movement can possibly arise – which in the UK, with its insistence on retaining the strict liability criminal offence of making a mistake on a customs declaration, is once 10 years have elapsed since import.

The effect of the draft provisions

Let us consider a regular series of simple imports to free circulation, where the importer uses a deferment account to delay the payment of the debt. The duty on the goods imported amounts to £10,000 per month, the VAT is £116,700 and the duty is collected on the 15th day of the month following import. Accordingly, the customs administration requires a guarantee to cover two months' worth of imports – £253,400. Under current practice the guarantor's liability could never exceed this sum, so the guarantee facility will cost a small fraction of it.

This much is clear. However, I explained to the Commission back in 2005 that the provisions of the new code, in exponentially extending the guarantor's potential liability, will also increase the cost of the guarantee. As they saw things, either there is no

significant increase in liability, or else the guarantor will accept the increased liability without passing on a corresponding increase in cost. Consequently, the objectionable provisions were taken into the final draft and enacted into law.

'Under the Modified Code the guarantor is to be kept on the hook in respect of every import until no further debt can arise from that import. Let us imagine that in this case the UK importer has accidentally got his classification wrong, thereby reducing the duty rate on imports from the correct rate of 3% to 1.5%. This is a criminal offence in the UK under CEMA 1979, section 167(3), so for an import made on 1 January 2008 the additional duty can be recovered from the guarantor at any time until 31 December 2017. It follows that by the end of December 2017 the guarantor's maximum possible liability for unpaid duty is not £10,000, as it was under the old Code, but now stands at £1,200,000 (an additional £10,000 per month for 120 months). As this maximum duty liability is 120 times greater than it was, it seems reasonable that the fee for providing the guarantee will increase correspondingly.

However, this is not the worst of the situation. Under Article 56(4) the guarantee must cover not only the duty but also the VAT (and any excise duties or other charges if there are any; we'll assume for the sake of simplicity that no such duties or charges apply here). Duty rates average around 3%. European VAT rates average around 18%. So let us assume the VAT is six times the duty. Our guarantor under the Modified Code must guarantee not only £1,200,000 duty but also the VAT on the duty hit, which is £210,000. His total potential liability has shot up from £20,000 to £1,410,000 – an increase of 6,950%! It seems reasonable to suppose that if the original guarantee cost £100, the new one may well cost £70,500.

Counter argument

The Commission noted in 2005 that Article 65 merely restates the current provisions of Article 199 of the existing Code. While this is true, it is clear that the applicable law has to date been ignored completely by all EU administrations – presumably to avoid the absurdity outlined above. It makes no sense to draft new legislation in the hope and expectation that it will be ignored in order to avoid its own damaging consequences, so we must now assume that the EU, having been alerted to the true consequences of the existing law and having nonetheless replicated it warts and all, intends those consequences to be enforced.

The guarantor's considerations

To date the guarantor has known exactly how much his potential liability amounts to. If the guarantee is for £10,000, there is no possibility of the guarantor being asked to pay £10,001 – and the duration of the guarantee is limited to the duration of the

movement, or the length of time it takes to pay the charges in respect of it. Accordingly, the guarantor can make meaningful calculations in order to ensure that the fee he charges covers the risk that he assumes. This will not be the case under the Modified Code.

Under the Modified Code the guarantor remains 'on risk' until 10 years after the movement has happened. Even if we were to limit this duration to the three years that the Commission seems to have foreseen originally, the consequences for the guarantor are still dire. Firstly, he must consider the variables which impact upon his risk. The entire panoply of a posteriori controls must be considered. The most likely errors are that the classification is wrong, leading to an incorrect duty rate; and/or that the valuation is wrong, leading to the duty rate being applicable to a potentially larger number.

Neither is capable of reasonably accurate quantification by the guarantor. The classification error could lead to a doubling of duty and VAT, or a trebling. In extreme cases it may lead to an exponential increase, in sectors where anti-dumping duties have been evaded through the use of an incorrect commodity code. The quantum of any possible valuation error is even more difficult to pin down. There are several sectors where royalty issues are key. The dutiability of royalties is always a difficult decision – and many customs administrations have made bizarre decisions on this question. Duty on ten years – or even three years – of royalty payments can be a significant amount. Equally, there are many areas where declared values may be suspect: related-party transactions; discounted sales of capital items where the revenue generator is expected to be future sales of consumables or service contracts; assists not factored into the price. The potential increase in value is really open-ended from the guarantor's perspective.

When looked at from the point of view of a business case, provision of a customs-related guarantee is a very hard one to justify. How much is the guarantor's maximum potential liability? What will be the average rate of recidivism under the new, more rigorous regime, where customs administrations target their resources using pan-EU risk analysis? How long does the risk last? When one considers all these questions, it is inconceivable that a guarantor would charge the same price under the new regime as under the old, and it is highly possible that guarantors might well decline to offer guarantees in the customs field, since the upside is limited and the downside is unquantifiable. Needless to say, this would be a most undesirable outcome – but one that seems by no means impossible under the Modified Code.

Increased need for a guarantee

To date customs administrations have been able to waive the taking of a guarantee for businesses con-

sidered acceptable credit risks. HMRC takes the view that a guarantee will generally not be required where HMRC has seen fit to issue a standing authorisation for a conditional duty relief.

The EU, as the signatory to the WTO on behalf of its membership, is required to act as though it were a single customs authority. Allowing different Member States to exercise judgement on whether or not to take a guarantee for suspended duty is arguably contrary to this obligation. To remedy this the Modified Customs Code's draft Implementing Provisions currently impose a default situation, which is that there must be a guarantee taken to secure all duty suspended under any duty relief. Only Authorised Economic Operators will be enti-

Importers need to ascertain the extent and cost of the guarantees they currently hold and to consider becoming AEOs to minimise the impact of the possibility that guarantors might decline to offer the requisite levels of cover

pled to a guarantee reduction – which may take the required guarantee down to zero as a result of the high-quality AEO processes operated by those businesses.

If that draft is taken into law, all goods held under IPR, Customs Warehouse, PCC, End-Use and Community Transit will require a guarantee for duty and VAT in the UK – which is not currently the case. This will hugely increase the need for guarantees from UK importers – and the guarantors should be very worried indeed about the potential for open-ended and unquantifiable liabilities on these goods.

Conclusion

Under the Modified Code guarantees will be much more important than they are under the existing Code. It was recognised as a reason for modifying the Code that some countries were not being sufficiently rigorous about compliance. Increased compliance presupposes a greater call on guarantees – so the adequacy of guarantees takes on added significance.

Further, it is proposed to require guarantees in many situations where they are not currently required. The intention must be to make more claims against guarantors. Business cannot safely assume that the EU elected to draft the Modified Code's legislation in the hope that those provisions would be ignored, so importers need to ascertain the extent and the cost of the guarantees they currently hold, and they need to consider becoming AEOs in order to minimise the impact arising from the possibility that guarantors might decline to offer the requisite levels of cover.

Option-washing Fails

Brayfal Ltd

Tribunal decision 20781

The appellant was the exporting company in a contra-trading ring. HMRC failed to persuade the Tribunal that the appellant knew, or had means of knowing, that it was concerned with fraudulent trading. It is perplexing that HMRC seems repeatedly unable to impress the Tribunals with the inherent unreality of the trading market in mobile telephones.

Risbey's Photography Ltd; Digital Albums Ltd

Tribunal decision 20783

The two appellants are under common ownership. Risbey's provides a full wedding photographic service, taking the pictures and compiling them into a 'wedding book' which also incorporates suitable text (if required by the customer). Digital compiles 'wedding books' from pictures supplied to it by outside photographers.

The Tribunal held that the 'wedding book' typically supplied by either appellant is not a book for zero-rating purposes. It is a standard-rated wedding album, which is of interest only to those immediately connected with the wedding, containing pictures and text which has no value in its own right. As the Tribunal put it:

'The functional characteristics of the wedding book as a wedding album outweighed its physical similarities to a book.'

HMRC argued in the alternative that the appellants made single, standard-rated supplies of photographic services. The Tribunal agreed in the case of both appellants – even though Digital took no photographs itself: Digital's services in compiling the 'wedding book' were standard-rated photographic services and not the supply of a book or album, or of both services and goods.

Shurgard Storage Centres UK Ltd; Graham Anthony Farley and Philip Robert Cox t/a West London Self-Storage Centre

Tribunal decision 20797

Messrs Farley and Cox ran the West London Self-storage Centre (WLSC). They had opted to waive the exemption in respect of the premises. Shurgard made an offer for the business but was not keen to make an option to tax in order to take a VAT-free transfer of the business, as that would mean it would have to charge its non-business customers irrecoverable VAT.

On advice the appellants decided to seek to disapply WLSC's option to tax (so-called 'option-washing'). The intention was that WLSC should create a capital item by expending more than £250,000 on refurbishment of the property. Shurgard would finance that refurbishment. Then, when WLSC sold the business to Shurgard, the

option to tax would be disapplied because Shurgard had been involved in financing the development in question.

In practice Shurgard wished to manage the refurbishment itself, so WLSC vacated the premises, granting Shurgard a licence to occupy. This meant that WLSC's business of self-storage ceased from the date it vacated the premises and before the new capital item had been created. VAT Regulations 1995 (SI 1995/2518), Regulation 112 provides that a capital item is 'an item which a person ... uses in the course or furtherance of a business carried on by him, and for the purpose of that business, otherwise than solely for the purpose of selling the item'. The Tribunal held that a capital item had not come into being qua WLSC, because its business had already ceased, so it could not use the item 'in the course or furtherance of a business carried on by' it.

Because there was no capital item qua WLSC, it was not a developer of the land for the purpose of the disapplication provisions in Value Added Tax Act 1994, Schedule 10, paragraphs 2(3AA) and 3A(2). Interestingly, the appellants argued that WLSC would be a developer because it 'intended or expected' the refurbishment to be treated as a capital item (see paragraph 3A(2)(b)). The Tribunal rejected this so-called 'subjective test'.

Rainbow Pools London Ltd

Tribunal decision 20800

Value Added Tax Act 1994, Schedule 8, Group 5, Item 2 zero-rates services supplied in the course of construction of a new dwelling. Item 4 further zero-rates building materials incorporated into a new dwelling but subject to exceptions. By Note 22 to Group 5 building materials are those which 'in relation to any description of building' are 'ordinarily incorporated by builders in a building of that description'.

This appeal concerned two features of swimming pools incorporated in new dwellings:

- * electronic, retractable covers; and
- * moveable floors.

The Tribunal held that neither retractable covers nor moving floors were so integral to a swimming pool that the matter was closed by asking whether a pool is ordinarily incorporated in a new dwelling.

In the case of the retractable cover the Tribunal found as a fact that more than 90 per cent of indoor pools are now built with an integral cover, so that if the pool is ordinarily included, so is the cover. However, the Tribunal also had to disagree with the Tribunal in *Leisure Contracts Ltd* 19392, which decision was based on the assumption that an electrically-powered cover is an 'electrical appliance' (excluded from zero-rating by Note 22). The

*Chris Reece
summarises a
selection of
recent VAT
Tribunal
decisions*

Tribunal held that the intrinsic nature of a cover was not as an electrical appliance and that merely because the cover could be (and indeed usually was) powered by electricity did not make it an electrical appliance.

The moveable floor was a different matter. This is a buoyant structure which may be raised or lowered in order to cover the pool and provide a usable floor to the room in which the pool is situated, or to provide a shallow pool for children or the elderly, or a normal-depth pool. A 4mm-wide space around the floor allows water to move up or down as the floor is moved. The Tribunal held that such a device is so new and so rare as to be 'extraordinary' if found in a pool and so cannot be said to be 'ordinarily incorporated' unless a different meaning be attached to the phrase 'ordinarily incorporated by builders'. The Tribunal considered and rejected an interpretation which took that phrase to mean 'ordinarily incorporated by builders as opposed to other workers'.

Adath Yisroel Synagogue

Tribunal decision 20809

The appellant built an 850-metre-long wall around a cemetery, to protect the graves from both animals and humans. Zero-rating depended on this wall being a 'building'. However, the Tribunal noted that when the European Court ruled in 1988 that the UK had zero-rated too wide a category of building work, zero-rating was confined to certain buildings and civil engineering work generally was excluded. This suggested that civil engineering works generally were not buildings and the Tribunal's impression was that a mere wall was not a building either.

Merlewood Estates Ltd

Tribunal decision 20810

The appellant intended to convert the roof spaces of five blocks of flats into 12 new flats. It applied to be registered for VAT but HMRC refused on the ground that the appellant would be making only exempt supplies. The appellant's case was that in creating the new flats it would be converting non-residential parts of existing buildings into new dwellings and when it granted a major interest in those flats it would be making taxable (albeit zero-rated) supplies. HMRC's view was that the roof spaces were integral to the existing dwellings within the blocks of flats.

The roof spaces in four of the buildings had nothing in them save television aerial cables passing out to roof-top aerials; the fifth roof space contained both aerial cables and old, unused water tanks. The roof spaces were not owned or occupied by the owners of any of the flats, who had no access to the roof spaces.

The Tribunal noted that this was not a case where the roof space of a building used as a single household and occupied with the rest of the house was to be converted. Its decision was that the roof spaces were non-residential.

East Norfolk Sixth Form College

Tribunal decision 20816

The only issue for the Tribunal was whether a new teaching block, which it was agreed was an annexe, was 'capable of functioning independently from the existing building' – see Value Added Tax Act 1994, Schedule 8, Group 5, Note 17(a).

The annexe was on two floors, each containing six rooms. One room was equipped for computer use, the others were general-purpose classrooms or storage rooms.

The appellant argued that simply as a classroom block the annexe was capable of independent function. HMRC argued that the test must be considered in the light of the context in which the annexe was placed. The classroom block could not function independently of the rest of the facilities of the school.

The Tribunal considered that not all of the rooms could be used for storage, some must be used as classrooms. The consequence of that was that the annexe was not capable of functioning independently from the existing building, since it contained no toilets.

H5 Ltd t/a High Five

Tribunal decision 20821

H5 sells a high-carbohydrate, low-fat product called Energy Bar, made from glucose syrup, oat flakes, rice crisps, raisins, maltodextrin, honey and vitamin B1, coated variously with chocolate or yoghurt and including variously caramel, banana flavour or mixed fruits.

Confectionery is standard-rated and includes 'any item of sweetened prepared food which is normally eaten with the fingers' (see Note 5 to Value Added Tax Act 1994, Schedule 8, Group 1).

H5 argued that its bars were not confectionery, either because they are not 'sweetened' or because the man in the street would not regard them as confectionery, because they are marketed to serious runners, not as sweets.

The bars do include sweet ingredients but H5 argued that they were basic ingredients not included for the purpose of sweetening the product. The Tribunal did not have to adjudicate what is a basic ingredient and what is an ingredient added for the purpose of sweetening, however. It relied on the Chancellor's decision in *HMRC v Premier Foods Ltd* [2008] STC 176 to the effect that one does not test whether the product has been sweetened but merely whether it is sweet. H5's bars are sweet, so its argument on this point was rejected. (Indeed, the coating appeared to the Tribunal to have been added partly to sweeten the product, so it is probable that the appeal would have been lost on this point in any case, even had the principle been as argued for by the appellant.)

The Tribunal then held that the man in the street's view of confectionery is not relevant, because the term is defined in the legislation, as above. H5's bars fell within the definition and so were properly zero-rated.