HM TREASURY

HM Revenue & Customs

Impact Assessments

June 2010

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Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury/ HM Revenue and Customs	**Impact Assessment of Changes to the Tax-based Venture Capital Schemes and Enterprise Management Incentives**	
Stage: Final	**Version:** 1	**Date:** 7 June 2010
Related Publications:		

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http://www.hm-treasury.gov.uk

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What is the problem under consideration? Why is government intervention necessary?

This impact assessment covers legislative changes announced at PBR 2009 and proposed in Finance (No 2) Bill 2010 for the Venture Capital Schemes - the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) - and Enterprise Management Incentives (EMI). The venture capital schemes give tax relief to investors in small companies that otherwise have difficulty raising finance. EMI gives tax advantages to some employee share options, to help smaller companies, particularly in the riskier areas of the economy, recruit and retain the staff they need to grow. The changes are needed to ensure the schemes comply with the European State Aid Risk Capital guidelines and EU fundamental treaty freedoms while remaining effective and attractive means of levering risk capital.

What are the policy objectives and the intended effects?

State aid approval was received for the schemes in 2009. The objective is to meet commitments given to the European Commission, as a basis for the approval, that they would comply with the Risk Capital Guidelines and the fundamental freedoms. Complying will secure the future of the schemes and ensure they remain an effective means of promoting business growth and enterprise among small higher risk trading companies. This is especially important given the current challenging economic conditions which are making access to finance problems more acute.

What policy options have been considered? Please justify any preferred option.

Option 1: Ensuring compliance with the state aid guidelines by: (a) making the venture capital schemes and EMI more flexible by relaxing the limitations on where target companies can carry on their activities and where VCTs can be listed; (b) excluding enterprises in difficulty from the venture capital schemes and (c) changing the minimum equity requirements for VCTs.

Option 2: Doing nothing. Failure to take action could result in state aid approval being withdrawn. Operation of the schemes would then be suspended and relief already given might have to be repaid.

Option 1 is preferred as the best way of meeting the policy objectives.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? Impacts will be assessed on an ongoing basis. Any significant impact on VCT fundraising will be seen by 2011. EIS will take several years because of the long time lags for company returns as will EMI, due to time lags between grant and exercise of share options.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the impact assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs'.

Signed by the responsible Minister:

Date: 7 June 2010

Summary: Analysis & Evidence

Policy Option: 1	Description: Amend the schemes to improve flexibility and achieve compliance with state aid rules

COSTS

ANNUAL COSTS	
One-off (Transition)	Yrs
£ 200,000-300,000	
Average Annual Cost (excluding one-off)	
£ 100,000-120,000	

Description and scale of **key monetised costs** by 'main affected groups' Relaxing territorial restrictions should see more companies and individuals using the schemes and incurring average annual costs in providing information. VCTs will incur one-off costs from adapting investment strategies to the need to hold a greater share of new qualifying investments in eligible shares.

Total Cost (PV) | **£ see evidence base**

Other **key non-monetised costs** by 'main affected groups' Allowing VCTs to list on any European Union Regulated Market is not expected to significantly increase compliance costs. Overall, the net increase in the value of tax relief claims is forecast to be around £20m in 2011-12, £30m in 2012-13, and £40m per annum thereafter.

BENEFITS

ANNUAL BENEFITS	
One-off	Yrs
£ 0	
Average Annual Benefit (excluding one-off)	
£ 35,000-45,000	

Description and scale of **key monetised benefits** by 'main affected groups' There may be a reduction in VCT fundraising due to the change to the minimum equity requirement. If this occurs, it will marginally reduce the volume of information VCTs and their investors need to pass to HMRC each year.

Total Benefit (PV) | **£ see evidence base**

Other **key non-monetised benefits** by 'main affected groups' Companies gain improved access to finance. Investors gain additional tax relief of around £20m in 2011-12, £30m in 2012-13, and £40m per year therafter by making higher risk investments than they might otherwise have done. Average investment returns are particularly uncertain and are therefore not monetised.

Key Assumptions/Sensitivities/Risks The extent to which increased flexibility will lead to a net increase in investment is uncertain, as is the ability of VCTs to adapt to being required to hold a greater proportion of qualifying holdings in eligible shares for new investments. It is assumed that there are no cost implications from relaxing the territorial rule for EMI and excluding companies in difficulty.

Price Base Year 2009	Time Period Years p.a	**Net Benefit Range** (NPV) **£ See evidence base**	**NET BENEFIT** (NPV Best estimate) **£ See evidence base**

What is the geographic coverage of the policy/option?	United Kingdom			
On what date will the policy be implemented?	2010			
Which organisation(s) will enforce the policy?	HMRC			
What is the total annual cost of enforcement for these organisations?	£ 0			
Does enforcement comply with Hampton principles?	Yes			
Will implementation go beyond minimum EU requirements?	No			
What is the value of the proposed offsetting measure per year?	£ 0			
What is the value of changes in greenhouse gas emissions?	£ 0			
Will the proposal have a significant impact on competition?	No			
Annual cost (£-£) per organisation (excluding one-off)	Micro As small	Small **<£750**	Medium **N/A**	Large N/A
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)

Increase of £ 50,000 | Decrease of £ 5,000 | **Net Impact** £ 45,000 increase

Key: **Annual costs and benefits:** **(Net) Present**

Evidence Base (for summary sheets)

THE ISSUE

The Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs) are tax-based venture capital schemes. They aim to improve small higher risk trading companies' ability to secure longer-term financial support in the form of equity investments.[1] They do this by offering investors income, capital gains and corporation tax reliefs in return for investing in small companies undertaking an activity (trade) that qualifies under either scheme.

Enterprise Management Incentives (EMI) are tax advantaged employee share schemes, under which companies can offer their employees share options with income tax and National Insurance contribution advantages. EMI is designed to help smaller companies, particularly in the riskier areas of the economy, to recruit and retain the staff they need to grow.

The EIS has raised almost £6.3 billion, which has been invested in around 14,500 small companies. VCTs have raised £3.5 billion and invested in over 1,500 small companies.

Access to finance is currently a particular concern to many businesses: the availability of capital is limited and banks have changed their approach to risk, tightening lending conditions. It is therefore important to ensure the venture capital schemes remain an effective and attractive means of levering risk capital into small companies, which now face further difficulties in securing appropriate levels of finance than previously.

The schemes were notified to the European Commission as state aids in May 2007. They received approval in 2009, subject to a number of changes being made at the first opportunity to ensure that the rules governing the schemes comply with the State Aid Risk Capital guidelines and the EU fundamental treaty freedoms. Failure to comply could jeopardise the approval, leading to the schemes having to be suspended. This would have a negative impact on the supply of risk capital flowing to small companies.

For the State Aid Risk Capital guidelines, published in 2006, please see: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2006:194:0002:0021:EN:PDF.

POLICY OBJECTIVES AND INTENDED EFFECTS

The main policy objective is to ensure the venture capital schemes remain an effective and attractive means of incentivising investments in smaller companies that might otherwise struggle to raise appropriate levels of finance and that EMI continues to be effective. This is particularly important given the current challenging economic conditions. The Government intends to achieve this by securing state aid approval for the schemes.

This will secure the future of the schemes, ensuring that they play as active a role as possible in supporting small companies during the downturn. This is also important to ensure the stability of the EIS and VCT sectors, allowing them to plan for the future and continue to play a role in the economic recovery.

Changes to secure this approval will involve relaxing the limitations on where the trade is carried on. This presents the additional benefit of increasing the number of small companies eligible for investments under the schemes. Some companies which may previously have been ineligible as a result of their international activity may now be able to qualify for investments. It will also allow companies, already benefiting from investments under the schemes, to take greater advantage of the international opportunities to expand.

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[1] The schemes' rules outline what is meant by a small higher risk trading company in this impact assessment. Small companies are defined as having gross assets not exceeding £7 million before the share issue and £8 million after; employment must be less than 50 full-time equivalent employees when shares are issued. There are also rules to ensure companies are independent and trading. Certain activities are excluded from the schemes in order to target higher risk trades more in need of support. (For details, please see: http://www.hmrc.gov.uk/manuals/vcmmanual/index.htm).

In the same vein, the Government also intends to allow VCTs to list elsewhere in Europe, should that make most commercial sense.

OPTIONS

Option 1 Amend the schemes' rules:

(a) Relax the rule requiring investee companies' activities to be carried on "wholly or mainly" in the UK (common to both schemes and EMI) and the requirement for VCTs to be UK-listed;

(b) Exclude "Enterprises in Difficulty" from the venture capital schemes; and

(c) Change the minimum equity requirements for VCTs.

Option 2 Do nothing

The Government prefers option 1 because it is expected to deliver the policy objectives, whereas option 2 clearly would not.

Option1: Amend the Scheme Rules

(a) Relax the rule requiring investee companies' activities to be carried on "wholly or mainly" in the UK (common to both schemes and EMI), and the requirement for VCTs to be UK-listed.

- Companies qualifying to receive investments under the schemes are currently required to carry out their qualifying activities "wholly or mainly" in the UK as are companies benefiting from EMI. HMRC interpret the requirement as meaning that more than 50 per cent of the qualifying activities should be in the UK.
- The Government now intends to relax this rule to simply require any company receiving investments under the tax-based venture capital schemes to have a permanent establishment in the UK. The definition used will be based upon that contained in Article 5 of the OECD Model Tax Convention on Income and on Capital (2003).
- There is also currently a requirement for VCTs that "the shares making up the company's ordinary share capital...have been or will be included in the official UK list throughout the relevant period".
- The Government now proposes to relax this rule. Instead, the shares making up the company's ordinary share capital will be required to be admitted to trading on a European Union Regulated Market. A "European Union Regulated Market" is any regulated market named under the Markets in Financial Instruments Directive (MiFID).

This option is preferred as it also responds to calls from small business and the venture capital sector to make the schemes more flexible. It will also play a part in the broader efforts to improve access to finance, as more UK companies would qualify for investments under the schemes. This will stimulate investment activity by providing more investment opportunities for individuals and facilitating cross-border activity.

The Government therefore intends to introduce legislative changes in Finance Bill 2010 to give effect to these relaxations.

(b) Exclude "Enterprises in Difficulty" from the venture capital schemes

- There is currently no exclusion of enterprises "in difficulty" from benefiting from either of the schemes

- The Government now proposes to introduce a rule excluding companies that are “in difficulty” according to the criteria set out in the Commission’s guidelines on State aid for rescue and restructuring from the benefit of the venture capital schemes

This option gives a simple test, based on the Commission’s own guidance. The Government considers it unlikely that companies genuinely in difficulty according to these criteria would be able to raise equity funding.

(c) Change the minimum equity requirements for VCTs

VCTs are currently obliged to onward invest a minimum of 70 per cent of their total fund in ‘qualifying holdings’. Of that 70 per cent, a minimum of 30 per cent (i.e. 21 per cent of the total fund) must be in ‘eligible shares’, which the Commission accepts constitutes ‘equity’ according to the definitions in the State Aid Risk Capital guidelines. However, these guidelines require that 70 per cent of qualifying holdings be invested in ‘equity’ or ‘quasi-equity’.

The Government therefore intends to introduce legislation in Finance Bill 2010 to require that a minimum of 70 per cent VCTs’ qualifying holdings (i.e. 49 per cent of the total fund) must be in a form that the Commission would accept as ‘equity’ <u>or</u> ‘quasi-equity’. The Government does not propose to use the term ‘quasi equity’ but legislation will define the sorts of instrument that will count towards the new requirement.

This option is preferred as the Government is legally obliged to ensure the rules governing the VCT scheme comply with the State Aid Risk Capital guidelines. Failure to do so would result in state aid approval for the scheme being withheld and the suspension of the schemes.

Option 2: Do Nothing

Failure to implement these changes could result in the European Commission revoking state aid approval and operation of the schemes being suspended. The UK Government would probably at this stage be forced to abolish the schemes. This impact assessment considers only the cost of the schemes having to be closed to new investments. However, the European Commission could in principle also potentially require the UK Government to reclaim some relief already given under the schemes. This would apply to relief given directly to investors, which the small companies benefited from indirectly.

CONSULTATION

HMRC published draft legislation at PBR and consulted stakeholders on its detail. Stakeholders were generally content with the suggested approach. The legislation to be proposed takes account of a number of points of detail, in particular by relaxing the rule that determines when a VCT “controls” a company in which it requests, reflecting the changes described at (c) above.

COSTS & BENEFITS

The compliance costs and benefits of the policy options are estimated based on the expected impact on normally efficient and compliant businesses and individuals. Compliance costs are likely to consist of either:

- the average time taken by individuals, small companies, and VCTs to complete tasks themselves charged at an average wage rate; or
- the average increases in professional fees where tasks are likely to be undertaken by an agent.

The wage rate used is £12.50. This is based on the 2008 average gross hourly rate for clerks and bookkeepers, uplifted for overheads (taken from the Annual Survey of Hours and Earnings).

Option 1: One-Off Costs

Businesses

Some small companies and VCTs seeking investment as well as professional advisers will be directly affected by the relaxation of the "wholly or mainly" in the UK rule. They will incur learning costs in understanding the impact of the new rule and the new opportunities it may present. As a proxy for this we assume that each company/VCT raising funds in the first year incurs an average cost of £50 each in time and/or a marginal increase in professional fees. The total cost of this is estimated at around £100,000.

We do not expect established VCTs to move to another European Union Regulated Market because of the costs of moving relative to any benefits. Estimated cost is negligible.

Increasing the minimum equity requirement for all new VCT investments should only result in significant one-off costs for VCTs raising funds. The cost per VCT of learning of the change is assumed to cost an average of £50. Implementing the change will be more costly because many VCTs looking to raise funds will have to amend their investment strategy for new investment in terms of how they structure their qualifying holdings in small companies. The information received by HMRC on the composition of VCT qualifying holdings has only partial coverage, but suggests that some trusts already appear to exceed 70 per cent equity. These are mainly AIM quoted plus some specialist VCTs. Meanwhile, those closer to the current 30 per cent rule appear to be mainly generalist VCTs. Without scope for consultation on the likely implementation costs, we assume that the one-off costs of implementation in terms of time and other costs will on average be around £5,000 per VCT raising funds. We assume this applies to around three-quarters of those raising funds. These costs are in addition to any learning costs. There have been around 40 VCTs per year raising funds on average while income tax relief has been at 30 per cent (see http://www.hmrc.gov.uk/stats/venture/table8.6.pdf). Total cost is estimated at around £150,000.

Individuals

We expect the one-off costs for individuals to be negligible from the relaxation of the "wholly or mainly" in the UK rule because they are only indirectly affected by what amounts to the reworking of an existing rule. There will be more companies that can use EIS and more companies for VCTs to invest in. However, the learning and search costs per individual are unlikely to be significantly different for investors who would have invested through the schemes anyhow. Evidence that only a minority of investors keep abreast of changes to the scheme rules once they have invested would tend to support this (see http://www.hmrc.gov.uk/research/report.pdf).

We expect the one-off costs for individuals to be negligible from changing the minimum equity requirement for VCTs because they are only indirectly affected by what amounts to the reworking of an existing rule. Therefore, learning costs per investor are unlikely to change significantly as a result.

Option 1: Average Annual Costs

Businesses

Relaxation of the "wholly or mainly" in the UK rule should result in more small companies raising equity through the schemes. This will result in a flow of additional information having to be provided to HMRC each year by the additional companies and the VCTs in respect of these extra investments. Providing such information constitutes an average annual cost. Based on existing estimates for the administrative burden of the schemes, we calculate the costs to be around £55,000. This is based on additional activity equivalent to around 10-15 per cent more companies and VCTs raising funds through the schemes. Although this cannot be reliably forecast, it would imply around 250 more EIS companies and around 5 more VCTs than would otherwise have been the case. (For overall activity in the schemes, see http://www.hmrc.gov.uk/stats/pensions/index.htm).

The change to the minimum equity requirement is a change to an existing rule, and so should not generate significant additional burdens in providing information to HMRC. Any new VCTs entering the market would have to apply one threshold rather than another. Therefore, the average annual costs to VCTs are estimated to be nil or negligible.

Individuals

Consistent with the increase in the number of companies raising equity through the schemes, we also expect additional investors. Although it is difficult to predict with any accuracy, we assume the policy change will attract around 2,000 additional EIS investors and around 2,500 more in VCTs (i.e. an increase of around 15 per cent). These taxpayers will need to provide information to HMRC in order to obtain their tax relief. These additional claims and additional people learning about the schemes each year form an average annual cost. Income tax claims are typically relatively simple and straightforward. They are claimed either via Self Assessment, a scheme specific form or a PAYE coding notice. We therefore assume the cost to be an average of £12.50 per additional claim to proxy for the individual's time or a marginal increase in professional fees for those represented by an agent. Claims will predominantly be from higher rate taxpayers and often those already on SA with relatively complex tax affairs. The total cost is estimated at around £55,000.

For changing the minimum equity requirement for VCTs, we expect the average annual costs for individuals to be negligible. This is because they are only indirectly affected by what amounts to the reworking of an existing rule. The tasks undertaken to make an investment and claim relief would remain the same.

Option 1: Benefits

There are no one-off benefits anticipated. The average annual benefits of improving the flexibility of the schemes are potentially:

- Businesses – More companies will be able to attract risk capital using the schemes and those with a significant share of their trade carried out overseas will no longer see their potential limited in scope by a "wholly or mainly" in the UK rule. The ability of the schemes to address the 'equity gap' encountered by small, higher risk trading companies will therefore be improved. Empirical evidence suggests that the schemes may have a positive effect on the investment levels of EIS/VCT companies (see http://www.hmrc.gov.uk/research/report44.pdf).
- Individuals – Investors will be able to obtain tax relief on a wider range of risk capital investments through the schemes, which may lead to better post-tax rates of return on capital that may have been invested elsewhere.

The only anticipated on-going benefits to business and individuals from changing the minimum equity requirement for VCTs are from compliance cost savings due to a reduction in VCT fundraising:

- Businesses: Although it is speculative, we have estimated that there will be around 5 fewer VCTs raising funds each year, which will reduce the cost of providing information to HMRC by around £5,000 per annum.
- Individuals: We have assumed a similar proportionate reduction for individuals claiming tax relief each year, reducing the need to provide information to HMRC by around £35,000 per annum.

The above benefits do not include the forecast value of additional tax relief claims. This is because in cost-benefit analysis terms tax relief represents a transfer payment from one group in society to another rather than a net increase in the welfare of society as a whole. Instead, any positive impact on output in the economy due to the additional tax relief or any reductions in compliance costs count as benefits. The cost of tax relief is incurred from 2011-12 rather than 2010-11 due to the time lags involved in administering the reliefs.

The difficulty here is that while we can make reasonable estimates of compliance cost savings, any positive impact on the economy of more investment through the schemes cannot be reliably measured. This is because the schemes are just one factor affecting small company performance relative to the alternative investment choices that could have been made instead (i.e. in the absence of the venture capital reliefs). The economic impact of more investment through the schemes is not quantified as a monetised benefit and is instead described qualitatively in the non-monetised box on page 2. Research evidence points towards the tax relief being the primary attraction of investments through the schemes in many cases (see http://www.hmrc.gov.uk/research/report.pdf and http://www.hmrc.gov.uk/research/cgt-final-report26.pdf). However, given the risky nature of the investments, many are loss-making in pre-tax terms.

The table below summarises the above monetised costs and benefits. Estimates have not been produced on a net present value basis both because the schemes have no end date and because the main benefits of option 1 could not readily be monetised.

Option 1: Monetised Costs and Benefits			
Impact:	**Impact on:**	**Estimate:**	**Published Range:**
One-Off Cost	**Businesses**	£250,000	-
	Individuals	£0	-
	TOTAL	**£250,000**	**£200,000-£300,000**
Average Annual Cost	**Businesses**	£55,000	-
	Individuals	£55,000	-
	TOTAL	**£110,000**	**£100,000-120,000**
One-Off Benefit	**Businesses**	£0	-
	Individuals	£0	-
	TOTAL	**£0**	**£0**
Average Annual Benefit	**Businesses**	£5,000	-
	Individuals	£35,000	-
	TOTAL	**£40,000**	**£35,000-45,000**

Option 2: Do Nothing

As already outlined, this option would lead to the suspension of the schemes. Investors would lose tax relief and small, higher risk trading companies would find it more difficult to secure the funds they need to invest and grow.

One-Off Costs

It is likely that most VCTs would incur the one-off costs of running down in the years after the scheme closes to new investment. The majority are unlikely to be sustainable without tax relief. Such costs cannot be readily quantified and are thus non-monetised in our estimates.

Average Annual Costs

As discussed under the benefits of option 1, any investment returns accruing to investors and other shareholders cannot be readily estimated and generalised. With option 2, therefore, the cost of suspension in these terms is likewise difficult to quantify.

One-Off Benefits

There would be no one-off benefits of suspension.

Average Annual Benefits

Suspending the schemes would mean that small companies, VCTs and their investors would no longer incur the average annual costs of providing information to HMRC each year. Based on current populations of companies, VCTs and investors using the schemes each year and the same assumptions used for option 1, the average annual cost savings of suspending the schemes would be around £700,000.

Although it has not been possible to quantify all of the cost and benefits, the benefits in terms of the additional investment returns generated by the schemes are still likely to outweigh the compliance cost savings of suspension. For example, in 2006-07 total funds raised through the venture capital schemes were almost £1billion versus compliance costs per year of less than £1million. Therefore, the schemes would only have to generate additional pre-tax investment returns of around 0.1 per cent for the benefits to businesses and individuals from retaining them to exceed the costs each year.

The table below summarises the above monetised costs and benefits. Estimates have not been produced on a net present value basis both because the schemes have no end date and because the main costs of option 2 could not readily be monetised.

Option 2: Monetised Costs and Benefits			
Impact:	**Impact on:**	**Estimate:**	**Published Range:**
One-Off Cost	**Businesses**	£0	-
	Individuals	£0	-
	TOTAL	**£0**	**£0**
Average Annual Cost	**Businesses**	£0	-
	Individuals	£0	-
	TOTAL	**£0**	**£0**
One-Off Benefit	**Businesses**	£0	-
	Individuals	£0	-
	TOTAL	**£0**	**£0**
Average Annual Benefit	**Businesses**	£400,000	-
	Individuals	£300,000	-
	TOTAL	**£700,000**	**£600,000-800,000**

ADMINISTRATIVE BURDEN

HMRC is subject to quantified targets to reduce one aspect of compliance costs in particular; the admin burden of disclosing information to HMRC or to third parties. This burden is assessed through the 'Standard Cost Model' (SCM), an activity based costing model which identifies what activities a business has to do to comply with HMRC's obligations, and which estimates the cost of these activities, including agent fees and software costs.[2]

[2] The 'Standard Cost Model' (SCM) has been used to derive an estimate of the costs to business of complying with HMRC obligations to disclose information to HMRC or to third parties. The SCM considers which activities a business has to do to comply with an HMRC obligation, how many businesses have to comply, and how often they need to comply. The SCM considers the burdens applying to different sizes of business.

The SCM estimates the costs of using agents; the costs of undertaking work in-house; and the costs of actually transmitting the information. The SCM does not consider one-off costs or transitional costs. The SCM does not consider costs which a business would have incurred anyway had the relevant HMRC obligation not existed. It considers the costs which apply to a normally

Central estimates of admin burdens are £50,000 per annum for part (a) of option 1, £0 for part (b) and -£5,000 per annum for part (c). These are burdens incurred by companies and VCTs. Burdens borne directly by individuals who are a separate legal entity to the business, such as directors, employees and shareholders, are not included under the SCM. A 2005 wage rate of £11.70 is assumed for in-house tasks. As described under average annual costs, part (a) of option 1 should result in additional burdens due to more activity through the schemes, whereas part (c) should result in a reduction in VCT fundraising.

On the same basis, the administrative burden savings from option 2 is estimated at around £385,000 per annum.

Assumptions & Risks

With option 1, the main risk is that the measure has less of a positive overall impact on small companies' ability to raise risk capital. The negative effect on VCTs could be greater, whereas the increase in funds raised because of increased flexibility could be less than assumed here. The extent of the impact of the changes is difficult to predict in advance. The timing of the tax effects is on a National Accounts basis.

Equity and fairness

These changes will affect small companies (with fewer than 50 employees and gross assets of less than £7 million before investment) that receive, or may seek to receive investments under the EIS and VCT schemes. Individuals who make investments in these small companies, either through the EIS or through a VCT, will also be affected as will the VCT and EIS Fund industries. These changes should not disproportionately affect any other sectors.

Implementation plan, monitoring and evaluation

The changes will be legislated in 2010. Guidance will be published on the HMRC website. Implementation of the policy will not require additional resources for HMRC. National Statistics on the schemes are published annually on the HMRC website and the impact of these changes should be reflected in this monitoring data. Statistics on VCT fundraising are currently published within 6 months of the end of the tax year. EIS statistics take three years to compile due to the time companies have to file those returns. Further evaluation studies may be commissioned to assess the overall impact of the schemes in addition to those already published by HMRC.

Small Firms Impact Test

These options affect only small companies (with a headcount of fewer than 50 employees and gross assets of less than £7 million before investment) that receive or may seek to receive equity investments benefiting from tax relief under the tax-based venture capital schemes.

With option 1, the relaxation of the "wholly or mainly" test described should benefit small companies receiving investments under the venture capital schemes, by improving their ability to take advantage of opportunities to expand internationally. Changing the VCT minimum equity requirement should have no direct impact on small companies, as they apply to requirements governing VCTs.

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efficient business and the costs to businesses which comply. The SCM does not consider wider compliance cost issues, such as the costs of business uncertainty, cash flow costs, or the costs of deciding whether or not to do something.

The Impact Assessment template requires SCM figures to be presented in May 2005 prices, as admin burden reduction targets relate to a May 2005 baseline. The Impact Assessment also uplifts those figures to current day prices.

Under option 2, small companies would be harmed by the reduction in the availability of equity finance that would ensue from the suspension of tax relief offered by the schemes.

It was not possible to carry out a consultation among small companies on the effect of these changes prior to their announcement. This was due to the confidential nature of negotiations between the UK Government and the European Commission, and due to market sensitivities.

Competition Impact Test

The proposed changes are not expected to have any adverse impacts on competition. Neither option should:

- directly limit the number or range of suppliers;
- indirectly limit the number or range of suppliers;
- limit the ability of suppliers to compete; nor
- reduce suppliers' incentives to compete vigorously.

Under option 1, the changes are required to ensure compatibility with state aid guidelines. State aid control is intended to ensure that Government interventions do not distort competition or intra-community trade. The tax-based venture capital schemes are interventions intended to correct for 'equity gap' market failures whereby small companies in qualifying trades can struggle to raise appropriate finance compared to larger businesses or lower risk trades. They should have a positive effect on competition in markets by supporting new entrants.

Relaxing the territorial requirements of the schemes should have a positive effect on the competition process by opening the schemes up to more business opportunities that may face an 'equity gap'. Raising the minimum equity requirement for VCTs (from 30 per cent to 70 per cent) should also aid the competition process by reducing any distortions caused by the scheme; it should better focussing VCT portfolios on those companies most likely to be both eligible for the schemes and facing an equity gap. Even if some VCTs that already meet the 70 per cent requirement gain a head start or some exit the market, competition between VCTs is unlikely to be significantly diminished. This is because the change is not expected to significantly raise barriers to entry, meaning that the threat of new VCTs entering the market will remain a constraint on the behaviour of incumbents.

Under option 2, suspension of the schemes would remove any competitive distortions caused by the schemes favouring small companies in qualifying trades over other businesses, large and small. However, it would exacerbate the 'equity gap' in the UK, making it harder to raise the equity needed for small companies to enter markets, compete and grow.

Other Impact Tests

Competition assessment

We have applied the Office of Fair Trading competition filter to these changes and concluded they have no impact on competition

Small Firms Impact test

The changes ensure that the Venture Capital Schemes – which support small companies in raising finance – will continue to be available. After consultation the sector, based on draft legislation, the original proposals have been modified to take account of view received

Legal aid

There will be no need for new criminal sanctions or civil penalties

Sustainable development

The changes will be in accordance with the principles of sustainable development

Race equality, disability equality, gender equality and human rights

An initial equality impact assessment has confirmed that the changes have no negative impacts

Rural issues

The changes will not have a significantly different effect in rural areas. Neither will they significantly impact carbon emissions, other environment or health.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Summary: Intervention & Options

Department /Agency:	Title:	
HMRC	**Impact Assessment of Excise: Modernisation and Compliance Checks**	
Stage: Final	**Version:** Final	**Date:** 28th May 2010

Related Publications: Consultation Documents – Modernising Powers, Deterrents and Safeguards: Excise: Modernisation and Compliance Checks – 9th July 2009 and 9th December 2009

Available to view or download at:

http://www.hmrc.gov.uk/consultations

Contact for enquiries: Laura Lucking **Telephone: 078255 46464**

What is the problem under consideration? Why is government intervention necessary?

Excise legislation has evolved over many years, resulting in different systems and procedures applying to different regimes. These differences impact particularly on those involved in the production, holding and movement of alcohols, tobacco and oils. While there are good reasons for this in some cases, in others it has led to duplication of information and unnecessary administrative complexity.
After the Commissioners of Revenue and Customs Act 2005 created HMRC from the two former Departments a project was set up to review the powers, safeguards and deterrents available across the different tax and duty regimes, introducing alignment where appropriate and ensuring they are fit for modern purposes. Excise forms the final tranche of this work on compliance checking powers.

What are the policy objectives and the intended effects?

Following the 2008 Finance Act (FA 2008) and with extension in the 2009 Finance Act (FA 2009), HMRC have aligned record-keeping rules, information and inspection powers and assessment and claim time limits across the majority of taxes and duties for which they have responsibility. Excise duties have been the main exception. The focus of the excise review was to ensure that HMRC has powers that are modern and can be used effectively to tackle large scale excise frauds, met the needs of changing operational focus and retain sufficient safeguards for legitimate traders and businesses. It was also important to look at aligning any areas with changes made in the FA 2008 and 2009, where appropriate.

What policy options have been considered? Please justify any preferred option. 1. Do nothing

2. Modernise the excise administrative provisions (this is now being progressed over a longer period so is not covered in this Impact Assessment. Estimated benefits are in the version published 9th Dec 2009)

3. Modernise the excise compliance checking powers, including alignment of record-keeping rules and time limits for assessing additional duty due or making claims for duty relief.

Option 3 is preferred, with Option 2 following over a longer period to allow requirements, costs and benefits to be more fully explored. Improved compliance checking powers will help HMRC deal more effectively with those operating illicitly while limiting the impact on the legitimate trade.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? A post implementation review will take place between 1 – 3 years after the full implementation of any option.

Ministerial Sign-off For final Impact Assessment:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister: Date: 2 June 2010

Summary: Analysis & Evidence

Policy Option: 3	**Modernise the excise compliance checking powers**

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'. HMRC costs will be on staff training, which should be minimal as these are relatively small changes to existing legislation. If appropriate HMRC will share training material with traders, whose only costs in relation to the changes will be to update their knowledge.
One-off (Transition)	**Yrs**	
£ Negligible		
Average Annual Cost (excluding one-off)		
£ Not Applicable		**Total Cost** (PV) **£ Negligible**

Other **key non-monetised costs** by 'main affected groups' As with any change in policy there would be an initial familiarisation process with the changes to the powers, however it is expected this will be minimal for taxpayers. The key change would be in relation to the new information power and taxpayers may need to understand that process for making representations.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' Uniformity across recording-keeping principles would assist taxpayers in understanding their obligations, reducing instances of mistake. Aligned time-limits will make it easier for traders to know what is expected and when. There may be a negligible increase in the level of yield recovered from assessments that can cover 4, rather than 3, years.
One-off	**Yrs**	
£ Negligible		
Average Annual Benefit (excluding one-off)		
£ Negligible		**Total Benefit** (PV) **£ Negligible**

Other **key non-monetised benefits** by 'main affected groups' Taxpayers would benefit from aligned record-keeping principles and time limits across the taxes and duties. Enhanced HMRC powers to tackle illegitimate trading, used in conjunction with operational strategies to address the non-compliant should benefit legitimate businesses who face unfair competition from illicit trade.

Key Assumptions/Sensitivities/Risks While this option should help to reduce taxpayers' compliance costs through aligned time limits and make HMRC more efficient in carrying out its responsibilities, HMRC does not have the evidence base to provide accurate figures for the overall benefits or impacts of these changes.

Price Base Year 2009	Time Period Years 10	**Net Benefit Range** (NPV) **£ Not quantifiable**	**NET BENEFIT** (NPV Best estimate) **£ Not quantifiable**

What is the geographic coverage of the policy/option?			United Kingdom	
On what date will the policy be implemented?			01/04/11	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			£ Negligible	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			No	
What is the value of the proposed offsetting measure per year?			£ N/A	
What is the value of changes in greenhouse gas emissions?			£ N/A	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro £0	Small £0	Medium £0	Large £0
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices)				(Increase - Decrease)	
Increase of	£ **Negligible**	Decrease of	£ **Negligible**	**Net Impact**	£ **Negligible**

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Introduction

HMRC has approximately 11,000 customers across the different excise regimes, ranging from large to small businesses. Taxpayers within these regimes bring in over £45 billion per year, the vast majority from a small number of big players. This represents 10 per cent of the total amount of revenue collected by HMRC each year.

This revenue is generated within the following excise regimes which are examined in this consultation:

- goods for consumption: alcohol (beer, wine, made-wine, cider, perry and spirits), tobacco and energy products, including the holding and movement of such goods in duty suspension;
- gambling: profits based (general betting duty, bingo duty, pool betting duty, gaming duty and remote gaming duty); and by ticket sales (lottery duty);
- air passenger duty (APD) currently charged on chargeable passengers in chargeable aircraft[1]; and
- Amusement Machine Licensing Duty (AMLD)[2].

The current tax gap figures for the excise regimes state that the exchequer is losing between £1.9 billion and £4.7 billion in unpaid duty every year[3] –

Tobacco (cigarettes and hand rolling tobacco): £1bn - £2.65bn
Alcohol (spirits only): £150m - £350m
Oils (petrol and diesel in Great Britain and Northern Ireland): £790m - £1.740bn.

In the period since 2005 HMRC has seized nearly 15 million litres of alcohol with a taxable dutiable value of over £33 million, issued demands for more than £178 million of evaded duty and prosecuted 15 major criminal gangs who were involved in alcohol fraud.[4]

For oils[5] in the period since 2005, 4 million litres of diesel has been confiscated, 84 fuel laundering plants have been disrupted and 45 criminal convictions have been successfully obtained.

For tobacco, in the period since 2000 HMRC has seized over 14 billion cigarettes and more than 1000 tonnes of hand rolling tobacco in the UK and abroad. It has broken up over 370 criminal gangs, successfully prosecuted over 2,000 people and issued over £35 million worth of Confiscation Orders[6].

HMRC needs effective powers to be able to counter this level of threat.

Excise legislation focuses on those classified as Revenue Traders (s1(1) Customs and Excise Management Act 1979 - CEMA). This term is wide ranging and includes any person carrying on a trade or business subject to any of the revenue trade provisions of the customs and excise Acts and those who ‘buy, sell, import, export, deal in or handle’ any goods liable to excise duty[7].

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[1] The Government has set out its plans to review the current basis on which Air Passenger Duty is charged.
[2] The Government issued a consultation on the future of gaming machine taxation on 16 July 2009. The deadline for responses was 23 October 2009. The Government is analysing the responses received to the consultation, and will give full consideration to the industry’s views before any decisions are taken.
In addition to the consultation on gaming machines, the Government will continue to engage with the gaming machine industry about the general state of the sector and the impact of taxation.
[3] From ‘Measuring Tax Gaps 2009’, HMRC, December 2009, www.hmrc.gov.uk/stats/measuring-tax-gaps.pdf
[4] Figures from the “Renewal of the Tackling Alcohol Fraud” Strategy published by HMRC and UKBA at Budget 2009 http://www.hmrc.gov.uk/budget2009/tackling-alcohol-2850.pdf
[5] HMRC Autumn Performance Report 2008 p.53 http://www.hmrc.gov.uk/about/autumn-report-2008.pdf
[6] Figures from “Tackling Tobacco Smuggling Together” published by HM Revenue and Customs and the UK Border Agency in November 2008 http://www.hmrc.gov.uk/pbr2008/tobacco-2800.pdf
[7] Annex A in the first Impact Assessment includes a more detailed list of excise sectors covered by this consultation, and a list of the most common types of revenue trader. Annex B in the first Impact Assessment provides indicative figures of the numbers involved in and the amounts generated by the main excise regimes.

Policy objectives and intended effects

When the Commissioners of Revenue and Customs Act 2005 created HMRC it left in place all the legislation that governed the different tax and duty regimes. This meant that there were different powers and obligations for the different taxes. The Review of Powers, Deterrents and Safeguards was introduced to address this issue, looking across the regimes to ensure the powers and safeguards were suitable for the modern climate, and introducing alignment where appropriate.

As a result of this work legislation was passed in the Finance Acts 2008 and 2009 providing aligned powers for all HMRC taxes and duties in relation to time limits, record-keeping requirements and information and inspection powers. However the significant differences in the excise regimes, where the focus is on goods rather than records, resulted in excise being reviewed separately.

The main focus of excise powers is to enable HMRC officers to check that goods held or moved in duty suspension do not enter the market without duty being paid, and to enable officers to check the quality of excisable goods coming into the UK market (e.g. whether the diesel being sold through petrol stations is safe). Therefore to complete the work of the Review of Powers it was necessary for HMRC to look at whether the legislation and powers governing the excise regimes provided the powers needed to tackle the current risks, whilst also giving the safeguards needed in modern times.

During the first consultation HMRC took the opportunity to look at possible ways to modernise the administrative processes of the excise framework. Excise administrative requirements have grown up over a long period, and often in a piecemeal fashion, and therefore can be complex and difficult to manage. HMRC was looking for ways to simplify the processes and procedures involved for taxpayers engaging in the regime.

The responses to the proposed changes were broadly positive but stakeholders made it clear that the modernisation should be solidly based with computerised solutions. In light of this, the modernisation work is being taken forward over a longer time scale to allow HMRC to build a better picture of what an IT system would need to deliver and the costs and benefits involved for both the Department and the trade.

As part of a wider project the compliance powers for customs duties and international trade are being reviewed over the next few years. The changes made to excise as a result of this work will be taken into account as the customs work moves forward.

Policy Development Process

First Consultation (July – October 2009)

The consultation process started with the publication of the Excise: Modernisation and Compliance Checks consultation document, and the first impact assessment, on 9th July 2009. That process lasted 12 weeks until 1st October 2009.

The consultation document sought views on the full range of proposals relating to both modernisation of excise administration and the review of the compliance checking powers.

The responses are detailed in the 'Excise: Modernisation and Compliance Checks; the next stage' document and impact assessment that were published on 9th December 2009[8].

The consultation sought views from a broad cross section of external stakeholders, both through representative bodies and through direct contact with key businesses, as well as from a wide range of internal stakeholders involved in operating the excise regimes. Information was also gathered from HMRC analysts and through interrogation of internal HMRC systems.

[8] Documents can be found at http://www.hmrc.gov.uk/pbr2009/supplementary.htm#ia

HMRC conducted nine one to one external meetings; attended three meetings hosted by representative bodies to discuss the proposals and received fourteen written responses.

Responses to the first consultation were in general positive, both in relation to the modernisation proposals and the compliance checks changes. The first consultation successfully gained responses from across the different excise sectors and they helped refine the proposals.

Second Consultation (December 2009 – March 2010)

The second consultation was published on 9th December 2009, again providing a 12 week period for responses. With modernisation proposals being taken forward over a different time frame this iteration focused on the detail of proposed changes to the compliance powers within CEMA, with draft clauses published on 14th January 2010.

HMRC received written responses from across the regimes and held meetings which were attended by a variety of external stakeholders to discuss the details of the proposed legislation, as well as attending various other Fora. The key comments are outlined below. HMRC also held meetings with internal stakeholders with views sought from across the Department.

Responses were generally positive, recognising that HMRC is attempting to ensure it has all the tools necessary to tackle the illicit trade, whilst ensuring there is adequate and useful protection for legitimate businesses.

Option 3 – Modernise the excise compliance checking powers, including record-keeping requirements and time limits for assessing additional duty due or making claims for duty relief (Recommended)

The way in which HMRC checks that the right tax has been paid across the majority of HMRC taxes and duties is broadly similar. But there are key differences in the types of check required for goods based excise duty regimes and those required for other HMRC taxes and duties where the focus is much more on paper audit. Within excise goods based regimes the risk lies predominantly with the goods themselves, including their holding and movement in duty suspense, where the high margins provide an incentive for people to involve themselves in the illicit market for those goods.

Proposals Consulted on:

The second consultation provided detailed proposals on the following areas:

1. an aligned high-level record-keeping rules;
2. aligning time limits for claims and assessments to 4 years, retaining the 20 year extension for certain cases;
3. inspection powers amended in sections 112 and 118 CEMA to allow inspection of documents, and in section 161A to allow the search for documents under a warrant;
4. explicit prohibition of entry to premises used solely as a dwelling;
5. a new power that would enable HMRC to impose a penalty when an officer encounters obstruction on an unannounced visit. To use this penalty the visit would need to be pre-authorised by the tribunal; and
6. a new information power that would allow HMRC to seek information from other parties such as banks. Safeguards would be a formal notice requirement and new right of appeal.

It also sought views on proposals to improve the way HMRC shares information with external licensing authorities regarding excise wrongdoing by those with licences, and on whether there was any merit in looking to utilise VAT anti-fraud techniques in the excise arena.

Responses to the Second Consultation - Compliance Checks

1. Record Keeping – stakeholders generally felt the alignment was sensible, although there was some concern that it was not used to change the type of documents required to be retained which it was felt should always be related to business documents.

HMRC can reassure respondents that there are no plans to change the regime specific requirements in relation to records.

2. Time Limits – no issues were raised with the principle and it was generally considered that alignment with the other taxes was sensible. There were questions regarding whether transitional arrangements would be used.

HMRC can confirm that there are plans to use transitional arrangements, and that they are likely to be based on those used for the VAT changes,

3. Inspection Powers – stakeholders were generally supportive of the changes proposed. The focus on ensuring HMRC were able to access documents in relation to goods was welcomed, as was making it explicit that officers cannot enter solely domestic dwellings, although there were questions raised regarding the objectivity that would be applied to the concept of ‘solely’. There was support for HMRC using its powers robustly to target illicit trade, and a recognition that there should be detailed guidance for officers on how and when to use the various powers.

When the changes proposed are implemented HMRC will review the guidance available for officers and will ensure that it provides clear guidance on the changes and how the powers should be used, specifically in relation to domestic dwellings.

4. Information Powers – there was support for HMRC’s need to be able to access information to determine the provenance of goods. The need for tribunal approval to request information from a non-revenue trader was welcomed, but it was raised that the non-revenue traders should be able to appeal against supplying it, especially if there is a cost involved.

HMRC can confirm that those who are asked for information under an information notice will be given opportunity to provide representations if they do not think they should be required to. These representations will be supplied to the tribunal (possibly in summary form) as part of the application for the information notice.

5. Penalty for obstruction – There were no strong views either way in response to this idea. Although some stakeholders could see a theoretical use in having it they could not see that it would add practical value. There was particular concern that it would actually be used against the wrong people i.e. those left in charge of premises but who are not in control of the stock etc. There were also suggestions that to be effective the penalty would have to be so high that it would become disproportionate.

HMRC will not be taking forward this aspect of the proposals as a result of the various issues raised during consultation.

6. Information sharing – it was proposed that HMRC should be making better use of information that it holds on excise wrongdoing by those licensed to operate in the excise arena, e.g. retail sellers of alcohol, hauliers. There was mixed response to the concept. Although most saw some value in it, as an additional tool to restrict the amount of illicit market available, there were strong suggestions that various safeguards be put in place to ensure it could not be used against innocent parties.

HMRC can give reassurance that the information sharing proposal will have a range of safeguards built into the framework. The initial test for passing information will be three seizures from the same premises/person. Each of these seizures has an appeal right and a decision as to whether information will be passed will not be made until the opportunity for appeal has passed. A single HMRC team will have the responsibility for leading this work.

7. VAT anti-fraud concepts – HMRC also asked for views on the practicalities of using VAT anti-fraud concepts in relation to excise. Particularly whether there would be benefit in using a joint and several liability approach where a purchaser ‘knew or should have known’ that duty had not been paid on the goods they were buying, Although stakeholders welcomed HMRC looking for innovative ways to tackle the illicit trade there were concerns that the VAT approach had a disproportionate impact on legitimate trade and that it would not easily fit with transferral to the excise arena because of the significant differences in the way the duty is administered, However the work did highlight that some of the issues currently causing difficulty in this area may be addressed with the transposition of the EC Directive 118/08/EC in new Holding and Movements regulations. These regulations become effective from the 1st April 2010 and HMRC will monitor the impact that these regulations have, particularly in relation to this issue.

Again due to issues raised as part of the consultation this proposal is not being taken forward.

In light of these comments, and discussions with internal stakeholders, the penalty proposals and VAT fraud concepts will not be taken any further at this time. The impacts assessed below are therefore only in relation to the proposals being taken forward as part of the Finance Bill.

Full details of the responses, including issues raised that were outside the scope of the consultations, can be found in the Excise: Modernisation and Compliance Checks: the next stage, Consultation Response Document, March 2010.

Current Proposals

It was recognised throughout both consultations that HMRC needs distinct powers for excise, in order to operate the regime effectively and to successfully protect the public, the exchequer and the legitimate trade from the risks associated with illicit and counterfeit product. Whilst aligning record-keeping and time limits was seen as sensible, it was agreed early on that it was not appropriate to align excise information and inspection powers to the compliance checking framework introduced for the other taxes in FA 2008 and 2009. Different powers are needed when the risk is associated with goods and therefore the proposals have focused on making small amendments to the current legislation to ensure that the powers provide what is needed.

The legitimate trade recognised that HMRC need robust powers, acknowledging that safeguards would be in how those powers are applied. They were mainly focused on wanting HMRC to use its powers to their full force to tackle the illicit trade that can undermine their businesses.

Therefore the measure put forward is made up of the following components:

Align Record-keeping rules

The proposal is to align excise with the FA 2008 rules about record-keeping.

This will allow taxpayers to retain information rather than the original records themselves, unless conditions or exceptions are specified in writing by HMRC. Although it is not quantifiable, this should reduce the administrative burden on taxpayers who will be able to store all their records in the form most suitable to their business, with the same overarching principle governing record-keeping for all taxes and duties. It also represents a minor simplification by expressing the requirement in the same way across all taxes and duties.

There are no proposals to change the record keeping requirements specific to individual excise regimes, or the period for which records should be retained.

Align Assessment and claim time limits

The proposal is to bring excise time limits into line with time limits for the other taxes and duties, following the FA 2008 and 2009 changes. This means extending the three year limit for claims and assessments to four years. The 20 year extension will be retained but the behaviours that trigger its use will be aligned so that there is consistency. However the 20 year extension will not be triggered for a failure to notify unless it is deliberate, which is slightly different to other taxes.

Amend Information and inspection powers

Most people in the UK want to pay the tax and duty they owe; however for the minority their determination not to pay what is due is part of a wider failure to comply with the law. This is particularly true in relation to excise duties, where those who smuggle alcohol and tobacco may be linked to counterfeit products and the funding of organised crime. Therefore HMRC needs a framework for checking compliance that is strong enough to tackle illicit trade, and is an effective tool in protecting the public, the trade and the exchequer.

It is because of the additional risk that is inherent in goods based excise regimes that it is proposed that the framework set out in Schedule 36 will not be sufficient.

The first consultation highlighted the need to strengthen HMRC's ability to request the records necessary to establish the provenance of the goods. Therefore the amendments made to the CEMA powers largely focus on access to information.

The measure would now introduce the following amendments to the CEMA powers:

- to allow inspection of documents when entering premises of a revenue trader, or suspected revenue trader, under section 112 or section 118 CEMA;

- a legislative prohibition on entry to solely domestic dwellings (within both s112 and s118)'

- an amendment of section 161A CEMA to allow the search warrant to be used to search for documents relating to goods liable to excise duty; and

- to clarify the existing entry powers to include premises owned by others who are storing excise goods but who may argue that they are not revenue traders.

The proposals also introduce a new information power that is based in powers introduced by Schedule 36 for other taxes:

- The power would allow HMRC to ask for information from a wider range of institutions and individuals than is currently the case. The information must pertain to excise matters and the protection of the revenue, but using this powers it could be requested from for example a bank. The power has an inbuilt safeguard to ensure that it is used proportionately and appropriately, as this information can only be requested by a notice that has been approved by the tribunal.

Passing details of infringements to other UK regulatory authorities

HMRC is continuing to look at establishing a more consistent and regular approach to passing information about excise wrongdoing to the relevant UK regulatory authorities, so that this information can be used to inform their assessment of an individual's fitness to hold such a licence and prompt a review of the licence.

This would not require further legislation as HMRC is entitled to disclose information for the purpose of achieving its functions (under section 18(2) Commissioners of Revenue and Customs Act). HMRC has continued to work with the Home Office and other interested parties (particularly the Traffic Commissioners and Vehicle and Operator Services Agency) to establish the details and structure of a protocol.

The current suggestion is that HMRC would pass to external licensing authorities' information where there have been 3 or more failures to comply with the excise regimes (or where a substantial assessment is raised). The independent licensing authority would then be able to decide whether it was relevant to the criteria for retaining that licence. This would act as a deterrent to businesses who currently risk having goods seized due to the high returns but are less likely to risk losing a licence that is crucial to their business. It would also work for the benefit of legitimate traders who may see licences removed or amended for those businesses who are not acting legitimately, and therefore are able to undercut prices.

HMRC would in no way seek to influence how the information was used, as a key safeguard is the independence of the licensing authority.

This work will continue, and although a legislative change is not required, the benefits of the change are included below as this could have an important impact on HMRC's work to tackle those repeatedly found to be engaged in excise wrongdoing.

Implementation

A discrete team within the Compliance area will lead on the implementation of the changes to CEMA, as part of their work on New Ways of Working. Although the changes to excise are different and less substantial, the experience they have of implementing the changes to compliance checks (main and other taxes) legislated in FA 2008 and 2009 will be invaluable. As part of this role they will be working to update guidance and develop training material which, as previously, they aim to share with key stakeholders.

The work of the team will be overseen by a Project Board which has experience of working on the implementation of previous changes.

Further details on the costs are detailed below.

New proposals: Impact

Revenue

There may be an impact on revenue from changes to time limits, as it will allow taxpayers to make a claim for repayment and HMRC to assess for duty for an additional year.

The level of repayments within excise varies from regime to regime. Approximately £160m is repaid, in total, every year. The majority of this amount is made up of drawback[9] claims from hydrocarbon oils and alcohol (£81 million and £24 million respectively). These drawback claims are sent in quarterly as soon after the relevant event as possible. Therefore the extension to 4 years is likely to have a very limited impact on the value of claims.

As an indication of the amounts involved, in 2007-08 for excise duties there were £170 million in net additional revenue from duty assessments and error corrections by taxpayers.

To try to determine what the overall impact of this change will be on revenue a sampling exercise has being carried out by HMRC's operational areas. This looked at the number of assessments that were affected by the current 3 year cap as a proportion of assessments raised by those areas. It was not possible to carry out a representative sample because of the time it would have taken. So the number of cases that were reviewed across the different areas means that these figures are merely indicative.

The results show that the number of cases per year currently impacted by the 3 year cap is very small. It is assumed that the number of cases using the extension to 4 years would be the same percentage as those currently using the full 3 years, and that the same amount will be assessed for the fourth year as the third year. The result would be an increase in the value of assessments by up to £2 million per annum[10]. This is a negligible increase in revenue and supports the anecdotal view given in consultation

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[9] Drawback allows for the repayment of excise duty paid on goods that have not been and will not be consumed in the UK.

[10] This is an upper estimate.

meetings, where experience (rather than data) suggested that there would be a minimal impact on traders since it was very rare for circumstances to arise where there would be need to go back 3 years for either a claim or an assessment.

Costs

Implementation

There may be one-off ‘implementation’ costs for some taxpayers and agents as they learn about the changes. The cost is likely to be limited as the proposed changes are relatively minor and amend existing legislation rather than replacing it. The key area will be the new information power and the obligations around it. However as this is based on the powers within Schedule 36 it is expected most will be familiar with the processes. HMRC will also share its own training and guidance where appropriate.

There will be costs for HMRC in training operational and policy staff involved in excise duties, but the type and intensity of training will vary according to their roles. This will be a one-off cost as future training programmes will incorporate the changes for new staff and therefore will be part of business as usual costs.

Although more work is needed to develop the training packages and establish the precise length and nature of the training required, initial figures show between 3,000 and 3,500 staff will need training to some degree. Approximately 2,000 staff will only need a short update on the minor change to the scope of the warrant which is expected to take up to an hour (i.e. to allow search for documents as well as goods). Others will need more comprehensive training to ensure they are versed in all the changes applicable to their work and regimes. This is likely to be completed through e-learning. There may need to be some face-to-face training for up to 80 managers, and this is expected to take up to 1 day (at a cost of £150 – 175 per day per person).

The costs of training the staff and updating guidance will be small and will be absorbed as part of normal business activity.

Information Sharing

The proposals to have a more consistent process for sharing information with licensing bodies suggest using a central team to coordinate what cases are passed, so that they can take a view on the proportionality issues involved in each case and provide oversight on what information is actually sent. It is expected that this role will sit within an existing team and form part of their established business, therefore not requiring any additional funding.

Benefits

The impact on HMRC costs and yield from checking will depend on a large number of factors, including how many checks are carried out, how well they are targeted, and the extent and nature of non-compliance in the UK in future years.

Taxpayers will benefit from aligned record-keeping rules that will be consistent across the tax regimes. Whilst specific requirements will remain in place for the regimes uniform underlying rules will help taxpayers understand their obligations.

They will also benefit from a single set of time limits in respect of claims and assessments, as this will apply across their various tax obligations. Modernised criteria for engaging the 20 year extension will also link into the language used in Schedule 36 FA 2008 so that taxpayers can better understand what their rights and obligations are.

Key benefits for taxpayers in relation to the inspection and information powers will stem from knowing that the powers are fit for purpose in relation to tackling the large levels of fraud that take place in these regimes, and that HMRC is able to operate them effectively. The modernised powers will support the revised Alcohol Strategy which is changing the way that HMRC resource is used, to ensure that it is utilised to target the higher risk areas.

Legitimate businesses in the excise sector understand that the powers need to be sufficient to deal with the fraudulent end of the market, and therefore appreciate the need for specialist powers regarding entry, access and information. They also gain significant benefits from using duty suspension arrangements and so accept that in exchange for those benefits they agree to certain conditions, such as unannounced visits. Stakeholders have also repeated throughout the consultation that these powers provide an important reassurance to business that HMRC is acting to protect them by reducing the quantity of illicit product on the market. These powers will assist HMRC's operational ability to level out that playing field and reduces instances of them being undercut by illegitimate competitors.

The type of checks that can take place under the powers in relation to excise products also produces higher levels of confidence in consumers, who would be at risk from counterfeit products entering the market.

There should also be a benefit to legitimate business if work to establish an information sharing protocol with licensing authorities is completed. Although no legislative change is required HMRC has carried out some work to assess the impact of the protocol. Conducting a sample of seizures over a year (2006/7) 203 traders would have fallen within the 3 seizures rule. This is not a substantial number in terms of work load for HMRC or receiving authorities, however these traders made up 24% of total seizures. Therefore the benefit of an additional deterrent via the licensing authority is could be considerable.

Specific Impact Tests: Checklist

Full details of the specific impact tests are listed at: http://bre.berr.gov.uk/regulation/ria/toolkit/specific_impact_tests.asp. These have been applied to the options considered in this consultation.

The process of Equality Impact Assessment screening has been started and this will continue during the course of consultation and policy development.

Competition Assessment

The aim of the modernisation options considered was to make systems and procedures simpler for businesses to operate, while providing greater certainty about how HMRC views the way in which businesses manage and conduct their tax affairs.

Under the amended compliance powers, those businesses that HMRC does not view as low risk could expect to spend more time dealing with HMRC and those classified as low risk will usually spend less. But this will not impact on any business's capacity to enter markets or compete rigorously within them. These powers should help HMRC to more effectively tackle the illicit market in the excise sectors therefore improving the 'level playing field' for compliance businesses.

Applying the Office of Fair Trading's competition filter we have considered whether the proposals contained within the consultation would:

1. Directly limit the number or range of suppliers?
2. Indirectly limit the number or range of suppliers?
3. Limit the ability of suppliers to compete?
4. Reduce suppliers' incentives to compete vigorously?

1. The modernisation proposals, once fully implemented, will not impact on the number or range of suppliers as the idea behind these is to simplify the administration processes for businesses involved in excise regimes. The compliance checks will apply to all businesses, as currently, and there is no evidence that the proposals will impact on the ability of compliant businesses to trade. The revised compliance checks should help HMRC reduce the level of illicit product on the market, improving the ability of legitimate traders to compete

2. There have been no indications that the proposals will indirectly impact on the number or range of suppliers.

3. The compliance checking proposals should improve the ability of legitimate businesses to compete by making it easier for HMRC to remove illegitimate traders from the market. This will mean that legitimate businesses will not be struggling to compete with the significantly lower prices of illicit goods.

4. The proposals will in no way impact on the incentives for suppliers to compete vigorously.

These proposals will not therefore have a negative impact on competition within the excise sector. If the amended powers are taken forward they may help to improve the 'level playing field' and encourage competition by reducing the numbers of those trading in illicit goods.

Small Firms Impact Test

The modernisation proposals within this consultation are designed to reduce administrative burdens on the average compliant business. It is therefore appropriate to encompass all small firms to ensure that they can also access the cost savings. During the consultation process there have been no comments regarding disproportionate impact on small businesses.

The compliance checking proposals will generally not increase costs for compliant businesses. Views have been sought from small businesses during consultation..

Legal Aid

These proposals would not significantly increase legal aid impacts.

Sustainable Development

These proposals are in accordance with the principles of sustainable development. Simplified administrative processes, and increased ability to tackle the illicit market, supports the principles of a sustainable economy.

HMRC has committed to five principles of sustainable development. These are

1. Living within environmental limits;
2. Ensuring a strong, healthy and just society;
3. Achieving a sustainable economy;
4. Promoting good governance; and
5. Using sound science responsibly.

The proposals within this consultation do not impact on the first and fifth test as there is no use of science or any impact on environmental limits.

However simplification of the administration processes through modernisation and enhanced powers to assist in tackling the illicit sector of the excise market can be seen to contribute to ensuring a just society and a sustainable economy. This is particularly relevant in relation to the serious non-compliance that takes place within excise which has been used to fund organised crime. If HMRC can better tackle those involved it supports the principle of a just society. This will also help ensure that the market for excise goods becomes more legitimate and therefore promotes the sustainability of that sector.

Environmental Impact Tests

Carbon – the proposals have no significant carbon emissions impact.

Other Environmental – the proposals have no significant environmental impacts.

Health Impact

Using the Health Departments three stage screening questions it can be seen that the proposals have no significant impact on health or well-being, and therefore a complete health impact assessment does not need to be completed. However, HMRC's enhanced compliance checking powers may help to reduce risks to health by removing and preventing the sale of potentially harmful counterfeit excise goods to the public.

1. The proposals will have no direct or significant impact on health through its effects on Income, Crime, Environment, Transport, Housing, Education, Employment, Agriculture or Social cohesion. There is the possibility for a minor impact on the reduction of crime through the improved compliance checking powers but this is in relation to crimes of failing to pay duty rates and therefore any following impact on health would be minor.

2. There will be no impact on the lifestyle variables such as physical activity, diet or sexual behaviour. We can speculate that there may be an impact on alcohol use in that reducing illicit activity may push the market price up, by limiting the amount of non-duty paid product available. However that is speculative and would have a very minimal impact.

3. There will be no impact on health and social care services from these proposals.

Rural Proofing

There are no indications that these proposals will impact differently in rural areas.

Equality Impacts Tests

Equality Impacts have been considered as part of the consultation process for these proposals. This has been done in conjunction with the customer units, and reviewed with external stakeholders. It indicates that these proposals:

- will have no significant race equality impact.
- will have no significant disability equality impact.
- will have no significant gender equality impact.

The Review has undertaken Equality and Privacy Impact screening as part of developing and consulting on the proposals for this measure. No requirement for full impact assessments on these issues has been identified. The adjustments identified as part of the Review are for operational business and implementation. The Review will continue to monitor progress on these.

Human Rights

The potential impact on human rights of these proposals has been considered as part of the development of these options. The powers covered by the proposals are modernised versions of the previous CEMA powers. These powers give rise to Human Rights compatibility considerations. Our analysis is that these powers are for legitimate purposes, are lawful and proportionate, therefore justifying any interference with Human Rights. Further more the powers are supported by those who are legitimately operating in the excise arena.

The current powers were reviewed in 1998 to ensure that they were compatible with the, then new, Human Rights Act. They were held to be compliant and therefore the modernisation of those powers is also considered to be human rights compliant.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Summary: Intervention & Options

Department /Agency:	**Title:**	
HMRC	**Impact Assessment of a change to the standard rate of VAT**	
Stage: Implementation	**Version:** 1.0	**Date:** 22 June 2010
Related Publications:		

Available to view or download at:

http://www.hmrc.gov.uk/better-regulation/ia.htm

Contact for enquiries: Ian Allen/Kevin Reid **Telephone:** 0207 147 0009

What is the problem under consideration? Why is government intervention necessary?

The most urgent task facing the country is to implement an accelerated plan to reduce the deficit. Reducing the deficit is a necessary precondition for sustained economic growth. Given the scale of the fiscal challenge, tax must contribute to the task of cutting the deficit.

What are the policy objectives and the intended effects?

The proposed increase in the standard rate of VAT will result in increased tax revenue, which will contribute to the necessary tackling of the deficit, and it will support a rebalancing of the tax system from direct to indirect tax.

What policy options have been considered? Please justify any preferred option.

As part of the Budget process, the Government concluded that the package including a VAT increase was consistent with a sustainable and economically efficient reduction in the deficit. To minimise the costs to business, the Government is implementing the increase in the standard rate of VAT from 17.5% to 20% in one step, rather than increasing it in a number of phases. Recognising the problems for retailers and others in implementing a rate change over the New Year, it will take effect on 4 January 2011.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? For all policy changes, compliance costs are routinely reviewed one to three years after implementation.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:

Date: 22 June 2010

Summary: Analysis & Evidence

Policy Option: 1	Description: Change to VAT standard rate

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups' Expected costs are from familiarisation with the changes, re-pricing, book-keeping and accounting checks, and system changes. The revenue effects of the policy are discussed in the Budget document.
One-off (Transition)	**Yrs**	
£ 300m	1	
Average Annual Cost (excluding one-off)		
£ 0		**Total Cost** (PV) **£ 300m**

Other **key non-monetised costs** by 'main affected groups'

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' The overall benefits of the policy are discussed in the Budget document.
One-off	**Yrs**	
£ -		
Average Annual Benefit (excluding one-off)		
£ -		**Total Benefit** (PV) **£**

Other **key non-monetised benefits** by 'main affected groups' The key benefits will be felt in terms of the wider public finances as the increase in the standard rate of VAT reduces the UK budget deficit.

Key Assumptions/Sensitivities/Risks This Impact Assessment looks at the one off compliance costs to business to implement the increase in the VAT rate. The Exchequer effect is not included in the costs and benefits figure above as in economic terms it represents a "transfer" being both a cost to the individual taxpayer and a benefit to the public finances.

Price Base Year 2010	Time Period Years	**Net Benefit Range** (NPV) £	**NET BENEFIT** (NPV Best estimate) £

What is the geographic coverage of the policy/option?			UK	
On what date will the policy be implemented?			4/1/2011	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			£ Negligible	
Does enforcement comply with Hampton principles?			Yes	
Will implementation go beyond minimum EU requirements?			N/A	
What is the value of the proposed offsetting measure per year?			£ 0	
What is the value of changes in greenhouse gas emissions?			£ not quantifiable	
Will the proposal have a significant impact on competition?			No	
Annual cost (£-£) per organisation (excluding one-off)	Micro **£0**	Small **£0**	Medium **£0**	Large **£0**
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)
Increase of £ 0	Decrease of £ 0	**Net Impact**	£ 0

Key: **Annual costs and benefits: Constant Prices** **(Net) Present Value**

Evidence Base (for summary sheets)

1. The Issue

1.1 The Government recognises that action to tackle the fiscal situation is essential.

2. Policy objectives and intended effects

2.1 The objective of increasing the standard rate of VAT to 20 per cent is to contribute to the key objective of deficit reduction. Increasing the standard rate of VAT from 17.5 per cent is estimated to result in around £12.1 billion in additional Exchequer revenue in 2011-12, rising to around £12.5 billion in 2012-2013.

2.2 The increase in the standard rate is also expected to bring forward business and consumer spending, before the rate change takes effect.

2.3 In order to minimise the costs to business we are implementing the increase in the standard rate of VAT from 17.5 per cent to 20 per cent in one step rather than increasing the rate in a number of phases.

2.4 This Impact Assessment (IA) focuses on the identified compliance costs for business to implement the increase in the VAT rate. The Exchequer effect is not included in the costs and benefits figures in this IA as in economic terms it represents a "transfer", being both a cost to the individual taxpayer and a benefit to the public finances.

3. Data and evidence

3.1 Following the temporary change in the standard rate of VAT from 17.5 per cent to 15 per cent on 1 December 2008, HMRC contracted the research company ORC International to undertake a telephone survey of 2,000 VAT-registered businesses. The survey focused on obtaining detailed information on costs incurred by businesses as a result of the rate change to 15 per cent, in order to gather a stronger evidence base. It included gathering data on time taken, shares of businesses undertaking certain activities, and the level of personnel involved. Hourly rates are derived from the Annual Survey of Hours and Earnings (Office for National Statistics).

3.2 The main quantitative fieldwork took place in May and June 2009, and so the research does not measure the impacts of the return on 1 January 2010 to the 17.5 per cent standard rate of VAT.

3.3 The evidence used in this IA draws strongly on this external research. In summary, the key findings of the research are:

- Following the VAT rate change in December 2008 the majority of businesses took less than five hours to adjust to the new VAT rate, but nearly a third took more than five hours.
- Following the VAT rate change in December 2008 businesses undertook a number of activities in order to implement the rate change. Over three quarters of businesses surveyed had to familiarise themselves with the details of the rate change, and just over two thirds had to make system changes and pay more attention to book-keeping arrangements. Just over one quarter had to make additional changes to prices.

Activity	Percentage of businesses surveyed
Familiarisation	78
Extra book-keeping checks	71
System changes	67
Extra operational activities*	43
Extra changes to prices	27

*"Operational activities" are tasks thought not to be essential to implement the rate change, but tasks businesses decided to do.

- o In terms of overall compliance costs looking at both time and activities together, familiarisation represented the largest proportion of the total burden.

Activity	Percentage of overall time taken
Familiarisation	38
Extra book-keeping checks	31
System changes	23
Extra changes to prices	8
Total	100

- o Larger businesses were more likely to spend longer complying with the rate change.
- o The impact of implementing the rate change varied across sectors. The research found that the public administration and defence sector, the human health and social work sector and the electricity, gas, steam and air conditioning sector showed a larger compliance burden.
- o Across all sectors, managers and senior officials were commonly involved. This was particularly the case for familiarisation-type activities, since this category, in the external research, captured time spent making commercial decisions.

3.4 At face value, the research suggests a total cost to business of the VAT rate change in December 2008 (as perceived and reported by businesses) of around £500 million. However, it is not appropriate to use this face value figure directly in this IA for two key reasons:

- o It includes time taken by businesses to undertake discretionary activities such as deciding whether to pass the VAT rate change on to customers and other commercial decisions. While it is acknowledged that businesses may choose to do these things, they do not have to do so in order to comply with a change in a rate of VAT. For this reason, the IA focuses on those activities a business <u>must</u> carry out in order to implement the VAT rate change.
- o The research also includes a number of outliers within the results; for example, businesses with atypically high reported compliance costs. Since impact assessments aim to examine the impacts of regulatory changes on typical and normally efficient businesses, the effects of these outliers should not be included within the headline figures of the IA. However, we recognise that some businesses with particularly extensive and/or complicated business arrangements will face higher compliance costs compared to others.

3.5 We have carried out detailed analysis of the research, with the aim of quantifying discretionary activities and atypically high reported compliance costs. Our cautious estimate is that accounting for both of them together decreases the original £500 million estimate to around £350 million.

3.6 Our internal analysis of the research has also identified a number of other broad findings, including:

- o Half of the surveyed organisations reported compliance costs of below £85. A significant minority of businesses did report very high compliance costs, around 10 per cent of those surveyed reported costs greater than £1,200. Consequently it is clear that there is a wide range of costs surrounding the broad figures for typical businesses as set out in this IA.
- o As identified in the research, we found that there was a positive link between compliance costs and business size which was statistically significant. This is in line with the expectation that larger businesses have more staff to inform, more goods and services that might be affected, and are more likely to have complex systems to adapt.

- Businesses reporting that the VAT rate change was passed on in full or in part tended to experience higher compliance costs. The expectation is that businesses passing on the VAT rate reduction to their customers are more likely to have spent time deliberating on their course of action, increasing the time taken and therefore the cost.
- Businesses supplying goods and services to final consumers rather than to other businesses tended to incur higher compliance costs. The rationale for this is that businesses supplying to final consumers are likely to have had to take more time and effort to re-price goods and services and re-print promotional materials. Businesses selling mainly to other businesses are more likely to be trading in terms of VAT-exclusive prices (since in many cases VAT can be recovered at this stage in a supply chain) and may have only had to focus on altering invoices.
- In addition to those sectors identified in the research (see paragraph 3.3), the education, manufacturing and accommodation & food sectors particularly seemed to face relatively high compliance costs. However, sectors such as agriculture, forestry & fishing, administration & support services, transport & storage, and arts, entertainment and recreation appeared to face particularly low compliance costs compared to other sectors. The reasons for these results are likely to vary from sector to sector, but broadly seem to reflect the type of customer and/or likely re-pricing costs (with some exceptions).

3.7 The research dealt with the initial VAT rate change to 15 per cent, and did not cover the subsequent rate rise. Although the survey asked businesses if they thought the costs of subsequent changes would be reduced as the experience of implementing a change became more familiar (and at the time only around a quarter of responses thought there would be such an effect), it cannot tell us whether businesses actually found the reversion in January 2010 to 17.5 per cent to be easier and less costly.

3.8 However, the initial change to 15 per cent in December 2008 was the first change in the standard rate of VAT for more than 17 years, whereas there have now been two VAT rate changes in the last two years. We expect that this will have helped reduce compliance costs for future VAT rate changes below the levels described by the survey. This is for a number of reasons:

- Businesses will have more direct experience of VAT rate changes; the degree of learning involved in this should help make the process more efficient.
- Some IT systems may now be more flexible and less costly to alter, having dealt with two recent VAT rate changes.
- HMRC has published extensive guidance to business for the last two VAT rate changes and will do so again for this VAT rate change. See section 8 of this IA.
- The lead-in time for a further VAT rate change (from both press and industry speculation and the gap between the time of announcement on 22 June 2010 and implementation on 4 January 2011) can reasonably be expected to help businesses manage this rate change more efficiently.

3.9 As a result of greater familiarity and efficiency with rate changes, we anticipate that the non-discretionary costs of this rate change as measured by this IA are likely to be lower than the cautious starting value of the estimated £350 million referred to above. Based on the research along with our own further analysis of the data our best estimate is that the total compliance cost for a further rate change is more likely to be in the order of £300 million. The detailed breakdown of that figure between the different types of compliance costs is set out in section 5 below.

4. The Options

VAT rates and exemptions

4.1 VAT is a tax on the final consumption of goods and services, collected at every stage of production and distribution. It is currently charged on the majority of goods and services at the standard rate of 17.5 per cent. The announced change to the standard rate will permanently increase this to 20 per cent with effect from 4 January 2011.

4.2 VAT is charged on a select group of goods and services at either a zero rate (including most food and non-alcoholic drinks, books and magazines, children's clothing and footwear, construction of domestic dwellings, domestic passenger transport, and drugs and prescriptions) or a reduced rate of 5 per cent (including domestic fuel and power). These rates will be unaffected by the proposed change. A number of goods and services are exempt from VAT because it is considered inappropriate to tax them (including public services such as health, education and welfare) or they are too technically difficult to tax (including financial services). There will be no change to the VAT exemptions.

Flat Rate Scheme and Payment on Account (POA) regime

4.3 Following on from the increase in the standard rate of VAT there are consequential legislative changes that will be made to the Flat Rate Scheme (FRS).

4.4 The FRS is an optional simplification scheme available to businesses with a VAT exclusive turnover not exceeding £150,000. Instead of paying HMRC the difference between tax charged on sales and tax they can reclaim on purchases and expenses, users account for VAT by multiplying their gross turnover by a single percentage. There are 55 different sectors with flat rates currently ranging from 3.5 per cent to 13 per cent, calculated by reference to the actual net VAT paid by all eligible businesses in the sector who use normal VAT accounting. The flat rate percentages will be increased in line with the increase of the standard rate of VAT from 17.5 per cent to 20 per cent.

4.5 Until the 4 January 2011 increase in the standard rate of VAT takes effect, businesses have to leave the FRS when their VAT inclusive turnover exceeds £225,000 (unless that is due to a one off transaction and there is an expectation of falling back below a VAT inclusive threshold of £187,500 in the following year) or it is likely to exceed £225,000 in the next 30 days. With effect from 4 January 2011 these thresholds will be increased to £230,000, £191,500 and £230,000 respectively to ensure that no business has to leave the FRS solely as a result of the increase in the standard rate of VAT to 20 per cent.

4.6 The POA regime requires all VAT-registered businesses with a current annual VAT liability of £2 million or more to make interim payments on account at the end of the second and third months of each VAT quarter. A balancing payment for the quarter (the quarterly liability less the payments on account made) is then made with the VAT return. The level of interim payments that apply for one year is based on the VAT liability of the business in the previous year. Businesses whose annual liability falls below £1.6m can apply to leave the POA regime.

4.7 The POA thresholds will be revised at a later date to reflect the increase in the standard rate.

4.8 Accordingly these consequential changes maintain the status quo in terms of businesses who choose to join/leave the FRS or are required to operate the POA regime. Therefore we consider that there are negligible compliance or administrative burden costs for businesses in respect of either of these consequential changes.

Number of businesses affected

4.9 There are currently around 1.95 million businesses registered to pay VAT in the UK. There are also an estimated 2.9 million businesses in the UK that are not registered for VAT. All UK VAT registered businesses will be affected to some degree by the proposed changes, and will have to make appropriate changes to their business systems.

5. Costs

5.1 There is no ongoing increase in the administrative burden (measured by the Standard Cost Model) of the VAT regime as a result of the rate change because the obligations to register for VAT, complete returns and pay VAT are unchanged. However, administrative burdens are only a subset of overall compliance costs. Other compliance costs include the one-off costs of transition and change (such as time spent becoming familiar with new VAT rules). It is these wider one-off costs which cover the impacts of a VAT rate change and which are the subject of this IA.

5.2 As set out in section 3 above this IA includes our best estimates of compliance costs for typical, efficient businesses. Therefore, we recognise that there will be businesses whose compliance costs are either higher or lower than the ones quoted in this IA, due to variations from business to business. It is accepted that there will be a significant one-off compliance cost for businesses in implementing the rate change, currently estimated at around £300m in total.

Caveats and risks

5.3 It is recognised that consumer facing businesses, such as retailers, incur the biggest costs when there is a VAT rate change. Furthermore it is acknowledged that every business is different, and that there can be a very wide variation in many business characteristics not explicitly captured by describing them, for example, simply as "small" or "large" businesses. We expect a very long tail in the distribution of small businesses; with the very smallest having very simple VAT affairs and potentially much lower costs than one towards the other end of the range of "small" businesses. In view of this, for each size group of affected businesses, we aim to describe the impact on a "typical" business within each size band. However, we recognise that because of this, many businesses may feel they are not described by the necessarily broad analysis in this IA.

Categories of costs

5.4 The expected one-off compliance costs fall into the following categories:

- Familiarisation
- Re-pricing and invoicing changes
- Extra accounting and book-keeping checks
- System changes/upgrades

5.5 All monetary amounts given in the sections below are in 2010 values. Although there is no administrative burden impact, the Standard Cost Model has been used to inform some details such as the distribution of VAT registered businesses between size bands, and the basis for hourly rates for various grades of personnel. The data on time taken by businesses are derived from averages within the research after excluding particular outliers. Information on the split of businesses across the size bands undertaking particular activities and the typical level of personnel involved are also taken from the core research data, after controlling for outliers. Typical wage levels are derived from the Annual Survey of Hours and Earnings, by the Office for National Statistics (uprated to include overheads and including a standard assumption of wage growth of 3.5 per cent per year).

Familiarisation

5.6 This category focuses on the time businesses will need to spend reading about and understanding the nature of the changes, as well as briefing staff.

5.7 It is recognised that there could be other potential familiarisation costs to businesses such as:

- deciding whether to pass on any increase in full to their customers, and if so to what extent across the whole of their business;
- consulting advisors, and

- (if businesses have contracts inclusive of VAT) potentially renegotiating terms of contracts.

5.8 However, while it is recognised that, in practice, some businesses may decide to incur such costs in light of commercial realities, since these costs arise from commercial decisions rather than being required in order to implement a VAT rate change they are not analysed as part of this IA.

5.9 Section 3 of this IA detailed the rationale for expecting further VAT rate changes to be less costly than the VAT rate change in December 2008. It is expected that this will apply in particular to costs related to familiarisation. To reflect this, the research estimates of familiarisation time in respect of the December 2008 change have been reduced by 25 per cent for the purposes of this IA.

5.10 Working from the survey data after the adjustment mentioned directly above, our estimates for familiarisation costs are based upon a range of between 1.3 hours for a small business with the simplest VAT affairs to 33 hours for a large business (taking into account that large businesses may also want to consult advisors).

5.11 According to the research, senior staff tend to be the majority of personnel involved in all size categories, though the trend is for more junior staff to play a part as businesses increase in size. The research indicates that nearly 85 per cent of familiarisation activities for the very smallest businesses were by senior staff, declining to around 50 per cent for the largest businesses.

5.12 Overall, the estimated familiarisation cost for the typical smallest business is around £15 per business, rising to around £500 for a typical larger business. In total, the cost of all familiarisation activities is estimated at around £65 million.

Re-pricing and invoicing changes

5.13 To prepare for the increase in the standard rate of VAT all VAT registered businesses selling standard rated goods, and particularly for those selling to final consumers, will need to re-price their products. The identified costs are, for example, re-labelling the prices of goods and altering bar code system databases, including on tills.

5.14 Traders are required to display clearly their prices inclusive of VAT. For a period up to 28 days they are permitted under the Price Marking Order 2004 (the Order) to let consumers know, by way of a general notice, that an adjustment in price, to take account of the VAT change will be made at the till. Following a consultation by the Department of Business, Innovation & Skills the 28 day period was increased from the previous 14 days allowed under the Order specifically in time for the last VAT rate change.

5.15 Businesses will also need to update their invoicing arrangements to reflect the increase in the VAT rate. It is expected that this update will be relatively straightforward, and should not take long to implement. However there will be some more complex changes, for example continuous supplies spanning the rate change, credit and debit notes, advance payments, returns of goods and contracts with fixed interval payments, where an affected business will need to establish which rate of VAT should apply to the particular transaction.

5.16 We expect that businesses affected by the two recent rate changes will make use of their experience when undertaking re-pricing which may reduce the costs they incur. The increased notice period under the Price Marking Order 2004 also allows traders more time to re-price their products in order to comply with the VAT rate change. We understand that businesses in certain sectors require a certain minimum lead-in time in order to update price list material that they make available to their customers. Such businesses are expected to incur higher re-pricing costs. Since this rate change is being announced on Budget Day, to take effect from 4 January 2011, we consider that this gives all businesses sufficient notice to make these changes.

5.17 Re-pricing is an exercise that will take a significant amount of time for businesses that have a large number of product lines, and its complexity will depend, in part, on how simple it is to update the existing system to reflect any increase in prices passed on to customers. It is recognised that certain sectors are likely to be hit harder than others in respect of re-pricing costs, such as restaurants and catalogue and mail-order businesses.

5.18 Based on the research, it is thought that the typical smallest businesses might each spend around one hour making these changes, while a typical large business could spend around 13 hours. Again, it is expected that senior personnel will be involved the most in making these changes; analysis of the research suggests that senior staff carried out 100 per cent of the re-pricing activities for the smallest businesses, falling to around 40 per cent for larger businesses.

5.19 Costs per business may be in the region of £5 and £125 for the typical smaller business to the typical larger businesses respectively.

5.20 In total re-pricing and invoicing costs are estimated to be around £35 million.

Extra accounting and bookkeeping checks

5.21 VAT registered businesses supplying standard rated goods and/or services where manual records are maintained in order to complete the VAT return may incur additional costs in checking that the correct amounts of VAT are included on the first VAT return due following the rate change. This is because businesses keeping manual VAT records will need to take extra care with their billing and accounting systems to take account of both supplies subject to the 17.5 per cent rate and those subject to the new rate of 20 per cent.

5.22 We consider that, generally, businesses will only need to make the changes to their accounting arrangements once, in time for their first VAT return after the rate increase. However, for businesses with a lot of product lines this can create a lot of work which is simpler to undertake in advance of transactions taking place. We expect that those businesses which were required to implement the recent VAT rate changes will have developed or improved processes to minimise costs in this area.

5.23 We expect that electronic accounting systems which can alter the VAT rate (see below) will include these checks automatically. Based on recent HMRC research it is expected that relatively few businesses use non-electronic accounting systems and that the vast majority of businesses that maintain paper records are small businesses with relatively simple VAT affairs.

5.24 Affected businesses will also need to pay extra attention to checking their accounts and VAT returns when the rate changes. This may lead to extra in-house costs for those businesses performing their own accounts work. Other businesses are likely to incur additional accountancy fees because they rely on an accountant or similar to complete their VAT return, whose services will need to be employed for longer in order to ensure that returns are correct.

5.25 From our further analysis of the research, we estimate that these extra accounts and bookkeeping checks could take around one and three quarter hours for the typical smallest businesses and up to around 33 hours for a typical large business. In keeping with the other categories of compliance cost, the research shows that senior personnel tended to be involved the most; around 85 per cent of the smallest businesses used senior staff to carry out these extra checks, while around 66 per cent of larger businesses used senior staff.

5.26 Costs per business may be around £20 - £25 for the smallest affected typical businesses, rising to around £650 for the larger typical businesses. In total it is estimated that the cost would be around £115 million. This total compliance cost is expected to be the largest out of all the identified categories.

System changes/upgrades

5.27 This category focuses on the costs involved in changing systems and upgrading software to cope with the rate change. Some businesses' electronic accounting systems may not be able to automatically alter the VAT rate and new systems or upgrades will be required. This might include either purchase costs and/or time costs for installing those new systems.

5.28 Following the two recent VAT rate changes it is assumed that the vast majority of VAT accounting packages will have the flexibility to adapt to the change and consequently full upgrades will not be required. However, it is expected that VAT registered businesses will need to alter systems in some form.

5.29 In general, smaller businesses might have to purchase patches or upgrades to accounts packages; on the other hand, these upgrades might be provided free by software providers as part of existing upgrade processes. Larger businesses might have to purchase upgrades to systems to accommodate the changes, while on the other hand these changes may be captured by terms of existing IT support contracts and not represent an additional cost.

5.30 However, purchase costs are not expected to be significant in the wake of the previous two VAT rate changes. It is expected that most businesses will, by now, have sufficiently flexible systems and will not need to make additional purchases. The research into the December 2008 rate change indicated that time-based costs accounted for around 95 per cent of all costs incurred, indicating that purchase costs were comparatively small even then.

5.31 Analysis of the research suggests that typical smaller businesses might take just over one hour and typical larger businesses with more complex systems might take around 35 - 40 hours. Smaller businesses again tend to carry out these activities with senior staff; however, according to the research, some businesses in the middle of the size distribution seem to give the job to junior staff, whereas larger businesses rely on intermediate-level staff. This pattern may be an anomaly in the research.

5.32 The estimated costs are estimated to range from £10 for a smaller typical business to around £650 for a larger typical business. In total, the estimated total cost of system changes is around £85 million. This is the second highest category of compliance cost.

6. Summary of total business cost impacts

Table 1: Total estimated compliance costs summary (2010 values, £ millions)

	2010-11
Familiarisation	65
Re-pricing and invoicing changes	35
Accounting and book-keeping checks	115
System changes	85
Total	**300**

7. Impact on HMRC

7.1 HMRC computer systems will require updating to reflect the change in the rate. However, the cost of these changes is minimal. There will be some costs in providing the additional advice and guidance on rate changes.

8. Implementation plan

8.1 HMRC will publicise the VAT rate change to all VAT registered businesses.

8.2 For the last two VAT rate changes HMRC published extensive guidance to businesses on what they would need to do to comply with the rate change. The feedback was that the guidance was helpful to business. Therefore HMRC will again publish extensive guidance to assist businesses in complying with this rate change. It will include general guidance on charging and accounting for the rate change, the rules for sales spanning a rate change, and special VAT accounting schemes such as the Flat Rate Scheme and Payment on Account regime. It will also provide specific guidance for particular sectors including retail businesses and the construction sector and guidance on transactions that are particular to certain business sectors. The guidance will be published on HMRC's website on Budget Day, so that it is available as soon as possible for businesses to familiarise themselves with the impact of the rate change.

8.3 HMRC intends to operate a light touch in relation to errors arising from the rate change and will publish details of the light touch guidance provided to HMRC staff on Budget Day. In summary HMRC will not target change of rate errors made in the first VAT return after the change where such errors are unlikely to lead to a material net revenue loss. If HMRC finds errors that relate to a change of rate issue HMRC will not seek an adjustment unless HMRC has reason to suppose that there is an overall revenue loss. Where HMRC needs to adjust, consideration will be given to difficulties faced by a business in adjusting to the rate change in terms of whether penalties apply.

9. Specific impact tests

Competition assessment

9.1 All VAT registered businesses selling standard rated goods and services will be affected equally, so competition between these businesses will not be affected. VAT charged on supplies to fully taxable businesses can usually be reclaimed in full, regardless of what rate of VAT applies. There may be marginal competition effects (becoming more competitive in terms of relative prices) where standard-rated products sold to final consumers can be substituted for zero-rated or reduced rated products. Aside from general economy-wide substitution effects, this factor may be concentrated in areas in which ‘borderlines’ exist between standard-rated goods and services and products with other VAT liabilities within particular sectors, such as in the VAT treatment of food.

9.2 There may also be marginal effects on the degree of competition between VAT-registered and unregistered businesses supplying goods and/or services that (if sold by a VAT registered business) would be standard-rated. However, this would be tempered to an extent by the fact that unregistered businesses cannot reclaim VAT they pay on their own expenses and costs, and the 20 per cent rate of VAT would increase the amount of non-recoverable VAT they incur.

9.3 Changing the standard rate of VAT should not limit the number or range of suppliers, directly or indirectly. Subject to the expected marginal effects noted above, changing the standard rate of VAT should also neither significantly limit the ability of suppliers to compete, nor significantly reduce incentives to compete. The long lead in time may result in increased incentives and opportunities to compete.

Small Firms Impact Test

9.4 An estimated 2.9 million of the smallest businesses are not registered for VAT. These businesses would not incur compliance costs.

9.5 For small businesses registered for VAT their compliance costs may represent a slightly higher burden relative to larger businesses as a percentage of turnover. However, small businesses are less likely to incur the relatively more expensive compliance costs involving advisors and system changes/upgrades. VAT arrangements for small businesses are also expected to be simpler than those of larger businesses, which should mean that a small business will require less time to implement the changes. Given this, we do not expect small businesses to incur any material competitive disadvantage by the increase in the standard rate of VAT, relative to larger businesses.

Other impacts

9.6 The economic impact of the increase in the standard rate of VAT is set out in the Budget documentation.

9.7 The increase in the standard rate of VAT will impact on (to a greater or lesser extent depending on the type of business) all UK VAT registered businesses supplying standard-rated goods and services in the UK in terms of compliance costs.

9.8 Retail businesses are expected to incur higher compliance costs, particularly in relation to the re-pricing changes that will be required as a result of the rate change. For example where they decide to pass the increase on to their customers they will need to re-price all their product lines. This is something which will take more time for businesses that have a large number of product lines. It is also recognised that certain sectors require a minimum lead in time in order to update the price list material that they make available to their customers, for example restaurants and catalogue and mail order businesses.

9.9 In addition, feedback from business, particularly those in the retail sector, was that a change in rate effective from 1 January creates additional compliance costs for those businesses that trade over New Year's Eve and New Year's Day.

9.10 In order to minimise the compliance cost impact of the rate change for businesses, the rate change will not take effect until 4 January 2011. This will give all affected businesses both sufficient time to decide and implement their pricing polices, and businesses will not be faced with having to apply two different standard rates of VAT where they trade between New Year's Eve and New Year's Day.

10 Monitoring and evaluation

10.1 For all policy changes, compliance costs are routinely reviewed one to three years after implementation.

10.2 The Government is always looking to improve its compliance cost assessments and is interested in feedback.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

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