VAT: Addressing the Borderline Anomalies

18 May 2012
1. Introduction

ICAS welcomes the opportunity to comment on the consultation published entitled “VAT: Addressing Borderline Anomalies”.

We welcome the extended closing date of 18 May 2012. The issues raised by the consultation range from the political decision to broaden the base of VAT thereby raising the tax yield and the technical and administrative implications of changing the VAT treatment of supplies of catering, sports drinks, self-storage, hairdressers’ chair rental, holiday caravans and alterations to listed buildings.

1.2 Executive summary

We are disappointed that the Government did not consult on the policy. This paper puts forward draft legislation as a technical consultation. It would have been better to begin with consultation on the policy.

The draft legislation is in most cases not fit for its purpose and should be withdrawn. The proposal should be withdrawn and further consultation should occur.

1.3 We are concerned that the Impact Assessments are misleading. For example, the description of economic impact in all cases is that the measures might lead to a small increase. That seems to us to be taking spin to an unacceptable level. In most instances, the economic impact of imposing VAT will be to increase the price from what was previously zero rated by 20% (or more).

1.4 Our comments are therefore addressed at the maintenance of the integrity of the tax system, the administration of the tax system following the change and the additional considerable compliance burden that will be imposed on many compliant taxpayers.

2. Hot food and premises

In recent years, there have been a number of tax cases which considered whether food which was supplied hot was a standard rated supply of catering or whether the supply of hot food was because at the time of supply the food had recently been cooked and was at an elevated temperature. The legislation governing this is to be found at schedule 8, group 1, note (3) of VAT 1994. A supply in the course of catering includes any supply of hot food for consumption off the premises on which it is supplied. Hot food means food which has been heated for the purpose of enabling it to be consumed at a temperature above the ambient air temperature and it is at the time of supply above that temperature.

2.1 Moving the borderline creates uncertainty

The test here is the intention of the supplier and since the 1987 decision in John Pimblett & Sons Ltd, the law was established by a decision of precedent in the Court of Appeal which confirmed that where the purpose of the supplier was to assure customers that the pies were freshly baked and fit for consumption, that supply was zero rated. For the purposes of determining the VAT output liability, it was immaterial that some customers might have bought the pies with the intention of eating them hot.

The consultation proposes to move the watershed line and to change the interpretation of the law substantially. In the short term, moving the line will not clarify the border but will result in renewed litigation and uncertainty on the position where the new border lies.

In recent years, technology has changed and it has become clear that HMRC were dissatisfied with the legal interpretation of the border. In Ainsley of Leeds Ltd, the Tribunal ruled that a baked savoury product was sold after being maintained at a hot temperature to ensure that what was sold was a tasty product rather than a hot one.

In Waterfields Leigh Ltd, HMRC again tested this principle in 2009 and again were criticised by the courts because the law was clear. Where food which needs to be
cooked is sold at above ambient temperature, the test is “what was the purpose of heating and what was the temperature at the time of supply?”

Modern technology means that food which is sold cold can be heated in a microwave quickly. This may mean that some suppliers will leave items which have been cooked on a shelf until they have cooled sufficiently to be sold.

As a result of the proposed change, the imposition of standard rate VAT will increase prices by at least 20%. This is likely to produce behavioural change so that vendors who currently sell food items at above ambient temperature but are not catering and therefore expect the benefit of zero rating will now ensure that those items are sold cold. The tax yield is therefore likely to be small as the effect of the proposed change will just be to move the borderline and in so doing introduce complications for the administration of tax and the definition of where the new border lies.

Over the years there has been extensive litigation on this point. In Domino’s Pizza Group the supply of hot pizzas and garlic bread for takeaway and delivery was correctly a standard rated supply. The intention of the vendor was examined by looking at advertising material and this indicated that the vendor appreciated the benefit of enabling the item to be consumed hot. In broad principle, if there were two purposes with one being to create a freshly prepared hot product and the other being to enable that product to be consumed hot, the latter was the dominant purpose. Thus where a retailer took steps to enable an item to be consumed hot, the products could not benefit from zero rating but would be standard rated.

2.2 There should be consultation on the policy

In late 2011, the German tax case of Manfred Bog ruled that under the German legislation a supply of goods and services where the food is not to be consumed at the place of supply could be taxed at a lower rate. Mr Bog sold drinks and food such as sausages and chips from mobile snack bars which had a sales counter and had an area where customers could consume the food protected from the rain by a folding roof. Under the German legislation, the question was whether the supply being made was one of goods or whether it was one of service. Where there was a substantial service element, standard rating undoubtedly applied. Conspicuous by their absence were the other elements of a supply of services such as offered in a restaurant and would include seating, a comfortable temperature in an enclosed space and support facilities such as cloakrooms and lavatories.

An option which might have been available to the UK Government on this issue would therefore to have been to enact provisions that reflected properly the requirements of the 6th Directive on VAT and, in particular to consider Article 12(3)(a) of the 6th Directive and apply a reduced rate.

It is clear and settled case law that, in matters of VAT, provisions which are in the nature of exceptions to a principle must be interpreted strictly. As said earlier, within the UK the law has been clear although the boundaries have been tested regularly. Because of the derogation which provides for zero rating of foodstuffs for human consumption, the 6th Directive has not applied in the UK. Following this German decision, there was a general consensus that the UK Government would probably have to change the law and this consultation would appear to be an attempt to so do.

The proposed new legislation will introduce a new note 3B. This imposes an obligation to have standard rate VAT applied if food which is above the ambient air temperature is provided to the customer, other than freshly baked bread.

2.3 Answering the questions

The first question asked is:
Q1: Does the proposed legislation meet its objective of ensuring that all hot takeaway food is taxed consistently at the standard rate of VAT? If not, why not and what changes are needed?

A: The proposed new legislation merely moves the border. It introduces a new test of whether food is being sold at above the ambient air temperature. How is this to be enforced given hygiene requirements that would demand that food is not contaminated by tests of its temperature being conducted in unhygienic conditions after the point at sale? More importantly, if ambient temperature means room temperature, there are going to have to be a range of temperatures and tolerance levels to deal with food which is intended to be sold cold but which has not yet cooled after having been cooked. At first glance, one has to conclude that this is a political decision made in an attempt to broaden the base of VAT. Its effect will be uncertain. It merely moves the border but will lead to new areas for litigation, greater uncertainty and unintended additional compliance costs. It will inevitably create new anomalies where products intended to be sold cold have a high specific heat and therefore take longer to cool than some other products. To the extent that it is a political decision which introduces the new test of whether an item to be sold is above ambient air temperature, the legislation would appear to be relatively clear.

Q2: What types of bread are most likely to be based on a retailer’s premises and are therefore above ambient air temperature at the time they are provided to customers?

A: We do not wish to comment on this question.

Q3: Does the proposed legislation meet its objective of ensuring that food courts, tables and chairs outside a café and similar eating areas are included within the definition of “premises”? If not, why not and what changes are needed?

We recognise and accept that a number of recent disputes have arisen where caterers question whether they are making a supply for consumption on the premises. In these cases it is often clear that the caterer occupies premises which are a small part of much larger buildings such as a shopping centre or even large offices. The proposed new legislation will add a new item note 3A which again will redraw a definition leading to new areas of uncertainty and litigation. To the extent that the proposed new legislation is directed at meeting an objective of ensuring that food courts, tables and chairs outside a café and similar eating areas are included within the definition of “premises”, we think that the proposed new legislation will succeed.

Q4: We have considered impacts on businesses and consumers of the changes to catering and these are set out in the Table of Impacts in Annex B. We would welcome comments on these impacts including any specific impacts on small business and would particularly welcome details of any impacts we have not identified.

A: We are concerned that the proposed change will create problems in areas such as airports where, for example, a passenger might buy a zero rated supply of a cold sandwich but might be eating that sandwich in a seating area set aside for passengers. This ambiguity and potential lack of clarity might be solved if after the words “include any area set aside” insert the word “solely”.

Annex B sets out a summary of the impacts expected as a result of the proposed changes. The initial reaction from Parliament and the media suggests that the impact has been under-estimated. It is likely that behaviour will change and that end user customers will alter their behaviour in order to avoid the imposition of VAT at 20% which is a significant increase. With modern technology such as freeze driers and microwaves, it is likely that the figures suggested for additional yield are optimistic. It is thought unlikely that the measure will help to reduce the number of disputes and the amount of litigation in the area of hot food. It is actually expected that in the short term uncertainty and therefore litigation is likely to increase. We are also concerned that a number of small firms may, if they implement the proposed change and increase the price of the food
supplied by 20%, face severe changes to their business model as a result of customers ceasing to buy the product.

3. **Sports nutrition drinks**

Standard rating applies to all beverages except milk and specific beverages such as tea and coffee which benefit from zero rating (VATA 1994, schedule 8, group 1). In recent years there have been a number of decisions testing whether zero rating was available for liquidised fruit such as Innocent smoothies.

2011 saw the Tribunals being asked to consider the VAT treatment of commodities such as Lucozade Sport and smoothies. Such litigation has provided persuasive authority to interpret where the borderline between a zero rated liquid foodstuff and a standard rated beverage lies. The proposed change is therefore analogous to closing the stable door after the horse has bolted. It aims to ensure that all sports drinks are taxed in a similar way, ensuring that there is consistent treatment of sports drinks whether consumed for rehydration or nutritional purposes.

Q5: Does the proposed legislation meet its objective of ensuring that sports nutrition drinks are taxed consistently with other sports drinks at the standard rate of VAT? If not, why not and what changes are needed?

A: We think that the proposed new legislation will achieve this objective. In the Summary of Impacts, it concludes that the overall macroeconomic impacts are expected to be negligible. We agree. We recognise that the number of disputes has recently been considerable but we doubt that the measure will help to reduce the amount of litigation or uncertainty.

4. **Self-storage**

Paragraph 25 discloses that HMRC believes that different types of storage can produce different and anomalous results. Article 135 of Directive 2006/112 makes it clear that member States have the discretion to apply further exclusions to the scope of the exemption. Recent cases such as Finnamore t/a Hanbridge Storage Services [2011] TC 01081 and UK Storage Company (SW) Ltd [2011] TC 01394 have been lost by HMRC challenging that exemption applied.

In our view, this seems to be a political decision to remove the exemption in relation to the self-storage facilities provided by some businesses. It is misleading to suggest that this is an anomaly. If there is avoidance we believe that HMRC could tackle such avoidance using existing powers and that the proposed legislation is not necessary. We are also concerned that a warehouse providing space to say a charity might be caught. We recommend that the proposed clauses need to be rewritten. In their present draft the outcome would be uncertainty and potentially causing disputes in unintended areas.

5. **Hairdressers’ Chair Rental**

We recognise that the technical interpretation of chair rental and hairdressing facilities has been a difficult area. It is not in anyone’s interest that uncertainty continues. We believe that the law has been reasonably clear since the decision in Simon Harris Hair Design Ltd in 1996 when the Tribunal decided that payments made by self-employed hair stylists to the owner of a salon were for a single standard rated supply. In that decision, an argument to split the payment allocating part to a licence to occupy that land was ancillary to a standard rated single supply of the rights under the chair agreement.

In our view, the proposed legislation will clarify and confirm that hairdressers’ chair rental is taxable. We are concerned that it may have unintended impacts on large employers who may arrange for employees to be able to have hair cut and styled at work and at residential care homes where a stylist might visit. Note 17 and the definition of “premises” needs to be improved. We are however disappointed that the proposed new legislation should contain a definition which imposes the reader to refer to the Corporation Tax Act 2010. The legislation would have greater clarity and certainty if the definition was self-contained within the proposed new legislation and we recommend that this be done.
6. **Holiday caravans**

On residential caravans, the law is quite clear that a caravan is not a residential caravan if residence in it throughout the year is stopped by the terms of a covenant, statutory planning consent or similar permission (VATA 1994, schedule 8, group 5, note 19). If the caravan site has a planning constraint which stops the use of the caravan at any time during the year, the supply would be standard rated and not zero rated. Accordingly, we believe that the proposed new test adequately ensures that all caravans used for holiday purposes are standard rated as intended. We do not think that it is necessary to duplicate the legislation. We do not comment on questions 13, 14, 15 and 16.

7. **Approved alterations to listed buildings**

We note the proposed changes for alterations to listed buildings and the transitional arrangements. Again it would appear that what is proposed is a political decision. It is inevitable that in some substantial and long term projects, the cut-off date will have an adverse effect. However there has to be a cut-off date made at some point and the date proposed is too short a timescale as projects can take many years.

8. **Conclusion**

Overall, the consultation is seeking views on the draft legislation in order to confirm, as far as possible, that it will achieve the intended policy effect with no unintended effects.

We believe that it is a political decision on policy to broaden the base of VAT charged at the standard rate.

We are conscious that there has been considerable political criticism of the proposed new legislation and we assume that this was anticipated. It will be interesting to learn about stages 4 and 5 where the change is implemented and monitored and then evaluated. We anticipate that the expected yield will not be achieved and that compliance cost will be higher than estimated.

For this reason, we suggest the changes should be withdrawn and there should be further consultation on the policy with new better targeted legislation brought forward.
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