PREM 19/2638

MT

SECRET

PART 1

Confidential Filing

Vat Zero Rates: Possible Infraction Proceedings

ECONOMIC POLICY

PART 1.

February 1982

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
15-2-82		17.6.88					
[illegible]		21.6.88					
4.3.85		22.6.88					
22.3.85		28.10.88					
14.12.82		2-2-89					
21.1.83		28-2-89.					
4.3.83							
31.1.84		ENDS					
15.10.84							
18.10.84							
8.11.84							
14.11.84							
26.11.84							
7.12.84							
4.12.85							
3.3.86							
10.7.86							
17.7.86							
5.8.86.							
4.11.87.							
2.12.87							
28.1.88							
19.4.88							

PREM 19/2638

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TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
OD(E)(82) 6	14/12/1982
OD(E)(82) 8th Meeting	08/10/1984

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed J. Gray Date 31/8/2016

PREM Records Team

● PART 1 ends:-

PS/Ch Ex to PG 28-2-89

PART 2 begins:-

PG to HMT 1-3-89

chex.rm/jmtl/68

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

28 February 1989

P R C Gray Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul

VAT ON PROPERTY AND CONSTRUCTION

Sir Jeffrey Sterling called on Sir Peter Middleton the other day, and left with him a copy of the enclosed note. The Chancellor thought that this might be of interest.

Yours ever

Jonathan

J M G TAYLOR
Private Secretary

MEMORANDUM

To: The Chairman

From: A M Robb

Date: 13 January 1989

VAT - PROPERTY AND CONSTRUCTION FROM 1 APRIL 1989

The current state of play is that all construction contracts for new commercial buildings entered into on and after 21 June 1988 will be subject to VAT at the standard rate from 1 April 1989. Other than one of cash flow this is of no particular significance where the client is able to recover the VAT, but where the client is exempt for VAT purposes, eg charities or financial institutions such as banks and building societies, it will increase the cost of the building. Consequently many construction companies, including Bovis Construction, are entering into pre-payment arrangements with their exempt clients so as to retain the benefit of zero-rating on contracts entered into after 20 June. Contracts entered into before 21 June 1988 however retain the benefit of zero-rating through to the completion of the building under special transitional rules.

What Godfrey Bradman is trying to achieve is to extend the transitional rules to include construction contracts entered into after 20 June 1988 if the projects to which those contracts relate were already conceived or were on the drawing board before 21 June 1988. It does not take much imagination to appreciate the enormous scope for manipulation that such a set of rules would open up.

P.S.

Of course we would not object if Godfrey Bradman achieved his aim, but on balance we do not think we should use up our own goodwill with Customs and the Treasury by actively supporting his claim because we have much more important battles to fight in matters such as VAT on transport, Duty Free and Excise Duty on ships' fuel. Furthermore, it must be very difficult for the Treasury to accede to his request knowing that it would be in breach of EEC law on an issue on which the European Court of Justice has already delivered an adverse ruling against the UK which has already been softened by the transitional arrangements currently in place.

.../2

The Chairman
VAT - Property and Construction from 1 April 1989

Our property interests will, of course, benefit from the imposition of VAT on rents and Earls Court will benefit from being able to recover all of their VAT costs as a result of the standard-rating of their licence fees etc.

On balance I suggest we should confine ourselves to making "grunting" noises of agreement.

A M Robb

SCOTTISH OFFICE
WHITEHALL LONDON SW1A 2AU

Peter Lilley Esq MP
Economic Secretary to the Treasury
Treasury Chambers
Parliament Square
LONDON
SW1P 3AG

28 February 1989

Dear Peter

HEALTH CARE INTERNATIONAL (HCI) AND VAT

Following my letter of 28 October, and your helpful reply, we have been maintaining contact with HCI in its attempts to secure funding for their very important Clydebank project. It is now absolutely clear that additional compensating grant will be an essential element of this funding package. In recent contacts with the company's financial advisers, we have established that a fresh approach to potential funding institutions will be made on that basis.

It was helpful to know that you were content that the provision of additional Regional Selective Assistance for the project should be pursued. This has enabled me to meet the company's requirements that the levying of VAT on construction services should not increase the project's funding requirement, which is already substantial.

I have decided therefore that the provision of extra grant is the best available means of solving HCI's VAT problem; this route has the advantage of being project specific and relatively readily delivered. I should say however that I continue to feel that there is a good case for maintaining zero rating on construction services for private hospitals. In particular, the following points seem to me to be relevant:

1. I do not think, for example, that the European Court of Justice ruled that commercial buildings as such could not be zero rated. If so, there would be no possibility of zero rating for houses supplied by, for example, a housing association run as a business (and I hope, under the auspices of Scottish Homes, we may have a number of such ventures). Similarly, there would be no possibility of zero rating for commercial buildings owned by charities or for nursing homes, both of which I believe are being considered.

2. You yourself acknowledge that health authorities would in principle under present proposals be at an advantage over private sector competitors. The sixth directive specifically prohibits distortion of competition.

However, I regard the solution identified in terms of HCI - additional compensating grant - as acceptable, and I am pleased that the original

package which my officials agreed with the company was so keenly negotiated as to allow sufficient headroom for extra grant within the normal limits.

As before, I am copying this letter to the Prime Minister and Tony Newton.

MALCOLM RIFKIND

Econ Pd - Val 200 Pdes
fob 82

CONFIDENTIAL

ECL

bc BG

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

2 February 1989

VAT: IMPLEMENTATION OF EUROPEAN COURT JUDGMENT ON NON-DOMESTIC CONSTRUCTION

Thank you for your letter of 1 February enclosing draft clauses to give effect to the scheme agreed at the meeting on 31 January, together with the revisions to the Written Answer and Customs' news release. The Prime Minister has seen this and is pleased to note the action now in hand.

PAUL GRAY

Miss Sheila James,
H.M. Treasury.

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est.ld/james/1 Feb/Gray

CONFIDENTIAL

Prime Minister

You will wish to see how Customs are planning to announce the agreement you reached yesterday with the Chancellor and Peter Lilley.

Treasury Chambers, Parliament Street, SW1P 3AG

Paul Gray
No.10 Downing Street
LONDON
SW1

1 February 1989

Good news

RHG
1/2

Dear Paul,

Following the meeting yesterday between the Prime Minister and the Chancellor and Economic Secretary, recorded in your letter of 31 January, Customs have amended their draft clauses to give effect to the scheme outlined in point (iv) of your letter. I attach the relevant extract from the proposed legislation, together with the consequent revisions to the written answer and Customs' news release.

Customs have confirmed that a concession on these lines will cover Phase I of Canary Wharf (involving the commitment to build some 5 million square feet of office space), but not less well advanced developments like King's Cross.

Customs are planning to go ahead with an announcement on Monday 6 February.

Yours,

S M A JAMES
PRIVATE SECRETARY

[illegible]

8. The Treasury may by order make such amendments of this Schedule as are necessary or expedient in consequence of the making of an order under this Act varying Schedule 5 or 6 to this Act."

7. At the end of section 42(2) (adjustment of contracts on changes in tax) of the Value Added Tax Act 1983 there shall be added the words "(including a change attributable to the making of an election under paragraph 2 of Schedule 6A to this Act)".

1983 c.55.

Interpretation

8. In section 48 (interpretation) of the Value Added Tax Act 1983, after the definition of "Commissioners" there shall be inserted—

""fee simple", in relation to Scotland, means—

(a) the estate or interest of the proprietor of the dominium utile, or

(b) in the case of land not held on feudal tenure, the estate or interest of the owner;".

Commencement

9.—(1) Subject to paragraph 10 below, the amendments made by paragraphs 1 to 4 of this Schedule shall have effect in relation to grants, [assignments] and other supplies made on or after 1st April 1989.

(2) Paragraph 5 of this Schedule and paragraph 6, so far as relating to paragraphs 1 and 7 of Schedule 6A to the Value Added Tax Act 1983, shall come into force on 1st April 1989; but, subject to that, paragraph 6 of this Schedule shall come into force on 1st August 1989.

(3) Paragraph 7 of this Schedule shall come into force on 1st August 1989 and paragraph 8 on 1st April 1989.

10.—(1) Subject to sub-paragraph (3) below, the amendments made by paragraphs 1 and 2 of this Schedule shall not have effect in relation to a grant or other supply where—

(a) it is made in pursuance of a legally binding obligation to make it which was incurred before 21st June 1988, and

"old" relief

412

SCH 1

(b) if the Commissioners so require (whether before or after it is made), it is proved to their satisfaction by the production of documents made before that date that it is so made.

(2) Subject to sub-paragraph (3) below, the amendments made by paragraphs 1 and 2 of this Schedule shall not have effect in relation to a grant of an interest in, or in any part of, a building or its site where—

(a) the grant takes place before 21st June 1993,

(b) the person making the grant was under a legally binding obligation incurred before 21st June 1988 to construct the building or any development of which it forms part,

(c) if the Commissioners so require (whether before or after the grant is made), it is proved to their satisfaction by the production of documents made before that date that he was under that obligation, and

(d) planning permission for the construction of the building was granted before 21st June 1988.

"new" relief

(3) Sub-paragraphs (1) and (2) above shall not apply in relation to a grant of a tenancy if and to the extent that the consideration is in the form of rent.

] applies to both "old" + "new"

(4) The amendments made by paragraphs 1 and 2 of this Schedule shall not have effect in relation to a supply relating to a building or civil engineering work where—

(a) the supply takes place before 21st June 1993,

(b) the supply is made to the person constructing the building or work,

(c) that person was under a legally binding obligation incurred before 21st June 1988 to construct the building or work or any development of which it forms part,

(d) if the Commissioners so require (whether before or after the supply is made), it is proved to their satisfaction by the production of documents made before that date that he was under that obligation,

(e) planning permission for the construction of the building or work was granted before 21st June 1988, and

(f) before the supply takes place the person constructing the building or work has given to the person making the supply a certificate in such form as may be specified in a notice published by the Commissioners stating that the supply is zero-rated (in whole or to the extent specified in the certificate) by virtue of this sub-paragraph.

SCHEDULE 2

REPEALS [J0300]

Chapter	Short title	Extent of repeal

AMENDMENTS TO WRITTEN ANSWER AND NEWS RELEASE

WRITTEN ANSWER

1. The paragraph beginning "On non-domestic construction..." should be revised as follows (changes underlined):

> On non-domestic construction, most of the changes I announced on 21 June are confirmed in the draft legislation but I am glad to say that as well as retaining zero rating for new housing it will also be retained for most new communal residential accommodation such as old people's homes, hospices and boarding accommodation at boarding schools. It will also be retained for new churches and other buildings for non-business use by charities. It has not been possible to retain zero rating for premises used for business, including private hospitals and fee-paying schools, which the judgement explicitly ruled were too remote from the final consumer. The change to standard rating for buildings which cease to qualify for zero rating comes into effect from 1 April 1989, although there will be some transitional relief. As I announced last June, this will preserve zero rating for agreements entered into, in writing and for a price, before 21 June 1988. Additionally, it will allow some relief for supplies made before 21 June 1993 in connection with developments that are the subject of binding legal obligation as a result of an agreement entered into before 21 June 1988 between a developer and a landowner or planning authority. The option to tax rents, which comes into effect on 1 August 1989, is being extended to agricultural land. Building land will not be taxed, except in defined cases where this is necessary to ensure fair competition.

2. The paragraph on revenue effects will need to be changed, as follows:

> The estimated yield from the private sector of the proposals contained in the draft clauses will be some £55 million in 1989-90, rising to about £165 million by 1992/93. This includes some £110 million from application of the Court ruling to non-domestic construction. Without the measures to mitigate the impact, the yield from construction would have been £450 million.

NEWS RELEASE

3. The passage on transitional relief at the end of the section on construction will be replaced by the following:

> The normal rules available for dealing with changes in the rate and coverage of VAT will apply. In addition there will be a special transitional relief for transactions that would have been zero rated under the current law and that constitute
>
> - the sale or construction of buildings or civil engineering works whose time of supply falls on or after 1 April 1989 but where the sale or construction had been agreed, in writing and for a price, before 21 June 1988.
>
> - the sale or construction, before 21 June 1993, of buildings or civil engineering works where the developer was, prior to 21 June 1988, under a binding legal obligation to proceed with a development and where the building or works concerned received planning permission also before 21 June 1988.

SUBJECT
CLIMATE

SECRET

FILE PWM 9

PW3AHS 1(a-b)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

31 January 1989

VAT: IMPLEMENTATION OF EUROPEAN COURT JUDGMENT ON NON-DOMESTIC CONSTRUCTION

The Prime Minister had a meeting this morning with the Chancellor and the Economic Secretary following my letter to Sheila James of 30 January.

The Prime Minister said she felt it was essential to have a fair deal for construction projects that were already under way. She recognised that it was not feasible to seek to define particular classes of project; and that projects that were little more than a gleam in developers' eyes - which might include Kings Cross - should not be exempted from the terms of the European Court ruling. However, she had noted the existing proposal for a five year transitional period for charities, and assumed that a similar arrangement could be made for major non-domestic construction projects.

In discussion the following points were made:

(i) the Chancellor and the Economic Secretary had carefully considered the position set out in the Economic Secretary's minute of 27 January, and they continued to believe this package provided the right balance. Developers had recognised the Government's efforts in vigorously fighting the case in the European Court, but had also realised in advance of the Judgment that the UK was likely to lose the non-domestic construction aspect of the case;

(ii) other aspects of the package put forward in the 27 January minute would provide substantial assistance to developers, such as the option to tax rents. On the other hand, this would provide little relief in the case of developments where tenants came from the financial sector;

(iii) any action to ease the position of large scale property developers carried the danger of creating new unfairnesses. For example, small and medium

size developers without financial muscle were unable to get financial commitments several years ahead and so would not benefit from a five year transitional period. And buildings that obtained the benefit of a five year transition were likely to continue in a favoured position after the end of the transitional period compared with other properties where the option to tax rent was introduced;

(iv) consideration had been given to the terms under which a five year transitional period might be introduced for non-domestic construction projects. This could be along the lines of a five year transition starting from 21 June 1988 (the date of the ECJ Judgment) for projects where a financially binding contract had been entered into by a developer with a land owner or other interested party. Further work was, however, required on the precise wording to be used should such an arrangement be included in the draft Finance Bill clauses. A concession along these lines was likely to cover the Canary Wharf project, where there was a financially binding contract with the LDDC. It would also be likely to cover most of the Broadgate development, but not projects such as Kings Cross. The revenue costs were very difficult to estimate, but might be some £50 million a year lasting for about ten years.

Summing up the discussion, the Prime Minister said it was agreed that a five year transitional arrangement should be introduced along the lines identified in discussion. The precise terms of the relevant draft clauses would need to be further considered, and this might mean that it would not be possible to make an announcement on the overall package as early as Thursday 2 February.

I am copying this letter to Sheila James (Economic Secretary's Office, H.M. Treasury).

PAUL GRAY

Alex Allan, Esq.,
H.M. Treasury.

PRIME MINISTER

VAT: IMPLEMENTATION OF EUROPEAN COURT JUDGMENT

I minuted out first thing this morning your reactions to the papers you saw over the weekend.

Treasury Ministers and Customs officials have been discussing the issue further today. I have now arranged for the Chancellor and Peter Lilley to come to see you at 1100 tomorrow morning. We do not have any further piece of paper this evening, but I think the Chancellor may have something to hand over at the meeting. I am told the Chancellor is likely to resist any further concessions.

I understand that attention today has focussed on the possibility of extending the period for transitional relief. I had a private talk this afternoon with Brian Unwin (please do not reveal) who told me that he thought additional transitional relief could be worked out and ring-fenced. But he could see no way of satisfactorily ring-fencing any more fundamental change like trying to redefine "contractually committed" to include "commercial" commitments.

This does point to focussing the discussion on what can be achieved by extending transitional relief. My understanding is that this would be helpful for Docklands' projects like Canary Wharf and I assume it would meet any difficulties for Broadgate, which is now quite well advanced. But I gather that the King's Cross development might not be covered, because that is so far into the future (? mid to late 1990s); and in any event Rosehaugh has little, if any, in the way of commercial commitment to it - what we have seen so far is mostly publicity.

You may like to have to hand the papers which you saw over the weekend; my letter of today is on the top.

Paul Gray

30 January 1989

MJ2DEC

CONFIDENTIAL

MRMAFQ

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

30 January 1989

VAT ZERO RATING: IMPLEMENTATION OF EUROPEAN COURT OF RULING

The Prime Minister has seen the Economic Secretary's minute of 27 January, plus attachments, together with your letter to me of the same date elaborating the position of VAT on non-domestic construction.

The Prime Minister remains extremely concerned about the proposed handling of the Court's ruling on construction and property. She has the following comments in relation to very large developments where substantial expenditure has been undertaken and it is customary to enter into contracts as the need arises:

These developments are needed, and the developers entered into their undertakings in the knowledge that the Government were in favour of zero rating and the assurance that the Government would fight the Court case "tooth and nail".

That knowledge and that assurance must have led to the assumption that, should the Court case be lost, the Government would bend over backwards to meet the problem developers then faced with their large liabilities. The Prime Minister does not believe the approach proposed measures up to what is required and bears the hallmarks of some prejudice against these developers. She feels that the present proposals are unfair and unequitable.

Moreover the proposed "relief" will not apply to the two major developments - Canary Wharf and Kings Cross - where many of the tenants are bound to be in the financial services. She does not believe the argument that to give transitional relief - say 5 years at least - would result in jeopardising the proposed treatment of charities as the Economic Secretary suggests.

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The Prime Minister therefore wishes the Economic Secretary to review this matter immediately, with a view to introducing a substantial period of transitional relief. She wishes this arrangement to be introduced at the outset, rather than the Government being driven to it in the Finance Bill with all the bad feeling that would then result.

I am sending a copy of this letter to Alex Allan in the Chancellor's Office.

Paul Gray

Miss Sheila James,
Economic Secretary's Office
HM Treasury

10 DOWNING STREET

URGENT

THE PRIME MINISTER

With regard to the very large development where substantial expenditure has been undertaken and it is customary to enter into contracts as the need arises —

(1) the reasons in the minute DOES NOT RING TRUE. It has all the hallmarks of some prejudice against these developers and a "they can afford it" approach.

(2) We need these developments, and the developers entered into them undertakings in the knowledge that we were for zero rating, and the assurance that we would fight the Court case "tooth and nail".

(3) That knowledge and that assurance would lead to the assumption that should things go wrong, we would lend over backwards to meet them in their problem of having enormous new liabilities. We have. We

Are being totally untrue. — thoroughly inequitable →
Moreover the alleged 'rebuilt' will not apply to the
2 main blocks of buildings - Carey Street + King & Lin.
where many of the tenants are towards be financial services.
I do not believe the argument that to grant
reasonable transitional relief (say 5 years at most)
would result in jeopardising changes etc. I don't believe
it would.

(4) Other London would welcome 'Costa rica for
their own people and to have such developments.
We must be seen to do so as well.

I MUST: Ask you to REVISE YOUR MINUTE
immediately with a substantial transitional period.
I don't want us to be driven to it in the future
Bill, with all the bad feelings that would result.

MT

PRIME MINISTER

VAT ZERO RATES: IMPLEMENTATION OF EUROPEAN COURT RULING

You have expressed concern about various aspects of the detailed implementation of last year's European Court VAT judgment; in particular -

- the effect of the transitional arrangements for VAT on non-domestic construction on inner city projects - the "Godfrey Bradman" problem;

- the impact on hospitals and hospices.

The attached papers cover these specific points and the more general question of implementation of the Court judgment:

Flag A - minute from Peter Lilley to you summarising the action he proposes to take next week with the publication of draft Finance Bill clauses on 2 February;

Flag B - draft arranged PQ;

Flag C - proposed press release;

Flag D - further letter from the Economic Secretary's office spelling out in more detail the arguments in relation to the Bradman problem;

Flag E - Policy Unit comments.

The Bradman problem

The issues here are best spelt out in the detailed Trasury letter at Flag D together with the Policy Unit's comments at Flag E. The Policy Unit have been rightly concerned that tax policy should not unnecessarily damage inner cities policy. My own view remains that, although not ideal, the approach

Peter Lilley is adopting is the best available course. Frankly, Godfrey Bradman has not done himself any good by substantially over-stating the problem that he and similar developers face.

Charities

Peter Lilley's minute at Flag A highlights the action it has been possible to take to ease the burden on charities. In particular hospices (and boarding accomodation at private schools) are fully protected. But regrettably, private hospital buildings and new teaching premises at private schools are not. But as Peter Lilley says the explicit reference to these in the Court ruling has left us with little option.

Action

Are you content to go along with the package summarised in Peter Lilley's minute at Flag A?

See my note

Or

Are there any further enquiries or action you want to take?

Yes. the developers who are now committed are being treated thoroughly

PAUL. unfairly. We are not being expedite and

(PAUL GRAY) should like to see the day when we

27 January 1989 given a transitional period proportionate

to the size of CONFIDENTIAL

the development - say 5 years - not

PRIME MINISTER

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(PAUL GRAY) should like to see the day when we

27 January 1989

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faxed 28/1 to Chancellor

PRIME MINISTER

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Action

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Or

Are there any further enquiries or action you want to take?

PAUL G.

(PAUL GRAY)
27 January 1989

PRIME MINISTER

27 January 1989

VAT: INNER CITY DEVELOPMENTS

We attended a meeting with Peter Lilley this morning. Senior officials from Customs were also present. It was apparent from their attitude that they view the construction industry with instinctive suspicion (and to a certain extent they are right to do so). They, therefore, start from a position that the impact of the VAT changes on major developments can be absorbed comfortably. But the amounts involved are so substantial that they should neither be underestimated nor ignored.

Two examples illustrate the point:

1) Canary Wharf: Olympia and York has entered into legally binding agreements with the London Docklands Development Corporation for the £1.25 billion of the first of three phases of the project. A substantial amount has already been spent. For practical purposes they are locked in to the whole project which will cost up to £3 billion. But they did not have one building contract before the European decision was taken. They do not, therefore, qualify for relief. The additional VAT cost over the life of the project will be in the region of £300m.

2) Kings Cross: Godfrey Bradman estimates the additional cost of VAT as £280m on a project total development cost of £2.4 billion. The implications for British Rail of this development would be a fall in profit from £600m to £400m. At this stage it is not possible to assess what impact this drop would have on British Rail's development of the Channel Tunnel terminal at Kings Cross.

The viability of the funding of these projects has also been questioned by S G Warburg - a highly reputable merchant bank - albeit in a letter to an interested party (attached).

The Treasury argue that, notwithstanding the significant impact of the VAT changes, the construction companies could have been under no illusions that European Court judgement would go against the UK. They, therefore, had ample time to factor in the imposition of VAT into their calculations. This argument is highly debatable:

- first, the Government's stated intention was to fight the VAT changes 'tooth and nail';

- second, in the event of losing the case the construction companies could reasonably expect that the Government would introduce the most generous transitional relief possible.

The nub of the issue is, therefore, the question of whether the Government is proposing the most generous relief possible. The Treasury can rightly point to a number of concessions. These include:

- giving the construction and property industries both transitional relief for contracts to build at a price set before the court ruled VAT was applicable;

- the 'option to tax';

- making the non-business activities of charities exempt.

What they have not considered adequately in our view is the scope for drafting watertight clauses to take account of larger scale development projects where - to quote the opinion of the well known City Law firm Clifford Chance - "formal contract documents are often entered into after considerable expenditure in the preparation and planning stages which may take many months or even years".

Everyone agrees that the imposition of VAT will increase rent. Peter Lilley argues that Godfrey Bradman is painting a bleaker picture than is the case. This may be true up to a point. But we still believe that the impact will be more significant than is anticipated by the Treasury.

First, as Peter Lilley rightly states it is true that only 3 per cent of firms - mainly in the financial sector - are wholly and partially exempt businesses. But surely it is reasonable to asume that at least 70-80% of all tenants in Canary Wharf and Kings Cross will be in the financial sector. The impact would therefore be substantial.

Second, Lilley argues that a level playing field will be created by giving landlords - including landlords of existing buildings - the ability to tax all rents if they wish. Surely, market forces will dictate the total rental cost including VAT. It will not depend on the decision of the landlord as to whether to tax rents or not.

CONCLUSION

We remain sceptical of the Treasury view that these VAT changes will not affect significantly inner city development. We do, however, recognise that it is the Treasury's view that to seek to provide more generous transitional relief than that already proposed would risk infraction proceedings by the European Court. This could

have undesirable side-effects. This is a matter of fine judgement and we are not in a position to provide a legal opinion on the liklihood of such a development. We recommend reluctantly, therefore, that you accept the Treasury proposal.

ANDREW DUNLOP

IAN WHITEHEAD

FX. [illegible]ISTER

27 January 1989

VAT: INNER CITY DEVELOPMENTS

We attended a meeting with Peter Lilley this morning. Senior officials from Customs were also present. It was apparent from their attitude that they view the construction industry with instinctive suspicion (and to a certain extent they are right to do so). They, therefore, start from a position that the impact of the VAT changes on major developments can be absorbed comfortably. But the amounts involved are so substantial that they should neither be underestimated nor ignored.

Two examples illustrate the point:

1) Canary Wharf: Olympia and York has entered into legally binding agreements with the London Docklands Development Corporation for the £1.25 billion of the first of three phases of the project. A substantial amount has already been spent. For practical purposes they are locked in to the whole project which will cost up to £3 billion. But they did not have one building contract before the European decision was taken. They do not, therefore, qualify for relief. The additional VAT cost over the life of the project will be in the region of £300m.

2) Kings Cross: Godfrey Bradman estimates the additional cost of VAT as £280m on a project total development cost of £2.4 billion. The implications for British Rail of this development would be a fall in profit from £600m to £400m. At this stage it is not possible to assess what impact this drop would have on British Rail's development of the Channel Tunnel terminal at Kings Cross.

The viability of the funding of these projects has also been questioned by S G Warburg - a highly reputable merchant bank - albeit in a letter to an interested party (attached).

The Treasury argue that, notwithstanding the significant impact of the VAT changes, the construction companies could have been under no illusions that European Court judgement would go against the UK. They, therefore, had ample time to factor in the imposition of VAT into their calculations. This argument is highly debatable:

- first, the Government's stated intention was to fight the VAT changes 'tooth and nail';

- second, in the event of losing the case the construction companies could reasonably expect that the Government would introduce the most generous transitional relief possible.

The nub of the issue is, therefore, the question of whether the Government is proposing the most generous relief possible. The Treasury can rightly point to a number of concessions. These include:

- giving the construction and property industries both transitional relief for contracts to build at a price set before the court ruled VAT was applicable;

- the 'option to tax';

- making the non-business activities of charities exempt.

What they have not considered adequately in our view is the scope for drafting watertight clauses to take account of larger scale development projects where - to quote the opinion of the well known City Law firm Clifford Chance - "formal contract documents are often entered into after considerable expenditure in the preparation and planning stages which may take many months or even years".

Everyone agrees that the imposition of VAT will increase rent. Peter Lilley argues that Godfrey Bradman is painting a bleaker picture than is the case. This may be true up to a point. But we still believe that the impact will be more significant than is anticipated by the Treasury.

First, as Peter Lilley rightly states it is true that only 3 per cent of firms - mainly in the financial sector - are wholly and partially exempt businesses. But surely it is reasonable to asume that at least 70-80% of all tenants in Canary Wharf and Kings Cross will be in the financial sector. The impact would therefore be substantial.

Second, Lilley argues that a level playing field will be created by giving landlords - including landlords of existing buildings - the ability to tax all rents if they wish. Surely, market forces will dictate the total rental cost including VAT. It will not depend on the decision of the landlord as to whether to tax rents or not.

CONCLUSION

We remain sceptical of the Treasury view that these VAT changes will not affect significantly inner city development. We do, however, recognise that it is the Treasury's view that to seek to provide more generous transitional relief than that already proposed would risk infraction proceedings by the European Court. This could

have undesirable side-effects. This is a matter of fine judgement and we are not in a position to provide a legal opinion on the liklihood of such a development. We recommend reluctantly, therefore, that you accept the Treasury proposal.

ANDREW DUNLOP

IAN WHITEHEAD

The National Archives

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PRIME MINISTER 27 January 1989

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ANDREW DUNLOP

IAN WHITEHEAD

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Treasury Chambers, Parliament Street, SW1P 3AG

Paul Gray Esq
No 10 Downing Street
LONDON SW1

27 January 1989

Dear Paul,

VAT ON NON DOMESTIC CONSTRUCTION

Your letter of 22 January invited us to look further at the treatment of transitional regimes and the issues raised by Mr Bradman.

In applying the Court's ruling on construction and property, we have had the following broad aims in mind:

(i) to minimise the tax and compliance burdens

(ii) to assist inner city refurbishment as far as possible

(iii) to provide a solution to genuine transition problems

(iv) to minimise the risk of "feast and famine" in construction activity.

I explain below what has led us to reject both Mr Bradman's proposals and other more modest ideas that we have considered.

But first it may be helpful to run briefly over the approach we have adopted.

Minimising the burdens

The effect of the various steps we have taken to reduce the impact of the Court's ruling can best be demonstrated by the revenue figures. Had we done nothing, the tax yield from the private sector (ie from the construction and property industries, and their customers) would have been some £450 million in a full year. But in practice we estimate that we will collect only some

£165 million. So the industries' burden is some £285 million lower than it would otherwise have been. This is achieved mainly through the option to tax. This enables landlords to put VAT on their rents (they are currently exempt), which in turn entitles them to reclaim VAT on their construction and other building costs. Most tenants will be fully taxable businesses and thus able to reclaim the tax on their rents. In this way most VAT simply washes out of the system. It "sticks" only with the exempt and partially exempt tenants - notably in the financial sector - who cannot reclaim all VAT charged on their rents.

Inner city refurbishment

By introducing the option to tax rents we will enable those refurbishing buildings to reclaim the VAT they incur on their costs. They are not able to do so at present. So this decision will reduce the VAT burden on refurbishment. This will be of particular help to inner city schemes. And the option itself is being phased in, thus reducing its immediate impact on tenants while allowing developers to deduct tax in full from the outset.

Transitional arrangements

First, where work "straddles" 1 April 1989, it is only work performed after that date that will be liable to tax - there is no element of retrospection.

Second, normal transitional rules for VAT changes will apply. These are quite generous, and will enable developers to escape VAT on payments made before 1 April 1989, even if construction work is not carried out until later. But this will be of more help to small projects than to very large schemes. We are issuing guidance notes to explain how businesses may benefit from this.

Third, we have introduced exceptional transitional rules. These cope with the specific problem of builders who had contracted to build at a price fixed before the Court ruled VAT would apply. Such contracts entered into before 21 June 1988 will remain zero rated until their completion.

Mr Bradman's proposals

Mr Bradman has asked us in effect to adopt a quite different approach. He wants to protect any developer who was economically committed to a project before the date of the Court ruling. This commitment is defined as:

a. any purchase of land for development in the 3 years prior to the Court ruling;

b. any general undertaking to carry out development work, whether or not specific buildings were commissioned at a specific price;

c. expenditure of sums above a threshold (to be fixed), by way of exploratory or preparatory work.

After detailed consideration, we have rejected this proposal, for the following reasons.

The most obvious consequence would be to retain zero rating for a number of years for very large projects - until the end of the century for some. We have an obligation to apply the ruling reasonably promptly. Keeping zero rating for an ill-defined and apparently indefinite period for a number of very large development projects would quite probably provoke the Commission into renewing infraction proceedings. Apart from the implications of this for the construction and property industries, it could throw the spotlight on to other aspects of our VAT changes where we had chanced our arm. It would be unfortunate if meeting Mr Bradman's demands ended up by putting charities, say, or the water industry in a worse position.

Another effect would be to give large developers an edge over smaller ones, and that for many years. Large concerns would be more likely, for example, to have land banks that would qualify under the first of Mr Bradman's criteria.

Mr Bradman argues that VAT will make uneconomic developments involving tenants in the financial sector (who are wholly or partly exempt, and thus unable to deduct the tax in full). This is hard to believe. Mr Bradman is almost certainly painting a blacker picture than is the case. He assumes that all potential tenants will be in the financial sector and unable to deduct any of their VAT. Neither is true. Many companies are partly exempt, and can deduct a proportion of the VAT on a rent. And most property developments, even if aimed at a particular sector, end up with a mixture of tenants (various fully taxed businesses, offering a range of services, are likely to be closely associated with Mr Bradman's developments). Wholly and partially exempt businesses amount to only three in every hundred firms. Mr Bradman seems to assume that he is concerned solely with that three per cent. In any case, we have provided a level playing field, in that all landlords, including those of existing buildings, will be able to tax rents if they wish. The exempt sector can thus expect to be faced with an increase in costs wherever they turn for accommodation. So the financial sector will ultimately bear a substantial part of the burden of this tax. It will not fall predominantly, let alone entirely, on the developers as Mr Bradman fears.

However, even to the extent that Mr Bradman's fears materialise and the level of rents obtainable on properties in financial centres are lower than they would have been, this is not a transitional problem. It will be a permanent factor facing new developments just as much as those initiated prior to the judgement. There is therefore no reason to grant a longlasting relief to one set of developers and not for their competitors.

It would be particularly hard to justify retaining the privilege of zero rating as Mr Bradman proposes specifically for developments on land acquired in the three years prior to the Court's judgement. That is roughly the period during which the case was before the Court. Any sophisticated development company knew it was pending. And it was widely accepted in the industry

that our chances of retaining zero rating on non-residential construction were slim. There would be a stronger case to protect those who made their "commitment" before infraction proceedings began. But as Mr Bradman's proposal tacitly acknowledges that would carry the concept of transitional relief to an absurdity.

Mr Bradman's claim that he is irrevocably committed to his projects is hard to square with his claim that they will not go ahead without special relief.

Mr Bradman's own estimates (which we believe excessively pessimistic) show that even after bearing VAT his projects generate substantial surpluses - in one case over £400 million accruing to the landowner, British Rail. It is hard to believe such a project will not go ahead even if BR must concede a greater share of the surplus to Rosehaugh. This would, of course, mean BR having somewhat less to reinvest in new infrastructure. But it would be quite wrong for us to try to channel investment funds to BR by the oblique route of a tax relief for certain types of development.

Alternatives

We have considered possible alternative schemes that would offer some consolation to this lobby. They generally fall foul of the criticisms above, but could possibly be more EC-proof than Mr Bradman's prescriptions.

The obvious concession would be to go along with Mr Bradman's argument but to apply a time-bar to continuing zero rating (ie allow relief to run for a further year or two where there is an economic commitment). Even if the Commission objected, it is unlikely that they could get us to Court before the relief expired.

On similar lines, we considered delaying implementation of the whole package. But we concluded this would aggravate the "feast and famine" problem by allowing ample time for all sorts of developments to be brought forward. Introduction of VAT would then be followed by a serious slump in building activity. On a smaller scale this would be true if the relief covered only inner city projects - but overheating is acutest in this area, in London in any case.

Finally, we could keep zero rating for buildings already under construction on 21 June 1988. But if limited to actual buildings, it would be hard to see how this relief would go much beyond what we have already proposed (since building work under way would either be the subject of a fixed price contract or would be open to prepayment to avoid VAT on 1 April 1989). Extending the concept - for example, to any work done on a site - would make it indistinguishable from Mr Bradman's original idea, with all its drawbacks, since this would be tantamount to accepting <u>any</u> commitment as triggering the relief.

Cost

Cost has not been a primary consideration in rejecting various more extensive transitional reliefs (although it has to be said that, cumulatively, it could turn out to be considerable, since we would get nothing from many construction projects and have no compensating revenue from the rents because the developer would have no incentive to opt to tax them). Given the Government's main objective (to mitigate the impact of the ruling while complying with the terms of the Judgement), revenue grounds alone would not be a sufficiently compelling reason. Our arguments are based much more on considerations of equity and, especially, of the need to be seen to comply with the Judgement in a reasonably prompt and even-handed way.

Yours,

S M A JAMES
Private Secretary

est.ld/lilley/27 Jan/PM

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Treasury Chambers, Parliament Street, SW1P 3AG

PRIME MINISTER

VAT ZERO RATES : IMPLEMENTATION OF EUROPEAN COURT RULING

Introduction

We shall shortly be taking our next public step. This note explains what we are about to do, outlines our broad policy approach, and describes points of particular political sensitivity.

The Court's ruling was published on 21 June last year, and the Government responded on the same day with an outline of the measures it proposed to take to comply with the Judgement. Two consultation papers were published and the consultation process was detailed and extensive, drawing to a close at the end of last year. We gave an undertaking to publish draft legislation early in 1989, and that is the next step that we are about to take.

Proposed action

Our aim is to publish draft Finance Bill clauses on 2 February, supported by a Customs and Excise news release and detailed explanatory material. I will tell the House in a written reply on the 2nd that these papers are available, and will use my answer to rehearse the Government's approach to the Court's ruling. I shall

also be available to explain the issues to the media, but will not actively seek further publicity.

I attach copies of the draft written answer and the Customs news release. You may also care to glance at the enclosed draft clauses and explanatory material.

Policy approach

The main points to put across are these. The UK takes its Treaty obligations seriously and aims to comply with judgements of the European Court reasonably promptly. However, in this case our main objective is to do so in a way that minimises the tax and compliance burden and which as far as possible shields those affected from the worst effects of the change. Thus we will give the construction and property industries both transitional relief for contracts to build at a price set before the Court ruled VAT was applicable and the "option to tax", a device that enables much of the new VAT to be deducted by the industries' customers. To help charities, their non-business activities will be largely exempted from the change (however, the Judgement is framed in a way that prevents us from preserving relief for private hospitals and fee-paying schools). The notion of "housing" has been interpreted generously to include especially deserving or particularly sensitive areas like hospices, children's and old people's homes, and school boarding accommodation. Last year's extensive consultations helped the Government to refine its broad decisions and translate them into detailed proposals. The draft clauses now show how those proposals are to be couched in legal language. The Government is publishing them at the earliest possible moment in order to allow maximum time for consideration and preparation by those whom the changes will affect. We shall make it clear that, except where we say so specifically, the decisions are firm and it is only their legal expression that is open to comment.

Sensitive issues

We are under great pressure from certain large property developers to give more generous transitional relief. A particularly

vociferous petitioner has been Mr Bradman (of Rosehaugh Plc) who is seeking relief for certain large inner city developments, such as Kings Cross and Ludgate, on the grounds that he is already financially committed to proceed. My office is writing separately about the detailed arguments involved, but these demands face us with a real problem. It is not primarily a revenue issue - we are anxious to mitigate the effect of the Judgement as far as possible, and we are not looking to maximise VAT receipts. Our difficulty is that some very large developers are committed to projects that will take many years to complete. A concession would mean in effect that for buildings in this category zero-rating would remain in force quite possibly to the end of the century. There is an expectation generally in the Community that European Court judgements are complied with as promptly as is reasonably practicable, and such long term relief would not square with this principle. We could find that it attracted the attentions of the Commission and led to renewed infraction proceedings (which could result in the downfall of other reliefs in our package where we have taken a chance and which would not by themselves catch the Commission's eye). Another argument is that relief for these large developers would probably not be available in the same way or on the same scale to smaller firms, and there would be complaints of unequal treatment. I cannot say that the developers' arguments evince much sympathy. It has been clear for years that the UK was likely to lose its case on commercial building and they could have planned accordingly. Moreover, the lobbyists paint an excessively black picture of the financial consequences of applying VAT.

A second difficult area is charities. We have done as much as we reasonably can to shield them from the effects of the Judgement. We have excluded from the tax supplies, whether of land and buildings or fuel and power, that are made for a charity's non-business purposes. Charities may have to bear tax on some things, particularly rents where landlords exercise the option. Here we have introduced a five-year transitional period. Generally we cannot hope to go further without running a very real risk of challenge from the Commission. Nevertheless we can expect heavy pressure from deserving causes that find they must bear an

increased burden of tax on their business activities. Another problem area is village halls. Many of their activities are technically business under EC VAT law and it is not possible to shield them fully from the effects of the Judgement, but Customs are examining with the village halls forum ways of minimising their liability.

The application of VAT both to construction of new school and private hospital buildings and their supplies of fuel and power will not be welcome to our supporters. We will have to emphasise that the explicit reference to them in the Court ruling left us no way of excluding them from the tax.

Conclusion

This will all be tricky to handle. We must make it clear that this adverse Judgement is based on an interpretation of existing Community law to which the Labour Government gave its assent in 1977. We must resist claims for special treatment that will lead to obvious unfairness or a heightened risk of EC challenge. And we shall try to maximise the credit due to the Government for mitigating as far as possible the impact of the ruling and for its speed of reaction and openness in preparing and discussing its proposals for legislation.

I should be glad to know if you are content with this broad approach.

I am copying this minute to David Young, Nicholas Ridley and Cecil Parkinson.

PETER LILLEY

27 January 1989

B

ANNEX A

Parliamentary Question for Written Answer

Question To ask Mr Chancellor of the Exchequer if he will make a further statement about implementation of the judgement of the European Court of Justice on 21 June 1988, respecting certain of the UK's VAT zero rates.

Answer I told the House on 21 June 1988 (OR 21 June 1988, Col 957-958) that the Government would propose legislation to implement the judgement of the European Court of Justice affecting certain of the UK's VAT zero rates. As I also promised at that time, there has been an extensive consultation. The Government is very grateful to the many organisations and individuals who have responded. Some matters are still under discussion, but I am now able to announce decisions on most features of the implementing legislation which the Government will be proposing to the House as part of this year's Budget and Finance Bill. I am taking this unusual step in order to allow the maximum feasible time for technical consideration of the Clauses and preparation on the part of those traders who will have to operate them, in many cases from 1 April 1989.

As I made clear in my statement to the House on 21 June, this adverse judgement is based on an interpretation of existing Community law to which the UK gave its assent in 1977. We are obliged to comply with it. This means applying VAT to a number of goods and services at present excluded. Our aim has been to implement the ruling in a way which, while respecting the terms of the judgement, minimises the burden of tax and compliance. The Government has in large measure been able to meet the legitimate demands of the construction and property industries, by introducing the option to tax rents and devising suitable transitional arrangements, consistently with the obligation to implement the judgement promptly. And we have had particular regard to the potential impact

on charities. I regret they cannot be wholly shielded because many of them have activities which constitute "business" for VAT purposes and therefore come within the ambit of the judgement. But we have done as much as we can to safeguard their position.

I am including several minor changes from the current provisions for construction and property in Zero Rate Group 8 and Exempt Group 1 which do not flow directly from the European Court judgement. These have been inserted to rectify weaknesses in the law which have become apparent in recent years, often as a result of litigation. These changes are marked with an asterisk in the explanatory notes to the draft clauses.

The provisional draft clauses with explanatory notes on their effect are contained in Customs and Excise documents which I am placing in the Library of the House.

On non-domestic construction, most of the changes I announced on 21 June are confirmed in the draft legislation but I am glad to say that as well as retaining zero-rating for new housing it will also be retained for most new communal residential accommodation such as old people's homes, hospices and boarding accommodation at boarding schools. It will also be retained for new churches and other buildings for non-business use by charities. It has not been possible to retain zero rating for premises used for business, including private hospitals and fee paying schools, which the judgement explicitly ruled were too remote from the final consumer. The change to standard rating for buildings which cease to qualify for zero rating comes into effect from 1 April 1989. The option to tax rents, which comes into effect on 1 August 1989, is being extended to agricultural land. Building land will not be taxed, except where this is necessary to ensure fair competition.

I am now able to announce decisions on the other groups affected by the judgement.

The fuel and power changes will be effective on 1 July 1990. Zero rates will continue for domestic consumers, and for charities for non-business purposes. Domestic use will include not only private dwellings, caravans, houseboats and self catering holiday accommodation but also communal residential homes, hospices, school and student boarding accommodation but not private hospitals and fee paying schools.

The water and sewerage services changes will be effective on 1 July 1990. All supplies of services of emptying cesspools, septic tanks etc to industrial users for use in connection with the carrying on of a business will be standard rated. Similarly so will all supplies of water to industry. Industry means any activity described in any of Divisions 1 to 5 of the Standard Industrial Classification. All other supplies will be zero rated.

News services changes will be effective on 1 April 1989. The zero rating will be repealed, and the standard rate thus applied to all news services. This includes supplies to newspapers and individual members of the public (but the Court ruling did not extend to newspapers themselves).

Protective boots and helmets supplied to employers will become standard rated from 1 April 1989.

The estimated yield from the private sector of the proposals contained in the draft clauses will be some £60 million in 1989-90, rising to a full year yield of £220 million in 1991-92. This includes some £165 million from application of the Court ruling to non-domestic construction. Without the measures to mitigate the impact, the yield from construction would have been £450 million.

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ANNEX B

No 2 February 1989

VAT ZERO RATES INFRACTION PROCEEDINGS: CHANGES IN VAT LIABILITY

The Economic Secretary to the Treasury, Mr Peter Lilley MP, announced today the measures which the Government will propose in the Budget and Finance Bill to implement the judgement of the European Court of Justice on VAT zero rates.

In answer to a Parliamentary Question Mr Lilley said:

> I told the House on 21 June 1988 (OR 21 June 1988, Col 957-958) that the Government would propose legislation to implement the judgement of the European Court of Justice affecting certain of the UK's VAT zero rates. As I also promised at that time, there has been an extensive consultation. The Government is very grateful to the many organisations and individuals who have responded. Some matters are still under discussion, but I am now able to announce decisions on most features of the implementing legislation which the Government will be proposing to the House as part of this year's Budget and Finance Bill. I am taking this unusual step in order to allow the maximum feasible time for technical consideration of the Clauses and preparation on the part of those traders who will have to operate them, in many cases from 1 April 1989.
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> As I made clear in my statement to the House on 21 June, this adverse judgement is based on an interpretation of existing Community law to which the UK gave its assent in 1977. We are obliged to comply with it. This means applying VAT to a number of goods and services at present excluded. Our aim has been to implement the ruling in a way which, while respecting the terms of the judgement, minimises the burden of tax and compliance. The Government has in large measure been able to

meet the legitimate demands of the construction and property industries, by introducing the option to tax rents and devising suitable transitional arrangements, consistently with the obligation to implement the judgement promptly. And we have had particular regard to the potential impact on charities. I regret they cannot be wholly shielded because many of them have activities which constitute "business" for VAT purposes and therefore come within the ambit of the judgement. But we have done as much as we can to safeguard their position.

I am including several minor changes from the current provisions for construction and property in Zero Rate Group 8 and Exempt Group 1 which do not flow directly from the European Court judgement. These have been inserted to rectify weaknesses in the law which have become apparent in recent years, often as a result of litigation. These changes are marked with an asterisk in the explanatory notes to the draft clauses."

The main points of the draft clauses now published are as follows.

1. Construction -
effective date 1 April 1989

The Court ruled that, while zero-rating for housing was acceptable, the zero rates for industrial and commercial buildings and community and civil engineering works were not because the supplies concerned were not provided to final consumers.

Zero Rated

- New dwellings ie individual houses, flats.

- Most new buildings to be used for communal residential purposes.

- New buildings used by charities for their non-business activities. This includes new churches.

- Approved alterations to protected buildings when the buildings are of a type which would qualify for zero rating when newly constructed (and approved alterations to other protected buildings to convert them for a qualifying use).

Standard Rated

- All new buildings other than those which qualify for zero rating as listed above.

- New civil engineering works, subject to minor exceptions.

- All demolition services, subject to minor exceptions.

- All work done to existing buildings or civil engineering works (other than approved alterations to qualifying protected buildings).

- The self-supply of building services for the construction of a new building for use by the business and also for works which increase the floor area by 10% or more but only when the value of the self supply is £100,000 or more.

- The use of land to build new standard rated buildings or civil engineering works will be taxed on a self-supply basis from 1 August 1989 but in practice the charge will only apply in limited circumstances. This provision is subject to a derogation being obtained from the European Community under Article 27 of the Sixth VAT Directive.

Exempt

Option to Tax - effective date 1 August 1989

- From 1 April 1989 supplies consisting of the letting, in return for a rent, of land and buildings or of civil engineering works on or in the land will generally be exempt from VAT.

  BUT from 1 August 1989, an option is to be introduced to allow owners or landlords, who would otherwise make these exempt supplies, to elect to tax the rents on a building by building basis at the standard rate. The option to tax will also apply to the sale of existing buildings and civil engineering works and to agricultural land and any other land which would otherwise be exempt. The exercise of this option is, however, subject to certain conditions and is not available at all for buildings which qualify for zero rating when new, ie dwellings, residential and charity buildings, for non business use.

The exercise of an option with effect from 1 August 1989 will allow, in certain circumstances, input tax to be recovered on relevant supplies received or importations made between 1 April 1989 and that date.

Transitional Relief

- The normal rules available for dealing with changes in the rate and coverage of VAT will apply. In addition there will be a special transitional relief for the sale or construction of buildings or civil engineering works whose time of supply falls on or after 1 April 1989 but where the sale or construction had been agreed, in writing and for a price, before 21 June 1988 and where the transactions would have been zero rated under the current law.

- For tenants, whose landlords opt to tax existing leases from 1 August, there will also be a special transitional relief. All tenants will pay tax on only half of their rent for the first year and on the full amount for year two. However, for those tenants who are charities, VAT will be charged on 20% of the rent in year one, 40% in year two and so on until VAT is chargeable on the full rent in year five.

3. Fuel and Power - effective date 1 July 1990

The Court ruled that zero rating was not lawful insofar as it covered fuel and power supplied to other than final consumers.

Zero Rated

- Fuel and power to be used by domestic consumers, and by charities for non business purposes. Domestic use will include not only private dwellings, caravans and houseboats but also communal residential homes, hospices, school and student boarding accommodation, and self catering holiday accommodation.

- Certain sizes of deliveries of coal, oil and liquified petroleum gas can be zero rated regardless of the use to which the fuel or power is actually to be put. Discussions are continuing regarding a similar system for gas and electricity bills. Automatic zero rating is to apply to all wood, peat and charcoal held out for sale as fuel.

- Where the same supply of fuel is to be used for both standard and zero rated purposes, for instance one electricity meter supplying both a shop and a flat above, it can be treated as wholly zero rated if 60% or more is to go to a zero rated use. If less than 60% is for a zero rated purpose tax must be apportioned.

Standard Rated

- All other supplies of fuel and power.

3. Water and Sewerage Services - effective date 1 July 1990

The Court ruled that supplies of services provided to industry for the emptying of cesspools and septic tanks, and the supply of water to industry cannot be regarded as supplies to final consumers and so cannot be zero rated.

Standard Rated

- All supplies to industry of services of emptying cesspools, septic tanks etc used in connection with the carrying on of a business.

- All supplies of water to industry.

Industry means any activity described in any of Divisions 1 to 5 of the 1980 Edition of the Standard Industrial Classification. Divisions 1 to 5 cover the energy and water supply industries, the extraction of minerals and ores, and the manufacture of metals, minerals and chemicals, metal goods, engineering and vehicles and other manufacturing industries, and the construction industries.

Zero Rated

- All other supplies of water and sewerage services.

4. New Services - effective date 1 April 1989

The Court ruled that the supply of news services to businesses which do not themselves make zero rated supplies could not be regarded as supplies to final consumers and so should be

standard rated. The ruling does not affect the zero rating for newspapers, journals and periodicals themselves.

Standard Rated

- All supplies of news services.

The news services concerned are primarily those of news agencies such as Reuters and the Press Association.

5. Protective Boots and Helmets supplied to employers - effective date 1 April 1989

The Court ruled that supplies to employers for the use of their employees cannot be zero rated as the employer could not be regarded as a final consumer.

Standard Rated

- All supplies to employers for the use of their employees.

- All supplies of services in respect of protective boots and helmets supplied to employers for the use of their employees.

Zero Rated

- All supplies to any person other than an employer.

The provisional draft clauses, together with explanatory notes giving Customs' view of their effect, are available in two parts - one for construction and one for the other 4 Groups affected. With the material on construction there will be a guidance note on tax points. These are being sent out to those who have responded to the consultation exercise. Anyone who would like copies, or has any questions, should contact our General Information Branch Telephone 01-620 1313 extension 3997.

Issued by HM Customs & Excise, Press and Information Office, New King's Beam House, 22 Upper Ground, London SE1 9PJ Telephone 01-382 5468/5469/5471.

BACKGROUND NOTES

In 1983 the European Commission began infraction proceedings against the UK contending that by continuing to zero rate certain supplies the UK was failing to fulfil its obligations under a directive to which the UK gave its assent in 1977. Although the UK defended the zero rates vigorously before the European Court of Justice, in a judgement given on 21 June 1988 the Court ruled that some of the zero rates in question did not comply with Community law, insofar as they were not for the benefit of the final consumer nor were they for clearly defined social reasons.

On the day the ruling was announced the Economic Secretary to the Treasury made a statement to the House of Commons which stressed the UK's vigorous defence but accepted that, as there was no right of appeal from judgements of the Court, it was bound by its treaty obligations to comply with the terms of the judgement. The Government therefore announced a number of decisions and undertook to publish draft legislation in early 1989, as far as possible designed to mitigate the effects of the extension of VAT.

Customs and Excise issued consultation papers on construction and on the other zero rated items. These described the Court's rulings in more detail and invited comments from interested parties. Over three hundred bodies and individuals responded and meetings were held between Customs and the major trade and professional bodies.

ANNEX C

EXPLANATORY NOTES ON DRAFT LEGISLATION ON CONSTRUCTION AND LAND

Schedule 1, paragraph 1:

Group 8 of Schedule 5
Construction of dwellings etc.

Item 1

The revised item continues zero-rating for the grant, by the person constructing a building, of a major interest (the freehold or a lease of over 21 years - or the Scottish equivalents) when the new building is designed as a dwelling or number of dwellings or when it is used for a residential or a non-business charitable purpose. Such purposes are defined in Notes (2)-(3).

Item 2.

The revised item continues the zero-rating of construction services (other than professional services) for the new buildings described above. Newly included, however, is provision for the zero-rating of the essential infrastructure (concrete pitches, roads, installation of drains, sewers, mains water and electricity) on permanent residential caravan parks. This is necessary so that people who live permanently in caravans do not incur higher pitch fees because of the removal of zero-rating from the generality of civil engineering works.

Otherwise services supplied in the course of the construction of civil engineering works as such are standard-rated. However, where services of a civil engineering nature are supplied in the course of the construction of a zero rated building, they remain eligible for zero rating. The Commissioners interpret "in the course of" for this purpose as meaning services done contemporaneously or consecutively in relation to the building services.

Services supplied in the course of the demolition of any building or civil engineering work also become standard rated. The Commissioners will, however, accept that, where the contract for the construction of a zero rated building also extends to the demolition of any building on the site, the demolition services will be done in the course of the construction of the new zero-rated building and will thus continue to be zero-rated.

Item 3

* This item has been modified to ensure that the materials etc used in the construction of a zero-rated building qualify for zero-rating only when they are supplied to the same person who receives the construction services zero-rated under item 2.

Note (1)

This new Note ensures that a garage built at the same time as a dwelling, for use by the occupant of the dwelling, is included in the zero rating available for the dwelling.

Note (2)

This new Note ensures that zero rating for a new building is available when the building is to be used as a children's home; a home for old or disabled persons at which care is provided; a home for the rehabilitation of persons who suffer or have suffered from alcohol or drug dependency or mental disorder; a hospice; living accommodation for students or school children; living accommodation for members of the armed forces; living accommodation for members of religous communities; or any communal living accommodation which at least 95% of the residents use as their sole or main residence. Hospitals, prisons and other penal institutions; and hotels, inns or similar establishments, are not, however, included.

Note (3)

This new Note defines a non-business charity building as any building to be used by a charity otherwise than in the course or furtherance of a business except for a shop, office or warehouse. The main beneficiaries of this relief will be churches.

Note (4)

This new Note provides for apportionment where only parts of a building qualify for zero-rating. In such cases it will be necessary to split the supplies between the zero-rated and the other elements. For example, if a new building consisting of shop premises with a flat over them is sold freehold as a single transaction,the supply must be apportioned between the zero-rated sale of the flat and the standard-rated sale of the shop. And when such a building is constructed, the builder must apportion the work similarly.

Note (5)

This new Note requires that, except in the case of a dwelling, the person making the supply cannot zero-rate it unless he has obtained from the recipient of the supply a certificate showing that the building, or the construction work, qualifies for zero-rating. The form of the certificate will be published by the Commissioners in a VAT Notice or Leaflet in due course.

Note (6)

*This new Note prevents the zero-rating of dwelling accommodation acquired only for holiday purposes. (a) prevents the zero-rating of the grant of a major interest which is in effect "time-share". And (b) prevents the zero-rating of a major interest in accommodation which cannot be lawfully occupied as a permanent residence.

Note (7)

*This new Note has the effect of exempting continuing payments of rent and service charges under a lease after the initial zero rated sale or initial grant of the lease by the person constructing a dwelling or other qualifying building.

Notes (8) and (9) - substantially the same as existing Notes (1) and (1A) in the current law.

Note (10)

This new Note defines a residential caravan, for the purposes of the relief for works in connection with the development of permanent residential caravan parks (item 2), as one in which year-round residence is permitted.

Notes (11), (12) and (13) These are the same as existing Note (2)(d), (2A) and (3) respectively in the current law.

Schedule 1, paragraph 2:

Group 8A of Schedule 5
Protected Buildings

Notes (1) and (1A)

The revised existing Note (1) and the new Note (1A) to this Group have the effect of confining the relief for protected buildings to those which are dwellings, residential or non-business charity buildings (see under Group 8 above), or which are, after the substantial reconstruction or approved alteration, to be used as such. [This change is a direct consequence of the ECJ judgment - although Group 8A was not in existence at the time that the EC proceedings were begun]. Where only part of a protected building is eligible for zero rating, a supply relevant to the whole building must be apportioned to reflect the zero-rated element (as for new buildings). Similarly, the certification requirements applicable to Group 8 apply where residential buildings other than dwellings, and non-business charity buildings, are involved. The exclusions for time-share and rental etc. payments under long leases provided for in Notes (6) and (7) of Group 8 also apply to this Group. [The ability to tax the letting or sale of existing buildings (other than dwellings and residential or charity buildings) - see Schedule 6A - provides a means for recovering tax incurred on the reconstruction or alteration of any protected building which no longer qualifies for zero rating.]

Note (6A)

This new Note ensures that the services of constructing a new non-qualifying building built within the curtilage of a protected building are standard rated even if the protected building itself happens to be a qualifying building. For example a new workshop in the grounds of a listed dwelling would be standard rated whereas a new dwelling in the grounds of a listed hospital would be zero rated under Group 8.

Note (7)

This Note which is identical to Note (11) in the revised Group 8 is in substance a re-enactment of part of the existing Note (7) in Group 8A, the other part having been made otiose by the removal of the relief for civil engineering works.

Schedule 1, paragraph 3:

Group 11 of Schedule 5
Caravans & Houseboats

The Note to this Group has been altered to make it clear that a supply of rented accommodation in a caravan or houseboat of a type covered by the Group is not zero-rated. Such a supply is exempt under item 1 of Group 1 of Schedule 6 - unless the accommodation is holiday accommodation, in which case it is standard-rated under exclusion (d) from that Group.

Schedule 1, paragraph 4:

Group 1 of Schedule 6
Land

Item (1) and Note (1)
The "surrender" of any interest in or right over land, or of any licence to occupy land, has been dropped from item 1. Assignments of interests or licences back to the landlord or licensor - which are the equivalent of "surrenders" - have also been dropped. This means that such surrenders are now standard-rated.

(a) This new exclusion removes from the exemption, and thus standard-rates, the freehold sale of a new or partly-completed building or civil engineering work, other than a dwelling or a residential or non-business charity building.

(b) and (c) These are substantially the same as for exclusions (d) and (a) in the current law.

*(d) This is the same as for exclusion (aa) in the current law except that "tent" has been added to this exception to make it clear that the provision of holiday accommodation in tents provided and erected by the site operator is standard-rated.

*(e) This exception has been derived from the previous exception (b) "the granting of facilities for camping in tents and caravans". Together with Note (9) it now standard-rates the letting of all pitches at caravan parks EXCEPT pitches used for permanent residential caravan accomodation (which remain exempt from VAT). Thus, nightly,weekly,yearly or any other agreements for the siting of caravans are standard-rated if the caravan so sited cannot be lawfully occupied at all times throughout the year. The provision of other facilities - such as winter storage - are also standard-rated whether or not a licence to occupy land is granted.

(f) This continues the standard rating for tent pitches and camping facilities previously covered by exclusion (b).

(g), (h) and (i) These are the same as for exclusions (c) (e) and (f) respectively in the current law.

*(j) This new exception is added in order to standard-rate the provision of facilities at sports stadia and places of entertainment, even where such provision might constitute the granting or assignment of an interest in or right over land or of a licence to occupy land.

(k) is the same exclusion as (h) in the current law.

N.B. The previous exclusion (g) for exhibition sites etc. has been removed altogether, but these supplies can remain taxable if the supplier makes an election under the new Schedule 6A.

Note (2)

This new Note defines completion of a building as the earlier of the time when the certificate of practical completion is issued or the time when it is first fully occupied.

Note (3)

This new Note adopts the same definitions of residential or non-business charity buildings as are used for the continued zero-rating reliefs in Group 8.

Note (4)

This new Note defines a building or civil engineering work as new during the period up to 3 years from the date of its completion. This does not apply, however, if it was commenced before 1 April 1989.

Note (5)

This new Note defines completion of a civil engineering work as the earlier of the time when the certificate of completion is issued, or the time when it is first fully used.

Note (6)

* This new Note is added to make it clear that freehold - as well as leasehold or any other - disposals of fishing and shooting rights are standard-rated. The Note also makes it clear that where a grant of an exempt interest in land includes fishing or shooting rights of significant value these rights must be apportioned and standard-rated.

Notes (7), (8) and (9) are the same as existing Notes (4), (2) and (1) respectively in the current law.

Note (10)
*This new Note defines "seasonal" pitches for the purpose of new exception (e), above.

Notes (11) and 12 are the same as existing Note (3) and (5) in the current law.

Schedule 1, paragraph 5:

New Section 35A and Schedule 6A, VAT Act 1983

Paragraph 1

Residential and Non-Business Charity Buildings: Change of Use

This paragraph deals with the position where, within 10 years of obtaining zero-rating for the purchase, lease or construction of a new communal residential or non-business charity building (under Group 8 of Schedule 5), a person disposes of, or changes the use of, the building or part of the building, so that it is no longer used for purposes which would have qualified for the relief. Sub-paragraph 1 makes it clear that the provision applies only where the zero rating has occurred since 1 April 1989. Sub-paragraphs 2 and 3 deal with the situation where an interest in the building, or part of the building, is disposed of by way of sale or letting, the supply by the proprietor of the residential establishment or by the charity will be standard-rated (rather than exempt under item 1 of Group 1 of Schedule 6). Sub-paragraph 4, 5 and 6 deal with the situation where the use is changed to a non-qualifying use; the person concerned will be treated as having made a standard-rated self-supply of the building or part of the building, in the course or furtherance of a business. The value for tax is defined in such a way as to ensure that the person pays an amount of tax equal to the amount of tax that would have been chargeable on the building if it had not benefited from zero rating at the construction stage.

Paragraph 2-4

Election to waive exemption (Option to tax)

These paragraphs authorise the facility known as the option to tax rents and supplies of buildings and land that would otherwise be exempt. The person who opts does so to recover input tax and so there has to be a substantial legal framework to establish the conditions under which the option can be exercised and the special rules for establishing accountability for output tax and for input tax entitlement.

Paragraphs 2(1) and (2) establish the basic scope for the option for taxation. Once the election (option) has been made and has effect a person must treat all supplies by him in relation to a particular building or land which would otherwise be exempt under item 1 of Group 1 of Schedule 6 as standard-rated supplies. However any supply in respect of any dwelling (or a building or part of a building which is intended to be used as a dwelling, as a residential or non-business charity building of a type that would qualify for zero rating under Group 5 or 5A) must remain exempt..

Paragraphs 2(3) to (5) deal with input tax entitlement. This can be divided between the long term provision and the special arrangements applying on the introduction of the option from 1 August 1989. The basic rule (para 2(3) is that no input tax is allowable until the option has effect. Once the option has effect, input tax already incurred then becomes allowable but only if the person concerned has made no exempt supplies in respect of the particular building or land (para 2(4)(a) although exempt supplies made in the four months 1 April - 31 July 1989 which would have been zero-rated or taxable supplies under the current law are disregarded for this purpose (para. 2(4)(b)). However, the special introductory arrangments are as follows:-

1. No input tax can be claimed before 1 August 1989.

2. If an election has effect from 1 August 1989, input tax can be claimed retrospectively when it is input tax incurred on supplies or importations attributable to supplies made by the taxable person on or after 1 April 1989 which would have been zero rated or taxable supplies under the current law (para 2(5)).

Paragraph 3(1) provides for the option to tax to be available from 1 August 1989. It may, however, be exercised at any time after that date: there is no cut-off point. Exceptionally, if the option is exercised **before** 1 November 1989 it can be given retrospective effect from any date not earlier than 1 August 1989.

Paragraph 3(2) deals with the permitted scope of each election. It may cover:-

- o any specified building (other than a building on agricultural land).
- o all agricultural land in which the person electing has an interest; this includes all buildings on the land but tax cannot be charged on a farmhouse or other dwellings.
- o any other land specified in the same election.

For these purposes buildings linked by a walkway or similar means and individual shops in a shopping precinct etc are to be taken as a single building and must thus be covered by the same election.

Paragraphs 3(3) and (4) deal with the mechanics of making an election which, once made, cannot be revoked. Written notice of the election, which must normally be given not later than 10 days after the election is exercised, must be given to the local VAT office except for any category of cases to be specified in a Customs and Excise Notice.

Paragraphs 4(1) to (4) prescribe special tax point rules for dealing with receipt of payments of rent which relate to periods before or after the election takes effect. The substance of these rules is that rent must be apportioned so that tax is chargeable only for such time as the election is effective.

Paragraphs 4(5) provides a transitional relief for existing buildings and civil engineering works, i.e. those completed before 1 August 1989, and for tenants and licenees of agriculture or other land who were in occupation immediately prior to that date. In the general case the relief takes the form of VAT being charged on only half the rent for the period 1 August 1989 to 31 July 1990. For tenants who are charities the tax is phased in over the period to 31 July 1993 with tax being chargeable only on 20% of the rent in the first year, 40% in the second year and so on until tax is charged on 100% of the rent from 1 August 1993.

Paragraphs 5 and 6

Building land

Paragraphs 5 and 6 provide for a special VAT charge on land used for constructing new buildings and civil engineering works (other than dwellings and other buildings qualifying for relief under Group 8 of Schedule 5). However it will only be payable in limited circumstances. It will not be payable:

1. when there is to be a freehold disposal of the completed building liable at the standard rate; or

2. when the letting of the completed building is to be standard rated by reason of an option to tax having been exercised.

3. when in the absence of either 1 or 2, the occupier is a fully taxable person or if he is exempt or partly exempt where the completed building costs less than £100,000 to erect.

In other words it will only be payable either when a developer is intending to let the building on an exempt basis or when a building, costing £100,000 or more, has been constructed for own occupation by an exempt or partly exempt person.

In more detail paragraph 5(1) defines the nature of the construction to which the charge applies. It applies to any construction not entitled to the relief for dwellings and for other buildings and works for which zero rating is retained.

Paragraphs 5(2) and (3) set out the nature of the charge. VAT at the standard rate is to be charged on a self-supply of the developer's freehold or leasehold interest (whichever is appropriate) in the site of the building and the value of the self-supply is to be the open market value of the supply of an equivalent interest immediately before construction commences.

Paragraph 5(4) has the effect of not applying the charge where the developer gives a declaration to Customs and Excise that he intends to sell the freehold within three years of the building being completed or that he intends to occupy the building for at least ten years as a fully taxable person or that in any event the cost of constructing the building is less than £100,000.

Paragraphs 5(5) and (6) apply the charge when the intentions with regard to selling the freehold or occupying the building are not realised. The charge is the same as under (2) and (3) except that the time of supply is the last day of the accounting period in which the third anniversary of the completion of the building falls and the open market valuation is also the one applying at that time.

Paragraph 5(7) provides a relief for interests acquired before 1 April 1989. Here the value of the self-supply is to be at cost.

Paragraphs 5(8) and (9) are interpretative in relation to the nature of the interest held and the time at which construction commences.

Paragraph 6 defines the person liable for the charge. In the normal case it is the person constructing the building who either has a freehold or leasehold interest at the time construction commences or who will, under a development contract, have such an interest when the building is completed. Where the person constructing the building has no present or prospective interest, the chargeable person is the person who is most closely connected with the development or failing that the freehold owner of the site.

Paragraphs 7 and 8

General

Paragraph 7 applies the interpretive notes to Zero Rate Group 8 and Exempt Group 1 to the relevant references in the new Schedule 6A thus obviating the need for repetitious definitions.

Paragraph 8 gives the Treasury power to amend Schedule 6A by order when the amendments are consequential to orders varying the Zero rate and Exemption Schedules in the VAT Act 1983.

Schedule 1, paragraph 7

Section 42 of the VAT Act 1983 (adjustment of contracts on changes in tax).

The effect of this amendment is to give to suppliers who elect to charge tax on their otherwise exempt land and property transactions the same facility to add VAT to the contractual price as is currently available to them when there is a compulsory change of liability from exemption (or zero rating) to standard rating.

Schedule 1, paragraph 9

Commencement

This paragraph stipulates the effective dates for the various changes made by Schedule 1. The effective date for the changes in Zero Rate Groups 8, 8A and 11 and for the change of use provisions for residential and non-business charity buildings is 1 April 1989. That for the option to tax and the building land charge is 1 August 1989. The paragraph also provides a transitional relief which retains zero-rating for supplies of construction services and disposals of new buildings and civil engineering works made on or after 1 April 1989 which are zero-rated under the current law and for which a contract in writing covering the relevant supply or supplies has been entered into before 21 June 1988. In relation to leasehold disposals, the relief extends only to any premium and not to supplies for which rent is consideration. The Commissioners will accept that businesses are entitled to this special relief when there is a formal signed contract to support it or when there is evidence of normal commercial correspondence such as acceptance of tenders, letters of intent or similar documentation, indicating that the parties are legally committed to going ahead with the supply for a specified consideration.

The Value Added Tax (Self-Supply of Construction Services) Order 1989.

This order creates a VAT charge on a person carrying on a business, whether or not already registered, who does "in-house" building work when the value of that work is £100,000 or more and is of a kind that would be standard rated if done by a contract builder. The order catches not only the construction of new buildings and civil engineering works (including any preparatory demolition work) but also alterations extensions and annexations to any existing building providing additional floor area of 10% or more. The order extends to "in-house" building work done within group registrations. The charge is effected by creating a self-supply to be valued on an open market value basis. The order comes into effect from 1 April 1989 but where the in-house work is actually in progress on that date tax is only to be accounted for on the value of the work done on or after that day and where that value is £100,000 or more.

DRAFT CLAUSES/SCHEDULES

PART II

VALUE ADDED TAX

Zero-rating etc.

1. Schedule 1 to this Act (which makes provision about value added tax on supplies relating to buildings and land) shall have effect. Buildings and land. [j0301]

SCHEDULES

SCHEDULE 1 Section 1.

VALUE ADDED TAX: BUILDINGS AND LAND [J0302]

Zero-rating

1. For Group 8 (construction of buildings etc.) of Schedule 5 (zero-rating) to the Value Added Tax Act 1983 there shall be substituted— 1983 c.55.

"GROUP 8 - CONSTRUCTION OF DWELLINGS, ETC.

Item No.

1. The grant by a person constructing a building—

(a) designed as a dwelling or number of dwellings; or

(b) intended for use for a relevant residential purpose or a relevant charitable purpose,

of a major interest in, or in any part of, the building or its site.

2. The supply in the course of the construction of—

(a) a building designed as a dwelling or number of dwellings or intended for use for a relevant residential purpose or a relevant charitable purpose; or

(b) any civil engineering work necessary for the development of a permanent park for residential caravans,

of any services other than the services of an architect, surveyor or other person acting as consultant or in a supervisory capacity.

3. The supply to a person of—

(a) materials; or

(b) builder's hardware, sanitary ware or other articles of a kind ordinarily installed by builders as fixtures,

by a supplier who also supplies to the same person services within item 2 of this Group or Group 8A below which include the use of the materials or the installation of the articles.

Notes:

(1) "Dwelling" includes a garage constructed at the same time as a dwelling for occupation together with it.

SCH. 1

(2) Use for a relevant residential purpose means use as—

(a) a home or other institution providing residential accommodation for children;

(b) a home or other institution providing residential accommodation with personal care for persons in need of personal care by reason of old age, disablement, past or present dependence on alcohol or drugs or past or present mental disorder;

(c) a hospice;

(d) residential accommodation for students or school pupils;

(e) residential accommodation for members of any of the armed forces;

(f) a monastery, nunnery or similar establishment; or

(g) an institution which is the sole or main residence of at least 90 per cent. of its residents,

except use as a hospital, a prison or similar institution or an hotel, inn or similar establishment.

(3) Use for a relevant charitable purpose means use by a charity—

(a) otherwise than as a shop or office; and

(b) otherwise than in the course or furtherance of a business.

(4) Where a building is designed partly as a dwelling or number of dwellings or intended for use partly for a relevant residential purpose or a relevant charitable purpose—

(a) a grant or other supply relating to any part of the building designed as a dwelling or number of dwellings or intended for use for a relevant residential purpose or a relevant charitable purpose (or the site of any such part) shall be treated as relating to a building so designed or intended for such use;

(b) a grant or other supply relating to any part of the building not so designed and not intended for such use (or the site of any such part) shall not be so treated; and

(c) in the case of any grant or other supply relating to, or to any part of, the building (or its site) which is not within paragraph (a) or (b) above, an apportionment shall be made to determine the extent to which it is to be so treated.

(5) No grant or other supply relating to a building all or part of which is intended for use for a relevant residential purpose or a relevant charitable purpose shall be treated as so relating unless before it is made the person to whom it is made has given to the person making it a certificate in such form as may be specified in a notice published by the Commissioners stating that the grant or other supply (or a specified part of it) so relates.

SCH. 1

(6) The grant of an interest in, or in part of, a building designed as a dwelling or number of dwellings is not within item 1 if—

(a) the interest granted is such that the grantee will not be entitled to reside in the building, or part, throughout the year; or

(b) residence there throughout the year will be prevented by the terms of a covenant, statutory planning consent or similar permission.

(7) Where the major interest referred to in item 1 is a tenancy—

(a) if a premium is payable, the grant falls within that item only to the extent that it is made for consideration in the form of the premium; and

(b) if a premium is not payable, the grant falls within that item only to the extent that it is made for consideration in the form of the first payment of rent due under the tenancy.

(8) Where the benefit of the consideration for the grant of a major interest as described in item 1 accrues to the person constructing the building but that person is not the grantor, he shall for the purposes of that item be treated as the person making the grant.

(9) The reference in item 2 to the construction of a building or work does not include a reference to—

(a) the conversion, reconstruction, alteration or enlargement of an existing building or work; or

(b) any extension or annexation to an existing building which provides for internal access to the existing building or of which the separate use, letting or disposal is prevented by the terms of any covenant, statutory planning consent or similar permission;

and the reference in item 1 to a person constructing a building shall be construed accordingly.

(10) A caravan is not a residential caravan if residence in it throughout the year is prevented by the terms of a covenant, statutory planning consent or similar permission.

(11) Item 2 does not include the supply of services described in paragraph 1(1) or 5(3) of Schedule 2 to this Act.

(12) The goods referred to in item 3 do not include—

(a) finished or prefabricated furniture, other than furniture designed to be fitted in kitchens;

(b) materials for the construction of fitted furniture, other than kitchen furniture;

(c) domestic electrical or gas appliances, other than those designed to provide space heating or water heating or both; or

(d) carpets or carpeting material.

SCH. 1

(13) Section 16(3) of this Act does not apply to goods forming part of a description of supply in this Group."

2.—(1) Group 8A (protected buildings) of that Schedule shall be amended as follows.

(2) In Note (1), for the words "a building which" there shall be substituted the words "a building which is designed to remain as or become a dwelling or number of dwellings or is intended for use for a relevant residential purpose or a relevant charitable purpose after the reconstruction or alteration and which, in either case,".

(3) After that Note there shall be inserted—

"(1A) Notes (1) to (7) to Group 8 above apply in relation to this Group as they apply in relation to that Group."

(4) After Note (6) there shall be inserted—

"(6A) For the purposes of item 2 the construction of a building separate from, but in the curtilage of, a protected building does not constitute an alteration of the protected building."

(5) The following Note shall be substituted for Note (7)—

"(7) Item 2 does not include the supply of services described in paragraph 1(1) or 5(3) of Schedule 2 to this Act."

3. In Group 11 (caravans and houseboats) of that Schedule, for paragraph (b) of the Note there shall be substituted—

"(b) the supply of accommodation in a caravan or houseboat."

Exemptions

1983 c.55.

4. For Group 1 (land) of Schedule 6 (exemptions) to the Value Added Tax Act 1983 there shall be substituted—

"GROUP 1 - LAND

Item No.

1. The grant of any interest in or right over land or of any licence to occupy land, other than—

(a) the grant of the fee simple in—

(i) a building which has not been completed and which is neither designed as a dwelling or number of dwellings nor intended for use for a relevant residential purpose or a relevant charitable purpose;

(ii) a new building which is neither designed as a dwelling or number of dwellings nor intended for use for a relevant residential purpose or a relevant charitable purpose after the grant;

(iii) land on or under which a civil engineering work which has not been completed is being constructed;

(iv) land on or under which a new civil engineering work has been constructed;

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(b) the grant of any interest, right or licence consisting of a right to take game or fish;

(c) the provision in an hotel, inn, boarding house or similar establishment of sleeping accommodation or of accommodation in rooms which are provided in conjunction with sleeping accommodation or for the purpose of a supply of catering;

(d) the provision of holiday accommodation in a house, flat, caravan, houseboat or tent;

(e) the provision of seasonal pitches for caravans, and the grant of facilities at sites to persons for whom such pitches are provided;

(f) the provision of pitches for tents or of camping facilities;

(g) the grant of facilities for parking a vehicle;

(h) the grant of any right to fell and remove standing timber;

(i) the grant of facilities for housing, or storage of, an aircraft or for mooring, or storage of, a ship, boat or other vessel;

(j) the grant of any right to occupy a box, seat or other accommodation at a sports ground, theatre, concert hall or other place of entertainment; and

(k) the grant of facilities for playing any sport or participating in any physical recreation.

Notes:

(1) "Grant" includes an assignment, other than an assignment of an interest made to the person to whom a surrender of the interest could be made.

(2) A building shall be taken to be completed when—

(a) an architect issues a certificate of practical completion in relation to it; or

(b) it is first fully occupied;

whichever happens first.

(3) Notes (1) to (5) to Group 8 of Schedule 5 to this Act apply in relation to item 1 of this Group as they apply in relation to that Group.

(4) A building or civil engineering work is new if it was completed less than three years before the grant unless it was completed before 1st April 1989.

(5) A civil engineering work shall be taken to be completed when—

(a) an engineer issues a certificate of completion in relation to it; or

(b) it is first fully used;

whichever happens first.

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(6) Where a grant of an interest in, right over or licence to occupy land includes a valuable right to take game or fish, an apportionment shall be made to determine the supply falling outside this Group by virtue of paragraph (b) of item 1.

(7) "Similar establishment" includes premises in which there is provided furnished sleeping accommodation, whether with or without the provision of board or facilities for the preparation of food, which are used by or held out as being suitable for use by visitors or travellers.

(8) "Houseboat" includes a houseboat within the meaning of Group 11 of Schedule 5 to this Act.

(9) "Holiday accommodation" includes any accommodation advertised or held out as such.

(10) A seasonal pitch is a pitch—

(a) which is provided for a period of less than a year; or

(b) which is provided for a year or a period longer than a year but which the person to whom it is provided is prevented by the terms of any covenant, statutory planning consent or similar permission from occupying by living in a caravan at all times throughout the period for which the pitch is provided.

(11) "Mooring" includes anchoring or berthing.

(12) Paragraph (k) shall not apply where the grant of the facilities is for—

(a) a continuous period of use exceeding twenty-four hours; or

(b) a series of ten or more periods, whether or not exceeding twenty-four hours in total, where the following conditions are satisfied—

(i) each period is in respect of the same activity carried on at the same place;

(ii) the interval between each period is not less than one day and not more than fourteen days;

(iii) consideration is payable by reference to the whole series and is evidenced by written agreement;

(iv) the grantee has exclusive use of the facilities; and

(v) the grantee is a school, a club, an association or an organisation representing affiliated clubs or constituent associations."

Special provisions

5. The following section shall be inserted in the Value Added Tax Act 1983 after section 35— 1983 c.55.

"Buildings and land.

35A. Schedule 6A to this Act shall have effect with respect to buildings and land."

6. The following Schedule shall be inserted in the Value Added Tax Act 1983 after Schedule 6— SCH. 1 1983 c.55.

"SCHEDULE 6A Section 35A.

BUILDINGS AND LAND

Residential and charitable buildings: change of use etc.

1.—(1) In this paragraph "relevant zero-rated supply" means a grant or other supply taking place on or after 1st April 1989 which—

(a) relates to a building intended for use for a relevant residential purpose or a relevant charitable purpose; and

(b) is zero-rated, in whole or in part, by virtue of Group 8 of Schedule 5 to this Act.

(2) Sub-paragraph (3) below applies where—

(a) one or more relevant zero-rated supplies relating to a building have been made to any person; and

(b) the person grants any interest in, right over or licence to occupy the building (or any part of it) within the period of ten years beginning with the day on which the building is completed.

(3) Where this sub-paragraph applies, if and to the extent that the grant mentioned in sub-paragraph (2)(b) above relates to any part of the building—

(a) to the intended use of which the zero-rating of the relevant zero-rated supply (or of any of them) was attributable; and

(b) which is not intended for use for a relevant residential purpose or a relevant charitable purpose after the grant,

it shall be taken to be a taxable supply in the course or furtherance of a business which is not zero-rated by virtue of Group 8 of Schedule 5 to this Act (if it would not otherwise be such a supply).

(4) Sub-paragraph (5) below applies where—

(a) one or more relevant zero-rated supplies relating to a building have been made to any person; and

(b) within the period of ten years beginning with the day on which the building is completed the person uses for a purpose which is neither a relevant residential purpose nor a relevant charitable purpose any part of the building to the intended use of which the zero-rating of the relevant zero-rated supply (or of any of them) was attributable.

(5) Where this sub-paragraph applies, his interest in, right over or licence to occupy that part of the building shall be treated for the purposes of this Act as supplied to him for the purpose of a business carried on by him and supplied by him in the course or furtherance of the business when he first uses it

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for a purpose which is neither a relevant residential purpose nor a relevant charitable purpose.

(6) Where sub-paragraph (5) above applies—

(a) the supply shall be taken to be a taxable supply which is not zero-rated by virtue of Group 8 of Schedule 5 to this Act (if it would not otherwise be such a supply); and

(b) the value of the supply shall be such that the amount of tax chargeable on it is equal to the amount of the tax which would have been chargeable on the relevant zero-rated supply relating to the part in question (or, where there was more than one such supply, the aggregate amount which would have been chargeable on them) had the supply (or supplies) not been zero-rated.

Election to waive exemption

2.—(1) Subject to sub-paragraph (2) below, where a person has made an election under this paragraph in relation to any building or land, if and to the extent that any supply made by him in relation to it at a time when the election has effect would (apart from this sub-paragraph) fall within Group 1 of Schedule 6 to this Act, the supply shall not fall within that Group.

(2) Sub-paragraph (1) above shall not apply in relation to a supply if the supply is made in relation to a building intended for use as a dwelling or number of dwellings or for a relevant residential purpose or a relevant charitable purpose.

(3) Subject to sub-paragraph (4) below, no input tax on any supply or importation which, apart from this sub-paragraph, would be allowable by virtue of the operation of this paragraph shall be allowed if the supply or importation took place before the first day for which the election in question has effect.

(4) Subject to sub-paragraph (5) below, sub-paragraph (3) above shall not apply where the person by whom the election was made—

(a) has not, before the first day for which the election has effect, made in relation to the land or building to which the election relates any supplies falling within Group 1 of Schedule 6 to this Act; or

(b) has before that day made in relation to that land or building supplies so falling but all those supplies—

(i) took place in the period beginning with 1st April 1989 and ending with 31st July 1989; and

(ii) would have been taxable supplies but for the amendments made by Schedule 1 to the Finance Act 1989.

(5) Sub-paragraph (4) above does not make allowable any input tax on supplies or importations taking place before 1st August 1989 unless—

(a) they are attributable to supplies made by the person which take place on or after 1st April 1989 and which would have been taxable supplies but for the amendments made by Schedule 1 to the Finance Act 1989; and

(b) the election has effect from 1st August 1989.

3.—(1) Where a person makes an election under paragraph 2 above the election shall have effect—

(a) from the beginning of the day on which the election is made or of any later day specified in the election; or

(b) where the election is made before 1st November 1989, from the beginning of 1st August 1989 or of any later day so specified.

(2) An election under paragraph 2 above may be made in relation to—

(a) any building specified, or of a description specified, in the election other than a building on agricultural land;

(b) all agricultural land (including the buildings on such land) in which the person making the election has an interest, over which he has a right or which he has a licence to occupy; or

(c) any land except land on which a building has been or is being constructed or agricultural land specified, or of a description specified, in the election;

and for the purposes of paragraph (a) of this sub-paragraph buildings linked by a walkway or similar means, and parades, precincts and complexes divided into separate units, shall be taken to be single buildings (if they otherwise would not be).

(3) An election under paragraph 2 above shall be irrevocable and, except where it is an election of a description specified in a notice published by the Commissioners, notification of the election shall be given to the Commissioners together with such information as the Commissioners may require.

(4) Except where the Commissioners otherwise allow, a notification required under sub-paragraph (3) above shall be given not later than the end of the period of ten days beginning with the day on which the election is made.

4.—(1) This paragraph has effect where rent is payable in consideration of the grant of an interest in, right over, or licence to occupy any building or land to which an election under paragraph 2 above relates (or any part of any such building or land).

(2) If—

(a) the rent relates to a period beginning before and ending on or after the first day for which the election has effect; and

(b) the supply for which the rent is consideration would, apart from this sub-paragraph, take place before that day,

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the supply shall be treated as taking place on that day to the extent that it is made for rent relating to the part of the period falling on or after that day.

(3) If—

(a) the rent relates to a period beginning on or after the first day for which the election has effect; and

(b) the supply for which the rent is consideration would, apart from this sub-paragraph, take place before that day,

the supply shall be treated as taking place on the first day of the period to which the rent relates.

(4) If—

(a) the rent relates to a period beginning before the first day for which the election has effect; and

(b) the supply for which the rent is consideration takes place on or after that day,

tax shall not be chargeable on the supply by virtue of paragraph 2 above to the extent that it is made for rent relating to any time before that day.

(5) Where the rent is payable by a person in relation to a period when he is in occupation of a building completed before 1st August 1989 (or part of such a building) or land of which of which he was in occupation immediately before that date, any tax which would be chargeable by virtue of paragraph 2 above on the supply for which such the rent is consideration—

(a) except in the case of a charity, shall be chargeable as if the consideration were reduced by 50 per cent. if and to the extent that the rent relates to or to any part of the year beginning on 1st August 1989 and ending on 31st July 1990; and

(b) in the case of a charity—

(i) shall be chargeable as if the consideration were reduced by 80 per cent. if and to the extent that the rent relates to or to any part of the year beginning on 1st August 1989 and ending on 31st July 1990;

(ii) shall be chargeable as if the consideration were reduced by 60 per cent. if and to the extent that the rent relates to or to any part of the year beginning on 1st August 1990 and ending on 31st July 1991;

(iii) shall be chargeable as if the consideration were reduced by 40 per cent. if and to the extent that the rent relates to or to any part of the year beginning on 1st August 1991 and ending on 31st July 1992; and

(iv) shall be chargeable as if the consideration were reduced by 20 per cent. if and to the extent that the rent relates to or to any part of the year beginning on 1st August 1992 and ending on 31st July 1993.

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5.—(1) This paragraph applies in the case of—

(a) the construction on any land of a building, other than a building designed as a dwelling or number of dwellings or intended for use for a relevant residential purpose or a relevant charitable purpose; or

(b) the construction on or under any land of a civil engineering work, other than a work necessary for the development of a permanent park for residential caravans.

(2) Where this paragraph applies, subject to sub-paragraph (4) below, the relevant interest of the chargeable person shall be treated for the purposes of this Act as supplied to him for the purpose of a business carried on by him and supplied by him in the course or furtherance of the business on the last day of the prescribed accounting period in which he commences construction.

(3) Where sub-paragraph (2) above has effect—

(a) the supply shall be taken to be a taxable supply; and

(b) subject to sub-paragraph (9) below, the value of the supply shall be the open market value of an actual supply of the interest immediately before he commences construction.

(4) Sub-paragraph (2) above shall not have effect where the chargeable person—

(a) holds the fee simple of the land, or is by virtue of any contract entitled to the fee simple in the land concerned on or before the day on which the building or work is completed, and has made to the Commissioners before he commences construction a written declaration that he will dispose of it at some time during the period of three years beginning with the day on which the building or work is completed;

(b) has made to the Commissioners before he commences construction a written declaration that he will occupy the whole building or work on completion for a period of at least ten years and that either he will be a fully taxable person throughout the period of ten years beginning with the day on which the building or work is completed or the aggregate value of any services supplied to him in the course of the construction of the building or work will be less than £100,000; or

(c) has made an election under paragraph 4 above in relation to the building or land concerned which has effect from the day on which he commences construction or an earlier day.

(5) Where—

(a) sub-paragraph (2) above is disapplied by sub-paragraph (4)(a) above in the case of a chargeable person; but

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(b) he has not disposed of the fee simple by the end of the period of three years beginning with the day on which the building or work is completed,

the relevant interest shall be treated for the purposes of this Act as supplied to him for the purpose of a business carried on by him and supplied by him in the course or furtherance of the business on the last day of the prescribed accounting period in which that period ends.

(6) Where—

(a) sub-paragraph (2) above is disapplied by sub-paragraph (4)(b) above in the case of a chargeable person; but

(b) he ceases to occupy the building or work, or to be a fully taxable person, during the period of ten years beginning with the day on which the building or work is completed or the aggregate value of the services supplied to him in the course of the construction of the building or work equals or exceeds £100,000 by virtue of the making of a supply,

the relevant interest shall be treated for the purposes of this Act as supplied to him for the purpose of a business carried on by him and supplied by him in the course or furtherance of the business on the last day of the prescribed accounting period in which the event mentioned in paragraph (b) above occurs.

(7) Where—

(a) sub-paragraph (2) above is disapplied by sub-paragraph (4)(c) above in the case of a chargeable person;

(b) the person occupies the building or work (or any part of it) at any time during the period of ten years beginning with the day on which the building or work is completed; and

(c) at a time when he so occupies the building or work he is not a fully taxable person,

the relevant interest shall be treated for the purposes of this Act as supplied to him for the purpose of a business carried on by him and supplied by him in the course or furtherance of the business on the last day of the prescribed accounting period in which he first occupies the building or work (or part) at a time when he is not a fully taxable person.

(8) Where sub-paragraph (5),(6) or (7) above applies—

(a) the supply shall be taken to be a taxable supply; and

(b) subject to sub-paragraph (9) below, the value of the supply shall be the open market value of an actual supply of the relevant interest on the last day of the prescribed accounting period mentioned in the subsection concerned.

(9) Where the relevant interest was acquired before 1st April 1989 its value shall be taken to be the aggregate of the consideration given for it and any expenditure (apart from tax) incurred before the commencement of construction in preparing the land for construction.

(10) In this paragraph "relevant interest", in relation to a person, means the interest, right or licence by virtue of which he is the chargeable person.

(11) For the purposes of this paragraph a person is a fully taxable person at any time if he is at that time entitled to credit for input tax on all supplies to, and importations by, him.

(12) Any reference in this paragraph to the time when the chargeable person commences construction shall have effect in relation to a chargeable person who does not undertake construction as a reference to the time when construction is commenced.

6.—(1) This paragraph has effect for determining for the purposes of paragraph 5 above who is the chargeable person in relation to the construction of any building or work.

(2) Where at the commencement of construction of a building or work the person constructing it holds the fee simple in or a tenancy of the land or is by virtue of any contract entitled to the fee simple or a tenancy on or before the day on which the building or work is completed, that person shall be the chargeable person.

(3) Where sub-paragraph (2) above does not apply—

(a) if one or more persons holding any interest in, right over or licence to occupy the land are connected with the construction at its commencement, the person so connected or, where there is more than one, the one most closely so connected; and

(b) in any other case, the person holding the fee simple at the commencement of construction,

shall be the chargeable person.

(4) Where—

(a) a person would (apart from this sub-paragraph) be the chargeable person by virtue of sub-paragraph (2) above or sub-paragraph (5) below;

(b) sub-paragraph (2) of paragraph 5 above is disapplied in his case by sub-paragraph (4) of that paragraph; and

(c) he ceases to construct the building or work at a time before it is completed,

he shall not be the chargeable person.

(5) Subject to sub-paragraph (6) below, where sub-paragraph (4) above applies, the person who next constructs the building or work and who, at the time when he commences construction, holds the fee simple in or a tenancy of the land, or is by virtue of any contract entitled to the fee simple or a tenancy on or before the day on which the building or work is completed, shall be the chargeable person.

(6) Sub-paragraph (5) above shall not apply in relation to a person if he acquired the interest mentioned in that subsection from the person who last constructed the building or work on a

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taxable supply.

General

7. The Notes to Group 8 of Schedule 5 to this Act and Group 1 of Schedule 6 to this Act apply in relation to this Schedule as they apply in relation to their respective Groups but subject to any appropriate modifications.

8. The Treasury may by order make such amendments of this Schedule as are necessary or expedient in consequence of the making of an order under this Act varying Schedule 5 or 6 to this Act."

1983 c.55.

7. At the end of section 42(2) (adjustment of contracts on changes in tax) of the Value Added Tax Act 1983 there shall be added the words "(including a change attributable to the making of an election under paragraph 2 of Schedule 6A to this Act)".

Commencement

8.—(1) Subject to sub-paragraph (2) below, the amendments made by paragraphs 1 to 4 of this Schedule shall have effect in relation to supplies made on or after 1st April 1989.

(2) Subject to sub-paragraph (3) below, the amendments made by those paragraphs shall not have effect in relation to a supply if it is proved to the satisfaction of the Commissioners by the production of documents made before 21st June 1988 that the supply was made in pursuance of a contract made before that date for the making of that supply.

(3) Sub-paragraph (2) above shall not apply in relation to a grant or assignment of a tenancy for a period exceeding 21 years if and to the extent that the consideration is in the form of rent.

(4) Paragraph 5 of this Schedule and paragraph 6, so far as relating to paragraphs 1 and 7 of Schedule 6A to the Value Added Tax Act 1983, shall come into force on 1st April 1989; but, subject to that, paragraph 6 of this Schedule shall come into force on 1st August 1989.

(5) Paragraph 7 of this Schedule shall come into force on 1st August 1989.

SCHEDULE 2

REPEALS [J0300]

Chapter	Short title	Extent of repeal
1984 c.43.	The Finance Act 1984.	In Schedule 6, Part II.

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Chapter	Short title	Extent of repeal
S.I. 1986/704.	The Value Added Tax (Land) Order 1986.	The whole Order.
S.I. 1986/716.	The Value Added Tax (Land) (No.2) Order 1986.	The whole Order.
S.I. 1987/1072.	The Value Added Tax (Construction of Buildings) (No.2) Order 1987.	Article 2.

This Part of this Schedule has effect in relation to supplies made on or after 1st April 1989.

STATUTORY INSTRUMENT

1989 No.

VALUE ADDED TAX

The Value Added Tax (Self-Supply of Construction Services) Order 1989

Made	1989
Laid before the House of Commons	1989
Coming into force	1st April 1989

The Treasury, in exercise of the powers conferred on them by sections 3(6) and (5) and 29(2) of the Value Added Tax Act 1983 (a) and of all other powers enabling them in that behalf, hereby make the following Order:-

1. This Order may be cited as the Value Added Tax (Self-Supply of Construction Services) Order 1989 and shall come into force on 1st April 1989.

2. In this Order "the Act" means the Value Added Tax Act 1983.

3.-(1) Where a person, in the course or furtherance of a business carried on by him, otherwise than for a consideration and for the purpose of that business, performs any of the following services, that is to say -

(a) the construction of a building; or

(b) the extension or other alteration of, or the construction of an annexe to, any building such that additional floor area of not less than 10 per cent of the floor area of the original building is created; or

(a) 1983 c.55.

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(d) in connection with any such services as are described in sub-paragraph (a), (b) or (c) above, the carrying out of any demolition work contemporaneously with or preparatory thereto,

then, subject to each of the conditions specified in paragraph (2) below being satisfied, those services shall be treated for the purposes of the Act as both supplied to him for the purpose of that business and supplied by him in the course or furtherance of it.

(2) The conditions mentioned in paragraph (1) above are that -

(a) the value of such services is not less than £100,000; and

(b) such services would, if supplied for a consideration in the course or furtherance of a business carried on by a taxable person, be chargeable to tax at a rate other than nil.

(3) The preceding provisions of this article shall apply in relation to any bodies corporate which are treated for the purposes of section 29 of the Act as members of a group as if those bodies were one person, but anything done which would fall to be treated by virtue of this Order as services supplied to and by that person shall be treated as supplied to and by the representative member.

4.-(1) The value of any supply of services which is to be treated as taking place by virtue of this Order is the open market value of such services.

(2) Where any services of a description specified in article 3(1) above are in the process of being performed on the day this Order comes into force, the value of such services for the purposes of this Order shall be the value of such part of those services as are performed on or after that day.

1989

Two of the Lords Commissioners
of Her Majesty's Treasury

GUIDANCE ON TAX POINT IMPLICATIONS

Introduction

1. As a result of the proposed changes certain supplies of land and buildings will change from being zero rated (or exempt) to being standard rated on either 1 April or 1 August.

Whether a particular supply will be zero rated (or exempt) or standard rated at the time of the change-over depends on the time when the supply is made.

In order to avoid any misunderstanding this note gives guidance on the rules which will apply.

Normal rules for determining the time of supply

2. VAT is charged at the rate of tax in force at the time the supply is made. This is often called the "tax point". The time of supply of goods and services is normally the earliest of:

a) the date when the services are performed, or the goods are delivered or made available to the customer (known as the basic tax point);

b) the date when payment is received for the supply; and

c) the date when the invoice is issued.

The following paragraphs look at these tax points in more detail.

Application to land and buildings

3. Tax invoices

Invoices issued in respect of zero rated or exempt supplies are not "tax invoices" for the purposes of the VAT legislation. Therefore for such supplies a tax point cannot be created by issuing an invoice. This mean that only the basic tax point (of performance of services or removal of goods), or the "payment received" tax point can apply to these changes.

4. Basic tax point

Freehold Transfers

Buildings and land cannot be removed in the normal sense of the word. The basic tax point for supplies of the freehold of land or buildings is therefore considered to be when they are made available to the customer. Customs have taken the view in the past that the time when a building is made available is the date of the transfer of title to the property. However, in most cases this tax point is not applicable because the transfer of title is preceded by payment - which in itself creates a tax point.

If title to the property is transferred before the building is completed Customs do not consider that a "made available" tax point can occur for any part of the supply other than what is actually in existence on the day the title is transferred. "Made available" is merely an alternative to "removal" for goods which are physically incapable of removal; and you cannot remove goods which do not exist. In the case of a new building, what would be capable of being made available would normally be the work which had been certified by the architect as having been completed.

5. At the time of a liability change there is no advantage to be gained by artificially bringing forward the transfer of title to industrial or commercial buildings. For the forthcoming changes Customs will accept, under the normal rules for changes of rate, that a supplier may zero rate (where otherwise appropriate) either the work actually carried out or, if greater, the work for which he has received payment, before 1 April 1989 irrespective of whether title has been transferred. In the absence of a valid prepayment, a tax point created by the transfer of title on 31 March will only establish a zero rated supply (where otherwise appropriate) to the extent of the work which has been completed by that date and which can therefore be made available to the client. Work done, and paid for, after 31 March will be standard-rated.

6. Leases

There is no "removal" or "made available" tax point for leases (see para 16).

This includes those which exceed 21 years.

7. Tax point for input tax

The tax point for supplies of goods and services to a business may also be significant. It may determine whether or not attributable input tax can be deducted by a business when it elects to tax the rental or sale of a property (under the "option to tax" provisions which are to come into effect from 1.8.1989).

8. Many supplies of services which property owners or developers receive are continuous and will not, therefore have a basic tax point. The tax point for such a supply is the earlier of the date when payment is received or the date an invoice is issued. However, other supplies of services and most supplies of goods will have a basic tax point - when the services are performed or the goods delivered or made available. This basic tax point can only be overridden by the issue of an invoice if it is issued within 14 days of the basic tax point. For these supplies, therefore, there is only limited scope for asking a supplier to delay issuing an invoice until after the date when an election takes effect.

9. There are in addition special rules for input tax recovery arising from the election to tax the rental or sale of property. These are spelled out in the commentary on the draft law.

10. "Receipt of payment"

In order for a payment made in advance of a supply to create a tax point under Section 5(1) of the VAT Act 1983 it must be received by the supplier. It is not sufficient simply to prove that the customer has paid for the supply; there must also be proof that the supplier has received the payment. The question of whether payment was "received" within the meaning of Section 5(1) is at the heart of a number of VAT Tribunal and Court cases arising from the 1984 Budget changes when certain supplies in the construction industry became standard-rated for the first time. Some of these case are still the subject of litigation.

11. Customs consider that in order to establish a prepayment tax point some, if not all, of the following features must be present:

(i) the payment must be substantive, not notional ie there should be real money involved;

(ii) the money must have been transferred to the unfettered control of the payee, not placed in a special bank account;

(iii) it must be available to the payee to dispose of as he pleases without reference to the payer; and

(iv) the payer must not be able to claim an equitable right over the sum.

12. Two VAT Tribunal cases, those of Double Shield Window Company Limited and J W Goodyer and Co (Builders) Limited have established beyond doubt that certain devices do not create a tax point. In the Double Shield Window Company Limited case the customer's advance payments were held by their solicitor and only released to the company when the customer gave a certificate that the work had been carried out satisfactorily. This is analogous with the practice in property transactions whereby a part payment made on exchange of contracts is held by the vendor's solicitor as stake holder. In J W Goodyer & Company (Builders) Limited the advance payment was handed immediately to a bank which issued a bond to the client guaranteeing repayment of the advance payment in the event that the builder failed to complete the work under the contract. The bank's liability under the bond reduced as each stage of the work was certified by the architect as having been satisfactorily completed. As certificates were issued the bank released appropriate amounts of the prepayment to the builder.

13. This arrangement, where the bond is provided by the person holding the prepayment, should not be confused with the more commonly found performance bond where a small amount, typically 2%, of the advance payment is paid as a premium to an insurance company who then provide cover against the failure of the supplier to complete the work. A prepayment in these circumstances will create a tax point.

14. Four other cases, where the High Court has rejected Customs' contention that payments have not been received, are being appealed to the Court of Appeal. Two cases involve fettered payments: Dormers Builders Ltd and Nevisbrook Limited. The two other cases involve 'pay and loan back' arrangements: Faith Construction and West Yorkshire Independent Hospital (Contract Services) Limited. Details of these cases are contained in the annex to this note.

15. **Until such time as the legal position is settled Customs and Excise will not accept that arrangements similar to these four cases will create a tax point within the meaning of Section 5(1).** Anyone who is in doubt as to whether a scheme will be acceptable or not should contact their local VAT office for advice.

Taxable leases

16. Normal rules

The tax point for leases which become taxable as a result of a lessor exercising an option to tax his rents will in general be the earlier of the date of the issue of the invoice or the receipt of payment.

When rents become taxable lessors may either

a) issue individual invoices for each rental payment in which case the tax point is the earlier of the date of the invoice or of receipt of payment, or

b) issue one invoice to cover up to one year ahead setting out the dates on which the payment is due, in which case the tax point is the earlier of the date when each payment is due or is received.

Rent demands or reminders do not constitute tax invoices and hence do not create a tax point provided they are clearly marked **"This is not a tax invoice"**. If a lessor issues a rent demand, receives payment and then issues a tax invoice, the tax point will be the date of receipt of payment.

17. Transitional rules

However, special rules will apply when the option to tax is first exercised. These are designed to ensure that tax is paid equally by all businesses after their landlord has opted to tax, irrespective of when their rent was normally payable. Before a landlord exercises his option to tax, rents will be exempt and therefore the issue of an invoice cannot create a tax point (because it is not a "tax invoice). Additionally, under these special provisions, the payment of rent before the option to tax becomes effective, where the rent is attributable to a period after that date, will not create a tax point for an exempt supply. Similar arrangements apply to the end of a transitional period.

18. Further information about tax invoices can be found in Notice 700 (The VAT General Guide) Section VI.

Annex

Dormers Builders client borrowed £600,000 from their bank which was held in a special account entitled "Williams and Glyn Bank Plc re Dormers Builders". The deposited sum was charged to the bank as security for the loan to the client. The money was not released to Dormers' current account until architects' certificates were issued showing the value of work carried out. No money was released until after 1 June 1984.

In **Nevisbrook** the money was deposited in an account in the name of Nevisbrook but the sole signatory was a Director of the client company. Again no money was released until architects' certificates were obtained, all post 1 June.

Faith Construction's client Delmon borrowed £300,000 from their bank and paid it over to Faith on 29 May 1984. In order that Delmon could immediately repay the loan to the bank Faith lent the same sum to them, also on 29 May, on terms which allowed Delmon to repay the sum to Faith after 1 June in stages as the work proceeded. This repayment was effected by Delmon again borrowing sums from its bankers equal to amounts certified from time to time by its architect and paying the same to Faith in discharge of its loan.

In the **West Yorkshire** case three companies were involved, the client and two newly formed subsidiaries trading as a finance company and a builder. On the same day, 30 May 1984, the client borrowed £1m from the finance company with which to pay the builder who loaned £1m to the finance company. Construction work began in December 1984. As and when the building company needed funds to pay their subcontractors they called in part of the loan to the finance company who in turn called in the loan to the client.

CONFIDENTIAL

WATER & SEWERAGE SERVICES

Draft Clause 1 to Finance Bill 1989

Summary

Water and sewerage services of emptying cesspools, septic tanks etc, are to be excluded from zero-rating, with effect from 1 April 1990, where these supplies are made to industry for use in connection with the carrying on of a business. These supplies will then become subject to the standard-rate of VAT.

Subsection (1) identifies the zero rate Group dealing with water and sewerage services as requiring amendment to implement the changes.

Subsection (2) amends item 1 of Group 2 so that the emptying of cesspools, septic tanks etc. used in connection with the carrying on of a business falling within the industrial classification detailed in subsection (4) below, are excluded from zero-rating.

Subsection (3) amends item 2 of Group 2 to exclude the supply of water, used in connection with the carrying on of a business falling within the industrial classifications detailed in subsection (4) below, from zero rating.

Subsection (4) introduces a note to the end of Group 2 defining "relevant industrial activity" as any activity described in the Divisions 1 to 5 of the Standard Industrial Classification; that is, the energy and water supply industries, the extraction of minerals and ores, and the manufacture of metals, minerals and chemicals, metal goods, engineering and vehicles and other manufacturing industries, and the construction industry.

Subsection (5) brings the changes in liability into effect on 1 April 1990.

NEWS SERVICES

Draft Clause 2 to Finance Bill 1989

Summary

All supplies of news services are to be liable to the standard rate of VAT from 1 April 1989.

Subsection (1) repeals the zero-rating for news services contained in Schedule 5, Group 6 of the VAT Act 1983.

Subsection (2) brings this into effect on 1 April 1989.

FUEL AND POWER FOR DOMESTIC OR CHARITY USE

Draft Clause 3 to Finance Bill 1989

Summary

Fuel and power is to be zero rated only when supplied for domestic use or to a charity for a non-business use. Other uses of fuel and power are to be standard-rated from 1 April 1990.

Subsection (1) identifies the zero rate Group dealing with fuel and power as requiring amendment to implement the changes.

Item 1 of the amended Group provides that types of fuel and power currently zero-rated are to be zero-rated only when supplied for a qualifying use.

Note 1 identifies qualifying use as domestic use or non-business use by a charity.

Note 2 lists certain types of fuel or sizes of delivery which can automatically be assumed to be for domestic use and therefore zero-rated (The zero rate will apply even if at the time of supply it is known that the fuel will in fact go to business use.) At present the Note makes no provision for supplies of gas and electricity - discussions on similar limits for these are still in progress with trade representatives.

Note 3 defines domestic use. This covers not only ordinary private dwellings, but also caravans, houseboats, self-catering holiday accommodation and communal residential establishments as defined in Note 4.

Note 4 defines the communal residential establishments which are to be eligible for zero rating. These include children's and old people's homes, hospices, school boarding accommodation, university halls of residence, military barracks, religious communities and any other communal establishment which is the main home of at least 90% of its occupants. (The same types of establishments are also to be eligible for zero rating on new construction under Group 8.) Hospitals, prisons, hotels and similar establishments are specifically excluded.

Note 5 defines self-catering holiday accommodation for the purposes of Note 3.

Note 6 defines "houseboat", limiting relief to houseboats which are places of permanent habitation.

Note 7 provides that where a supply of fuel and power is made partly for zero- and partly for standard-rated purposes, it can be treated as wholly zero-rated if 60% or more of it is for a zero-rated use. If less than 60% is for zero-rated use tax is to be apportioned.

Notes 8 to 14 replicate Notes 1 to 7 of the existing Group.

Subsection 2 brings the changes in liability into effect on 1 April 1990.

PROTECTIVE BOOTS AND HELMETS

Draft Clause 4 to Finance Bill 1989

Summary

The clause excludes supplies of protective boots and helmets made to employers for the use of their employees from zero-rating with effect from 1 April 1989. The supplies will then become subject to the standard rate of VAT.

Subsection (1) amends the zero rate Group dealing with clothing and footwear to exclude from zero rating protective boots and helmets for industrial use supplied to a person for use by his employees.

Subsection (2) amends note 5 to Group 17 to exclude services related to items supplied to a person for use by his employees from zero rating.

Subsection (3) brings the changes in liability into effect on 1 April 1989.

CIVIL PENALTIES

Draft Clause 5 to Finance Bill 1989

It is envisaged that, where suppliers of fuel and power are in doubt as to an individual customer's eligibility for zero rating, they will ask the customer to provide a written certificate that he is entitled, in whole or in part, to receive fuel at the zero rate. A certificate of entitlement

to zero rating will also be required from the customer before certain supplies of construction services or new buildings can be zero rated. This clause deals with the civil penalty regime for incorrect certificates.

Subsection (1) of the main clause amends the civil penalty provisions of the 1985 Finance Act to add these new arrangements.

Subsection (1) provides that where an incorrect certificate as to entitlement to zero rating for fuel and power, construction services or new buildings has been given, the person giving it shall be liable to a civil penalty.

Subsection (2) provides that the penalty will be equivalent to the amount of tax under-charged as a result of the incorrect certificate.

Subsection (3) provides that no penalty will be due if the person who gave the certificate has a reasonable excuse. (The 1983 VAT Act provides a right of appeal to a VAT Tribunal over both the imposition of the penalty and its amount.)

Subsection (4) provides that there is to be no civil penalty if the person concerned has also been convicted of a criminal offence in connection with the incorrect certificate.

Subsection (2) of the main clause provides that civil penalties shall apply to incorrect certificates given after Royal Assent to the 1989 Finance Act.

DRAFT CLAUSES/SCHEDULES

Zero-rating

Sewerage services and water. [j0305]

1983 c.55.

1.—(1) Group 2 (sewerage services and water) of Schedule 5 (zero-rating) to the Value Added Tax Act 1983 shall be amended as follows.

(2) In item 1, there shall be substituted for paragraph (b)—

"(b) emptying of any cesspools, septic tanks or similar receptacles which are used otherwise than in connection with the carrying on in the course of a business of a relevant industrial activity."

(3) In item 2, there shall be inserted at the beginning the words "The supply, for use otherwise than in connection with the carrying on in the course of a business of a relevant industrial activity, of".

(4) The following shall be inserted at the end—

"*Note:* "Relevant industrial activity" means any activity described in any of Divisions 1 to 5 of the 1980 edition of the publication prepared by the Central Statistical Office and known as the Standard Industrial Classification."

(5) This section shall have effect in relation to supplies made on or after 1st April 1990.

News services. [j0303]

2.—(1) In Schedule 5 to the Value Added Tax Act 1983 Group 6 (news services) shall be omitted.

(2) This section shall have effect in relation to supplies made on or after 1st April 1989.

Fuel and power. [j0304]

3.—(1) For Group 7 (fuel and power) of Schedule 5 to the Value Added Tax Act 1983 there shall be substituted—

"GROUP 7 - FUEL AND POWER FOR DOMESTIC OR CHARITY USE

Item No.

1. Supplies for qualifying use of—

(a) coal, coke or other solid substances held out for sale solely as fuel;

(b) coal gas, water gas, producer gases or similar gases;

(c) petroleum gases, or other gaseous hydrocarbons, whether in a gaseous or liquid state;

(d) fuel oil, gas oil or kerosene; or

(e) electricity, heat or air-conditioning.

Notes:

(1) "Qualifying use" means—

(a) domestic use; or

(b) use by a charity otherwise than in the course of a business.

(2) The following supplies are always supplies for domestic use—

(a) supplies of not more than one tonne of coal or coke held out for sale as domestic fuel;

(b) supplies of wood, peat or charcoal;

(c) supplies of not more than 2,000 litres of petroleum gas in a liquid state and supplies of such gas in cylinders of which the net weight is less than 50 kilogrammes;

(d) supplies of not more than 2,300 litres of fuel oil, gas oil or kerosene.

(3) Supplies not within Note (2) are supplies for domestic use if and only if the goods supplied are supplied for use in—

(a) a building, or part of a building, which consists of a dwelling or number of dwellings;

(b) a building, or part of a building, used for a relevant residential purpose;

(c) ~~a house or flat used as~~ self-catering holiday accommodation;

(d) a caravan; or

(e) a houseboat.

(4) Use for a relevant residential purpose means use as—

(a) a home or other institution providing residential accommodation for children;

(b) a home or other institution providing residential accommodation with personal care for persons in need of personal care by reason of old age, disablement, past or present dependence on alcohol or drugs or past or present mental disorder;

(c) a hospice;

(d) residential accommodation for students or school pupils;

(e) residential accommodation for members of any of the armed forces;

(f) a monastery, nunnery or similar establishment; or

(g) an institution which is the sole or main residence of at least 90 per cent. of its residents,

except use as a hospital, a prison or similar institution or an hotel or inn or similar establishment.

(5) Self-catering holiday accommodation includes any accommodation advertised or held out as such.

(6) "Houseboat" means a boat or other floating decked structure designed or adapted for use solely as a place of permanent habitation and not having means of, or capable of being readily adapted for, self-propulsion.

(7) Where there is a supply of goods partly for qualifying use and partly not—

(a) if at least 60 per cent. of the goods are supplied for qualifying use, the whole supply shall be treated as a

supply for qualifying use; and

(b) in any other case, an apportionment shall be made to determine the extent to which the supply is a supply for qualifying use.

(8) Paragraph (a) shall be deemed to include combustible materials put up for sale for kindling fires but shall not include matches upon which a duty of customs or excise has been or is to be charged.

(9) Paragraphs (b) and (c) do not include any road fuel gas (within the meaning of the Hydrocarbon Oil Duties Act 1979) on which a duty of excise has been charged or is chargeable. 1979 c.5.

(10) Paragraph (d) does not include hydrocarbon oil on which a duty of excise has been or is to be charged without relief from, or rebate of, such duty by virtue of the provisions of the Hydrocarbon Oil Duties Act 1979.

(11) "Fuel oil" means heavy oil which contains in solution an amount of asphaltenes of not less than 0.5 per cent. or which contains less than 0.5 per cent. but not less than 0.1 per cent. of asphaltenes and has a closed flash point not exceeding 150°C.

(12) "Gas oil" means heavy oil of which not more than 50 per cent. by volume distils at a temperature not exceeding 240°C and of which more than 50 per cent. by volume distils at a temperature not exceeding 340°C.

(13) "Kerosene" means heavy oil of which more than 50 per cent. by volume distils at a temperature not exceeding 240°C.

(14) "Heavy oil" shall have the same meaning as in the Hydrocarbon Oil Duties Act 1979."

(2) This section shall have effect in relation to supplies made on or after 1st April 1990.

Protective boots and helmets. [j0306]

4.—(1) In item 2 of Group 17 (protective boots and helmets) of Schedule 5 to the Value Added Tax Act 1983 there shall be inserted at the beginning the words "The supply to a person for use otherwise than by employees of his of". 1983 c.55.

(2) In Note (5) to that Group (supply of certain goods to include supply of certain services in respect of such goods) there shall be inserted at the end the words ", but, in the case of goods comprised in item 2, only if the goods are for use otherwise than by employees of the person to whom the services are supplied."

(3) This section shall have effect in relation to supplies made on or after 1st April 1989.

Incorrect certificates. [j0307]

5.—(1) The following section shall be inserted in the Finance Act 1985 after section 13— 1985 c. 54.

"Incorrect certificates as to zero-rating etc.

13A.—(1) Subject to subsections (3) and (4) below, where—

(a) a person to whom one or more supplies are, or are to be, made gives to the supplier a certificate that the supply or supplies fall, or will fall, wholly or partly within Group 7, 8 or 8A of Schedule 5, or Group 1 of Schedule 6, to the principal Act; and

(b) the certificate is incorrect,

the person giving the certificate shall be liable to a penalty.

(2) The amount of the penalty shall be equal to the difference between the amount of the tax chargeable on the supply or supplies and the amount which would have been so chargeable if the certificate had not been incorrect.

(3) The giving of a certificate shall not give rise to a penalty under this section if the person who gave it satisfies the Commissioners or, on appeal, a value added tax tribunal that there is a reasonable excuse for his having given it.

(4) Where by reason of giving a certificate a person is convicted of an offence (whether under the principal Act or otherwise), the giving of the certificate shall not also give rise to a penalty under this section."

(2) This section shall have effect in relation to certificates given on or after the day on which this Act is passed.

SCHEDULES

SCHEDULE 1

REPEALS [J0309]

Chapter	Short title	Extent of repeal
1983 c.55.	The Value Added Tax Act 1983.	In Schedule 5, Group 6.

The above repeal has effect in relation to supplies made on or after 1st April 1989.

fp.nh/rm/42

CCPU.

Treasury Chambers, Parliament Street, SW1P 3AG

21 November 1988

The Rt Hon Malcolm Rifkind
Secretary of State for Scotland
Scottish Office
Whitehall
LONDON SW1

Dear Malcolm.

You wrote to Nigel Lawson on 28 October about VAT on the proposed international medical centre at Clydebank.

In your letter you say that charging VAT on the construction services for private hospitals seems inequitable, both because those who provide private health care cannot recoup VAT since health charges are exempt, and because we have insulated the public sector against the impact of VAT on construction services.

I regret the fact that the Court's ruling will result in higher costs for private health care. As you know, we opposed the EC's case vigorously but having lost, we must implement the judgement.

As you correctly indicated in your letter, VAT zero-rating has to be for clearly defined social reasons and for the benefit of final consumers. The court ruled that we could not zero rate the construction of commercial buildings, and a private hospital run as a business is clearly a commercial building. Even if it were not, the supply has to be to the final consumer if relief is to be possible. The supply in this case is to the hospital company which is not a final consumer, since it is the patients who are the final consumers. While the Court provided a limited relaxation from the final consumer test in a case where the supply, if not actually to the final consumer, is sufficiently close to him to be for his benefit, they specifically rejected that argument for hospitals in the case of fuel and power, and we do not see how we could justify taking a different view in respect of construction services.

On the question of insulating the public sector from VAT, it was clear to us that one way or another, health authorities had to be given the means to maintain their construction programmes intact. Given the existing concession in respect of VAT charged on contracted out services - which assists the private sector - we took the view that the best and simplest course was to allow health authorities to reclaim VAT on new construction.

By allowing health authorities to reclaim VAT in this manner, I accept that if pay bed charges do not incorporate VAT costs, health authorities would in principle be at an advantage over private sector competitors, and I shall keep the matter under review. But I am not convinced there is a case for immediate change. Capital costs would in practice represent a relatively small proportion of the fees, so the VAT might make no more than 1 or 2 per cent difference to the price. I would not expect price differences of this order to have a significant effect, particularly as private hospitals would be tending to compete in any case on non-price aspects.

I regret that, for these reasons, I cannot help you so far as VAT is concerned.

You raise also the point that recipients of regional aid who are unable to reclaim additional VAT, may need a higher level of assistance if the project is to proceed. It is for you to consider whether Health Care International still offers sufficient value for money to justify additional support. In principle, this tax change is no different from other taxes which the public has to bear and increased provision cannot be justified simply on the grounds that any additional expenditure will be matched by additional receipts. But I know that John Major would be content for you to pursue the provision of additional regional selective assistance provided this is within the framework of the existing RSA guidelines and can be accommodated within your existing RSA provision.

I am coping to the Prime Minister and Kenneth Clarke.

Yours ever

Peter

PETER LILLEY

Econ Pol: Zero Rates for VAT
Feb 82

S.G.WARBURG & CO. LTD.
33 KING WILLIAM STREET, LONDON EC4R 9AS
TELEPHONE: 01-280 2222
TELEX: 22941
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22nd December, 1988

Dear Godfrey,

VAT: Funding of RSD Development Programme

Our Report on Bank Lending and Funding Alternatives was written to assist RSD in the evaluation of funding options for its current development programme. We have discussed a number of the issues outlined in the Report which potentially affect the economics of these developments and hence the availability of sufficient finance. We have, subsequently, been giving further thought in particular to the proposed changes to the VAT regime in the light of the judgement of the European Court.

We understand that you have made representations to the Government to widen the scope of the transitional arrangements to include projects for which commitments had been made prior to the judgement of the European Court and for which substantial funding will soon be required. Without appropriate concessions the viability of a number of committed projects could well be impaired as they will be likely to incur additional costs which could not have been anticipated at the outset.

It is our view that without adequate transitional relief for such projects a climate of uncertainty will be created which will make it more difficult to raise the necessary finance. Under HM Customs' current proposals funders will necessarily take a prudent view as to the proportion of tenants able to recover VAT within rents and hence on the costs of, and returns from, each project to the developer. This will have a significant impact on judgements regarding the total debt capacity of each project and will compound the difficulties to which we have referred in our Report with respect to future funding of these projects.

..../2

We do, of course, recognise that projects contemplated in the future will also be affected by problems of funding under a changed VAT regime but at least those considering whether to become committed to such projects will be able to do so in full knowledge of the tax position. Given the support which the financial community as both tenant and funder has been providing for major urban developments and the continuing requirement for such support, we hope you will be successful in your representations to Government.

We look forward to discussing further with you the implications of our Report for the funding of RSD's development programme.

Yours sincerely,

Jonathan P. Scott

G.M. Bradman, Esq.,
Rosehaugh Stanhope Developments
Holdings plc,
Rosehaugh PLC,
53-55 Queen Anne Street,
London.
W1M 0LJ

JPS/jb/seam/603

Prime Minister
You will wish to be aware of this exchange; on the Economic Secretary's letter below suggests there seems no alternative to supporting HCI through higher regional assistance.
RLG 28/11

cc PS

SECRETARY OF STATE FOR SCOTLAND

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

The Rt Hon Nigel Lawson MP
HM Treasury
Parliament Street
London SW1P 3AG

28 October 1988

NSR see by PM SL update by late correspondence. Reduce NSPM.
RLG 1/12

Dear Nigel

VAT AND HEALTH CARE INTERNATIONAL

As you are aware, the European Court of Justice on 21 June this year gave a judgement regarding our policy of zero rating, for VAT purposes, the provision of certain goods and services. I am writing because of the potential impact of the judgement (and of our response to it) on a particular project (Health Care International) and a particular sector (private health care). The problem is that private hospitals may well be forced to pay 15% VAT on a key input (construction costs) without being able to recoup it on output (charges to patients). This problem is causing major difficulties for HCI, which is the largest inward investment proposed for Scotland in recent years; and I need by mid-November to be able to reassure the company that a solution will be found. The company require assurances in this timescale if they are to complete funding in time to meet the project schedule of starting on site in spring 1989 before opening in 1992.

The Project

The project comprises the establishment of an international medical centre of excellence for treatment, teaching, training and research, in the field of complex surgical illnesses, such as cancer, heart disease and neurosurgery. It involves the raising of £210 million, of which the greater bulk (£194 million) is to be provided by the private sector. It will create 2,200 jobs directly in Clydebank and a further 1,800 as a result of its requirement for goods and services, creating a total of 4,000 jobs in Scotland. My department, with the agreement of Treasury, has offered £12 million regional selective assistance in support of the project.

While it is a project with tremendous opportunity for Scotland, it is also a high risk development. Completing the funding is an ambitious task which, if VAT is levied at standard rate thereby adding some £10 million to contribution costs, will become impossible. This view has been clearly expressed by the company's main loan and equity backers, Samuel Montagu in the UK and Montgomery Medical Ventures in the US.

PRG301F5

The Sector

I am concerned not just about the possible loss to the UK of a project of this size and quality, but also about the effect which levying VAT could have on the sector as a whole. Charging VAT on construction services for private hospitals seems to me to be inequitable both because they cannot recoup VAT since health charges are exempt in European Community law, and also because we have insulated the public sector against the effect of introducing VAT on construction services. While the private sector would suffer a 15% penalty, the public sector - even when providing paybeds for private patients - would not. I think that similar arguments may well apply not just to health, but to education.

The Legal Position

The most attractive solution to these problems would be to retain zero rating for the construction of private hospitals. If we were to seek to do so, we would need, of course, to be convinced not just of the political attractions, but of the legal justification of our position.

I enclose a supporting annex which outlines a potential case which

a. is consistent with the European Court of Justice judgement and based, therefore, on arrangements made for social reasons, and for the benefit of the final consumer or sufficiently close to the consumer as to be of advantage to him;

b. is consistent with the Community's 6th Directive which governs member states' treatment of VAT, and based, therefore, on the need to avoid distortion of competition between public and private sector;

c. may provide Customs and Excise with a rationale for defining both the final consumer and circumstances in which services provided further up the distribution chain could be regarded as of benefit to the final consumer; and

d. may provide Customs and Excise with a defence against the charge of significantly distorting competition.

I hope that you will agree that Customs and Excise should consider taking this case up with the VAT Committee of Member States in order to seek to ensure that proceeding in this way would not be likely to lead to further infraction proceedings by the Commission against us.

Conclusion

I believe a solution must be found to the HCI problem. The best solution on all grounds is to maintain zero rating for private hospital construction. By so doing we would be not so much encouraging as not discouraging private sector provision and funding, since otherwise we will be positively discriminating in favour of the public sector against the private sector. Moreover this is at a time when we are looking to the commercial world for a greater contribution.

If this solution cannot be delivered I would be prepared, with your agreement, to pursue the provision of additional regional selective assistance to offset VAT, but I regard this as very much a second best solution. At all events, however, I need to be able to tell the company that a solution will be found.

Because of the implications for private health care provision in England and Wales I am copying this letter to Kenneth Clarke, and, in view of her interest in the HCI project, to the Prime Minister.

MALCOLM RIFKIND

PRG301F5

ANNEX

EUROPEAN COMMUNITY LAW AND VAT TREATMENT OF CONSTRUCTION SERVICES FOR PRIVATE HOSPITALS

1. Any case advanced for retaining VAT zero rating for construction services for private hospitals would need to be consistent with the judgement of the Court of Justice of the European Communities of 21 June 1988 and with the Community's 6th Directive which governs member states' treatment of VAT.

2. The judgement states (paragraph 3) that member states may provide for reduced rates or exemptions with refund (or zero rates) if measures are taken "for clearly defined social reasons and for the benefit of the final consumer". The judgement goes on to say that it is for member states to determine their own social policy (paragraph 12), to define final consumers as those at the final stage in the manufacturing and commercial chain with no right to deduct VAT (paragraph 15), and to clarify that "the provision of goods or services at a stage higher in the production or distribution chain which is nevertheless sufficiently close to the consumer to be of advantage to him must also be considered to be for the benefit of the final consumer" (paragraph 17).

3. Specifically the judgement supports the Government and finds against the Commission in allowing zero rating not just for food but for animal feedingstuffs, seeds and live animals on the grounds that the supplies are sufficiently close to the final consumer to be of advantage to him (paragraph 20). Secondly, the judgement also supports the Government against the Commission in allowing zero rating not just for housing constructed by local authorities but for all housing on the grounds that the Government has social reasons for facilitating home ownership (paragraph 36).

4. Naturally the judgement is not uniformly favourable; provision of fuel and power, for example, cannot be zero rated, even that supplied to schools and hospitals, since final consumers "derive only very indirect advantages from (such) zero rating" (paragraph 32). Nevertheless there is the basis of a case for retaining zero rating for construction services for private hospitals on the grounds that the Government has a social policy objective of increasing private sector provision and funding of health care and that the constuction of a hospital provides a service of direct, not indirect, benefit to the final consumer or patient who is using not merely professional services of doctors and medical supplies but also the facilities of the building.

5. It might also be possible to base a legal position not just on the judgement itself, but on general principles of European law regarding VAT. First, Article 13 A.1 of the Community's 6th Directive exempts certain services from VAT. These exemptions appear to be consistent with the 21 June judgement of the European Court of Justice concerning circumstances in which exceptions to standard rating are justified. In other words, the exempted services (largely medical services) both reflect social reasons (the desirability of not taxing health, education and welfare), and benefit the final consumer. In respect only of these exempted services, it would be consistent to argue that services provided higher in the distribution chain which benefit the final consumer should not be subject to VAT when the supply to the final consumer is exempted by Article 13. This could provide Customs and Excise with a clear rationale which may not exist at present, for defining circumstances in which services provided further up the distribution chain could be regarded as of benefit to the final consumer.

6. Secondly, Article 4.5 of the 6th Directive states that tax treatment of public and private sector transactions should not result in "significant distortions of competition". If differential treatment of public and private sector provision of health case is established, the Government's practice may be inconsistent not just with its own social policy objectives but with the mandatory requirements of Article 4.5 of the 6th Directive.

Summary

7. The case for retaining zero rating for construction services for private hospitals stands on two grounds; first that zero rating is justified for social reasons and for the benefit of the final consumer, and second that zero rating preserves parity between public and private sector health care provision and avoids distortion of competition.

8. In addition, the case provides Customs and Excise with a rationale based on Community legislation for defining final consumers and for clarifying circumstances when services provided further up the distribution chain could be regarded as of benefit to the final consumer.

SLHAYC

cc HMT
Gen Sec

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

22 June 1988

I am writing on behalf of the Prime Minister, who as you know is currently on a visit to Canada, to thank you for your letter of 17 June concerning the judgement by the European Court of Justice on the operation of zero-rated VAT in the United Kingdom. We also subsequently spoke about this on the telephone.

As you will be aware the Economic Secretary to the Treasury made a statement to the House of Commons about this yesterday afternoon and also issued a consultation document. In case you have not already seen it, you may find it helpful to have the enclosed Hansard extract and copy of the consultation document.

PAUL GRAY

Godfrey Bradman, Esq.

VAT (European Court Decision)

The Economic Secretary to the Treasury (Mr. Peter Lilley): With permission, Mr. Speaker, I wish to make a statement about the judgment delivered by the European Court of Justice today in the case brought by the European Commission on certain of our VAT zero rates.

The court ruled that the United Kingdom was not in breach of its treaty obligations by zero rating private housing, animal feeding stuffs, seeds and live animals yielding food for consumption. However, it ruled that the zero rating by the United Kingdom of a number of other goods and services was not permitted under European Community law. In broad terms, these items are: the construction of buildings for industrial and commercial use, water and sewerage services supplied to industry, news services supplied to other than final consumers, fuel and power supplied to other than final consumers, and protective boots and helmets purchased by employers. I have placed the full text of the judgment in the Library of the House.

I should make it clear that this adverse judgment is based on an interpretation of existing Community law to which the United Kingdom gave its assent in 1977. It has nothing whatever to do with the Commission's proposals for the approximation of VAT, which are not law and could not become law without the unanimous agreement of all member states.

The Government will study carefully the detailed terms of the court's judgment, against which there is no right of appeal and with which it is obliged to comply. The Government will consult interested parties, including trade and professional bodies, and also charities, on how the judgment can best be applied in practice. Legislation to implement the judgment will then be brought before the House for approval as part of next year's Budget. I can give the House an assurance that no changes will take effect before 1 April 1989.

In the meantime, I am concerned to avoid the damaging effects of a period of uncertainty for the construction industry and its customers, and to mitigate the effects of the extension of VAT to non-domestic construction. I therefore have the following decisions to announce.

Non-domestic construction, the sale of new non-domestic buildings, and the sale of building land for non-domestic developments will be taxed at the standard rate of VAT from 1 April 1989. All contracts entered into before today will continue to be zero-rated. Public sector construction programmes will be protected by allowing, where necessary, compensating adjustments to the relevant central Government expenditure provision. Full refunds of VAT on non-domestic construction will be available to health authorities and local authorities.

Owners of non-domestic property will be given the option to charge VAT on rents, and on sales of used buildings, from 1 August 1989. This option will apply to existing buildings as well as new ones. Where it is exercised, landlords and tenants will be able to reclaim VAT on input costs in the normal way. This means that, where buildings are occupied by fully taxable businesses, neither landlord nor tenants will be worse off. To protect tenants who are not fully taxable, any VAT on rents will be phased in over two years. For charities, the transitional period will be five years. I hope that it will be possible to publish draft Finance Bill clauses relating to non-domestic construction by January.

The estimated yield from the proposals that I have announced will be some £65 million for the initial year, 1989-90, rising to a full year level of £160 million in 1991-92. That compares with the full year yield of £425 million that would accrue from the tax if the measures of mitigation which I have just announced were not introduced.

A consultation document on the changes affecting non-domestic construction will be available in the Vote Office and Library when I sit down. A more general consultation paper on the other aspects of the judgment will be available shortly. Much remains to be considered and there will be full consultation by the Customs and Excise on the implication of the changes.

We find ourselves obliged by undertakings Her Majesty's Government gave in 1977 to impose VAT on non-domestic construction and certain other services. I have announced today measures to mitigate their impact and to minimise uncertainty. I assure the House that there will now be full consultation so that the necessary legislation can be properly considered and prepared for next year's Finance Bill.

Dr. John Marek (Wrexham): The whole country will be disappointed at the outcome of the European Court's judgment. Yet again new taxes are to be imposed on the public against the wishes of Government and Parliament. However, is the Economic Secretary aware that we welcome the court's decision not to insist on the imposition of VAT on all building for housing, animal feed, seeds, and live animals used as food for human consumption. Before implementing the court's decision, will he consult all interested parties carefully so that appropriate transitional arrangements can be found and so that those with contractual obligations are not unfairly penalised?

As some building land is to become subject to VAT, how does the Economic Secretary propose to define it? Will he confirm that, although the construction of schools and hospitals will become subject to VAT, full relief will automatically be available for any and all VAT payable in the future by the authorities responsible for those schools and hospitals when constructing the buildings, and for any associated expenses?

Will the Economic Secretary undertake to ensure that any extra moneys necessary to pay VAT on fuel for schools and hospitals will be provided by the Exchequer? Will county councils be fully reimbursed for any VAT that they may have to pay on road construction? Does he intend that VAT to be paid on construction of railways will be paid for by the travelling public, or can he give an undertaking to the House that the Exchequer will reimburse British Rail for all extra VAT costs? Can he assure the House that the Channel tunnel construction, until completion, will not be subject to VAT?

Will the Economic Secretary go the Commission to try to obtain derogation for some or all of the items to be subject to VAT, or can he introduce a second lower tier? If that is not possible, will he try to obtain an agreement within the Council of Ministers for a fairer and more just interpretation of the sixth VAT directive so that items such as these and spectacle frames, which have been the subject of legislation in the past, can be free of VAT?

Does the Economic Secretary think it fair that the United Kingdom should pay all the costs of the court case, in spite of being vindicated in two important areas?

hon. Gentleman and others to make their points on another occasion. The point at issue was that the original arrangements, which had worked for a long time, fell foul of some legal decisions, and the Government propose to put forward what they believe to be an equitable solution in a difficult area.

It is a black day when the taxation of the British people is decided by other than their Parliaments and the House of Commons. The Common Market can succeed, but it is not going about it the right way.

Mr. Lilley: The hon. Gentleman suggested that there will be universal disappointment at the ruling. However, we have won on the most important issue of private homes, and that will be greatly welcomed. There will also be recognition that the fundamental commitment to the sixth directive was taken by the Labour Government in 1977. It ill behoves the Labour party to express disappointment now.

I have made it clear that there will be full consultation with all those affected by the decisions relating to the implementation of the points that I have made and the other items covered by the ruling. The definition that we propose on building land is that such land without planning permission for domestic housing will be subject to VAT, but we shall obviously consult on how that will be interpreted in practice. I assure the hon. Gentleman that schools and hospitals in the public sector will be fully reimbursed for any VAT that they may incur. County councils likewise are automatically reimbursed for all VAT on all items that they purchase. That will consequently apply equally to roads.

I imagine that the constructors of the Channel tunnel will also secure registration for VAT and be able to reclaim VAT. However, I will confirm that and write to the hon. Gentleman if there is any difference.

With regard to the hon. Gentleman's question about seeking derogation or a lower tier rate, any attempt to seek derogation from the European Commission would scarcely be credible since the Commission brought the case. As for the lower tier rate, we believe that it is far better to have a single positive rate and an extensive zero rate. We do not want to return to a complex system with multiple rates.

We understand that the Commission will not be seeking payment of its costs in the court case. That is the normal practice in the circumstances. We will have to pay our costs, the bulk of which are internal. Only some £7,000 of consultancy fees and counsel opinion costs were incurred.

Mr. Terence L. Higgins (Worthing): Is the Minister aware that he is absolutely right to stress that the decision does not affect the fundamental issue of zero rating? Will he take careful note of the court's view that the Commission does not dispute the legality of the zero rating system in general? May I congratulate my hon. Friend the Minister on stating that the right system is one with zero rating and a single positive rate? Will he fight for that in the political negotiations which are to come? In general, I believe that it is right that my hon. Friend has abided by the rule of law, even though that is the consequence of a decision taken by a predecessor Government.

Mr. Lilley: I am grateful for my right hon. Friend's remarks. I confirm that we shall stick to a single positive rate and the extensive use of zero rating, as has been the practice. I believe that my right hon. Friend oversaw that system when it was introduced. It is correct that in the court case the Commission did not try to overrule our basic right to have zero rates. We welcome that.

Mr. Simon Hughes (Southwark and Bermondsey): Will the Economic Secretary to the Treasury accept that the judgment seems eminently reasonable and that the Government are to be congratulated on arguing successfully for an exemption for domestic housing, which clearly is a case on its own? Will the hon. Gentleman therefore confirm that now there is no VAT—a policy which has been upheld — on domestic house new building but that there is still VAT on renovation, restoration, and the like? Does he accept that in the next Budget the Government's inner city policy should require further tax changes, in addition to the changes that the Minister has already announced, to give incentives to people to restore and to build in the inner city rather than equal encouragement to build on green field sites?

Mr. Lilley: The hon. Gentleman will probably be in a very small minority in welcoming the judgment as a whole, although possibly he is harking back to the dead parrot manifesto of his erstwhile leader, who wanted VAT extended to almost everything. There will be no change to VAT on renovation and repairs in relation to domestic properties and we do not propose to make any changes.

Mr. John Biffen (Shropshire, North): When the legislation necessary to give effect to these somewhat contentious proposals is before the House and the House amends or rejects it, what then?

Mr. Lilley: Exactly the same consequences would flow as would always be the case if we failed to implement legislation passed to us from the European Community.

Mr. Peter Shore (Bethnal Green and Stepney): We have heard not so much a statement as a mini Budget. Is this not another brutal reminder of the extent to which the House has ceased to be master of its own affairs? Is it not a clear breach of faith? Were we not assured that the existing United Kingdom zero rate would continue until the Council, by a unanimous vote, agreed to adopt what it called a "Europe without fiscal frontiers"? Have not the procedures laid down by the Commission for review under article 28 simply been flouted and ignored? Is not the court acting ultra vires? In those circumstances, what obligation has Britain to carry out the court's ruling?

Mr. Lilley: The right hon. Gentleman is correct in saying that the ruling is a brutal reminder of the decision taken by the Government of whom he was a member. He is also correct in saying that we will retain a zero rate. There is no question of the court acting ultra vires; it is intepreting the sixth directive that was agreed by the House and the Government in 1977. Any attempt to remove zero rates could be taken only with the unanimous consent of all member states, including this country.

Mr. David Curry (Skipton and Ripon): Does my hon. Friend accept that there will be great relief that the Government have acted so promptly in outlining the precise measures that they intend to take in response to the judgment? Nothing could have been worse than a long period of delay with uncertainty. Does he also accept that the construction industry will be especially pleased by the offer of an option for taxation and that the public spending targets will be upgraded to take account of VAT that the Government will now charge on their construction projects?

Will my hon. Friend remind the House that the mitigation measures have cost the Treasury a substantial sum? Will he speculate on whether the Opposition would have been in a position to grant such generous mitigation?

Mr. Lilley: I am grateful to my hon. Friend for his remarks, the last of which is very apposite. I cannot imagine that a party committed to such widespread increases in public expenditure would have been prepared to forgo the large amount of revenue that we have forgone by mitigating the measures. I hope that the construction industry will welcome the decisions that we have taken today, although it will not welcome the ruling itself any more than we do. It sought—and we have endeavoured to provide in the statement — a delay before its implementation so that there would be time for consultation, protection of existing contracts, the option to rent and protection of public sector construction programmes. We have provided for all those and more, because we have also suggested that the procedure be phased in over a couple of years—five years in the case of charities — which, in fact, goes beyond what the construction industry sought.

Mr. John D. Taylor (Strangford): Does the Minister agree that the ruling is a total routing of the Government by the European court? Is that why he has hidden the fact that the entire costs of the case have been awarded against the Government? Is it not true that this Parliament has lost because it has no option other than to accept the new legislation that the Minister will propose? Is it not also true that the people of the United Kingdom have lost because they will have to spend £160 million more per annum in higher costs throughout the land? Have not the Government surrendered their authority to an agency outside the United Kingdom?

As Northern Ireland has no local authorities other than district councils, what will be the position of education boards and of housing associations that provide ancillary facilities for elderly residents in their complexes? Will they, too, have to pay VAT?

Mr. Lilley: The hon. Gentleman is not correct in saying that this is a complete routing. I have already said that we won on the crucial point of domestic housing. However, he is correct in saying that we have no option but to implement the ruling of the court, which is a consequence of the treaty obligations that we entered into in 1972 and the subsequent decisions taken in 1977 specifically affecting VAT.

In response to the hon. Member for Wrexham (Dr. Marek), I said that the costs were very small — only £7,000 of out-house costs. We do not expect to have to bear the costs of the Commission, which usually expects to bear its own costs.

I believe that education boards and housing associations in Northern Ireland will be protected in the same way as are comparable authorities in this country. We will, of course, be consulting as to the precise definition which is appropriate within the ruling for residential property, and what will constitute residential property in that context, and that consultation will apply throughout the United Kingdom. I welcome comments from Northern Ireland as well as from elsewhere.

Sir Richard Body (Holland with Boston): Further to the question of my right hon. Friend the Member for Shropshire, North (Mr. Biffen), if we are to adhere to the principle of no taxation without representation, are we not now on the way to transferring the fiscal powers of the House to that supranational institution which the House, by statute, has elevated to a Parliament?

Mr. Lilley: The decision to transfer some powers of taxation to the European Community was taken much earlier. This is merely a consequence of it. No transfer of the House's powers to the Community can be made without the consent of the House. We have a veto in these matters.

Mr. Rhodri Morgan (Cardiff, West): Will the Economic Secretary undertake to consult his colleagues in the Department of Trade and Industry as to the effect of the ruling, particularly in regard to VAT on new commercial and industrial construction, and on the level of investment forthcoming in the next few financial years in Britain? Does he agree that that will have a particularly harsh effect on regions of high unemployment such as Wales? Will he consult the Department of Trade and Industry and his Treasury colleagues about whether the level of investment will now drop because of the combined effect of this ruling increasing the cost of construction of new building, the national non-domestic rate in areas where it will increase such as my own constituency in Cardiff, plus the South American-style inflation in the building industry in the past year? If that has a devastating effect on the level of investment, will he agree to reconsider bringing in investment allowances to compensate for the effect of the EEC ruling and to preserve the level of investment?

Mr. Lilley: The level of activity in the construction industry in this country is extremely healthy; the industry is growing fast. We are determined that its prospects should be preserved, and that is why I have announced an extensive range of measures to protect its future. I believe that the industry will be able to continue growing well, nationally and in Wales. In particular, we have protected the position of the public sector.

The main burden of the extra tax which cannot be passed on or reclaimed from the Government will fall on industries such as the financial services sector, which is exempt from VAT and therefore cannot claim back VAT on the cost of inputs. That is an important industry, even in Wales, but it is not the principal industry in Wales, as it is in parts of England and Scotland.

Mr. Tim Smith (Beaconsfield): Contrary to what the hon. Member for Wrexham (Dr. Marek) said, is it not clear that the impact of this decision on the final consumer will be very limited, mainly because of the victory on private sector house construction? What will be the effect of the decision on the retail prices index?

Mr. Lilley: My hon. Friend is quite right. The effect of the decision on the man-in-the-street will be negligible and unnoticeable. There will be no effect on his housing costs, and the effect on the retail prices index will be extremely small. When £160 million of extra tax is spread across the whole of consumer expenditure, it is a fraction of 1 per cent.

Mr. Bob Cryer (Bradford, South): If the Minister is right and Parliament has a lingering power of veto, why does he not invite Parliament to use that veto, and, instead of producing legislation imposed by the European court, why does he not produce legislation to repeal section 2 of the European Communities Act 1972 which would place beyond any doubt the power of this Parliament to raise money and decide expenditure, instead of accepting the continuing drift and erosion of our powers so that this place becomes something like a parish council and the European Community strips away all our powers?

Mr. Lilley: It ill behoves the hon. Gentleman to talk about losing our lingering power of veto since he voted in favour of that measure when it was brought before the House in 1976.

Mr. Nigel Spearing (Newham, South): No, he did not.

Mr. Lilley: That was on 29 November 1976. Unlike the hon. Member for Newham, South (Mr. Spearing), who voted against the measure, the hon. Member for Bradford, South (Mr. Cryer) voted in favour.

Mr. Tim Yeo (Suffolk, South): I warmly welcome the extended introductory period in applying these measures to charity. Is my hon. Friend aware that the judgment's consequences for charities are serious and that the annual expenditure on unrecoverable VAT of the 45 charity organisations which are members of the Charities VAT and Tax Reform Group will rise from £6·2 million a year to more than £12 million a year? Is my hon. Friend aware that the effect of this judgment on charities is the same as if my hon. Friend had announced an increase in the rate of VAT from 15 per cent. to 30 per cent.?

Mr. Lilley: I pay tribute to the role that my hon. friend has played in voicing the concern of charities generally about the impact of VAT before this ruling. I recognise the important consequences for charities of that ruling. Naturally, we shall consult my hon. Friend, and the organisations which he represents, to ascertain how best to deal with the consequences of the ruling, within its scope and latitude.

Mr. Nigel Spearing (Newham, South): Does the Minister agree that if, in 1975, the British people thought that tax would be levied on public facilities, such as roads, railways and water, they might have given a different answer? Does he recall that the Prime Minister has made no statement on taxation of domestic water, which is in the next package which awaits the House? When the hon. Gentleman talks about a veto, will he be correct himself and agree, that, although the Government may have a veto under the treaty of Rome, at the moment the House has not?

To stop such problems arising in the future, would it not be better for the House to pass a motion saying that any future VAT package should be passed by an affirmative resolution of the House and not be entirely in Minister's hands, even if it is in the Prime Minister's name? Is not such a provision entirely within the terms of the treaty of Rome, retaining those few powers that the House has left in that respect?

Mr. Lilley: None of today's rulings has any bearing on consumers. I do not think that if they had been known at the last election—I hope that I correctly interpret the hon. Gentleman's question——

Mr. Spearing: At the referendum.

Mr. Lilley: I do not think that if the rulings had been known at the referendum they would have had any impact on the outcome.

On the hon. Gentleman's remarks about the Government and the House, I stand corrected. He is right. If any change were to be made, it would have to be made in the manner that he suggests; but it would not necessarily obtain a majority in the House.

Mr. Teddy Taylor (Southend, East): Does my hon. Friend recall that, when the House agreed to the directive in 1977—without my support—a clear assurance was given in good faith that this kind of decision could not be made because we had residual powers under article 26 of the sixth directive, provided the Council of Ministers unanimously decided to abolish exemptions? As the assurances in this case and many others are being overturned and, basically, breached by the various institutions of the Community, can my hon. Friend, who has given a splendid answer today, give us an assurance that the Commission has said that it will not seek any more cases of this sort, or does my hon. Friend foresee the power of the House being slowly eroded, not by what we or the Common Market do but by the institutions taking more and more power and authority?

Mr. Lilley: Under the sixth directive, the British Government were entitled to maintain zero rating where it was for a clearly defined social purpose and for the benefit of the final consumer. The court has ruled that these specific items, on which we lost, were not for the benefit of the final consumer. The court merely made a legal judgment as to whether those items fell within the directive, to which the House assented with that caveat and definition in 1977. Any changes in exemptions from zero rates of VAT which are not made on that legal basis in conforming to the legislation can be made only by unanimous decision of the Council of Ministers and, therefore, with our consent. That applies to any wholesale changes that anyone might seek to make, including those proposed recently by Lord Cockfield.

Mr. Alex Salmond (Banff and Buchan): The Economic Secretary dealt at length with non-domestic construction. How closely has he analysed the impact of that, and the decision to impose VAT on fuel and power supplies, on industry? Will he undertake to examine the matter to establish whether particular industries or areas will be affected by the extension, and will he introduce measures in mitigation similar to those that he has announced for non-domestic construction?

Mr. Lilley: The overall impact of VAT on fuel and power supplies for industry is comparatively small. The vast majority of industries affected will be able to reclaim the VAT that they pay as an input cost. Therefore, the decision will have no impact upon them except possibly a small cash-flow effect. the only major exceptions are the financial services industries, which will have to bear the cost of VAT on their fuel and power; they cannot reclaim it because they are exempt from VAT.

Mr. John Heddle (Mid-Staffordshire): My hon. Friend said that the effect of the judgment on the consumer would be nil. Does he not agree that, given time, the judgment will ultimately affect the cost of land upon which non-domestic buildings were constructed? In that context, will he reconsider whether two years will be long enough, given the length of the planning process? Similarly, will he have regard to the effect that the judgment may have on inner-city renewal—on mixed buildings, shops, offices, houses and flats?

Mr. Lilley: I think that I said that the effect on the consumer and the retail prices index would be minimal rather than nil. We acknowledge that there is likely to be a full year revenue in 1991-92, when the charges are fully operational, of £160 million, which will obviously have to be paid for by someone. To the extent that it affects

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consumer goods, it will be paid for by the consumer. To the extent that it comes out of profit margins, it will be paid for by investors and shareholders. To the extent that it comes out of land values, it will be paid for by landowners. A two-year phase-in period is perfectly reasonable. The industry did not ask us for any phase-in period; we have gratuitously offered the two-year period, which we think will be beneficial. The period for charities will be five years to give them longer to adjust.

Ms. Joyce Quin (Gateshead, East): Does the Minister agree that the court's judgment as it affects protective boots and helmets is unreasonable, especially as to the final consumer—the employee—the equipment is vital? Will he assure the House that safety in factories and other places of work will not be jeopardised as a result?

Mr. Lilley: I do not think that there is much point in criticising the reasonableness or otherwise of the judgment. It has been made and there is no appeal, and we have to try to implement it as sensitively as possible, using such discretion as remains to us. By and large, protective footwear and helmets are required by health and safety legislation. There will not be a fiscal penalty on employers who purchase them because they will be able to offset the purchase cost against VAT and reclaim it. It will not make a great deal of difference to them, although we should have preferred to have kept the original system.

Mr. John Redwood (Wokingham): Does my hon. Friend agree that there is widespread feeling on both sides of the House that we have already surrendered too many powers and that we have gone too far in allowing the sovereignty of this House to be removed? Will he assure that, unlike their predecessors, the Government do not plan us to give away any more powers in negotiations on tax harmonisation?

Mr. Lilley: It is manifest from the response to my statement that the sentiments expressed in the first part of my hon. Friend's remarks are echoed on both sides of the House; that is a simple fact. I recognise that there is concern about these matters. We are certainly jealous of the powers of the House and, as regards the proposals on the table from Lord Cockfield, we have no intention of acceding to proposals that would restrict the right of the House to retain zero rates.

Mr. Harry Ewing (Falkirk, East): The Minister made a clever debating point. He has been briefed well. Can he tell us how the Tory Opposition voted in 1977, when the matter came before the House? Before he tells me that I also voted for the measure that night, may I confirm that. Having reversed the results of every other vote cast during that Labour Government's period in office, why do not the Government reverse that vote as well? I assure the Minister that he has my full permission to reverse that vote, and I shall help him to do so.

My hon. Friend the Member for Gateshead, East (Ms. Quin) made a specific point about safety helmets and footwear. Will the Minister give us an absolute assurance that the Government will watch developments carefully and that no damage will be done to health and safety at work? The Minister speaks eloquently about the construction industry, but some of us have a greater feeling for those who work in the industry than for those who own it.

Mr. Lilley: I am grateful to the hon. Gentleman for his compliments on the quality of my briefing and his revelations about the inconsistency of his voting habits. The Government are not in the habit of standing on their heads that frequently and we do not intend to do so on this occasion.

The hon. Gentleman asked about how the then Opposition voted in 1977. From my examination of the records, they appear largely to have abstained.

I shall take up the hon. Gentleman's point about the health and safety implications of the protective clothing and helmets item and we shall make sure that health and safety objectives are not undermined.

Mr. David Heathcoat-Amory (Wells): Will the Minister confirm that the permitted derogations for zero rating are not time-limited in any way? Will he also confirm that there will be no more court cases and that the unfortunate legacy of the last Labour Government is finally behind us?

Mr. Lilley: As far as we know, the Commission has no further disagreements with the existing structure of zero rates in this country. The Commission has clearly brought forth in this case all the aspects of the present structure with which it disagrees on legal grounds. My hon. Friend asked about the durability of our zero rates. As long as we insist on the retention of zero rating for exports, we can retain zero rates domestically as well. We have no intention of conceding that point while we wish, as we do, to keep the right to retain zero rates.

Mr. Sydney Bidwell (Ealing, Southall): The Minister alluded to the Labour Government's bringing in VAT. Does he not agree that it was a Tory Government who almost doubled it and that the recent Budget made matters substantially easier for the rich? In face of his difficulties, would it not be a good idea to recommend to the Chancellor that in his next Budget he cuts the rate of VAT substantially? He should restore high income tax for the higher income bracket and substantially cut consumer taxation which affects the poor.

Mr. Lilley: One thing that my right hon. and learned Friend the Foreign Secretary did when he was Chancellor of the Exchequer in 1979 was to simplify the system so that we had just one positive rate of VAT instead of two rates of VAT and the multiple rates of purchase tax that we had prior to that. I am determined that we should not go back to a multiple-rate system of VAT. Whenever I think of it, I almost feel the shade of Sir Gerald Nabarro hovering over the House and imagine him raising all the absurdities that arise from multiple rates of indirect taxation. I entirely reject the proposal of the Labour Front Bench spokesman, the hon. Member for Wrexham (Dr. Marek), that we should have a lower rate of VAT alongside the present rate. I do not think that that would be helpful.

Mr. John M. Taylor (Solihull): Does my hon. Friend agree that, regardless of the merits of the arguments about migration of powers, it would be far simpler to have VAT on everything at a lower rate than 15 per cent., and thus do away with all the contradictions and anomalies?

Mr. Lilley: That might have a brutal simplicity, but it is not a policy that appeals to the British Government.

Mr. Ron Leighton (Newham, North-East): Does the Minister recall the manifesto of the Government in office at the time of the referendum, which said that no new tax would be levied on the British people without the support

of British Ministers and the British Parliament? Is he not humiliated that this Parliament is being robbed of its powers over taxation? As that comes on top of Common Market interference with the Government's industrial policy in relation to the Rover Group, should we not increasingly seek the repeal of section 2 of the European Communities Act to bring those powers back to the House?

Mr. Lilley: It was the Labour Government who in 1975 held the referendum and gave the assurances. It was the same Labour Government who in 1977 gave their permission to the sixth directive under which this court case was heard. They fulfilled the claim that there can be no changes to the tax system without the assent of the British Government, but they then gave that assent.

Mr. Ian Taylor (Esher): Will my hon. Friend reflect on the fact that the ruling shows that the British Government achieved a considerable success in winning their case for the exclusion of domestic housing construction, particularly as I understand that VAT rates are applied to that sector in other continental countries? Will my hon. Friend confirm that no VAT will be levied on private individuals for fuel and power? Will he also note that the judgment seems to comment favourably on the principle of zero rating, which is this Government's policy?

Mr. Lilley: My hon. Friend is absolutely correct. He is right to point out that domestic heating was the big and potentially painful item had we lost this case. I never doubted that we would win it. The position is now clear and the whole House and country will be relieved to know that on that issue we won. My hon. Friend is correct in saying that the European Commission never sought to impose VAT on fuel and power for individuals. He is also right in saying that during the case the European Commission accepted Britain's right to have zero rates and did not contest that right. The court seemed to endorse it.

Mr. Dennis Skinner (Bolsover): If the Minister wants to complete the history lesson, why does he not refer to the fact that on 28 October 1971 it was a Tory Government, supported by the present Prime Minister, who dragged an unwilling Britain into the Common Market, along with such allies as Lord Jenkins, Shirley Poppins and the rest of them? Is he aware that some of us fought against that decision, which turned out to be an unmitigated disaster, and that in 1977 the Labour Government, bogged down with the Lib-Lab pact, went along with it? If the Minister wants to take the history lesson a bit further, it is no use rabbiting on about vetoes and all the other technicalities. The truth is that the only way to stop this happening is to get out of the Common Market and prevent this bureaucracy, this bankrupt Common Market — £5 billion in the red once again and wanting another £900 million loan from the British people this autumn—from running our lives.

Mr. Lilley: I admire the hon. Gentleman first, for his consistency and, secondly, for his willingness to criticise the Labour Government. I think that we can learn from both aspects.

Mr. Michael Latham (Rutland and Melton): Can we please not have any talk about this decision being welcomed by the construction industry? The industry will be appalled by the rate of 15 per cent. Why has my hon. Friend agreed to impose VAT on contracts as from tonight, although that provision is to be included in a Bill that will not be introduced until next year? That was not done with beer, and there is no possible justification for it.

Mr. Lilley: I certainly did not suggest that the construction industry would welcome the ruling. I suggested only that it would welcome the decisions that we have taken to mitigate the impact of the ruling. The industry made mild allusions to the possibility of a lower rate, but only as an alternative to the option to tax, which was the first preference and the one for which we have opted.

Mr. Latham: But why impose it as from tonight?

Mr. Lilley: If we had not made it clear that contracts entered into before tonight are zero rated and that those after tonight by implication will not be, there would have been a tremendous incentive for people to bring forward contracts and there would have been a boom and bust in the construction industry.

Mr. Robert Sheldon (Ashton-under-Lyne): So what?

Mr. Lilley: The construction industry was very anxious to avoid the possibility of a boom and bust because of people rushing to complete contracts ahead of the next Budget or introducing new contracts ahead of the next Budget. We listened very carefully to the industry and introduced this provision at its request.

Mr. Win Griffiths (Bridgend): Will the Minister confirm that all other countries run more than a single rate of VAT and that it would be possible for the Government to introduce a lower band of VAT? Is he saying that the Commission's proposals for the single market will be vetoed all along the line and all the time? Does he not believe that it would be far better if charities were given a complete derogation of VAT? The only reason for that not being done is that the Government do not want to do it rather than because there is a legal impediment to that process being undertaken.

Mr. Lilley: It is true that virtually all our partners in the Common market have more than one positive rate of VAT. However, we consider that our system is simpler and more desirable. Also, it has a social benefit, in that certain supplies that are more likely to be consumed by those who are on low incomes tend to be zero rated. It is not, therefore, a regressive tax.

We shall not assent to Lord Cockfield's proposals on tax approximation because we do not approve of them. There is no question of having to introduce a veto because the proposals have failed to gain the support of other countries. They have been extremely widely criticised by other member states, many of whom have a range of difficulties over them. There is certainly no question of the Government vetoing the proposals on some occasions but not on others.

Mr. Ian Gow (Eastbourne): Is my hon. Friend aware that, despite the assurances that he has given, that the Commission is now well satisfied with our system of value added tax, following the decision of the European court, and that Treasury Ministers will come to the Dispatch Box again and again over the coming months and tell the House that VAT is to be altered or extended in a way that is not approved of by Her Majesty's Government?

Is my hon. Friend further aware of the inconsistency of his statement? He said, first, that we are required to

[Mr. Ian Gow]

implement the judgment of the European court, and, secondly, that that implementation requires the approval of the House. There can be no requirement to implement if there is also the right of this House to reject what the Government propose.

Mr. Lilley: I am sure that I did not express a view about the European Commission's mental state about our zero rates. I have no idea about its internal state of satisfaction with them. We are well satisfied with the present tax structure and we intend to retain it. Proposals for change may emanate from a variety of spheres, but they will always remain proposals unless they have the assent and the consent of this Government and this House. Under the European treaty to which we gave our consent—some willingly and some unwillingly—in the early 1970s, this House must consent to legal measures that are agreed to by the combined countries of the European Community. If the House failed to do so, there would be a constitutional impasse, the consequences of which would be very serious.

Mr. Austin Mitchell (Great Grimsby): Will the Minister confirm that when we accepted the sixth directive in 1977 we were assured that it precluded changes in zero rating without the unanimous decision of the Council of Ministers? Will he accept that this is a change of what is loosely called the Commission's mind? That change has been ratified by the European court, which is essentially just an instrument of European unity. Will the Minister confirm that we can throw out the legislation without it coming into force under section 2 of the European Communities Act 1972? If that is so, why does he not give hon. Members a free vote so that he can test how his hon. Friends feel about this grovelling abdication of Britain's rights?

Mr. Lilley: The hon. Member must take up with the Ministers who were concerned with the matter in 1977 any assurances that they gave in respect of the sixth directive. However, it has always been the case that it is only possible for us to introduce zero rates under that directive that conform to the criteria that they are for clearly defined social purposes and for the benefit of the final consumer. It is solely on their alleged failure to fulfil those criteria that the European Commission was able to take this country to court and, in some respects, win its case. In others it lost. It was unable to alter the law of the land or of the Community unilaterally, and any changes in the law will require the Government's consent and that of Parliament. It has always been the case in this country that laws emanating from this place must be interpreted as is appropriate by courts, when there is any dispute as to their meaning.

Mr. Robert McCrindle (Brentwood and Ongar): In view of the Minister's comments about the effect of this measure on the financial services industry, was it correct for him to say that there will be no effect on housing costs? Is it not likely that banks, insurance companies and building societies will pass on their VAT commitments on the supply of gas, electricity and water, which will result in at least marginal increases in borrowing costs for those of us who are buying our houses on mortgages?

Mr. Lilley: My hon. Friend is correct and there could be a few arithmetically detectable implications of the kind he suggests. I do not believe that they would be detectable by the consumer because they would be so small as not to be measurable against all the other changes. The total revenue collected as a result of this measure, when it is fully implemented, is likely to be about £160 million per year. When that sum is spread over all the industries which will bear it, the overall effect will be very small, and it will not seriously alter the cost of housing or anything else.

Mr. Anthony Beaumont-Dark (Birmingham, Selly Oak): Does my hon. Friend accept that many of us have a genuine personal respect for the fact that he has made for our country the best that he can out of a very difficult situation? However, we keep on being told that we are jealous of our powers, but in the next breath we are told that we must consent to this, that and the other. As the country is now being run, week after week, another regulation is brought before the House and hon. Members are told that there is nothing they can do about it. Ultimately, Parliament must decide who runs the country. Are we to be the United Kingdom or are we, by stealth and by the death of a thousand regulations, to become the "United States of Europe", which is something for which this country should not and will not vote?

Mr. Lilley: I am grateful to my hon. Friend for his opening remarks. I agree that there is an excessive passion in some quarters of the Community to introduce harmonisation measures that are not always necessary and to pursue legalistic points which make no effective change to the amount of tax which people bear but merely alter the name by which it is known and from whose pockets it comes and to which is then returned. We deplore such unnecessary changes, but they are the consequence of our adherence to the treaty of Rome. Unless my hon. Friend is suggesting that we should resile from that treaty, we must accept those consequences, while arguing with the Commission that it should not pursue too vigorously unnecessary harmonisation measures.

Mr. Christopher Gill (Ludlow): Does not my hon. Friend deprecate the fact that, as fast as the Chancellor simplifies and reduces taxes, the Community appears to frustrate his efforts?

Mr. Lilley: I am not sure that this measure vastly complicates matters, although it creates a certain amount of tax churning, which is to no one's great benefit. I acknowledge my hon. Friend's basic point that it is far more important to simplify and reduce taxes than it is to harmonise items for which there is no international trade. After all, I do not imagine that many people export houses or buildings from this country, or that enormous distortion was introduced by our having a different system previously for taxing protective helmets from that which applied on the continent.

Mr. Spencer Batiste (Elmet): Is my hon. Friend telling the House that a problem arises as a result of the Labour Government failing in 1977 to understand the implications of their own legislation, or that it is a consequence of the European Commission subsequently changing its grounds in a way that could not be foreseen? If the latter is true, that is certainly a matter of constitutional importance. If the former, what other problems remain unresolved in this area as a result of the Labour party's inability to understand its own policy?

Mr. Lilley: It is always possible, with the benefit of hindsight, to have 20/20 vision. However, at the time it could have been foreseen that some cases might be brought under those aspects of the legislation specifically stating that any zero rating had to be in respect of a clearer defined social need and for the benefit of the final consumer. It might not necessarily have been possible to predict absolutely the court's ruling on all the items, but to avoid the possibility of any such court cases it would have been necessary at that earlier stage to have agreed to a wider permission in the sixth directive than that to which we assented.

Mr. John Watts (Slough): While undertakings entered into by a former Labour Government may oblige the present Government to seek the House's consent to extending VAT in accordance with the judgment, can my hon. Friend confirm that there is nothing in the judgment requiring us to apply VAT at the current standard rate? Could we not comply with the letter of the judgment by introducing a rate of 0·00001 per cent.? In this instance are not the merits of the simplicity of a single rate system outweighed by the importance of the House insisting that its will to maintain as near to zero rating as possible shall prevail?

Mr. Lilley: My hon. Friend is correct, in that the court has not ruled that we must apply the standard rate. It is up to us to choose, but the law applies a constraint in respect of which low rate will apply. It is stated in the directive that the low rate must be sufficient to cover all the VAT likely to be reclaimed on the inputs into the industry to which that low rate applies. It is difficult to calculate what the lowest rate could be, but I recently saw a study by Arthur Andersen and Co. suggesting that the lowest rate we could apply in those circumstances would be as high as 10 per cent. We see little advantage in having a second tier rate of 10 per cent. alongside one of 15 per cent. That would cause difficulties for business and industry, as well as boundary problems.

Mr. Barry Field (Isle of Wight): Is my hon. Friend aware of the considerable concern there is in private industry and commerce at the inability to recover VAT, particularly among service industries, and the considerable privilege that local government enjoys in being able to recover VAT? Are not the concessions that my hon. Friend has announced this afternoon another example of the Treasury erecting a fence of privilege around local government and public enterprise to the detriment of private enterprise, which completely contradicts the Government's policy of privatising local government services?

Mr. Lilley: My hon. Friend is correct, and those who are exempt from VAT often regret that they are unable to reclaim the tax on their inputs—though they probably welcome the fact that they do not have to pay the tax on their outputs. Local government has long enjoyed exemption. Many years ago an assurance was given that services financed from the rates would be reimbursed their VAT. That continues, and it automatically applies to the measures announced today. We have not given local authorities any special new privilege but have merely taken advantage of an existing one.

Mr. Tony Marlow (Northampton, North): The Government are proud, and quite rightly so, that they have made life simpler for business and industry, but what my hon. Friend has announced today is a bureaucratic nightmare. My hon. Friend says that it is a small one, but it is a bureaucratic nightmare none the less. The only businesses that will benefit from it are the legal and accountancy professions. My hon. Friend is also a democrat, and he knows that right hon. and hon. Members will vote for what they feel is correct.

Can my hon. Friend expand on the answer he gave to my right hon. Friend the Member for Shropshire, North (Mr. Biffen)? What happens if the House votes down a Government proposal on VAT? Will we all be clapped in irons by the European Court? What will happen about the tax? Will it be applied or will it not be applied? Is the House sovereign or is it not sovereign? The House ought to know.

Mr. Lilley: My hon. Friend goes a little far in describing this measure as a bureaucratic nightmare. It extends the VAT system—which has its complexities, but which in other ways is a simple, structural tax—to an area where it did not apply before, or where it did not apply in full. We have introduced a number of transitional measures, which always creates a certain amount of complication. However, it will be possible for industry, by and large, to cope. It would certainly prefer the kind of measures that I have announced to automatically proceeding without the measures of transition and mitigation that I have announced.

As to the constitutional consequences of the hypothetical circumstances in which the House should vote against a fiscal measure required of us by the European court, the whole House must be aware that such action would create a constitutional impasse. I may be a democrat but I am not a lawyer, so I cannot elaborate. If I did so, you, Mr. Speaker, would rule me out of order.

Mr. Harry Ewing: On a point of order, Mr. Speaker. There is now genuine confusion because it is only during the last two or three questions and answers that it has become apparent that legislation is to be introduced into the House to back up the Economic Secretary's statement. There are certain circumstances under the treaty of Rome whereby all that is required is the Government's agreement and not that of the House. All I am asking is that it should be reinforced that legislation is to be introduced into the House and that it will be a House of Commons matter rather than purely a Government matter.

Several Hon. Members *rose*—

Mr. Speaker: Order. I think that I can help the House. I listened carefully to the statement and I understood the Minister to say that new clauses would be introduced in the Finance Bill next year.

Mr. Hugh Dykes (Harrow, East): On a point of order, Mr. Speaker. I was out of the Chamber during the later exchanges on the statement because I went to obtain a copy of the Customs and Excise document. It is not the fault of my hon. Friend the Economic Secretary, but the document was not available in the Vote Office until 4.22 pm whereas the Minister implied that it was available while he was speaking or when he had concluded his statement.

On a different point of order, Mr. Speaker. Can you again guide and help the House? You may agree with me and other hon. Members that during education questions

[Mr. Hugh Dykes]

and Prime Minister's questions, and now during the statement, although the subjects are important, the questions and answers have been of exceptional length. Is not that a growing tendency that is preventing other hon. Members from asking their questions. I think that on this occasion I speak with the moral authority of someone who was not seeking to catch your eye.

Mr. Speaker: I judged the statement to be of such importance that every hon. Member who wished to ask a question should be called and I did not curtail proceedings in any way. I cannot always promise to do that.

Mr. Biffen: Further to the point of order raised by the hon. Member for Falkirk, East (Mr. Ewing), Mr. Speaker. I believe that what is promised for the Finance Bill next year is probably a pioneer in these experiences where the House is invited to validate a judgment of the European court. The point that I had in mind was not necessarily that it should be rejected, but that the House should make amendments, the House being satisfied that those amendments were within the spirit of the European court's ruling.

I seek your guidance, Mr. Speaker—obviously not now, but at some future moment, although the earlier this is resolved the better for the House—on how it is determined whether an amendment that is put down is within the spirit of the court's judgment and whether the House is entitled to take a view that that decision is consistent with the court's judgment without merely accepting the say-so of the Treasury Bench. May I leave the matter there, Mr. Speaker. It is a matter of substance for the House that should be resolved and adjudicated earlier rather than later.

Mr. Speaker: I am not sure whether I can help. All I can say is that I shall consider carefully what the right hon. Gentleman has said.

Mr. Latham: Further to that point of order, Mr. Speaker. According to the statement made by my hon. Friend the Economic Secretary, the potentiality of the tax will be imposed on contracts signed after midnight tonight. Are we to assume that there will be no Ways and Means resolution, or any other vote of the House, before next year's Finance Bill Committee?

Mr. Speaker: I cannot answer such a question.

Several Hon. Members *rose*——

Mr. Speaker: Order. Hon. Members should have asked the Economic Secretary these questions when he was in a position to answer them. I am afraid that I cannot do so.

Mr. Spearing: Further to that point of order, Mr. Speaker. This is a procedural matter, if not for you, perhaps you could tell us for whom, because it cannot be for the Minister. If the Minister is to try to impose a tax from midnight tonight, following the point made by the hon. Member for Rutland and Melton (Mr. Latham), surely there must be either a constitutional provision or a Standing Order, which we have for the Finance Bill and the Budget resolutions, as I recall, which gives power for such executive action to be taken in advance of legislation.

The question that arises from the exchanges—not the Minister's statement—is what sort of constitutional mechanism exists, or what Standing Order there is in the House, which permits that executive action to be taken consequential to a European Court judgment rather than consequential to a statement by the Chancellor of the Exchequer when he opens his Budget. I think that that is the point.

Mr. Speaker: The House heard what the Economic Secretary said. I think that he said that new clauses were to be circulated to obtain the opinion of the House on this matter. I do not think that I can answer that question.

Mr. Richard Shepherd (Aldridge-Brownhills): Further to that point of order, Mr. Speaker. What we are asking is by what authority is taxation raised. The Treasury Bench tells us that the authority will come forward next year by amendment to the Finance Bill. We should like to know by what authority a tax is raised as of midnight tonight.

Mr. Speaker: These are all questions that should have been put to the Minister rather than to the Chair. This is not a matter of order.

Mr. Skinner: I think that your last remark, Mr. Speaker, was correct. You have been placed in some difficulty because one would have thought that by this time the Minister responsible, or his mate on the Front Bench, would have jumped to the Dispatch Box to remind the House how the Government will get over the 12-month period between the potentiality of taxes being raised from tonight and permission being granted by this sovereign House next year. If you will just cast your eye round the corner, Mr. Speaker—I know that you do not want to—there is a fellow there with a bit of paper in his hand who is anxious to tell the Minister something. He has now put that paper below the parapet. He has the answer that the Minister wants but he does not know how to get it to him and the Parliamentary Private Secretary has not been looking over there.

Mr. Speaker: We had better move on.

STATUTORY INSTRUMENTS &c

Mr. Speaker: With the leave of the House, I shall put together the five motions relating to statutory instruments.

Ordered,

That the Docks and Harbours (Rateable Values) (Amendment) Order 1988 be referred to a Standing Committee on Statutory Instruments, &c.

That the draft British Waterways Board (Rateable Values) (Scotland) Amendment Order 1988, be referred to a Standing Committee on Statutory Instruments, &c.

That the draft Docks and Harbours (Rateable Values) (Scotland) Amendment Order 1988, be referred to a Standing Committee on Statutory Instruments, &c.

That the draft Agriculture Improvement (Amendment) Regulations 1988, be referred to a Standing Committee on Statutory Instruments, &c.

That the Agriculture Improvement (Variation) Scheme 1988 (S.I., 1988, No. 1056), be referred to a Standing Committee on Statutory Instruments, &c.—*[Mr. Maclean.]*

Mr. Kenneth Hind (Lancashire, West): On a point of order, Mr. Speaker. Several hon. Members have approached me because they have received a writ that has been served on every Member of the House of Commons and upon every Member of the other place from a litigant in Sheffield's High Court. I have been in contact with the High Court in Sheffield and I am informed that the writ is genuine and that we shall all receive a copy of it. I seek your guidance, Mr. Speaker, on how we should deal with the matter.

Mr. Speaker: As far as I know, I do not appear on the writ.

Mr. Hind: You do.

Mr. Speaker: My copy must have gone astray then. The hon. Gentleman had better let me look into the matter.

British Identity Card

4.37 pm

Mr. Tony Favell (Stockport): I beg to move,

That leave be given to bring in a Bill to introduce a British identity card; and for other purposes.

With the British passport due to disappear in 1992, the time has come for us to introduce a British identity card and I intend that it be British passport blue. There can be few people who are not asked to supply proof of identity from time to time and many are regularly obliged to do so. These days we cannot enter most clubs, as well as many places of work and Government buildings without having to identify ourselves. Moreover, it is virtually impossible to cash a cheque without a cheque card.

The identity card that I propose will be issued to everyone over 18 years of age. It will be the size of a credit card and will contain the holder's photograph, his or her name and address, date of birth and signature. It will be computer readable which will minimise fraud.

An identity card of the type that I propose will help in the battle against football hooliganism. It will enable immigration authorities to identify hooligans upon whom I hope the courts will soon be able to impose travel restrictions. It will assist football clubs in identifying those whom they wish to ban from their grounds. It will also help in the fight against terrorism and crime in general.

One of the problems in identifying the IRA is that its members are free to enter Britain from the Republic of Ireland without a passport or, indeed, any form of identification. After a terrorist attack such as the appalling atrocity at Lisburn last week, it would greatly assist the security forces if those manning road blocks could readily ascertain whether people had come from far afield or were merely going about their normal day-to-day business.

Some of the nastiest crimes today are those inflicted on the elderly. It is now commonplace to read in the newspapers of crooks and thugs worming their way into old people's homes, often posing as gas men, meter readers or council officials. An instantly recognisable identity card from which details could be taken before admittance would help to deter those who prey on the most susceptible members of our society.

I recognise the fear that an identity card system could be seen as an intrusion on the privacy of the individual. An important part of my Bill will limit the information included on the card and limit those who will have access to that information. Clearly, the Revenue and the DHSS will be able to insist on its production to help eliminate fraud, the police will be able to ask for it when a crime has been committed or is anticipated and immigration authorities will be entitled to inspect it. That will help in the fight against terrorism and should eliminate the need for passports to travel to other countries in Europe.

It will be up to the holder to decide whether to show the card to private individuals. If he does not, the person asking to see it will be able to draw his own conclusions, in the absence of a reasonable explanation.

I know that some will oppose the introduction of an identity card on the grounds that it will infringe civil liberties. But the liberty of law-abiding citizens in Northern Ireland is already infringed by terrorists, the liberty of the elderly is infringed by bogus officials and the liberty of decent football fans to watch a football match free from violence and obscene gestures should be maintained.

[Mr. Tony Favell]

My Bill will be of great benefit to honest, law-abiding citizens, which most British people are, and I commend it to the House.

4.42 pm

Mr. David Winnick (Walsall, North): I oppose the measure which the hon. Member seeks to introduce. The introduction of identity cards is a wholly undesirable practice, far more associated with dictatorships than with democracies, except in wartime. There are, of course, various kinds of documentation relating to national insurance, health services, and so on, which are for specific reasons. However, such documents do not have to be carried on a daily basis, and one can be pretty certain that once an identity card is necessary it will be a requirement that the citizen carry it around with him on all occasions; he will be so required by the police. As I have said, the practice has far more in common with Eastern Europe than with Western-type democracy.

This is part of an authoritarian tendency in the Conservative party to try to control the lives of citizens as much as possible and have records on everybody in the country. I suppose that it is not surprising that a party which showed no concern and made no protest when Cathy Massiter exposed what was happening in the security services, when people were being questioned, had files drawn up on them and had their telephones tapped, should want to continue down a road that is completely undemocratic.

It is nonsense, as the hon. Member knows full well, to say that the issuing of identity cards will stop the football hooligans who are such a disgrace to our country, or stop crooks entering the homes of elderly people. The hon. Gentleman is certainly misleading the House when he makes such remarks.

I believe that this country requires less documentation and less control over the citizen. That is why I believe that acceptance of the hon. Gentleman's proposal for an identity card in peacetime would be a retrogressive step. Tory Members who vote for the Bill—there will be no Opposition Members—will show clearly that they want to continue down the road of further controls on the private citizen. We have said that it is the Conservative party, not the Labour Opposition, which is so keen on Eastern Europe practices and the hon. Gentleman, by his Bill, make our point very well indeed.

Question put, persuant to Standing Order No. 19 (Motion for leave to bring in Bills and nomination of Select Committees at commencement of public business):—

The House divided: Ayes 114, Noes 172.

Division No. 369] **[4.44 pm**

AYES

Adley, Robert
Aitken, Jonathan
Alexander, Richard
Alison, Rt Hon Michael
Ashby, David
Aspinwall, Jack
Atkinson, David
Banks, Robert *(Harrogate)*
Beaumont-Dark, Anthony
Bendall, Vivian
Benyon, W.
Bevan, David Gilroy
Boswell, Tim
Bowden, Gerald *(Dulwich)*
Braine, Rt Hon Sir Bernard
Brazier, Julian
Bright, Graham
Brown, Michael *(Brigg & Cl'Ts)*
Browne, John *(Winchester)*
Bruce, Ian *(Dorset South)*
Budgen, Nicholas
Butler, Chris
Butterfill, John
Carlisle, John, *(Luton N)*
Chapman, Sydney
Clark, Dr Michael *(Rochford)*
Clark, Sir W. *(Croydon S)*
Colvin, Michael
Curry, David
Day, Stephen
Devlin, Tim
Dicks, Terry
Evans, David *(Welwyn Hatf'd)*
Evennett, David
Favell, Tony
Fenner, Dame Peggy
Field, Barry *(Isle of Wight)*
Fookes, Miss Janet
Forth, Eric
Fox, Sir Marcus
Franks, Cecil
Fry, Peter
Gale, Roger
Gardiner, George
Gill, Christopher
Goodhart, Sir Philip
Goodson-Wickes, Dr Charles
Greenway, Harry *(Ealing N)*
Greenway, John *(Ryedale)*
Gregory, Conal
Griffiths, Peter *(Portsmouth N)*
Grylls, Michael
Hampson, Dr Keith
Hargreaves, A. *(B'ham H'll Gr')*
Hargreaves, Ken *(Hyndburn)*
Haselhurst, Alan
Hicks, Mrs Maureen *(Wolv' NE)*
Hill, James
Holt, Richard
Howell, Ralph *(North Norfolk)*
Howells, Geraint
Hughes, Robert G. *(Harrow W)*
Hunter, Andrew
Irvine, Michael
Janman, Tim
Jessel, Toby
Kellett-Bowman, Dame Elaine
Kilfedder, James
Knapman, Roger
Lloyd, Sir Ian *(Havant)*
McCrindle, Robert
McCusker, Harold
Macfarlane, Sir Neil
McNair-Wilson, Sir Michael
Marland, Paul
Marlow, Tony
Marshall, Michael *(Arundel)*
Martin, David *(Portsmouth S)*
Mates, Michael
Maxwell-Hyslop, Robin
Meyer, Sir Anthony
Mills, Iain
Morris, M *(N'hampton S)*
Morrison, Sir Charles
Moss, Malcolm
Mudd, David
Nicholson, David *(Taunton)*
Nicholson, Emma *(Devon West)*
Page, Richard
Paice, James
Patnick, Irvine
Pawsey, James
Price, Sir David
Ridsdale, Sir Julian
Rost, Peter
Sackville, Hon Tom
Sayeed, Jonathan
Shaw, Sir Giles *(Pudsey)*
Sims, Roger
Skeet, Sir Trevor
Smyth, Rev Martin *(Belfast S)*
Spicer, Sir Jim *(Dorset W)*
Stanbrook, Ivor
Steen, Anthony
Stewart, Allan *(Eastwood)*
Taylor, Rt Hon J. D. *(S'ford)*
Thornton, Malcolm
Walker, Bill *(T'side North)*
Watts, John
Whitney, Ray
Widdecombe, Ann
Wilkinson, John
Winterton, Mrs Ann
Winterton, Nicholas

Tellers for the Ayes:
Mr. John Townend and
Mr. Jacques Arnold.

NOES

Abbott, Ms Diane
Allen, Graham
Alton, David
Archer, Rt Hon Peter
Armstrong, Hilary
Ashley, Rt Hon Jack
Ashton, Joe
Barnes, Harry *(Derbyshire NE)*
Barron, Kevin
Battle, John
Beckett, Margaret
Bennett, A. F. *(D'nt'n & R'dish)*
Bennett, Nicholas *(Pembroke)*
Bidwell, Sydney
Blair, Tony
Body, Sir Richard
Bradley, Keith
Bruce, Malcolm *(Gordon)*
Buchan, Norman
Buckley, George J.
Caborn, Richard
Callaghan, Jim
Campbell, Menzies *(Fife NE)*
Campbell, Ron *(Blyth Valley)*
Campbell-Savours, D. N.
Canavan, Dennis
Carlile, Alex *(Mont'g)*
Cartwright, John
Clark, Dr David *(S Shields)*
Clay, Bob
Clelland, David
Clwyd, Mrs Ann
Coleman, Donald
Cook, Frank *(Stockton N)*
Cook, Robin *(Livingston)*
Corbyn, Jeremy
Crowther, Stan
Cryer, Bob
Cummings, John
Davies, Q. *(Stamf'd & Speid'g)*
Davies, Ron *(Caerphilly)*
Davis, Terry *(B'ham Hodge H'l)*
Dixon, Don
Doran, Frank
Douglas, Dick
Dover, Den
Duffy, A. E. P.
Dunnachie, Jimmy
Dunwoody, Hon Mrs Gwyneth
Eadie, Alexander
Eastham, Ken
Evans, John *(St Helens N)*
Ewing, Harry *(Falkirk E)*
Ewing, Mrs Margaret *(Moray)*
Fatchett, Derek
Fearn, Ronald
Fields, Terry *(L'pool B G'n)*
Fisher, Mark
Flannery, Martin
Flynn, Paul
Foot, Rt Hon Michael
Foulkes, George
French, Douglas
Galbraith, Sam

PAUL GRAY

With the Compliments

of the

PS/ Economic Secretary

Treasury Chambers,
Parliament Street,
SW1P 3AG

DE EUROPÆISKE FÆLLESSKABERS DOMSTOL

GERICHTSHOF DER EUROPÄISCHEN GEMEINSCHAFTEN

ΔΙΚΑΣΤΗΡΙΟ ΤΩΝ ΕΥΡΩΠΑΪΚΩΝ ΚΟΙΝΟΤΗΤΩΝ

COURT OF JUSTICE OF THE EUROPEAN COMMUNITIES

TRIBUNAL DE JUSTICIA DE LAS COMUNIDADES EUROPEAS

CVRIA

LUXEMBOURG

COUR DE JUSTICE DES COMMUNAUTÉS EUROPÉENNES

CORTE DI GIUSTIZIA DELLE COMMUNITÀ EUROPEE

HOF VAN JUSTITIE VAN DE EUROPESE GEMEENSCHAPPEN

TRIBUNAL DE JUSTIÇA DAS COMUNIDADES EUROPEIAS

21 June 1988

INFORMATION OFFICE

PRESS SUMMARY

Judgment of the Court in Case 416/85

Commission of the European Communities v United Kingdom

This summary is an unofficial document prepared by the Court's Information Office.

Background

The Sixth VAT Directive (Council Directive 77/388 of 17 May 1977) was intended to harmonize the basis of assessment to VAT in the Community. The need for such harmonization arose in particular from the decision to base the Community's own resources partly on VAT receipts. However, the Sixth Directive contained in Article 28 a number of transitional provisions allowing Member States to retain for the time being rules which departed from the general provisions of the Directive. Thus Member States were for example able to continue to tax certain items which should be exempt and, conversely, to exempt certain items which should be taxed. The Directive also provided, in Article 28 (2), that reduced rates and exemptions with refunds of tax could be retained, provided that they met the criteria laid down in Article 17 of the Second VAT Directive (Council Directive 67/228 of 11 April 1967), namely

that they be granted for clearly defined social reasons and for the benefit of the final consumer. On the basis of that provision the U.K. retained zero-rating for 17 groups of goods and services.

In monitoring compliance with the VAT directives the Commission came to the conclusion that the extensive U.K. system of zero-rating in some respects went beyond what was allowed by Article 28 (2)of the Sixth Directive. It therefore decided to institute proceedings against the U.K. under Article 169 of the Treaty in respect of those items. The case before the Court is therefore confined to the following:

Certain inputs into food (animal feedingstuffs, seeds and live animals used in food production), sewerage services and water supplied to industry, new services provided to undertakings which themselves provide services which are not zero-rated, such as banks and insurance companies, fuel and power supplied to persons other than final consumers, construction of buildings and protective boots and helmets supplied to employers.

The Commission did not dispute the legality of the zero-rating system in general, which it considered to be essentially equivalent to the exemptions provided for by Article 28 (2) of the Sixth Directive. The case turned on whether the contested zero rates met the above-mentioned requirements laid down in Article 17 of the Second Directive, namely that they must be granted "for clearly defined social reasons and for the benefit of the final consumer".

The Court's decision

The Court first of all considered the meaning of the terms "clearly defined social reasons" and "for the benefit of the final consumer".

Clearly defined social reasons

The identification of social reasons was in principle a matter of political choice for the Member States and could be the subject-matter of supervision at the Community level only in so far as, by distorting that concept, it led to measures which because of their effects and their true objectives lay outside its scope.

The phrase "for the benefit of the final consumer"

The final consumer was the person who acquired goods or services for personal use, as opposed to an economic activity, and thus bore the tax. It followed that having regard to the social purpose of Article 17 the term "final consumer" could be applied only to a person who did not use exempted goods or services in the course of an economic activity. The provision of goods or services at a stage higher in the production or distribution chain which was nevertheless sufficiently close to the consumer to be of advantage to him must also be considered to be for the benefit of the final consumer.

The Court then went on to deal with the individual items at issue.

Group 1 - **Food** (2. Animal feedingstuffs; 3. Seeds or other means of propagation of plants comprised in Items 1 or 2; 4. Live animals of a kind generally used as, or yielding or producing, food for human consumption.

All the supplies at issue contributed to the production of substances intended for human consumption and were sufficiently close to the final consumer to be of advantage to him. Moreover the negative effects of any taxation of those products on food prices, increases in which were particularly sensitive for the final consumer, who himself enjoyed zero-rating, could not be neglected. It followed that no infringement had been established with regard to the products at issue in this group.

Group 2 - **Sewerage services and water**

The Commission's case concerned, on the one hand, services provided to industry regarding the emptying of cesspools and septic tanks made necessary by the absence of a mains drainage system and, on the other, the supply of water to industry. In neither of these cases could the provision of services to industry be regarded as fulfilling the second criterion laid down in Article 17, since industrial users could not be regarded as final consumers.

Group 6 - **News services provided to certain undertakings**

The Commission's case concerned the supply of news services to undertakings which themselves provided services which were not zero-rated, such as banks or insurance companies. The undertakings to which the news services in question were provided, such as banks and insurance companies, could not be regarded as final consumers.

Group 7 - **Fuel and power** (coal, coke, coal gas, water gas, petroleum gases, fuel oil, gas oil, electricity etc.)

The Commission challenged the zero-rating of supplies of fuel and power other than to final consumers. Whilst the social reasons underlying the U.K.'s policy were not called in question, the services in question could not be considered to have been provided for the benefit of final consumers.

Group 8 - **Construction of buildings** (including in particular the initial sale of new buildings, the services provided by a contractor constructing a new building for a client who owns the site, the construction of commercial and industrial buildings, civil engineering works, the construction of roads, railways and airports)

The Commission challenged the zero-rating of all the items in Group 8 with the exception of housing constructed by local authorities. As regards buildings intended for housing the Commission's arguments

could not be upheld. The measures adopted by the United Kingdom in order to implement its social policy in housing matters, that is to say, facilitating home ownership for the whole population, fell within the purview of "social reasons" for the purposes of the last indent of Art. 17 of the Second Directive. However, activities included in Group 6 in relation to the construction of industrial and commercial buildings and to community and civil engineering works could not be considered to be for the benefit of the final consumer.

Group 17 - **Protective boots and helmets**

The Commission submitted that the supply of these products employers for the use of their employees could not be zero-rated The persons to whom these goods were supplied could not be regarded final consumers.

On those grounds the Court:

1. Declared that, by continuing to apply a zero rate of e added tax to supplies to industry of water and sewer services (emptying of cesspools and septic tanks) in d in Group 2 of Schedule 5 to the Value Added Tax Act 19 so far as they were not supplied to final consumers,

   to news services included in Group 6, in so far as ere not provided to final consumers,

   to supplies of fuel and power included in Group 7 a protective boots and helmets included in Group 17, far as they were not supplied to final consumers,

   to the provision of goods and services included in 8 in relation to the construction of industrial and comm l buildings and to community and civil engineering wor in so far as they were not provided to final consumers,

the United Kingdom had contravened the provisions of the Sixth Directive and had therefore failed to fulfil its obligations under the EEC Treaty;

2. For the rest, dismissed the application;

3. Ordered the United Kingdom to pay the costs.

COURT OF JUSTICE OF THE EUROPEAN COMMUNITIES

JUDGMENT OF THE COURT

21 June 1988

(Value added tax - Zero-rating)

In Case 416/85

Commission of the European Communities, represented by its Legal Adviser D.R. Gilmour, acting as Agent, with an address for service in Luxembourg at the office of G. Kremlis, a member of its Legal Department, Jean Monnet Building, Kirchberg,

applicant,

v

United Kingdom of Great Britain and Northern Ireland, represented by S.J. Hay, of the Treasury Solicitor's Department, acting as Agent, assisted by D. Vaughan, Q.C., with an address for service in Luxembourg at the British Embassy, 28 Boulevard Royal,

defendant,

APPLICATION for a declaration that by applying a system of zero-rating to certain groups of goods and services the United Kingdom has failed to fulfil its obligations under Article 28 (2) of the Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment (77/388/EEC, Official Journal 1977 No. L 145, p. 1),

THE COURT

composed of: Lord Mackenzie Stuart, President, G. Bosco, O. Due, J.C. Moitinho de Almeida and G.C. Rodriguez Iglesias (Presidents of Chambers), T. Koopmans, U. Everling, K. Bahlmann, Y. Galmot, C.N. Kakouris, R. Joliet, T.F. O'Higgins and F.A. Schockweiler, Judges,

Advocate General: M. Darmon

Registrar: H.A. Rühl, Principal Administrator,

having regard to the Report for the Hearing and further to the hearing on 15 September 1987,

after hearing the Opinion of the Advocate General delivered at the sitting on 2 December 1987,

gives the following

Judgment

1 By an application lodged at the Court Registry on 13 December 1985 the Commission of the European Communities brought an action pursuant to Article 169 of the EEC Treaty for a declaration that by continuing to apply a zero rate of value added tax to certain groups of goods and services the United Kingdom of Great Britain and Northern Ireland has contravened the provisions of Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment (Official Journal 1977 No. L 145, p. 1) (hereinafter referred to as "the Sixth Directive") and has therefore failed to fulfil its obligations under the EEC Treaty.

2 Article 28 of the Sixth Directive lays down transitional provisions for the progressive adaptation of national legislation in certain respects. Article 28 (2) provides as follows:

> "Reduced rates and exemptions with refund of the tax paid at the preceding stage which are in force on 31 December 1975, and which satisfy the conditions stated in the last indent of Article 17 of the Second Council Directive of 11 April 1967, may be maintained until a date which shall be fixed by the Council, acting unanimously on a proposal from the Commission, but which shall not be later than that on which the charging of tax on imports and the remission of tax on exports in trade between the Member States are abolished. Member States shall adopt the measures necessary to

ensure that taxable persons declare the data required to determine own resources relating to these operations.

On the basis of a report from the Commission, the Council shall review the above-mentioned reduced rates and exemptions every five years and, acting unanimously on a proposal from the Commission, shall where appropriate, adopt the measures required to ensure the progressive abolition thereof."

3 The last indent of Article 17 of Council Directive 67/228/EEC of 11 April 1967 on the harmonization of legislation of Member States concerning turnover taxes - Structure and procedures for application of the common system of value added tax (Official Journal, English Special Edition 1967, p. 16) (hereinafter referred to as "the Second Directive"), to which Article 28 of the Sixth Directive refers, provides that Member States may:

"provide for reduced rates or even exemptions with refund, if appropriate, of the tax paid at the preceding stage, where the total incidence of such measures does not exceed that of the reliefs applied under the present system. Such measures may only be taken for clearly defined social reasons and for the benefit of the final consumer, and may not remain in force after the abolition of the imposition of tax on importation and the remission of tax on exportation in trade between Member States."

4 On the basis of Article 28 (2) of the Sixth Directive, the United Kingdom has continued to apply a system called "zero-rating". Originally Schedule 4 to the Finance Act 1972 contained a list of 17 groups of goods or services which were zero-rated. That list was incorporated almost in its entirety in Schedule 5 to the Value Added Tax Act 1983.

5 The Commission considered that certain of the zero rates provided for by the United Kingdom legislation did not comply with the criteria contained in the last indent of Article 17 of the Second Directive; by a letter of 19 October 1981 it therefore called on the United Kingdom to submit its observations in accordance with the first paragraph of Article 169 of the EEC Treaty.

6 The United Kingdom did not agree that it had failed to fulfil its obligations under the Treaty, and on 4 September 1984 the Commission therefore delivered a reasoned opinion. Since the United Kingdom did not comply with that opinion, the Commission brought these proceedings.

7 Reference is made to the Report for the Hearing for a fuller account of the facts of the case, the course of the procedure and the submissions and arguments of the parties, which are mentioned or discussed hereinafter only in so far as is necessary for the reasoning of the Court.

The jurisdiction of the Court

8 The United Kingdom contends that there is a political motive behind the Commission's application to the Court and that such a motive is not a proper basis for an action pursuant to Article 169 of the EEC Treaty. The Commission's action is intended in fact to attain by means of judicial proceedings an objective which can be achieved only by a decision of the Community legislature. It is clear from the Commission's reply that its

intention in bringing these proceedings is to bypass the procedural requirements of Article 28 of the Sixth Directive, under which it is for the Council, acting unanimously, to decide to abolish the exemptions permitted by that article. The United Kingdom therefore submits that it is not the task of the Court "to substitute itself for the political procedures envisaged by Article 28 of the Sixth Directive and to substitute an immediate obligation upon a Member State for the progressive compliance envisaged by Article 28".

9 That argument cannot be upheld. In the context of the balance of powers between the institutions laid down in the Treaty, it is not for the Court to consider what objectives are pursued in an action brought under Article 169 of the Treaty. Its rôle is to decide whether or not the Member State in question has failed to fulfil its obligation as alleged. As the Court held in its judgment of 10 December 1968 (Case 7/68, Commission v Italian Republic, [1968] ECR 423), an action against a Member State for failure to fulfil its obligations, the bringing of which is a matter for the Commission in its entire discretion, is objective in nature.

Substance

10 It should be pointed out first of all that the Commission does not dispute the legality of the zero-rating system in general; it considers that system to be essentially equivalent to the exemptions provided for by Article 28 of the Sixth Directive, as it expressly stated in its proposal for

a Sixth Directive submitted to the Council on 29 June 1973. It submits, however, that the requirements laid down in the last indent of Article 17 of the Second Directive, which provides that exemptions may be made only "for clearly defined social reasons and for the benefit of the final consumer", are not met with regard to certain groups of goods and services included in Schedule 5 to the Value Added Tax Act 1983.

11 It must therefore be determined whether the zero-rating of the goods and services at issue complies with the conditions laid down in those provisions.

The concept of "clearly defined social reasons"

12 With regard to the first condition, that is to say that exemption may be granted only for clearly defined social reasons, the parties are agreed that the determination of their own social policy is a matter for the discretion of the Member States. They accept, however, that that discretion may be subject to supervision at the Community level.

13 In particular, the United Kingdom accepts that the Commission may challenge a measure where the social reason cannot be said to be sufficiently "clearly defined", where the social reason advanced cannot justify the measure or if the measure lacks all proportionality. The Commission states that by "social reasons" it understands measures which are introduced primarily for

general social purposes and not principally for industrial, sectoral or fiscal reasons; it accepts, however, that it may not challenge measures taken in pursuance of a Member State's social policy unless it can be shown that the social policy is not sufficiently clearly defined or that the measures in question either are not justified by or are disproportionate to the social reasons advanced.

14 The identification of social reasons is in principle a matter of political choice for the Member States and can be the subject-matter of supervision at the Community level only in so far as, by distorting that concept, it leads to measures which because of their effects and their true objectives lie outside its scope.

The phrase "for the benefit of the final consumer"

15 The Commission regards as "final consumers" those persons who stand at the final stage in the manufacturing and commercial chain and have no right to deduct VAT, that is to say non-taxable persons.

16 The United Kingdom considers that there is nothing in the general scheme of VAT to indicate that the term "final consumer" should be treated as synonymous with the term "non-taxable person". On the contrary, the final consumer must be taken to be the natural or legal person at the end of a

particular production or distribution chain for a particular product or service, even where that product or service is used in the production of other products or the provision of other services, regardless of whether or not the person is a taxable person.

17 Under the general scheme of VAT the final consumer is the person who acquires goods or services for personal use, as opposed to an economic activity, and thus bears the tax. It follows that having regard to the social purpose of Article 17 the term "final consumer" can be applied only to a person who does not use exempted goods or services in the course of an economic activity. The provision of goods or services at a stage higher in the production or distribution chain which is nevertheless sufficiently close to the consumer to be of advantage to him must also be considered to be for the benefit of the final consumer as so defined.

The zero rates at issue

A. Group 1 - **Food** (2. Animal feedingstuffs; 3. Seeds or other means of propagation of plants comprised in Items 1 or 2; 4. Live animals of a kind generally used as, or yielding or producing, food for human consumption)

18 The Commission's allegation is essentially that the zero-rating of these products does not comply with the second condition laid down in the last

indent of Article 17 of the Second Directive. It submits that transactions in these products are too remote from the final zero-rated food product to fulfil the criterion of benefit to the final consumer.

19 The United Kingdom argues that the application of a positive rate of VAT to these products would entail an increase in food prices and thus jeopardize the achievement of the social objectives which it is pursuing. It also disputes the Commission's argument concerning remoteness from the final product.

20 All the supplies at issue contribute to the production of substances intended for human consumption and are sufficiently close to the final consumer to be of advantage to him. Moreover, the negative effects of any taxation of those products on food prices, increases in which are particularly sensitive for the final consumer, who himself enjoys zero-rating, cannot be neglected.

21 It follows that with regard to the products of this group at issue the alleged failure of the United Kingdom to fulfil its obligations has not been established.

B. Group 2 - **Sewerage services and water**

22 The Commission's submission in this respect concerns services provided to industry regarding the emptying of cesspools and septic tanks made

necessary by the absence of a mains drainage system, on the one hand, and the supply of water to industry, on the other.

23 In neither of these cases can the provision of services to industry be regarded as fulfilling the second criterion laid down in Article 17, since industrial users cannot be regarded as final consumers.

24 With regard in particular to the supply of water to industry, the United Kingdom pointed out that such supplies are exempted in another Member State. In the course of the proceedings the Commission explained that that exemption is based on Article 28 (3) (b) of the Sixth Directive, according to which the Member States may, during the transitional period, continue to exempt the activities set out in Annex F, in this instance "the supply of water by public authorities". The United Kingdom has not sought to rely on that provision.

25 The failure of the United Kingdom to fulfil its obligations in respect of these products and services is therefore established.

C. Group 6 - **News services provided to certain undertakings**

26 The Commission's submissions concern the supply of news services to

undertakings which themselves provide services which are not zero-rated, such as banks or insurance companies.

27 The United Kingdom argues that the services in question can be included as an "incidental benefit" and that the intrinsic characteristics of news services remain the same whether they are supplied to a bank or to a newspaper, the latter being zero-rated.

28 Leaving aside the fact that an incidental benefit such as that relied on by the United Kingdom has no place in the concept of a benefit to the final consumer for the purposes of Article 28 of the Sixth Directive, it is clear that since the undertakings to which the news services in question are provided, such as banks and insurance companies, cannot be regarded as final consumers, the second criterion laid down in Article 17 of the Second Directive is not fulfilled.

29 The failure of the United Kingdom to fulfil its obligations in respect of these services is therefore established.

D. Group 7 - **Fuel and power** (coal, coke, coal gas, water gas, petroleum gases, fuel oil, gas oil, electricity etc.)

30 The Commission challenges the zero-rating of supplies of fuel and power other than to final consumers.

31 In its defence the United Kingdom relies essentially on the negative effects from the social point of view of any taxation of supplies of fuel and power, in particular to schools and hospitals.

32 Whilst the Court does not call in question the social reasons underlying that policy, it must point out that the services in question cannot be considered to have been provided for the benefit of final consumers, since final consumers as defined above derive only very indirect advantages from zero-rating. They therefore do not fulfil the second criterion of Article 17 of the Second Directive.

33 With regard to the United Kingdom's alternative argument to the effect that the difficulties in administering the tax if only supplies to final consumers were zero-rated would probably be insurmountable, it must be observed that where a Member State wishes to make use of the derogations in question it must take all the practical measures necessary for the correct application of those provisions. If it considers that such measures cannot be implemented, it must refrain from applying zero rates.

34 The alleged failure of the United Kingdom to fulfil its obligations is therefore established.

E. Group 8 - **Construction of buildings** (including in particular the initial sale of new buildings, the services provided by a contractor constructing a new building for a client who owns the site, the construction of commercial and industrial buildings, civil engineering works, the construction of roads, railways and airports)

35 The Commission challenges the zero-rating of all the items in Group 8 with the exception of housing constructed by local authorities. With regard to the housing sector, the Commission argues that the indiscriminate application of a zero rate to the whole sector, regardless of the nature of the dwellings concerned, is contrary to the first criterion laid down in the last indent of Article 17 inasmuch as it is disproportionate in relation to the objectives of the United Kingdom's social policy in housing matters. With regard to commercial and industrial buildings and to community and civil engineering works the Commission considers that any benefit to the final consumer is too remote to meet the second criterion laid down in the last indent of Article 17.

36 With regard to buildings intended for housing, the Commission's arguments cannot be upheld. The measures adopted by the United Kingdom in

order to implement its social policy in housing matters, that is to say, facilitating home ownership for the whole population, fall within the purview of "social reasons" for the purposes of the last indent of Article 17 of the Second Directive.

37 By applying a zero rate to the activities comprised in Group 8 with regard to housing constructed both by local authorities and by the private sector, the United Kingdom has not, therefore, contravened the last indent of Article 17 of the Second Directive.

38 However, activities included in Group 8 in relation to the construction of industrial and commercial buildings and to community and civil engineering works cannot be considered to be for the benefit of the final consumer.

39 It follows that the United Kingdom has failed to fulfil its obligations, as alleged by the Commission, in so far as it applies a zero rate to services in relation to the construction of industrial and commercial buildings and to community and civil engineering works.

F. Group 17 - **Protective boots and helmets**

40 The Commission submits that the supply of these products to employers for the use of their employees cannot benefit from zero-rating because they

cannot be regarded as inputs in the chain of production of products which are zero-rated.

41 The United Kingdom argues that protective boots and helmets must be considered in their own right, not as part of a production process. The employer must, it says, be regarded as the final consumer of these goods.

42 In the light of the considerations set out above, it must be held that the persons to whom these goods are supplied cannot be regarded as final consumers.

43 The alleged failure of the United Kingdom to fulfil its obligations in this respect is therefore established.

44 It follows from all the foregoing that by continuing to apply a zero rate of value added tax to the groups of goods and services specified above, the United Kingdom has contravened the provisions of Directive 77/388 and has therefore failed to fulfil its obligations under the EEC Treaty.

Costs

45 Under Article 69 (2) of the Rules of Procedure, the unsuccessful party is to be ordered to pay the costs. Since the United Kingdom has failed in most of its submissions, it must be ordered to pay the costs.

On those grounds,

THE COURT

hereby:

1. Declares that by continuing to apply a zero rate of value added tax

to supplies to industry of water and sewerage services (emptying of cesspools and septic tanks) included in Group 2 of Schedule 5 to the Value Added Tax Act 1983, in so far as they are not supplied to final consumers,

to news services included in Group 6, in so far as they are not provided to final consumers,

to supplies of fuel and power included in Group 7 and to protective boots and helmets included in Group 17, in so far as they are not supplied to final consumers,

to the provision of goods and services included in Group 8 in relation to the construction of industrial and commercial buildings and to community and civil engineering works, in so far as they are not provided to final consumers,

the United Kingdom of Great Britain and Northern Ireland has contravened the provisions of Council Directive 77/388 of 17 May 1977 and has therefore failed to fulfil its obligations under the EEC Treaty;

2. For the rest, dismisses the application;

3. Orders the United Kingdom to pay the costs.

Mackenzie Stuart Bosco Due

Moitinho de Almeida Rodriguez Iglesias Koopmans

Everling Bahlmann Galmot Kakouris

Joliet O'Higgins Schockweiler

Delivered in open court in Luxembourg on 21 June 1988.

A.J. Mackenzie Stuart
President

J.-G. Giraud
Registrar

J 416/85

ph6.18

CONFIDENTIAL
(UNTIL AFTER ECONOMIC SECRETARY'S STATEMENT 21 JUNE)

cc Press
Pol/Ust
PG.

VAT ZERO RATES: ECJ JUDGEMENT

STATEMENT BY THE ECONOMIC SECRETARY

With permission, Mr Speaker, I wish to make a statement about the judgement delivered by the European Court of Justice today in the case brought by the European Commission on certain of our VAT zero-rates.

The Court ruled that the United Kingdom was not in breach of its Treaty obligations by zero-rating private housing, animal feeding stuffs, seeds, live animals yielding food for consumption, and news services supplied directly to the public or in the production of zero-rated items (such as newspapers). However, it ruled that the zero-rating by the UK of a number of other goods and services was not permitted under European Community law. In broad terms these items are: the construction of buildings for industrial and commercial use, water and sewerage services supplied to industry, news services supplied to other than final consumers, fuel and power supplied to other than final consumers, and protective boots and helmets purchased by employers. I am placing the full text of the judgement in the Library of the House.

I should make it clear that this adverse judgement is based on an interpretation of existing Community law to which the UK gave its assent in 1977. It has nothing whatever to do with the Commission's proposals for the approximation of VAT, which are not law and could not become law without the unanimous agreement of all member states.

The Government will study carefully the detailed terms of the judgement, against which there is no right of appeal and with which it is obliged to comply. The Government will consult interested parties, including trade and professional bodies, and also charities, on how the judgement can best be applied in practice. Legislation to implement the judgement will then be brought before the House for approval as part of next year's Budget. I can give the House an assurance that no changes will take effect before 1 April 1989.

In the meantime, I am concerned to avoid the damaging effects of a period of uncertainty for the construction industry and its customers, and to mitigate the effects of the extension of VAT to non-domestic construction. I therefore have the following decisions to announce:

- Non-domestic construction, the sale of new non-domestic buildings, and the sale of building land for non-domestic developments will be taxed at the standard rate of VAT from 1 April 1989.

- All contracts entered into before today will continue to be zero-rated.

- Public sector construction programmes will be protected by allowing, where necessary, compensating adjustments to the relevant central government expenditure provision. Full refunds of VAT on non-domestic construction will be available to both health authorities and local authorities.

- Owners of non-domestic property will be given the option to charge VAT on rents, and on sales of used buildings, from 1 August 1989.

- This option will apply to existing buildings as well as new ones.

- Where it is exercised, landlords and tenants will be able to reclaim VAT on input costs in the normal way.

- This means that, where buildings are occupied by fully taxable businesses, neither landlord nor tenants will be worse off.

- To protect tenants who are not fully taxable, any VAT on rents will be phased in over two years.

- For charities, the transitional period will be five years.

- I hope that it will be possible to publish draft Finance Bill clauses relating to non-domestic construction by January.

The estimated yield from the proposals I have announced will be some £65 million for the initial year, 1989-90, rising to a full year level of £160 million in 1991-92. This compares with the full year yield of £425 million that would accrue from the tax if the measures of mitigation which I have just announced were not introduced.

A consultation document on the changes affecting non-domestic construction will be available in the Vote Office and Library when I sit down. A more general consultation paper on the other aspects of the judgement will be available shortly. Much remains to be considered and there will be full consultation by the Customs and Excise on the implications of the changes.

Mr Speaker, we find ourselves obliged by undertakings Her Majesty's Government gave in 1977 to impose VAT on non-domestic construction and certain other services. I have announced today measures to mitigate their impact ahd to minimise uncertainty. I assure the House that there will now be full consultation, so that the necessary legislation can be properly considered and prepared for next year's Finance Bill.

HM CUSTOMS AND EXCISE

NEWS RELEASE

RA

No 47/88 21 June 1988

VAT ZERO RATES INFRACTION PROCEEDINGS: JUDGEMENT

The European Court of Justice today gave its ruling in respect of certain United Kingdom VAT zero rates which the European Commission had challenged under Community law.

The Court accepted arguments put forward by the United Kingdom that zero-rating is lawful in respect of:

- private housing;
- animal feeding stuffs, seeds, live animals yielding food for consumption.

However, the Court ruled that the following zero-rates did not comply with Community law:

- construction of buildings for industrial and commercial use and in the community and civil engineering sector;
- fuel and power other than to final consumers;
- sewerage services and water supplied to industry;
- news services insofar as they are not provided to final consumers;
- protective boots and helmets supplied to employers.

In a statement made in Parliament today the Economic Secretary to the Treasury (Mr Peter Lilley, MP), said:

> "I should make it clear that this adverse judgement is based on an interpretation of existing Community law to which the UK gave its assent in 1977. It has nothing whatever to do with the Commission's recent proposals for the approximation of VAT, which have no legal status and could not become law without the unanimous agreement of all member states.
>
> "The Government will study carefully the detailed terms of the judgement, against which there is no right of appeal and with which it is obliged to comply. The Government will consult interested parties, including trade and professional bodies and also charities, on how the judgement can best be applied in practice. Legislation to implement the judgement will then be brought before the House for approval as part of next year's Budget. I can give the House an assurance that no changes will take effect before 1 April 1989."

The Economic Secretary went on to say:

> "Public sector construction programmes will be protected by allowing, where necessary, compensating adjustments to the relevant central government expenditure provision. Full refunds of VAT on non-domestic construction will be available to both health authorities and local authorities."

NOTE TO EDITORS

A consultation paper on changes affecting the construction industry has been issued today (attached at Annex A). In the next week or so a consultation paper will be issued on the other supplies affected by the Court's judgement.

ISSUED BY: HM CUSTOMS AND EXCISE PRESS AND INFORMATION OFFICE, NEW KING'S BEAM HOUSE, 22 UPPER GROUND, LONDON SE1 9PJ

TELEPHONE: 01 382 5468/5469/5471

ANNEX A.

CONSULTATION PAPER

VAT ON NON-DOMESTIC CONSTRUCTION

In the House of Commons today, the Economic Secretary to the Treasury announced the following decisions which will form the basis of legislation which will be proposed in the 1989 Budget:

(a) Non-domestic construction services and the freehold sale of new non-domestic buildings and of building land for non-domestic developments will be taxed at the standard rate.

(b) The change from zero- to standard-rating will apply from 1 April 1989. The normal transitional rules for bringing in a VAT change will apply. But in addition, because of the long term nature of many building contracts, there will exceptionally be a relief for contracts entered into prior to today. Zero-rating will thus continue for these qualifying contracts even if the supplies concerned would normally have tax points on or after 1 April 1989.

(c) In order to mitigate the effect on the construction and property industries, a provision permitted by Article 13C of the EC Sixth VAT Directive, known as the landlord's option to tax rent and used buildings, will be introduced. Landlords and others letting non-domestic buildings and selling used non-domestic buildings will be able to tax their transactions at the standard rate, thus being able to recover the tax they have borne. This will mean that there will be no real burden of irrecoverable tax where the buildings are occupied by fully taxable businesses.

(d) The landlord's option for taxation will take effect from 1 August 1989 and landlords will be able to opt to tax rents in relation to both new and existing buildings. If they decide to opt, they will have to do so for all lettings in the same building and that option will apply to any subsequent letting or sale. However in order to provide some mitigation for existing tenants whose landlords exercise the option to tax, the amount of VAT actually chargeable will be increased in stages. Tax will be charged on one half of the rent payable for the 12 months from 1 August

1989 and on the full rent from 1 August 1990 onwards. For charities, this relief will be spread over five years, rather than two, and the amount of rent chargeable to VAT will go up in annual increments of one fifth.

This paper gives further details of these decisions and invites comments from interested persons or representative bodies on other proposals associated with them. It also indicates other matters on which no decisions have been taken or proposals formulated; again representations on these matters will be welcome. (Legal references are to the VAT Act 1983 (as amended).)

A. Services by building and civil engineering contractors and sub-contractors

Item 2 of Group 8, Schedule 5, will be amended to remove from zero-rating services in the course of **(i)** the construction of a non-domestic building **(ii)** the construction or demolition of a civil engineering work and **(iii)** the demolition of any building. Item 2 of Group 8A will be amended to remove zero rating for services in the course of the approved alteration of a non-domestic protected building. Where a building or a protected building is to be used for both non-domestic and domestic purposes, contractors and sub-contractors will have to standard rate the non-domestic element and zero-rate the domestic element by means of a fair and reasonable apportionment of the total price for the whole job.

Comments are invited on how a domestic or non-domestic building should be defined so as to comply with the terms of the European Court's judgment.

The above amendments will take effect from 1 April 1989. The normal transitional rules will apply for establishing tax points in the circumstances of a change from the zero-rate to the standard rate; these are set out in Appendix F of the VAT Guide (Notice 700 October 1987). However, in addition work done or payments received under a written contract signed and sealed prior to today's date will remain eligible for zero rating under the existing law as a special transitional relief even if the relevant tax points would otherwise be on or after 1 April 1989.

B. **Freehold sales and long leases of buildings by a builder or developer; freehold sales of building land.**

Item 1 of Group 8, Schedule 5 will be amended to remove from zero-rating the freehold sale *, or the grant of a lease in excess of 21 years, of a non-domestic building or its site. Item 1 of Group 8A will be similarly amended in respect of a substantially reconstructed protected building or its site when the building is to be used for a non-domestic purpose.

Item 1 of Group 1, Schedule 6 will be amended to remove from exemption (and thus make liable to VAT at the standard-rate) the freehold sale* of a new non-domestic building and the freehold sale* of building land other than building land sold with planning permission wholly for residential development. It is proposed that a "new" building for this purpose would be one which is sold either prior to its completion or within a specified period from the date of its completion (it is suggested this period might be either three or five years.) The relevant Community law is contained in Article 4.3 and 13B(g) and (h) of the EC Sixth VAT Directive.

The above changes will take effect from 1 April 1989. The normal rules will apply for establishing tax points on a change of liability: these are set out in Appendix F of the VAT Guide (Notice 700 October 1987). In addition, contracts

- for the freehold sale* of buildings at present qualifying for zero-rating under item 1 of Group 8 or Group 8A; and

- for the freehold sale of non-residential building land at present qualifying for exemption under item 1 of Group 1

if already signed and sealed prior to today's date but with a tax point date on or after 1 April 1989 will still qualify for zero-rating and exemption, respectively.

Zero-rating may be retained for payments under long leases signed and sealed prior to today's date only to the extent of capital sums received on or after 1 April 1989 and payable under the terms of the lease. Zero-rating may **not** be retained for any payments of rent received on or after 1 April 1989.

Comments are invited on the definition of a domestic or non-domestic building; and on the most appropriate definition of "building land".

*or equivalent in Scotland

C. Option for taxation

With effect from 1 August 1989 any person making a supply in respect of any non-domestic building, or of any developed land (other than building land) used for a non-domestic purpose, which would be an exempt supply under item 1 of Group 1, Schedule 6, will be able to opt to convert that supply, and all his future supplies in respect of that particular building or land, into a taxable supply. The main features of the scheme will be :

(i) The option is entirely at the discretion of the supplier; he will not be obliged to consult the recipient before deciding whether to opt although he may choose to do so in practice.

(ii) The option applies to both new and existing buildings and must be exercised on a building by building basis. Once exercised, it cannot be varied for any future supplies (lettings or sale).

(iii) Landlords will have to send Customs and Excise a list of the buildings for which they are opting except where the only supplies eligible for option treatment in respect of a particular building are licences to occupy as opposed to leases/tenancies.

(iv) A landlord will not be able to opt for taxing a lease/tenancy/licence to occupy any part of a building which is to be used as a dwelling; any supply related to a dwelling must remain an exempt supply (or in appropriate cases, under Group 8 or Group 8A, a zero-rated supply).

(v) In respect of existing buildings, landlords will have to charge VAT as if the consideration for each supply under the option was one half of the rent due for the period 1 August 1989 to 31 July 1990. Tax will become chargeable on the basis of the full rent due for periods from 1 August 1990 onwards. For charities, the phasing in will be over a five year period, starting on 1 August 1989, with appropriate adjustments being made to the proportions of rent chargeable with VAT. For new buildings unoccupied by tenants or licensees at 1 August 1989, tax will become chargeable on the basis of the full rent due from the commencement of the lease or licence.

(vi) A landlord who opts for taxation from 1 August 1989 will be able, in

respect of lettings which up until 31 March 1989 were zero rated under item 1 of Group 8 or item 1 of Group 8A, to disregard for partial exemption purposes the four months from April-July 1989 in which the rents become exempt. In addition a landlord who has opted for any building or land and who has to apply the transitional relief described in (v) will be able to treat the input tax incurred in respect of that building or land for the years concerned as fully deductible subject to the normal rules.

Comments are invited on whether the option should apply to agricultural land and other undeveloped land (other than building land).

D. Self-supply of building services

It is proposed that there will be a VAT charge on businesses doing their own building work. This will be effected by an Order made under section 3(6) of the VAT Act 1983. This is an anti-avoidance measure designed to prevent exempt or partly exempt businesses avoiding VAT on the salary, labour and profit element of the building process.

Comments are invited on the precise scope of this Order.

E. Exhibition stands

It is proposed that the current exclusion (g) from item 1 of Group 1, Schedule 6 should be deleted. Exhibition organisers will be able to use the option facility if they wish to tax their supplies of space and stands to exhibitors.

F. Surrenders of Interests in Property

It is proposed to remove the relief for "surrenders" from item 1 of Group 1 of Schedule 6. If this is not done, there would be an added complication in relation to the landlord's option for taxation. Also there is no provision to relieve "surrenders" under Article 13 of the EC Sixth VAT Directive.

Any person or body wishing to comment on these proposals or otherwise make representations to Customs and Excise should write no later than 31 August 1988 to : VAT Administration Directorate, Division F, Room 413 New King's Beam House, 22 Upper Ground, London SE1 9PJ

Letters should make clear whether a meeting is requested but writers should bear in mind that it is hoped to publish draft Finance Bill clauses in January 1989.

53/2/LPD/3754/006

CONFIDENTIAL

cc PS/CHANCELLOR
PS/CST (E)/FST PS/PMG
SIR P MIDDLETON
MR ANSON
MR SCHOLAR
MR CULPIN
MR TURNBULL
MR GILHOOLY
MR RICHARDSON
MR BUSH
MR DYER
MR CROPPER
MR JEFFERSON-SMITH
MR WILMOTT
MISS BARNETT
MR PRH ALLEN
MR HAMMOND
PS/C+E

Paul Gray Esq
No.10 Downing Street
LONDON
SW1A 0AA

23 June 1988

Dear Paul

EUROPEAN COURT OF JUSTICE : VAT ZERO RATES JUDGEMENT

I attach a final draft of the statement the Economic Secretary intends to make tomorrow afternoon in the event that the European Court of Justice give a judgement similar to the Advocate General's Opinion.

I also attach Q & A briefing on this subject. Please note that the briefing is of three kinds. Some of it is background material which may be used at any time. Some may be used only after we know that the judgement of the European Court has followed the line of the Advocate General's Opinion. And some may be used only after the Economic Secretary's statement tomorrow afternoon. In the event of an unexpected judgement, the statement will be altered, so it will not be possible to use this section of the briefing.

I am copying this letter Alison Smith in the Lord President's Office and Mark Lyall in Lynda Chalker's office.

Yours sincerely,

P D P BARNES
Private Secretary

CONFIDENTIAL

DRAFT STATEMENT

With permission, Mr Speaker, I wish to make a statement about the European Court of Justice's judgement delivered today in the case brought by the European Commission on certain of our VAT zero-rates.

The Court ruled that the United Kingdom was not in breach of its Treaty obligations by zero-rating private housing, animal feeding stuffs, seeds, live animals yielding food for consumption, and news services supplied directly to the public or in the production of zero-rated items (such as newspapers). However, it ruled that the zero-rating by the UK of a number of other goods and services was not permitted under European Community law. In broad terms these items are: the construction of buildings for industrial and commercial use, water and sewerage services supplied to industry, news services supplied other than directly or indirectly to the public, fuel and power supplied to other than final consumers, and protective boots and helmets purchased by employers. I am placing the full text of the judgement in the Library of the House.

I should make it clear that this adverse judgement is based on an interpretation of existing Community law to which the UK gave its assent in 1977. It has nothing whatever to do with the Commission's proposals for the approximation of VAT, which have no legal status and could not become law without the unanimous agreement of all member states.

The Government will study carefully the detailed terms of the judgement, against which there is no right of appeal and with which it is obliged to comply. It will consult interested parties, including trade and professional bodies, and also charities, about which it is particularly concerned, on how the judgement can best be applied in practice. Legislation to implement the judgement will then be brought before the House for approval as part of next year's Budget. I can give the House an assurance that no changes will take effect before 1 April 1989.

In the meantime, I am concerned to avoid the damaging effects of a period of uncertainty for the construction industry and its customers, and to mitigate the effects of the extension of VAT to non-domestic construction. I therefore have the following decisions to announce:

- Non-domestic construction, the sale of new non-domestic buildings, and the sale of building land for non-domestic developments will be taxed at the standard rate of VAT from 1 April 1989.

- All contracts entered into before today will continue to be zero-rated.

- Public sector construction programmes will be protected by allowing, where necessary, compensating adjustments to the relevant central government expenditure provision. Full refunds of VAT on non-domestic construction will be available to both health authorities and local authorities.

- Owners of non-domestic property will be given the option to charge VAT on rents, and on sales of used buildings, from 1 August 1989.

- This option will apply to existing buildings as well as new ones.

- Where it is exercised, landlords and tenants will be able to reclaim VAT on input costs in the normal way.

- This means that, where buildings are occupied by fully taxable businesses, neither landlord nor tenants will be worse off.

- To protect tenants who are <u>not</u> fully taxable, any VAT on rents will be phased in over two years.

- For charities, the transitional period will be five years.

- I hope that it will be possible to publish draft Finance Bill clauses relating to non-domestic construction by January.

The estimated yield from the proposals I have announced will be some £65 million for the initial year, 1989-90, rising to a full year level of £160 million in 1991-92. This compares with the full year yield of £425 million that would accrue from the tax if the measures of mitigation which I have just announced were not introduced.

A consultation document on the changes affecting non-domestic construction will be available in the Vote Office and Library when I sit down. A more general consultation paper on the other aspects of the judgement will be available shortly. Much remains to be considered and there will be full consultation by the Customs and Excise on the implications of the changes.

Mr Speaker, we find ourselves obliged by undertakings Her Majesty's Government gave in 1977 to impose VAT on non-domestic construction and certain other services. I have announced today measures to mitigate their impact ahd to minimise uncertainty. I assure the House that there will now be full consultation, so that the necessary legislation can be properly considered and prepared for next year's Finance Bill.

VAT ZERO RATES INFRACTION PROCEEDINGS

Briefing for 21 June

Key points

(A) MAY BE USED AT ANY TIME

(i) What will Government do now?

Economic Secretary will make a statement in the House this afternoon.

(ii) What will be the effect on the ordinary consumer?

The Court's judgment does not affect supplies made to the ordinary consumer. Minimal effect on RPI.

(iii) Will it affect the VAT on houses, private fuel and power etc?

No. It will not change, in any way, the VAT zero rates on private housing or private fuel, power, or anything else.

(iv) What is the connection between this and VAT approximation?

None. We have a veto on new proposals for taxation. That is our protection against Cockfield's proposals. But this case is about interpretation of existing law to which previous administration signed up in 1977.

(v) Is there any appeal against the court's ruling?

No. Government bound to implement ruling under EC Treaty obligation.

May be used at any time

GENERAL

Will we have to pay more to Brussels because of the judgment?

No. UK payments to EC Budget calculated as if zero-rated items taxed at standard rate.

Will final consumer be affected at all?

The Court's judgment does not affect supplies made to the ordinary consumer. Minimal effect on RPI.

How did we get into this mess?

UK agreed to Sixth VAT Directive 1977. Government of the day believed zero-rating legal for many items. This true for bulk of zero rates. But Court has ruled some not legal in Community terms.

Must we comply with judgment?

Yes. Treaty obligation to observe judgments of European Court. No appeal possible.

Why has Commission picked on us?

It hasn't particularly. All member states have been challenged on VAT matters.

Why didn't we fight?

We did. Vigorous defence at all stages - and won on a most important aspect - Private Housing.

May be used at any time.

GOVERNMENT PLEDGES

Will Government pledges on VAT zero-rating be kept?

Yes. Pledges on VAT zero-rating to domestic consumers made during recent election campaigns and subsequently can be summarised as:

- Government will not extend VAT to food, domestic electricity and gas, young children's clothing and footwear;
- UK will reject any EC proposals which restrict right to retain any zero-rate of VAT. This case not about new proposals but about interpretation of existing law.

Infraction case in no way affects these pledges.

May be used at any time

EC VAT ISSUES

Is case connected with Commission's "Tax Approximation" proposals?

No: Infraction case is completely separate issue. Commission's proposals for VAT rate approximation in European Community (with lower rate band (4-9%) and standard rate band (14-20%), but no provision for zero-rate) were made public in August 1987 by Lord Cockfield. Commission believes approximation necessary for completion of Internal Market; Government does not.

Is UK involved in other cases before European Court?

No other VAT cases brought by EC Commission currently before Court. Number of other cases referred by UK courts or tribunals to ECJ for preliminary ruling on questions of interpretation of EC legislation, but no infraction cases.

Is case connected with recent judgment of ECJ on spectacles?

No. Separate issue entirely. Spectacles concerned with exemption; this case concerns zero-rating.

What other zero-rates are at risk?

No grounds for thinking any. No other zero-rates presently under challenge by Commission. And unlikely to start a challenge now, 11 years after existing zero-rates sanctioned by 6th Directive.

What scope for UK to introduce new zero-rates?

No power to introduce new zero-rates. 1977 Directive allowed existing zero-rates fulfilling existing criteria to continue.

CONFIDENTIAL UNTIL JUDGMENT KNOWN TO REFLECT ADVOCATE GENERAL'S OPINION
MAY BE USED IF JUDGMENT FOLLOWS LINE OF ADVOCATE GENERAL'S OPINION

CHARITIES/CHURCHES

Will Government do anything to alleviate effect on charities/churches?

Activities of charities many and varied, Government is concerned about potential effects on charities/churches; needs to study judgment in detail and consult interested parties; this will take time.

MAY BE HELD IF JUDGEMENT FOLLOWS LINE OF ADVOCATE GENERAL'S OPINION

ZERO-RATES SUCCESSFULLY CHALLENGED

Non-domestic construction: Private housing not affected. Zero-rating of construction of buildings for industrial and commercial use and in the community and civil engineering sector unlawful. Extent to which zero-rating might be retained to be considered in light of detailed terms of judgment and consultation.

Fuel and power supplied other than to final consumers. Government pledge not to extend VAT to domestic electricity and gas not affected and will be honoured. Most businesses can recover tax.

Sewerage services and water supplied to industry: supplies to domestic housing not affected - most businesses could recover any VAT charged.

News services (i) not supplied direct to the public, (ii) not for the production of zero-rated products such as newspapers.

Protective boots and helmets purchased by employers: most able to recover tax.

CONFIDENTIAL UNTIL AFTER ECONOMIC SECRETARY'S STATEMENT

(B) **TO BE USED ONLY AFTER ECONOMIC SECRETARY'S STATEMENT**

(vi) **When will VAT changes take place?**

There will be no changes of any kind before 1 April 1989. And no VAT on construction for contracts entered into before today.

(vii) **Will the Government seek views on the changes?**

There will be full consultation before changes are made.

(viii) **Why has Government announced construction, rents etc changes now then?**

Construction typically involves long-term plans and contracts. Those involved need to know the outlines of the new system now.

(ix) **The Court hasn't fixed a VAT rate for items to be taxed. Why not tax at lower rate?**

It has been consistent government policy to keep VAT simple by having a single positive rate of VAT, coupled with zero-rates where appropriate. That remains the case. In any event, the option to tax gives greater mitigation than a reduced rate on new non-domestic construction, since the minimum permissible could be as high as 8 or 10% [EC law means significantly lower rate probably illegal].

CONFIDENTIAL UNTIL AFTER ECONOMIC SECRETARY'S STATEMENT

For use only after Economic Secretary's Statement

CONSTRUCTION

Effects of the judgment

What construction affected?

Essentially new buildings in non-domestic sector (offices, etc). Does not affect private housing. We envisaged that there will have to be an apportionment for mixed use buildings such as flats over shops.

What about old people's homes, etc?

We will look at this in the light of the consultation exercise.

What about listed buildings - relief should be for repairs not alterations?

Repairs to listed buildings have always been taxed but in 1984 we were persuaded to retain zero-rating for approved alterations. The zero-rating for listed buildings used for non-domestic purposes will now have to end. EC law means we cannot introduce any new zero-rating or exemption for repairs to listed buildings.

CONFIDENTIAL UNTIL AFTER ECONOMIC SECRETARY'S STATEMENT

Mitigation

Will the Government reduce the impact on the construction/ property sectors?

No changes to take effect before 1 April 1989. Because non-domestic construction supplies have long lead-time, , a detailed statement has been made on this issue in the House this afternoon; a News Release and consultation paper have also been issued by Customs and Excise.

Owners of non-domestic property will be given the option to charge VAT on rents, and on sales of used buildings, from 1 August 1989, allowing them to reclaim VAT on input costs in the normal way. All contracts entered into before today will continue to be zero-rated.

What will happen between April 1989 and August 1989?

Rents which are at present zero-rated will become exempt but, provided a landlord opts for taxation from 1 August 1989, he will not suffer any input tax restriction in respect of the 4 month exemption.

CONFIDENTIAL UNTIL AFTER ECONOMIC SECRETARY'S STATEMENT

For use only after Economic Secretarty's Statement

CONSTRUCTION

What measures of mitigation had the construction/property industries asked for?

The Government has responded positively to the industries' requests. They asked for: (i) the landlords' option for taxation; (ii) relief for existing contracts; (iii) a reasonable lead-in period with scope for consultation; and (iv) no reduction in the real value of work undertaken for the public sector. All being met. Indeed on the option for taxation the Government has conceded a staged introduction which was not specifically requested.

How will the measures announced by my hon Friend help Inner City renewal?

They will help it. The developers/landlords will now have the opportunity of recovering all the tax they incur on their Inner City projects for non-domestic use.

How will conservation be affected by these measures?

Housing not affected but for non-domestic buildings VAT will no longer provide an incentive to demolish and build anew. The option to tax lettings and sales of used buildings will mean that the VAT incurred on restoring, refurbishing or converting buildings for non-domestic use will now be fully deductible by builders/developers/landlords.

Effect on construction industry?

Output in the industry is very buoyant at present, full impact of judgment will not be felt until well into the 1990s.

CONFIDENTIAL UNTIL AFTER ECONOMIC SECRETARY'S STATEMENT

For use only after Economic Secretary's Statement

CONSTRUCTION

Why has Government responded so quickly with these measures for the construction industry?

To remove as much uncertainty as possible and to avoid an excessive scramble for new developments before the next Budget. The measures announced are carefully balanced to protect existing expectations, to provide some scope for getting new projects at least started on the current zero-rated basis before next April and to prevent the complications of a dual liability system being projected too far into the future.

Why tax building land?

Leaving building land exempt would have caused a fiscal distortion between buying and leasing property on the one hand and building for own use on the other.

Who will suffer

What businesses adversely affected?

Business activities exempt from VAT could not recover any of the new tax charged on construction, fuel and power, etc. Finance and insurance industries affected in particular; private education and private health will also be affected.

What is effect on private health and private education?

VAT will not be applied to all these inputs so wrong to assume that

Prices will ~~not~~ rise by full 15%

Charities - see separate brief

CONFIDENTIAL UNTIL AFTER ECONOMIC ASSESSMENT ... STATEMENT
for use only after Economic Secretary's statement.

Why not a reduced rate of VAT?

It has been consistent government policy to keep VAT simple by having a single positive rate of VAT, coupled with zero-rates where appropriate. That remains the case. In any event, the option to tax gives greater mitigation than a reduced rate on new non-domestic construction, since the minimum permissible could be as high as 8 or 10% [EC law means significantly lower rate probably illegal].

Where is the revenue coming from?

The VAT is coming mainly from the taxation of rents where the tenants are exempt or partly exempt. This will be a very small proportion of total VAT yield and indeed of consumer spending.

CONFIDENTIAL UNTIL AFTER ECONOMIC SECRETARY'S STATEMENT.

To be used only after Economic Secretary's Statement

PUBLIC EXPENDITURE

What are the public expenditure consequences?

Normal policy that indirect tax changes are absorbed like other price increases. Exception for new construction reflects priority of Government's building programme.

Will there be a squeeze on Government construction?

Compensatory adjustments to be allowed where necessary in Public Expenditure Survey.

Why will there not be immediate public expenditure increases?

No tax effect before 1 April 1989. Survey proper place for public expenditure decisions. Costs for individual programmes need to be assessed carefully.

Public expenditure cost of construction VAT?

Difficult to say at this stage. Departments need time to assess implications, especially transitional mitigation.

Central Government rent increases?

Expected to be accommodated in existing programme totals. Normal for indirect tax increases to be absorbed as part of cash planning.

Public expenditure effects of water and fuel?

Too early to say. Consultations needed prior to decision on how tax to be applied.

*CONFIDENTIAL UNTIL AFTER ECONOMIC SECRETARY'S STATEMENT

Health Authorities' construction?

Health Authorities will be able to be compensated for new construction VAT by extension of current arrangements for refunds under Section 11 of Finance Act 1984.

Health Authorities' rent increases?

Expected to be very small. Presumption of absorption.

Local Authorities' VAT?

No net effects. Able to reclaim VAT in relation to non-business activities under Section 20 of VAT Act 1983.

CONFIDENTIAL UNTIL AFTER ECONOMIC SECRETARY'S STATEMENT.

FOR USE ONLY AFTER ECONOMIC SECRETARY'S STATEMENT

What will Government do to alleviate effect on charities?

"Option to tax" rents to be phased over 5 years rather than 2 as for others. Need to study judgment in detail and consult.

How great is impact on charities?

Activities of charities many and varied; no doubt potentially affected: Need to study judgment in detail and consult.

53/2/LPD/3754/006

CONFIDENTIAL

cc PAB

Treasury Chambers, Parliament Street, SWIP 3AG

Paul Gray Esq
No.10 Downing Street
LONDON
SW1A 0AA

20 June 1988

PDB 21/6

Dear Paul

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Peter Barnes

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Private Secretary

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Briefing for 21 June

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(v) Is there any appeal against the court's ruling?

No. Government bound to implement ruling under EC Treaty obligation.

May be used at any time

GENERAL

Will we have to pay more to Brussels because of the judgment?

No. UK payments to EC Budget already calculated as if zero-rated items taxed at standard rate.

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Why has Commission picked on us?

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May be used at any time. **GOVERNMENT PLEDGES**

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Infraction case in no way affects these pledges.

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EC VAT ISSUES

Is case connected with Commission's "Tax Approximation" proposals?

No: Infraction case is completely separate issue. Commission's proposals for VAT rate approximation in European Community (with lower rate band (4-9%) and standard rate band (14-20%), but no provision for zero-rate) were made public in August 1987 by Lord Cockfield. Commission believes approximation necessary for completion of Internal Market; Government does not.

Is UK involved in other cases before European Court?

No other VAT cases brought by EC Commission currently before Court. Number of other cases referred by UK courts or tribunals to ECJ for preliminary ruling on questions of interpretation of EC legislation, but no infraction cases.

Is case connected with recent judgment of ECJ on spectacles?

No. Separate issue entirely. Spectacles concerned with exemption; this case concerns zero-rating.

What other zero-rates are at risk?

No grounds for thinking any. No other zero-rates presently under challenge by Commission. And unlikely to start a challenge now, 11 years after existing zero-rates sanctioned by Sixth Directive.

What scope for UK to introduce new zero-rates?

No power to introduce new zero-rates. 1977 Directive allowed existing zero-rates fulfilling existing criteria to continue.

CONFIDENTIAL UNTIL JUDGMENT KNOWN TO REFLECT ADVOCATE GENERAL'S OPINION MAY BE USED IF JUDGMENT FOLLOWS LINE OF ADVOCATE GENERAL'S OPINION.

CHARITIES/CHURCHES

Will Government do anything to alleviate effect on charities/churches?

Activities of charities many and varied. Government is concerned about potential effects on charities/churches; needs to study judgment in detail and consult interested parties; this will take time.

CONFIDENTIAL UNTIL JUDGMENT KNOWN TO REFLECT ADVOCATE GENERAL'S OPIN
MAY BE USED IF JUDGEMENT FOLLOWS LINE OF ADVOCATE GENERAL'S OPINION

ZERO-RATES SUCCESSFULLY CHALLENGED

Non-domestic construction: Private housing not affected. Zero-rating of construction of buildings for industrial and commercial use and in the community and civil engineering sector unlawful. Extent to which zero-rating might be retained to be considered in light of detailed terms of judgment and consultation.

Fuel and power supplied other than to final consumers. Government pledge not to extend VAT to domestic electricity and gas not affected and will be honoured. Most businesses can recover tax.

Sewerage services and water supplied to industry: supplies to domestic housing not affected - most businesses could recover any VAT charged.

News services (i) not supplied direct to the public, (ii) not for the production of zero-rated products such as newspapers.

Protective boots and helmets purchased by employers: most able to recover tax.

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(B) **TO BE USED ONLY AFTER ECONOMIC SECRETARY'S STATEMENT**

(vi) **When will VAT changes take place?**

There will be no changes of any kind before 1 April 1989. And no VAT on construction for contracts entered into before today.

(vii) **Will the Government seek views on the changes?**

There will be full consultation before changes are made.

(viii) **Why has Government announced construction, rents etc changes now then?**

Construction typically involves long-term plans and contracts. Those involved need to know the outlines of the new system now.

(ix) **The Court hasn't fixed a VAT rate for items to be taxed. Why not tax at lower rate?**

It has been consistent government policy to keep VAT simple by having a single positive rate of VAT, coupled with zero-rates where appropriate. That remains the case. In any event, the option to tax gives greater mitigation than a reduced rate on new non-domestic construction, since the minimum permissible could be as high as 8 or 10% [EC law means significantly lower rate probably illegal].

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CONSTRUCTION

Effects of the judgment

What construction affected?

Essentially new buildings in non-domestic sector (offices, etc). Does not affect private housing. We envisaged that there will have to be an apportionment for mixed use buildings such as flats over shops.

What about old people's homes, etc?

We will look at this in the light of the consultation exercise.

What about listed buildings - relief should be for repairs not alterations?

Repairs to listed buildings have always been taxed but in 1984 we were persuaded to retain zero-rating for approved alterations. The zero-rating for listed buildings used for non-domestic purposes will now have to end. EC law means we cannot introduce any new zero-rating or exemption for repairs to listed buildings.

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Mitigation

Will the Government reduce the impact on the construction/ property sectors?

No changes to take effect before 1 April 1989. Because non-domestic construction supplies have long lead-time, , a detailed statement has been made on this issue in the House this afternoon; a News Release and consultation paper have also been issued by Customs and Excise.

Owners of non-domestic property will be given the option to charge VAT on rents, and on sales of used buildings, from 1 August 1989, allowing them to reclaim VAT on input costs in the normal way. All contracts entered into before today will continue to be zero-rated.

What will happen between April 1989 and August 1989?

Rents which are at present zero-rated will become exempt but, provided a landlord opts for taxation from 1 August 1989, he will not suffer any input tax restriction in respect of the 4 month exemption.

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CONSTRUCTION

What measures of mitigation had the construction/property industries asked for?

The Government has responded positively to the industries' requests. They asked for: (i) the landlords' option for taxation; (ii) relief for existing contracts; (iii) a reasonable lead-in period with scope for consultation: and (iv) no reduction in the real value of work undertaken for the public sector. All being met. Indeed on the option for taxation the Government has conceded a staged introduction which was not specifically requested.

How will the measures announced by my hon Friend help Inner City renewal?

They will help it. The developers/landlords will now have the opportunity of recovering all the tax they incur on their Inner City projects for non-domestic use.

How will conservation be affected by these measures?

Housing not affected but for non-domestic buildings VAT will no longer provide an incentive to demolish and build anew. The option to tax lettings and sales of used buildings will mean that the VAT incurred on restoring, refurbishing or converting buildings for non-domestic use will now be fully deductible by builders/developers/landlords.

Effect on construction industry?

Output in the industry is very buoyant at present, full impact of judgment will not be felt until well into the 1990s.

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CONSTRUCTION

Why has Government responded so quickly with these measures for the construction industry?

To remove as much uncertainty as possible and to avoid an excessive scramble for new developments before the next Budget. The measures announced are carefully balanced to protect existing expectations, to provide some scope for getting new projects at least started on the current zero-rated basis before next April and to prevent the complications of a dual liability system being projected too far into the future.

Why tax building land?

Leaving building land exempt would have caused a fiscal distortion between buying and leasing property on the one hand and building for own use on the other.

Who will suffer

What businesses adversely affected?

Business activities exempt from VAT could not recover any of the new tax charged on construction, fuel and power, etc. Finance and insurance industries affected in particular; private education and private health will also be affected.

What is effect on private health and private education?

VAT will not be applied to all their inputs, so wrong to assume that prices will ~~not~~ only rise by 15%

Charities - see separate brief

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Why not a reduced rate of VAT?

It has been consistent government policy to keep VAT simple by having a single positive rate of VAT, coupled with zero-rates where appropriate. That remains the case. In any event, the option to tax gives greater mitigation than a reduced rate on new non-domestic construction, since the minimum permissible could be as high as 8 or 10% [EC law means significantly lower rate probably illegal].

Where is the revenue coming from?

The VAT is coming mainly from the taxation of rents where the tenants are exempt or partly exempt. This will be a very small proportion of total VAT yield and indeed of consumer spending.

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PUBLIC EXPENDITURE

What are the public expenditure consequences?

Normal policy that indirect tax changes are absorbed like other price increases. Exception for new construction reflects priority of Government's building programme.

Will there be a squeeze on Government construction?

Compensatory adjustments to be allowed where necessary in Public Expenditure Survey.

Why will there not be immediate public expenditure increases?

No tax effect before 1 April 1989. Survey proper place for public expenditure decisions. Costs for individual programmes need to be assessed carefully.

Public expenditure cost of construction VAT?

Difficult to say at this stage. Departments need time to assess implications, especially transitional mitigation.

Central Government rent increases?

Expected to be accommodated in existing programme totals. Normal for indirect tax increases to be absorbed as part of cash planning.

Public expenditure effects of water and fuel?

Too early to say. Consultations needed prior to decision on how tax to be applied.

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Health Authorities' construction?

Health Authorities will be able to be compensated for new construction VAT by extension of current arrangements for refunds under Section 11 of Finance Act 1984.

Health Authorities' rent increases?

Expected to be very small. Presumption of absorption.

Local Authorities' VAT?

No net effects. Able to reclaim VAT in relation to non-business activities under Section 20 of VAT Act 1983.

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What will Government do to alleviate effect on charities?

"Option to tax" rents to be phased over 5 years rather than 2 as for others. On this and other issues Need to study judgment in detail and consult.

How great is impact on charities?

Activities of charities many and varied; no doubt potentially affected: Need to study judgment in detail and consult.

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GODFREY BRADMAN
Chairman and Chief Executive

17th June, 1988

The Prime Minister,
The Rt. Hon. Margaret Thatcher, MP, FRS,
10 Downing Street,
London SW1

MM

Dear Prime Minister,

EFFECT OF CHANGES IN THE VAT REGIME AFFECTING THE PROPERTY AND CONSTRUCTION INDUSTRIES

It is understood that the European Court of Justice is to give its decision on the operation of zero-rated VAT in the United Kingdom on 21st June, and that the Government will then be making a statement. The implications of changes to the VAT regime affecting the property and construction industries are very significant indeed, potentially wide ranging, damaging and affecting many sectors of the economy and aspects of Government policy, particularly in respect of inner city regeneration. I am sure you will agree that it is very important, therefore, that the statement takes proper account of the full potential implications of the decision of the Court and does not lead to a situation where the industries feel that they have to respond in an ill considered and precipitate manner to protect their commercial interests in anticipation of legislative change, and before the Government has had an opportunity to formulate its own views on how best to respond to the decision of the Court.

We have, for some months, been considering with our advisers the potential implications of the decision of the Court both for the property and construction industries in the UK, and for other sectors of the economy. A copy of a report prepared for us by Messrs. Arthur Andersen is enclosed. There can be no doubt that an extension of the standard rate of VAT, without appropriate mitigating and transitional provisions, would result in a significant additional burden on the property and construction industries which would adversely affect the level of economic activity in those sectors. There could also be significant wider implications, for example in the following areas:-

continued/...

(a) adverse effect on Government policies for urban regeneration, particularly in the most depressed areas where many schemes are only marginally viable;

(b) reduction in the ability of the London financial services sector to compete with New York and Tokyo as costs of accommodation would increase;

(c) increased cost to pension funds and insurance companies acquiring new property interests for their portfolios, with a resultant reduction in investment;

(d) increased burden on the private health and education sectors where expansion in response to Government initiatives involves new accommodation;

(e) additional VAT on construction would result in a reduction of demand for new commercial buildings and increased pressure on contracting margins. This would have adverse consequences for employment;

(f) increase in the inflationary pressures in the economy.

I have no doubt, therefore, that the potential implications of the ruling are of wide significance, touching upon - and possibly prejudicing - many aspects of Government policy, and not just the narrow interests of the property and construction industries. If, as is believed, the Court finds against the UK, it is important that all possible steps are taken to minimise the adverse effects on the property and construction industries, and the economy. It is essential that there should be full consultation with interested parties prior to any changes in legislation, with appropriate transitional arrangements; and the effective date of any change should, in our view, be deferred for as long as possible. I believe that it is important that the Government should make an announcement to this effect as soon as possible after the decision of the Court is known so as to avoid damage to the economy in the short term by the creation of a "false market" in the construction industry as a result of precipitate action being taken by developers in anticipation of fundamental changes to the VAT regime. I do hope that you will be able to ensure that this important matter is given urgent consideration, and that you will draw it to the attention of relevant Ministers before any statement is made.

Yours sincerely,

Stephen Boreham

VAT: PROPERTY AND CONSTRUCTION

PROPOSALS FOR CHANGE

Arthur Andersen & Co.
1 Surrey Street
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June 1988

VAT: PROPERTY AND CONSTRUCTION

PROPOSALS FOR CHANGE

1. INTRODUCTION

There has been much publicity about the European Commission's case against the United Kingdom Government that certain aspects of the zero-rate in force in the UK are contrary to the provisions of the Sixth Directive (77/338/EEC) of the European Economic Community.

One of the most costly issues in terms of value added tax, and particularly in relation to its effect on the UK economy, is the VAT applicable to property and construction. A substantial amount of tax may be charged where none was paid before. HM Treasury estimates put the additional amount of VAT that may be raised at approximately £350million at the present VAT rate of 15%.

This paper sets out the background to the requirement for VAT harmonisation in the EEC, the European Commission's case against the UK Government, the likely decision of the case, the changes likely to be introduced and their consequences, the possibility of introducing a reduced rate of VAT and other provisions that should be introduced by the UK Government in order to mitigate the impact of the Sixth Directive on the property and construction sector of the economy.

2. RECOMMENDATIONS

The implementation of any changes in the VAT status of supplies in the property and construction industry as required by the Sixth Directive without appropriate mitigating and transitional provisions, would result in a significant additional taxation burden on the property and construction industry and adverseley affect the level of economic activity in that sector.

The changes are likely to have an inflationary influence on the economy and will have significant effect in those areas where it is not possible to recover VAT input tax. For example:

* Urban regeneration where sales to institutional purchasers are paramount, will be jeopardised.

* Costs of accommodation for the financial sector will increase so reducing London's competitive position in relation to other financial centres.

* Provision of private health care and education will become more expensive.

* The additional VAT on building contracts is likely to result in a reduction of demand and increased pressure on contractors' margins with adverse consequences for reinvestment and employment generally and in the construction industry specifically.

Accordingly, it is recommended that the UK Government take the following steps which are discussed further in this paper.

1. Introduction of New Legislation

   In view of the very significant effect that the new provisions will have on the property sector and economy in general, it is recommended that the longest possible period should be permitted before giving effect to such changes.

2. Consultative Process

   There should be the opportunity for all interested parties to evaluate the implications of the proposed changes and make representations on the proposals the Government bring forward.

3. Option to Tax (Section 9.1)

The adoption of provisions giving the taxpayer the option to tax is fundamental if the additional tax burden on the property and construction industry is to be minimised. The option to tax should apply to all supplies that are exempt or become exempt as a result of the European Commission's ruling.

The option to tax must be exercisable at the landlords or developers sole discretion without the requirement to obtain the consent of the tenant and should be exercisable separately in relation to individual leases and tenants. Provision should also be made for rents under existing leases to be subject to the option to tax after any change in legislation.

4. Reduced Rate of Tax (Section 8)

A reduced rate of tax could provide a means of mitigating the harsh effects of the European Commission's ruling. The reduced rate will be of benefit to tenants and purchasers of commercial and industrial property and need not lead to a loss of revenue to the Exchequer.

The reduced rate of VAT should not be instead of the option to tax.

5. New Buildings and Building Land (Section 9.2)

New buildings and building land are presently classified separately for VAT purposes. They will be treated in the same way under the new legislation and the Government may have the option during the interim period permitted by the European Commission to treat them as exempt supplies. We would support such treatment provided that the vendor also had the option to tax.

6. Transitional Arrangements (Section 10)

Transitional arrangements should be introduced to ensure that existing development projects and those tendered for or in an advanced stage of planning at the time any changes in legislation are introduced, can be undertaken or completed without additional tax liabilities arising that were not in existence at the time of commencing or planning the project.

3. THE REQUIREMENT FOR VAT HARMONISATION

As a Member State of the EEC, the UK is subject to the provisions of the Treaty of Rome and the Treaty of Accession. Article 99 of the Treaty of Rome imposes a mandatory requirement for the harmonisation of VAT throughout the Member States of the Community. The UK has given effect to the various Directives issued by the Council of Ministers and the European Commission. It was the Sixth Directive which sought to harmonise VAT to the greatest extent and the Finance Act 1977 amended the VAT legislation in the UK to take account of the provisions of the Sixth Directive.

4. THE EUROPEAN COMMISSION'S CASE

The European Commission has alleged that certain provisions of the VAT zero-rate in force in the United Kingdom are contrary to the provisions of the Sixth Directive. Although Member States have the right to retain the equivalent of the UK value added tax zero-rate until the final establishment of a true Common Market by the abolition of fiscal frontiers (ie. 31 December, 1992), this can only be done provided that the goods or services in question are zero-rated for clearly defined social reasons and for the benefit of the final consumer. The European Commission has argued that these criteria have not been met in relation to a number of items which are currently zero-rated in the UK.

From an economic point of view, the most important issue under dispute is the property and construction sector since it covers the housing sector, industrial and commercial buildings and the community and civil engineering sector. This issue itself has been considered both by the UK Government and the European Commission in two broad parts, i.e. private housing and the rest of the property and construction sector.

As regards private housing, the UK has argued that it is very difficult to distinguish on social grounds, as the Commission has argued, between housing constructed for local authorities, which unquestionably qualifies for the zero-rate, and other housing especially since it is now the private sector which, because of the steps taken by the Government to encourage home ownership, provides an increasing proportion of housing for the most disadvantaged segments of the community.

As regards the industrial and commercial sector, the UK has argued that the zero-rate is used to encourage renewal of infrastructure and construction, especially from the point of view of employment. Furthermore, the UK has argued that the Commission has wholly disregarded the social reasons for building schools and hospitals and other civil engineering works and the resultant benefit to the consumers.

5. THE DECISION

The European Court of Justice is expected to give its decision on 21 June 1988. It is widely expected to follow the preliminary opinion of the Advocate General announced in December 1987.

The Advocate General has stated that the approach adopted by the UK to facilitate home ownership for the whole population clearly does not go beyond the discretion which the UK undoubtedly retains in pursuing its objectives. It is likely, therefore, that zero-rating will be retained at least until 31 December 1992 in respect of the construction of all private housing.

On the issue of industrial and commercial sector zero-rating, however, the Advocate General has stated that whilst the improvement of industrial infrastructure, the development of residential areas and, above all, the quantitative and qualitative effects of such development are clearly important social reasons, the UK has failed to fulfill its obligations. This is because although industrial and commercial sector construction undoubtedly benefits workers, users and citizens, it cannot be regarded as benefiting the final consumer as defined in the Sixth Directive. The Opinion goes on to say that to treat the entire population as a final consumer does not seem to be compatible with a provision which clearly concerns a person who acquires goods or services for his own use.

It is likely, therefore, that the European Court of Justice will rule against the UK Government on the question of industrial and commercial sector zero-rating.

If this proves to be the case, the UK Government will have to amend UK VAT law to conform with European law. However, based on previous decisions handed down by the European Court, it will not tell the UK Government how the law must be changed, neither will it dictate the timing of any changes. It is likely that new legislation will need to be introduced and the most appropriate forum for this would appear to be the next Finance Bill. In view of the fact that the matter is of great political significance in the light of the Government's policies for urban regeneration, health care and related matters as well as the potential effects of any changes to the significant economic activity currently being generated by the UK construction industry, these measures should be preceded by general consultations and debate to the fullest possible extent. Accordingly, it is possible that the Government will undertake to consult with the industry before introducing any changes.

THE NATURE OF THE CHANGES

Many types of property and construction services and supplies could be affected by the changes that the UK Government may introduce in order to comply fully with the EEC Sixth Directive. The full range of transactions that may be affected will clearly depend upon the precise terms of the legislation introduced in the UK. The changes could include the following:

* Sales of building land, currently exempt for VAT purposes, could become taxable or, remain exempt for a period of time as allowed by the Commission.

* New construction work and related services will become taxable rather than zero-rated as at present.

* Sales of freeholds of newly constructed buildings could also be taxed rather than zero-rated or, become exempt for a period of time as allowed by the Commission.

* The zero-rate on the grant of a "major interest in land" could be repealed and such supplies, other than in respect of new houses, could become exempt for VAT purposes.

* Rents and premiums paid in respect of all leases of buildings, whether newly constructed or not, could become exempt. Exemption could also apply to rents and premiums on existing leases even where these are currently zero-rated.

* The Government would be entitled to introduce an option to tax in respect of all or any of the above items which lose their zero-rating status and become exempt. The Government has a great deal of flexibility in determining the extent to which the option to tax would be available to taxpayers.

- Similarly, although sales of non-business land and sales of existing buildings are currently treated as exempt in accordance with the Sixth Directive, the UK Government would have the choice to give the taxpayer an option to tax such sales.

7. THE CONSEQUENCES OF THE LIKELY CHANGES

The potential changes will affect different sectors of the economy in different ways.

7.1 Owner-occupiers and tenants

A major additional VAT burden could, fall on non-business organisations which are not deemed to be taxable businesses and on certain businesses which make exempt supplies (i.e. supplies which are not taxable for VAT purposes) and are therefore regarded as wholly or partially exempt.

Partially exempt businesses can only recover VAT paid on purchases to the extent that the purchases can be attributed to taxable sales. Certain businesses in the financial services sector, health care, education and the property rental sectors will be adversely affected. The extent of the additional costs will depend upon the particular circumstances of each business. In some cases none of the VAT may be recovered.

However, any business which is fully taxable for VAT purposes, should be able to recover all of the VAT charged on new construction work on its business premises, the purchase of building land or the purchase of a freehold building for use in its business. Similarly, if the landlord of a building let to a fully taxable business exercises the option to tax rents or premiums in respect of that building or where the business acquires an existing building or non-building land in

circumstances where the seller has opted to treat such a sale as taxable, the business should be able to recover all of the VAT. For such a business, at worst there may be a small cashflow cost if VAT has to be paid over before it can be recovered from HM Customs & Excise. The business occupier who is fully taxable for VAT purposes should not, therefore, be affected to any significant extent by any changes that may be introduced.

7.2 Landowners

Sales of non-building land currently exempt for VAT purposes are likely to remain so. However, land defined as building land will ultimately have to be taxable although in the interim the UK Government could retain exemption with an option for taxpayers to treat the sales as taxable. This could be of some benefit to landowners since they should then be able to recover any VAT incurred in connection with the sale of the land which currently they may not be able to. However, this benefit has to be weighed against the potential cost to the purchaser of the land and this would depend upon whether the purchaser itself was fully taxable or partially exempt. There are likely to be cases where there may be a conflict between the buyer and the landowner but provided the option to tax is elective as regards each separate sale, the matter would best be settled by negotiation between the parties.

For this purpose, European law allows the UK Government to decide how it will define building land.

7.3 Building Contractors

The change from zero-rating to standard-rating for new construction work should not affect the VAT position of builders other than the cashflow effect. Input VAT incurred will continue to be recoverable. However, where new construction work is undertaken for persons who cannot fully recover the VAT, the additional VAT cost may depress demand and could put pressure on contract margins.

7.4 Developers

Sales of new buildings, currently zero-rated, will become taxable although the UK Government may, for an interim period, choose to exempt such supplies with an option for the taxpayer to treat the supply as taxable.

Grants of long leases over new buildings, currently zero-rated, will become exempt although the Government may introduce an option for the taxpayer to treat the supply as taxable.

The extent to which these changes will increase the costs to the developer or the purchaser will depend largely upon the VAT status of the purchaser.

However, the flexibility that arises from the option to tax and the opportunity it gives to minimise the incidence of VAT would make its introduction imperative.

7.5 Properties developed for investment purposes

In most cases, rents or premiums on properties developed by an investor for rental purposes are currently zero-rated. This allows a developer to recover all VAT incurred on inputs that carry the standard rate of VAT. These inputs do not currently include new construction work but the potential changes are likely to treat these as taxable. This coupled with the potential exemption of rents and premiums will add significantly to the costs of the owner of the completed building.

The Government could, however, introduce an option to treat the rents or premiums as taxable. This would enable the developer/investor to recover the input tax.

8. REDUCED RATE OF VAT

Whilst the option to tax discussed in Section 7.4 and 7.5 allows the developer to reduce the incidence of irrecoverable VAT, it may increase the costs of exempt or partially exempt tenants or purchasers. A means of reducing this effect is to introduce the option to tax at a reduced rate of VAT.

The Sixth Directive permits Member States to introduce a reduced rate of tax in certain circumstances, so that where supplies are taxable, they need not be subject to VAT at the standard rate. However, the Sixth Directive requires that such a reduced rate must be fixed at a sufficiently high level to ensure that for the classes of supply to which it applies, the aggregate amount of VAT charged on the supplies is at least as great as the aggregate amount of VAT deductible therefrom.

If the following cost/profit structure for a building was representative of the commercial and industrial new buildings sector of the property industry as a whole, the position would be as follows:

	Cost £	VAT £
Cost of construction etc.	100	15
Cost	30	-
Profit	20	-
Selling price	150	15

The VAT on the sales price could not be less than £15 i.e. 10%. This is the minimum reduced rate of VAT that could be applied to disposals of new buildings.

The advantage of a reduced rate of VAT is that it would reduce the irrecoverable VAT on the taxable sale or leasing of a new building to businesses such as financial institutions and health care organisations which are not able to recover the full amount of VAT incurred, without a loss of revenue to the Exchequer.

It is understood, however, that HM Customs & Excise have indicated that the reduced rate of tax is incompatible with the option to tax. It is unclear whether HM Customs & Excise consider this as a matter of policy or because they consider it as a breach or derogation of the Sixth Directive. It would appear, however, that policy considerations aside, this would appear to be a course of action that could reconcile the varying interests of developers, users and the Government's need to introduce changes that are revenue neutral. For this reason, it is suggested that serious consideration should be given to this possibility.

9. OTHER PROVISIONS TO MITIGATE THE IMPACT OF THE SIXTH DIRECTIVE

In any case, the impact of the provisions of the Sixth Directive as discussed above will be mitigated if the following permissible provisions are incorporated in any UK legislation.

9.1 Option to Tax

The inclusion of provisions giving the taxpayer the option to tax is fundamental if the additional tax burden on the property industry is to be minimised.

It is suggested that the option to tax should be introduced in the following areas:

a) Leases over buildings

It would be expected that the developer/landlord would normally apply the option to tax. This would allow the developer to recover the VAT on development costs relating to the building or that part of it which was being leased.

If the option to tax was exercised, a lessee unable to fully recover VAT would suffer an additional cost of occupation being the VAT on the rental or premium which it could not recover in full.

The lessee's position would be mitigated if a reduced rate of tax applied to the rents. In the absence of a reduced rate, it may be possible for the developer landlord to negotiate a higher rent on which the option to tax would not be operated. The objective would be to reduce the occupancy cost of the tenant (on the basis that the exempt rent is less than the taxable rent inclusive of VAT) but maintain the developer's rental yield on his costs taking account of the fact that it would not recover the VAT on construction costs.

Whilst it is possible that the option to tax could have the effect of creating a two tier rental market and add to the complexity of rental negotiations, it is considered that the advantages of the option to tax far outweigh the disadvantages.

In any case, the option to tax must be exercisable at the landlord's sole discretion without the requirement to obtain the consent of the tenant and should be exercisable separately in relation to individual leases. It is considered that the former would minimise the inevitable complications in lease negotiations and would be more appropriate since the recoverability of VAT may have been a factor in the developer's initial appraisal of the project. The latter should ensure that the particular circumstances of tenants in a multi-tenanted building can be taken into account in deciding when to operate the option to tax.

b) Sales of buildings other than newly constructed buildings

The Sixth Directive permits the UK Government to extend the option to tax to sales of existing buildings. This would be a slight relaxation of the existing position since VAT incurred on refurbishments could be recovered by the developer whereas it cannot at present.

There are sound reasons why the option to tax should be allowed on 'second-hand buildings'. These include:

i. The legislation could be simplified in that it would not be necessary to differentiate between new and second-hand buildings, an area that causes significant practical problems for Customs & Excise and the taxpayer under existing legislation.

ii. The option to tax would allow VAT on listed buildings to continue to be recovered as it is under existing legislation.

iii. The overall cost of the changes in VAT on the property industry would be reduced.

9.2 New buildings

Sales of new buildings and building land are to be regarded as taxable supplies. However, in accordance with Article 28(3) for a transitional period that will end on a date to be determined by the Commission, any member state may be able to regard sales of new buildings and building land as an exempt supply.

The greater flexibility for a developer arising from the option to tax would weigh in favour of these transactions being exempt with the option to tax on the same terms as set out for leases (Section 9.1.a above).

10. TRANSITIONAL PROVISIONS

The possible changes to the VAT legislation would have a very significant effect on not only the property sector but also the general economy of the country and therefore the longest possible period should be permitted before giving effect to such changes so as to allow adequate opportunity to adjust to the proposed changes.

In addition, it will be important that the legislation includes transitional provisions to ensure that existing development projects and those tendered for or in an advanced stage of planning at the time the changes in legislation are introduced, can be undertaken or completed without additional tax liabilities arising that were not in existence at the time of commencing or planning the project.

Legislation in the following specific areas should be introduced.

10.1 Construction contracts

Supplies made under building or construction contracts should continue to be zero rated (ie no VAT should be charged on contractors' invoices) if they would have been under the existing legislation, in the following circumstances:

a) A binding building or construction contract is entered into before the effective date of the introduction of the new legislation (C-Day) and supplies under that contract commence within, say, 18 months of that date.

b) Costs incurred without time limit under a building or construction contract entered into in pursuance of an obligation undertaken before C-Day contained in:

i. A headlease, or development agreement forming part of a contract for a headlease whether or not dependent on conditions precedent.

ii. An agreement under S.52 TCPA 1971 or other obligations undertaken pursuant to planning consent.

c) Costs incurred without time limit under a building or construction contracts entered into in pursuance of a proposal contained in a tender made before C-day.

d) Costs incurred under building or construction contracts entered into within, say, 18 months of C-day in respect of land acquired within 3 years before C-day.

10.2 Grants of major interests

The disposal of a major interest in a newly constructed building (i.e. the freehold or a lease of greater than 21 years) after C-Day should continue to be zero-rated in the following circumstances:

a) The grant of the major interest takes place within say 2 years of C-day and heads of agreement for the grant or an agreement for lease was entered into before C-day.

b) The grant of the major interest takes place within say 2 years of C-day, and the building was constructed under an obligation entered into before C-day and contained in:

i. A headlease or development agreement forming part of a contract for a headlease whether or not dependent on conditions precedent.

ii. An agreement under S.52 TCPA 1971 or other obligations undertaken pursuant to planning consent.

c) The grant of the major interest takes place within 2 years of C-day and the construction of the building commenced before C-day.

These provisions would ensure that VAT incurred on new construction, e.g. on professional fees and recovered under existing legislation on the basis that a taxable supply will take place on the disposal or leasing of the building should be protected. Otherwise, for instance, the granting of a lease of the building after C-Day which may be an exempt supply could result in the VAT previously recovered being repaid to Customs and Excise.

/6248e

CONFIDENTIAL FILE KK

sc: BG

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

17 June 1988

VAT: ZERO RATES INFRACTION PROCEEDINGS: JUDGEMENT

The Prime Minister was grateful for the Chancellor's minute of 16 June. She is content for the Economic Secretary to take the line proposed if the European Court of Justice judgement is as currently expected.

Copies of this letter go to the Private Secretaries to Members of Cabinet, the Chief Whip, the Minister of State Privy Council Office, the Economic Secretary, and to Sir Robin Butler.

(PAUL GRAY)

Alex Allan, Esq.
HM Treasury

CONFIDENTIAL

BS

PAM38

CONFIDENTIAL

Prime Minister

As promised. Content with the line proposed for the statement next Tuesday?

PRIME MINISTER

VAT: ZERO RATES INFRACTION PROCEEDINGS: JUDGEMENT

RRCG 16/6

As you know, the European Court of Justice (ECJ) is expected to deliver its judgement on Tuesday, 21 June, on the legality of the UK's zero-rates on construction, on fuel and power supplied other than to final consumers, sewerage services and water supplied to industry, and various other more minor items. This case has nothing whatever to do with the Cockfield proposals for harmonisation of VAT rates ("tax approximation"); it depends on the legal interpretation of our existing obligations under the Sixth Directive on VAT, of 1977.

We ourselves will not know the result of the judgement until it is made public on Tuesday morning. But the Court normally follows the Advocate General's Opinion, which we received in December. This - crucially - accepted the UK's zero-rating for private housing, but held that non-domestic construction, and fuel, power, sewerage services and water supplied to industry etc should not be zero-rated. I attach a note which sets out in more detail the Advocate General's opinions on the various different goods and services to be covered in the judgement.

We have no choice but to comply with the judgement, but we do have some flexibility about how to apply it, and about the timing of the introduction of VAT on items which had previously been zero-rated.

Assuming that the Court does follow the Advocate General's Opinion, we agreed at Cabinet this morning that, in my absence at the Economic Summit in Toronto, the Economic Secretary should make an

Oral Statement on Tuesday setting out the broad shape of what we propose, so as to remove uncertainty. If the judgement differs significantly from what we expected, he will simply make a holding statement.

In either case, we will then consult interested parties, including trade and professional bodies, on how the judgement can best be applied in practice. We would legislate in next year's Finance Bill, with the changes taking effect at the earliest on 1 April 1989.

Most of the supplies which stand to be affected will be made to firms which are registered for VAT and will be able to reclaim the tax they pay, just as they reclaim all other VAT on their input costs. The major groups who will not be able to reclaim the VAT in full are those below the VAT threshold, those whose business is exempt from VAT (principally banks and insurance companies), those who do not carry on a business (eg charities) and parts of the public sector. I propose to take a number of measures to alleviate the impact on these last two groups.

The most significant area where we would be required to make a change if the Court follows the Advocate General's Opinion is on non-domestic construction. At present, all such construction is zero-rated, and rents are exempt from tax. If we simply applied VAT to construction, but took no action on rents, that would create major distortions to the property market: firms who bought property for their own use would be able to reclaim the tax (except for banks, insurance companies etc), but landlords who owned buildings and let out space would not. I therefore propose to take advantage of a provision in EC VAT law (widely used in other Member States) which allows owners of non-domestic property the option to charge VAT on rents and on sales of used buildings. In particular, most landlords will opt to charge VAT, and this will mean they will be no worse off as a result of the judgement. Nor will their tenants, provided they are fully taxable and so able to reclaim the VAT.

The option to tax rents will have to apply to existing tenants as well as new ones, and so I propose to phase in VAT on rents over two years, so as to mitigate the effect on existing tenants who are not fully taxable and cannot reclaim the VAT they have to pay. It will also help taxable businesses to absorb the impact on their cashflow. In the special case of charities, the phasing in period will be five years.

Government Departments cannot, in general, reclaim the VAT they pay. Normally the cost of indirect tax changes like other prices are accommodated within programmes as part of cash planning, and I propose that this should apply to increases in rents resulting from the landlord's option to tax. But the imposition of VAT on non-domestic construction would have a sizeable impact on the Government's construction programme. Exceptionally, therefore, the Chief Secretary will be ready to consider sympathetically compensating adjustments to the relevant expenditure programmes in the Public Expenditure Survey. Full refunds of VAT on non-domestic construction will be available to both health authorities and local authorities.

The case before the Court does not challenge our right to zero-rate supplies of fuel and power to final consumers. But if the Court upholds the Advocate General's Opinion, we shall have to impose VAT on fuel and power supplied to other users. This will not be easy to implement, since it will require the supplier to distinguish between different types of customers, something he does not have to do now. It may be possible to retain a measure of zero-rating for charities, but we will need to consult the various bodies concerned about the practicality and implementation of this.

If we were simply to impose VAT on all the goods and services covered by the Advocate General's Opinion, without any offsetting action, the yield in a full year would be about £425 million. But the various measures I have outlined above will reduce the yield to about £65 million in 1989-90, rising to £160 million in 1991-92.

The Economic Secretary will be circulating a draft of his statement shortly. He will of course be ready to field bids from radio and TV; and we hope to produce a backbench brief for the Whips' Office. The main points to stress in public presentation are:

- this has got nothing to do with the VAT paid by the ordinary consumer: it will not change in any way the zero rates on private housing or private fuel, power, or anything else;

- there will be no changes of any kind before 1 April 1989;

- there will be full consultation before then;

- Tuesday's announcement minimises uncertainty about non-domestic construction, and mitigates the effects of the Court judgement;

- the judgement arises from an undertaking entered into by the last Administration in 1977, and has nothing whatever to do with the current Cockfield proposals.

I am copying this minute to the other Members of Cabinet, to the Chief Whip, the Minister of State Privy Council Office, the Economic Secretary, and to Sir Robin Butler.

Moira Wallace

pp [N.L.]
16 June 1988

Approved by the Chancellor and signed in his absence.

PAM39

ANNEX

VAT ZERO RATES INFRACTION PROCEEDINGS: ADVOCATE GENERAL'S OPINION

Advocate General's opinion, delivered in December, was that UK zero rates lawful in respect of:

- private housing;
- news services supplied directly to public or in production of zero-rated products such as newspapers; and
- animal feeding stuffs, seeds, live animals yielding food for consumption;

but considered remaining challenged UK zero-rates unlawful: ie

- construction of buildings for industrial and commercial use and in the community and civil engineering sector;
- fuel and power supplied other than to final consumers;
- sewerage services and water supplied to industry;
- news services not supplied directly to the public or for the production of zero-rated products such as newspapers;
- protective boots and helmets purchased by employers.

NSPM
PREM
19/4

Treasury Chambers, Parliament Street, SW1P 3AG

19th April 1988

Dear Peter

I attach a note giving the line the Economic Secretary proposes to take if challenged about VAT on food in Ways & Means Committee tomorrow.

You may well not think this worth showing to the Prime Minister, but given the sensitivity of the subject I thought you might like to know in advance what the Economic Secretary intended to say.

Yours sincerely

Peter Gardner

53/2/LPD/3764/003

RESTRICTED

Treasury Chambers, Parliament Street, SW1P 3AG

Paul Gray Esq
No.10 Downing Street
LONDON
SW1

19 April 1988

Dear Paul

THE VALUE ADDED TAX (CONFECTIONERY) ORDER 1988

The Economic Secretary will be appearing before the Third Standing Committee on Statutory Instruments at 10.30 am tomorrow to commend the Value Added Tax (Confectionery) Order 1988 to the Committee. The Order makes minor changes to the scope for the present provision which taxes confectionery, with the principal effect of making all cereal bars liable to VAT at the standard rate. The Order will remove the uncertainties, created by the recent development of new confectionery products, about the liability to tax of certain cereal bars, and provide a sounder basis for the taxation of confectionery in the future.

The Opposition may suggest that the Order conflicts with the Government's pledges to continue to have zero rating on food. If they do, the Prime Minister may like to know that the Economic Secretary intends to say it is absurd to claim that a minor adjustment of the confectionery borderline conflicts with such pledges. Roughly one third of consumer expenditure on food is already taxed, so it should be obvious that the Government's pledges referred not to these areas, but to the more or less basic food stuffs which have always been relieved. There are always bound to be occasions, such as the present one, when, in order to remove anomalies or uncertainties, or inequities between competing products, minor adjustments have to be made to areas which have long been subject to VAT.

Yours sincerely

Peter Barnes

P D P BARNES
Private Secretary

dti

the department for Enterprise

THE LORD BEAVERBROOK

Andy Bearpark Esq
Private Secretary to
the Prime Minister
10 Downing Street
LONDON
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Department of
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Our ref
Your ref
Date 28 March 1988

1. NCO
2. CF
3. CF

Dear Andy,

During Questions in the House of Lords last Friday, Lord Beaverbrook answered a Question, for the Treasury, on VAT on books and newspapers. At the end of the exchanges Lord Beaverbrook made a promise to Lord Molloy and others to bring to the Prime Minister's attention their concerns. I enclose a copy of the relevant extract of Hansard.

A copy of this letter goes to Guy Westhead (Mr Lilley's office), HM Treasury.

Yours sincerely

Nick Mitchell.

NICK MITCHELL
PRIVATE SECRETARY

IS3AAX

Lord Beaverbrook: My Lords, I have already mentioned chocolate eggs. Perhaps one of Carl Feberge's earlier works might also qualify.

Lord Rugby: My Lords, is not an Easter egg produced by a golden goose?

Lord Beaverbrook: My Lords, I do not wish to stray into the broader aspects of the economy in relation to this Question.

Books and Newspapers: VAT Rating

11.11 a.m.

Lord Bruce of Donington asked Her Majesty's Government:

Whether they will now give an undertaking to resist EC pressure to abolish the VAT zero-rating on books and newspapers.

Lord Beaverbrook: My Lords, the Government have made it clear on numerous occasions that the United Kingdom cannot accept proposals which would restrict their ability to apply VAT zero rates.

Lord Bruce of Donington: My Lords, is the noble Lord aware that the Treasury and Civil Service Select Committee in another place, which consists of Members of all parties (with the government party in the majority) specifically recommended that the Government should send a reply to the Commission in response to its representations and that this reply should be sent without delay,

"making plain that abolition of the zero-rating principle is not something on which there can be unanimity and that the Government is not prepared to consider any draft which includes it"?

Does the noble Lord agree that if such a taxation were levied on books, periodicals and newspapers, it would cost the public anything between an extra £140 million and £280 million per annum at the lower bracket rate and that there would be an additional cost to education authorities throughout the United Kingdom?

Lord Beaverbrook: My Lords, perhaps I may take the noble Lord's last question first. The cost to the public of a 4 per cent. VAT rate on books, periodicals and newspapers would be approximately £150 million. I agree with him in that respect. He also asked whether the Government should respond to the Commission's proposals. No member state appears to have regarded it as necessary to respond by writing to the Commission. It would be the normal route for proposals to be considered by the Committee of Economic and Finance Ministers. The Government will respond in that committee—ECOFIN—at the appropriate time.

Lord Barnett: My Lords, will the Minister clarify the somewhat ambiguous first reply he gave to my noble friend Lord Bruce of Donington? He did not ask whether the Government wanted to restrict themselves in removing zero-rating but whether the Government would be willing to compromise in any way on this subject in order to achieve the internal market by 1992.

Lord Beaverbrook: My Lords, the noble Lord will no doubt be aware that my right honourable friend the Prime Minister has made it absolutely clear that the United Kingdom could not accept proposals which restricted our right to apply VAT zero rates. The noble Lord asked about the completion of the internal market. We are not convinced that tax harmonisation on the lines proposed by the Commission is necessary to achieve the internal market.

Lord Boyd-Carpenter: My Lords, in respect of zero-rating of books and newspapers specifically, is my noble friend aware that, quite apart from the cost, many people would find it repulsive to impose taxation on knowledge and the dissemination of knowledge?

Lord Beaverbrook: My Lords, I am grateful to my noble friend for his view on that point. It is a well known convention that statements on tax matters are made at Budget time. I cannot go further than to say that that is a matter for my right honourable friend the Chancellor of the Exchequer.

Lord Bruce of Donington: My Lords, in regard to that last point, is the Minister aware that the Prime Minister herself has been extremely emphatic on the whole question of zero-rating for food and children's clothing and has given specific assurances that she will resist it? The purpose of this Question is to elicit an equally frank statement of view in regard to books, periodicals and newspapers. Cannot the Government give the same unequivocal declaration as the Prime Minister herself gave in regard to food and children's clothing?

Lord Beaverbrook: My Lords, an undertaking on food and children's clothing was indeed given by my right honourable friend the Prime Minister but no further commitment on books has been given for future years. The noble Lord would not expect me to go further at this stage.

Lord Peston: My Lords, may I——

Lord Broxbourne: My Lords, I am very much obliged to the noble Lord for his characteristic courtesy. Will my noble friend confirm that any such proposal would require unanimity and that, therefore, if, as is much to be hoped, the Government stand firm in their opposition to this proposal, it would be a case of *cadit quaestio*?

Lord Beaverbrook: My Lords, zero-rating in the United Kingdom cannot be abolished by the European Commission in the face of United Kingdom opposition.

Lord Peston: My Lords, if the issue is one of knowledge and of dissemination of knowledge, would it be possible to levy VAT at a maximum rate on some alleged newspapers while not levying it on serious newspapers?

Lord Beaverbrook: My Lords, the noble Lord may remember that about a year ago I said in your

Lordships' House that it was becoming increasingly difficult to tell what is a newspaper and what is some other form of daily publication.

Lord Molloy: My Lords, does the noble Lord agree that my noble friend Lord Bruce of Donington made his point transparently clear to all of us in the Chamber except the Minister? Inasmuch as the Prime Minister herself was opposed to VAT on children's clothing, will he ask her whether she takes the same attitude on books and newspapers, as set out in the Question on the Order Paper? Will he ask the Prime Minister that Question?

Lord Beaverbrook: My Lords, of course I am prepared to bring the comments of the noble Lord, and those of all noble Lords, to the attention of my right honourable friend.

Unleaded Petrol

11.19 a.m.

Lord Rodney asked Her Majesty's Government:

What measures have been taken to promote the use of unleaded petrol in the United Kingdom.

Lord Hesketh: My Lords, the Government have introduced a substantial duty differential in favour of unleaded petrol and will be requiring all new cars to be capable of using the new fuel by October 1990. We have taken a number of initiatives to promulgate information on unleaded petrol, where it can be obtained, and which cars can use it.

Lord Rodney: My Lords, I thank my noble friend for that encouraging reply. It is gratifying to note that unleaded petrol will now be easier and less expensive to obtain. However, can he say whether Her Majesty's Government will consider offering any form of financial encouragement to car owners to have their vehicles modified so that they will be able to accept unleaded petrol? I understand that in some cases such modification is quite an expensive operation. If the Government really want this improvement to take effect in the short term, I think that such an incentive would be most necessary.

Lord Hesketh: My Lords, beyond the Government offering the advantage of the reduced rate of duty on such petrol, there are no plans to offer further financial inducements. However, I should point out to your Lordships' House that most motor cars can be adjusted at very little cost to take unleaded fuel and thus should be able to take immediate advantage of the cheaper prices at the pump.

Lord McIntosh of Haringey: My Lords, I hope that the Minister will accept that the discrimination in favour of unleaded petrol in the Budget is one of the few parts of that document with which we on these Benches wholeheartedly agree. However, can he be a little more precise about what the Government can do to assist in the development of catalytic converters which are, after all, the means by which much of the environmental benefit of unleaded petrol can be brought to fruition?

Lord Hesketh: My Lords, if the noble Lord, Lord McIntosh of Haringey, would like to put down a Question on catalytic converters I shall be more than happy to answer it.

Business

11.21 a.m.

Lord Denham: My Lords, with the leave of the House, I should like to say a word about today's debate in the name of the noble and learned Lord, Lord Brightman. Although no time limit has been officially applied to the debate, Members of this House usually hope to rise on Friday no later than 4.30 p.m. for the sake of the staff. Therefore, assuming that the noble and learned Lord were to speak in opening for approximately 20 minutes and my noble friend in winding up at no greater length, if noble Lords in the body of the House were to submit themselves to a purely voluntary limit of 14 minutes, that desirable object would be achieved.

Infant Life Preservation

11.22 a.m.

Lord Brightman rose to move, That this House takes note of the report of the Select Committee on the Infant Life (Preservation) Bill [H.L.] (HL Paper 50).

The noble and learned Lord said: My Lords, I beg to move that this House takes note of the report of the Select Committee on Infant Life (Preservation) Bill.

I approach this debate with trepidation, because I fear that the conclusions of the Committee will offend the consciences of some people; and with hope because I believe that our conclusions are a basis for settling a controversy which will be deeply divisive for some years to come.

The first part of the Committee's report explains why the Bill which the Committee were called upon to examine could not possibly proceed, however worthy its purpose. I shall deal with that part as briefly as I can. The remainder of the report is directed to the question whether an alteration should be made to the maximum gestational age at which abortions may lawfully be carried out. No doubt that is the part of the report upon which noble Lords will wish to concentrate.

I shall address myself to the first part of the report: why Bishop Montefiore's Bill, introduced in the last Session and revived in this one, should not proceed. The Bill sought to substitute a gestational age of 24 weeks for the gestational age of 28 weeks in the Infant Life (Preservation) Act 1929. The Act was not an abortion Act; it was a criminal statute designed to fill a gap in the law of England and Wales which did not exist in Scotland. Whereas it was murder to take the life of a child when fully born and a crime to procure

Qz 05978

Prime Minister

Not too bad an outcome

CDP 2/XII

MR POWELL (10 Downing Street)

VAT ZERO RATES : ADVOCATE GENERAL'S OPINION

The Advocate General of the European Court of Justice delivered his Opinion on the VAT zero rates infraction case today which the Commission have taken to the European Court over our application of the Sixth VAT Directive. The Advocate General has suggested that VAT zero rating of domestic construction and animal feeding stuffs is compatible with the Directive, but that the other zero rates under challenge -

- non-domestic construction;
- sewerage and water for commercial use, except for food production;
- news services;
- fuel and power for commercial use; and
- safety boots;

are not.

The Advocate General's Opinion does not form part of the Court's judgment and no action has to be taken as a result of it. The Court's judgment is not likely to be delivered before the spring. If it follows the line of the Advocate General, it will relieve the fears of the main domestic interests concerned, the home construction industry, and in the other areas the incidence will generally be small. Moreover, supplies of fuel, sewerage and water for domestic use remain unaffected.

Whatever the judgment, it will not affect the level of our VAT-based contribution to the Community since that is assessed on the basis that VAT is applied on a harmonised base.

R G LAVELLE

53/2/LPD/3743/018

Treasury Chambers, Parliament Street, SW1P 3AG

Andy Bearpark Esq
No.10 Downing Street
LONDON
SW1

2 December 1987

Dear Andy

ZERO RATES INFRACTION CASE

I attach briefing for the Prime Minister's question tomorrow on the Zero Rates Infraction case, on which the Advocate General has delivered his opinion this afternoon.

2. Alex Allan will be sending to you separately a more detailed report on the Advocate General's Opinion.

Yours sincerely
Peter Barnes

P D P BARNES
Private Secretary

53/2/LPD/3743/016

ZERO RATES INFRACTION PROCEEDINGS : ADVOCATE GENERAL'S OPINION 2 DECEMBER 1987

Line to take

1. The Advocate General delivered his Opinion on the zero-rates infraction case in the European Court of Justice yesterday (Wednesday).

2. The Advocate General's Opinion is simply advisory and does not form part of the Court's judgement.

3. Until the Court's final judgement is delivered, which is likely to be early in the New Year, the consequences for the United Kingdom cannot be assessed. The detailed terms of the judgement will need to be carefully studied before the implications become more clear and the Government is able to take decisions.

4. The case has no connection with the tax approximation proposals recently made public by Lord Cockfield and which cannot be adopted without the unanimous agreement of the European Council.

Background Note

1. The Advocate General's role is to assist the Court in identifying the relevant issues in the case. His conclusions may be followed by the Court in its judgement but they are not binding, have no legal effect and no action need be taken as a result of them. Although the Advocate General's conclusions are in fact usually followed by the Court, this is not invariably the case.

2. It is widely known that, should the Commission's case be upheld in the European Court, either in whole or in respect of individual items, the United Kingdom would be obliged by the terms of the Treaty of Rome to tax the supplies in question at a positive rate. Current Community legislation would preclude the introduction of

Current Community legislation would preclude the introduction of a reduced rate of VAT below about 5%.

However, the Chancellor has preferred that the options open to him in the event of an adverse ruling should not be publicised. He has consented only to it being stated that the UK has a Treaty obligation to respect rulings from the European Court, that we shall study the detailed judgement closely and consider our options and that the judgement could not include a direction to apply a particular positive rate as a Community law does not prescribe one.

The items under challenge are:

- animal feedstuffs, seeds, live animals yielding food for consumption - (all supplies)
  Advocate General's Opinion: Supported UK zero rate

- sewerage services and water - (supplies to industry)
  Advocate General's Opinion: Opposed UK zero rate

- news services - (all supplies)
  Advocate General's Opinion: Opposed UK zero rate except for services direct to public or supplied for the production of zero rated products (ie newspapers).

- fuel and power - (supplies other than to final consumers)
  Advocate General's Opinion: Opposed zero rate

- construction, buildings etc - (supplies other than to final consumers within a social policy).

Advocate General's Opinion: Supported UK zero rates for domestic housing; opposed for civil construction

protective clothing and footwear - (supplies to employers).

Advocate General's Opinion : Opposed UK zero rate except for non-industrial footwear.

It should be stressed that the Commission is not challenging the zero-rating of food in the shops.

It contends that the items under challenge are incompatible with the Sixth VAT Directive which provides the basis for a common system of VAT throughout the Community as not being "for clearly defined social reasons" and "for the benefit of the final consumer". The Government does not accept this contention.

4. Lord Cockfield recently made public the Commission's proposals for tax approximation in the European Community with a lower rate band (4-9%) and a standard rate band (14-20%) but no provision for a zero-rate.

The infraction case is a completely separate issue and has no bearing on the tax approximation proposals. The only Government pledge which is in part affected by the Commission challenge is that on gas and electricity. However, the pledges are taken to apply to the "man on the street", then the Commission's challenge on fuel and power supplied to business users may be seen not to compromise the pledge.

5. Throughout the proceedings and particulaly in the summer of this year, there have been calls on the Government to disclose its pleadings and prove its claim that the UK defence had been pursued "vigorously" and "robustly". However, an unwritten convention of confidentiality precludes the disclosure by one party in infraction proceedings of the case of the other and this, together with the Commision's refusal to authorise any such disclosure in

this case, effectively binds the Government to preserve the confidentiality of the pleadings until the Court's final judgement has been delivered.

Impact on Construction Industry - (Politically, this is the most sensitive item)

6. The Building Employers Confederation were present at the Court for the oral hearing of the case and subsequently telephoned Customs to express their appreciation of the UK's presentation and wrote to the Times (17 September) to emphasise their "strong support" of the Government in its "determined opposition in this case".

PH1/207

UNCLASSIFIED

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

MOR

2 December 1987

Andrew Bearpark Esq
No.10 Downing Street
LONDON SW1

Dear Andy,

ZERO RATES INFRACTION CASE

... I enclose a further note on the Advocate General's opinion on the Zero Rates Infraction case, as promised by Peter Barnes in his earlier letter.

Yours
Alex

Moira Wallace
Assistant Private Secretary

CHANCELLORS SPEAKING NOTE : CABINET MEETING 3 DECEMBER 1987

VAT : INFRACTION CASE BROUGHT BY THE EUROPEAN COMMISSION AGAINST THE UK, IN RESPECT OF CERTAIN ZERO RATES

At the European Court of Justice in Luxembourg yesterday the Advocate General issued his Opinion on the infraction case brought by the Commission against the United Kingdom in respect of certain of its zero-rates.

The issue of the Opinion marks the penultimate stage in the infraction proceedings to be followed, probably early in the New Year, with the final judgment of the Court. The Advocate General's role is to assist the Court in identifying the relevant issues in the case. His conclusions may be followed by the Court in its judgment (more usually, but not invariably, they are), but they are not binding, have no legal effect and no action need be taken as a result of them.

The Opinion deals fully with the concepts of "benefit to the final consumer" and "clearly defined social reasons"; which are central to the whole case and goes on to consider the application of the Advocate General's views on these concepts to the individual items of zero-rating subject to the Commission's allegations.

The net result is that the following applications of zero-rates are regarded by the Advocate General as fulfilling Community legal requirements:

- domestic housing
- animal feedstuffs, seeds, and live animals yielding food for consumption.

The following zero-rates are regarded as outwith Community legal requirements:

- commercial construction
- community and civil engineering sectors

CTD

cc PE

Please bring forward on 1 December
CDP
4/XI

Treasury Chambers, Parliament Street, SW1P 3AG

Jeremy Godfrey Esq
Private Secretary to the Secretary of State
Department of Trade and Industry
1-19 Victoria Street
LONDON SW1H OET

4 November 1987

Dear Jeremy

VAT ZERO-RATES INFRACTION PROCEEDINGS

As you know, your Secretary of State has been involved in debates in the House of Lords concerning the zero-rates proceedings in the European Court of Justice. You may recall that we had previously been advised that the Advocate General's Opinion (a preliminary to the judgement of the full Court) would be delivered on 12 November (my letter of 16 October).

WILL REQUEST IF REQUIRED

As I mentioned to you on the telephone, we have now learned from the Court that the Opinion has been postponed; it will now be given on **Wednesday, 2 December**. As is usual, the Court does not give any reason for the delay. But deferments of this kind are not unusual and nothing, adverse or otherwise, should be read into the news. The Paymaster has told the House of Commons of the change of date, in response to a PQ from Teddy Taylor MP (Hansard 2 November, Col 511).

We shall be maintaining our line that no decisions on our VAT law can be taken until the Government has seen and studied the precise terms of the judgement itself - which we expect to receive early in the New Year.

I am copying this letter to David Norgrove (No 10) for his information.

Yours ever

Simon.

S P JUDGE
Private Secretary

LD/004

CCBG

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

The Rt Hon Nicholas Ridley AMICE MP
Secretary of State for the Environment
2 Marsham Street
London
SW1P 3EB

5 August 1986

CDP 6/8.

CDP - 25 Jan.

MGR

Dear Nick

Thank you for your letters of 10 and 17 July about the Commission's reply to our defence in the current VAT infraction proceedings (Case No 416/85) against our zero ratings.

I recognise the concern that you have expressed about the effect of the Commission's arguments being accepted by the Court. However, I should point out that we are still at a fairly early stage in the proceedings with each side lodging written submissions with the Court. We have some time yet to submit a rejoinder to the Commission's reply and it will be only after we have done so that a date for the oral hearing before the Court can be set.

Your letter of 17 July mentioned that the Prime Minister had written to the President of the House-Builders' Federation on 5 July 1984 and suggested that it would be helpful if I issued a similar firm statement. I realise why you would like me to, but the legal process is now under way and such a statement now would therefore have to admit the possibility that the Court might find the UK's use of the zero rate for all private housing disproportionate and therefore unlawful under the Sixth VAT Directive. This would hardly be helpful, and I do not therefore believe we should go beyond what George Young said in John Heddle's adjournment debate on 25 July. The plain fact is that the dispute with the Commission is a legal one and there is thus no political pressure which the Government can bring to bear on the Court or the Commission.

Needless to say, as both Peter Brooke and I have made clear in the House and elsewhere (Peter saw the House-Builders on 25 July with John Heddle) we are vigorously defending our case and will continue to do so. If however we receive an adverse judgement, it is worth noting that any goods or services which the Court decided were incorrectly zero rated would not immediately become liable to the standard rate. Indeed the Commission, in its reply to our

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defence, recognises that removing zero ratings in the UK could only be done over a long period of time, possibly by phasing them out gradually. This of course would be a matter for consideration in the light of the ECJ's judgement, should it go against us - which I have no reason to believe it will.

I am copying this letter to Cabinet colleagues and to Sir Robert Armstrong.

NIGEL LAWSON

CONFIDENTIAL

CCBG

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

17 July 1986

The Rt Hon Nigel Lawson MP
HM Treasury
Parliament Street
LONDON
SW1

Dear Chancellor,

VAT ZERO-RATES INFRACTION PROCEEDINGS
PRIVATE HOUSEBUILDING

I wrote to you on 16 July about the Commission's reply to our defence in the current VAT infraction proceedings.

I have now seen a copy of the letter of 16 July to the Prime Minister from the President of the House-Builders Federation. He refers to the Prime Minister's letter of 5 July 1984 to the then President of the House-Builders Federation, a copy of which I attach, in which she said that "we shall also continue to resist firmly moves within the European Community to bring the current VAT concession to an end". It would be very helpful, I believe, if you were to issue a statement, in similarly firm terms.

I am copying this letter and the enclosure to Cabinet colleagues, and to Sir Robert Armstrong.

Yours sincerely,

Isobel R. Shine (Private Secretary)

pp NICHOLAS RIDLEY

(Approved by the Secretary of State and signed in his absence)

M4 2306/1

10 DOWNING STREET

THE PRIME MINISTER

5 July 1984

Dear Mr. Roydon.

Thank you for your letter of 30 May. I am sorry you have not had an earlier reply.

I am happy to confirm that we have no plans to alter either the present zero rating for new housing, or the current basis of mortgage interest relief. We shall also continue to resist firmly moves within the European Community to bring the current VAT concession to an end.

Yours sincerely

Margaret Thatcher

Terry Roydon, Esq.

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CC

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CONFIDENTIAL

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

10 July 1986

The Rt Hon Nigel Lawson MP
HM Treasury
Parliament Street
LONDON
SW1

Dear Nigel

I have seen the letter from the Treasury Solicitor to your officials, enclosing the Commission's reply to our defence in the current VAT infraction proceedings (case No 416/85).

Should the Court accede to the Commission's arguments, there would appear to be potentially very worrying political and public expenditure implications. The implications of what is said on sewerage and water (Group 2) are perhaps of more presentational then substantive significance, but the threat to Group 8 construction, is much more serious. Excluding local authorities, our current public expenditure plans provide for some £6½ billion to be spent on new construction. That - or a substantial part of it - would appear to be threatened by the Commission's arguments. If the Commission's arguments were to carry the day, that would impose further pressures on capital spending within fixed expenditure ceilings.

So far as housing is concerned, the Commission's arguments are extremely flimsy, and I am more hopeful that we will be able to rebut them. But in the event of an adverse decision, there would clearly be major political and economic repercussions from having to impose VAT on new housing. So far as industrial and commercial development is concerned, I am much less hopeful that we will be able to carry the day - but I believe that the market has already substantially discounted the likely position of VAT there.

Once we have the Court's decision, we will clearly need to give it very careful and lengthy consideration. I hope that you will consider how best colleagues could be brought into this, particularly bearing in mind the possible effects of an adverse judgement on our public expenditure programmes, and on the construction industry.

I am copying this to our Cabinet colleagues, in view of the political implications of any decision on housing, and of the possible effects on their own programmes; and to Sir Robert Armstrong.

Yours ever

Nicholas

NICHOLAS RIDLEY

3 JUL 1986

THE TREASURY SOLICITOR

Queen Anne's Chambers
28 Broadway London SW1H 9JS

Direct Line 01-210 3383 / 3377
Telephones Switchboard 01-210 3000
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M F Hunt Esq.
H M Customs & Excise.

Please quote 4/192 /SJH
Your reference
Date 30 June 1986

PROCEEDINGS BEFORE THE EUROPEAN COURT : CASE NO. 416/85

Commission
-v-
United Kingdom (VAT - zero rating)

Further to earlier communications about this case copies are enclosed of another letter from the court, with enclosures.

Mrs S J Durrant
P.p. MRS S J HAY

cc T J G Pratt Esq - LAES
Ms Boyle - D Energy
Ms F McConnell - DOE
M Hoskins Esq - LOD
G Fotherby Esq - C & E Sols.

COPY

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COMMISSION
OF THE
EUROPEAN COMMUNITIES

Brussels, 20 June 1986

JUR(86) D/03596 ORIG. : EN

TO THE PRESIDENT AND MEMBERS OF THE COURT
OF JUSTICE OF THE EUROPEAN COMMUNITIES

R E P L Y

in case 416/85

by

THE COMMISSION OF THE EUROPEAN COMMUNITIES

represented by its Legal Adviser, Mr. D.R. GILMOUR, acting as Agent, with an address for service at the office of Mr. G. KREMLIS, Jean Monnet Building, Kirchberg, Luxembourg

against

THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND

seeking a declaration that certain provisions of the Value Added Tax Act 1983 concerning zero rates are incompatible with the 6th VAT Directive.

Registered at the Court of Justice
under No 244926
Luxembourg (no. 20.6.86) 20th day of June 1986
Registrar

SJ/432/86

J. A. Pompe
Deputy Registrar,

PART A: GENERAL

1. The United Kingdom Defence is based on its interpretation of Article 28(2) of the 6th Directive and Article 17, last indent, of the 2nd. The Commission agrees that the essence of the dispute between it and the United Kingdom is to be found in these provisions. Before replying to the specific arguments raised in defence of each of the contested zero rates, it is appropriate to indicate to the Court the Commission's purpose in bringing this case, together with the parallel proceedings in case 415/85, Commission v. Ireland, and also to state the Commission's general approach to the whole question of zero rates.

2. This case, together with that relating to Ireland, concerns not only the question of fiscal receipts, in those cases where zero rates are wrongfully attributed, but also the method by which zero rates as such are operated. For reasons explained below, in the case of acceptable zero rates, no real question of fiscal receipts, whether national or Community in the form of own resources, arises. Nevertheless, in the Commission's view the method used by the United Kingdom (and Ireland) in applying zero rates goes far beyond anything contemplated in the 6th Directive and as such impedes progress towards further harmonization in the VAT sphere. The Commission refers to its Report to the Council on the transitional provisions applicable under the Common System of VAT (COM(82) 885 final). With regard to Article 28(2) and zero rates, the Commission's purpose in this Report was, inter alia, to highlight the problem created by the extensive zero rate regimes in operation in Ireland and the United Kingdom and to announce its intention of putting forward proposals for the gradual elimination thereof. While the citation is extensive, it is useful to include in this text the relevant passages from the Report. As appropriate it states (the full Report is attached at ANNEX 1):

"So as to facilitate the move towards the final form of the common system of VAT, Article 28 of the 6th Directive lays down a number of transitional provisions relating to:

I. Article 28(2)

1. Maintenance of reduced rates and exemptions with refund of input tax (zero-rating)

Article 28(2) allows the Member States to maintain at the latest until fiscal frontiers between Member States are abolished 'reduced rates and exemptions with refund of the tax paid at the preceding stage which are in force on 31 December 1975, and which satisfy the conditions stated in the last indent of Article 17 of the 2nd Council Directive of 11 April 1967'.

This reference to the 2nd Directive means that such rates may be maintained 'for clearly defined social reasons and for the benefit of the final consumer' and 'where the total incidence of such measures does not exceed that of the reliefs applied under the present system'.

However, the main problem is that of zero-rating.

Annex I to this report lists the cases of zero-rating in force on 1 October 1982 by Member States. A look at this list shows that the scope of zero-rating is completely different in each of the five Member States in which it is applied. In Belgium, Denmark and Italy, zero-rating involves only a relatively small part of the VAT base, while in Ireland and the United Kingdom it involves more than one third (some 33% of consumption by households in Ireland and some 35% in the United Kingdom is relieved of VAT through zero-rating). In Belgium, Denmark and Italy zero-rating is generally simply an ad hoc measure introduced in specific instances with limited objectives in mind (for example, in order to reduce costs for the press); in Ireland and the United Kingdom, the large-scale use of zero-rating reflects a policy which is being pursued for historical, political and social reasons that are not easy to dismiss, especially psychologically, despite the economic and technical considerations set out below.

The Commission has had to check whether certain cases of zero-rating conform with the conditions laid down in paragraph 2 of Article 28 of the 6th VAT Directive. Infringement procedures have been initiated against three Member States.

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The application within the country of exemption with refund of the VAT paid at the preceding stage (zero-rating) presents several drawbacks, both generally in terms of the effectiveness of this system of taxation, and with regard to Community harmonization in this area. The reasons are that:

- at national level, the complete remission of tax for an economic sector by means of zero-rating inevitably increases the burden of VAT on sectors which are subject to it and thus aggravates the distortions created by differential rates in the allocation of resources;

- at Community level, if a category of activities is zero-rated in one Member State, traders in the same sector, or consumers, will claim the same benefit in other Member States;

- in terms of management, the refunds which have to be made to taxable persons as a result of zero-rating entail high administrative costs, which are not in any way offset by revenue;

- as regards the collection of VAT own resources, zero-rating at national level not only tends to weaken the very notion of own resources by making it necessary to provide for financial compensation, but also disrupts the tax link which own resources are supposed to establish between taxpayers and the Community.

As regards the social justification of zero-rating, which is that the remission of tax for large categories of goods and services regarded as being basic necessities (food, clothing, medicines, public transport, etc.) allows a significant reduction in the tax burden on the least well-off sections of society, it should be noted that several studies on this subject have concluded that even very wide application of this measure provides only a slight benefit to low-income groups, a growing proportion of whose expenditure is on goods or services that are subject to the standard rate or indeed to an increased rate.

There are therefore grounds for wondering whether an active social policy of granting aids or social benefits to persons really in need of them would not be more effective than this rather indiscriminate instrument whose effectiveness is open to doubt.

In adopting the 6th Directive, the Council implicitly accepted the Commission's arguments against maintaining and, a fortiori, extending the use of zero-rating, since Article 28 provides that:

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- until a date which shall be fixed by the Council, acting unanimously on a proposal by the Commission but which shall not be later than the abolition of fiscal frontiers, Member States may continue to apply zero rates which satisfy the conditions stated in the 2nd Directive and which were in force on 31 December 1975;

- on the basis of a report from the Commission, the Council must every five years review the zero rates applied by Member States and, acting unanimously on a proposal from the Commission, must, where appropriate, adopt the measures to ensure their progressive abolition.

The Commission indicates the following possible ways of progressively narrowing the scope of zero rates.

In Belgium, Denmark and Italy, the existing zero rates can probably be abolished without undue difficulty, especially if direct financial assistance could be granted, at least on a provisional basis, in their place.

In the case of Ireland and the United Kingdom, the problem is obviously much more difficult, since at present the whole of the population benefits, to a degree that varies with the socio-economic group from the remission of tax on a large proportion of consumption.

Looking at the problem simply in technical terms, a solution for Ireland and the United Kingdom and one which would necessarily have to be spread over a long period might be along the following lines:

- gradual increase in the taxation of goods and services which would thus be excluded from the scope of zero-rating; during an initial period, the rate of tax could be set at a fairly low level, though one which would be sufficient to allow deduction of input tax ('compensation rate'); subsequently, this special rate would be increased to the level of the reduced rate or the standard rate in one or more intermediat stages;

- gradual reduction in the level of the rate or rates of VAT, parallel to the process of narrowing the scope of zero-rating, where a Member State wished to maintain the total yield of VAT at the same level. Another possibility would be to keep VAT rates unchanged so as to provide some latitude for reducing the burden of other direct or indirect taxes.

The Commission envisages putting forward appropriate proposals on the above lines in light of the discussion which will be held on this report in the Council."

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3. The Commission also refers to the White Paper on the completion of the internal market in which the importance the Commission attaches to the elimination of zero rates is again highlighted. Noting that there are eight draft directives pending before the Council on other aspects of the VAT system, the White Paper states (paragraph 196)

> After their approval the main outstanding problems in this area will be the remaining derogations. .... Some of the most important derogations are connected with zero-rating of food and other goods and services in Ireland and the United Kingdom. This is why VAT coverage is as low as 35 per cent of private consumption in Ireland and 44 per cent in the United Kingdom whereas most Member States cover about 90 per cent. The high rates of tax imposed in Ireland and the comparatively low yield in the United Kingdom are both a reflection of this restricted coverage. A move towards a more uniform basis would therefore be helpful in both these respects.

4. The Commission's position is thus that exemptions with refunds, especially when used on the large scale of the Irish and United Kingdom zero rates, undermine the essential harmonization of the basis of assessment to VAT introduced by the 6th Directive. The Commission accepts, as it has already stated in its Application in both cases, that the operation of the zero rate system has no financial bearing on the question of own resources. Article 28(2) specifically obliged Member States making use of this transitional provision in whatever way to pay own resources on transactions relieved of tax. Further, in the context of Article 28(2), the Commission accepts that, at national level, there is no difference in fiscal receipts whether a positive rate of tax is levied on the input expenditure incurred in the manufacture of products the zero rate of which is allowable or whether such inputs are zero rated. If a positive rate of tax is levied it will be a deductible expense under Article 17. If inputs are zero rated, there is nothing to refund at the final stage since in practice the product has never been burdened by tax. Thus, as the Irish Government rightly

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points out, whether a positive rate of VAT is levied giving rise to deductions in the VAT returns or whether a zero rate is levied, there is no practical difference in terms of fiscal receipts[1].

5. Nevertheless, in the context of the completion of the internal market, of the abolition of fiscal frontiers, and of the drive towards a standardisation of the rate of VAT, it is the Commission's aim to limit the use of zero rates to those transactions which meet the criteria laid down in Article 28(2) of the 6th Directive and this as part of its overall fiscal policy of working towards the total phasing out of all zero rates or exemptions with refunds.

6. Interpretation of Article 28(2)

Article 28(2) lays down the requirement to fulfil two precise conditions in order to benefit from an exemption with refund or zero rate. It must be for clearly defined social reasons and benefit the final consumer.

Social reasons

In its Report to the Council, the Commission recognizes that, in the case of Ireland and the United Kingdom, zero rates were introduced on such a large scale as part of a tax policy pursued for historical, political and social reasons. In the light of this fact and except

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(1) It should also be noted that even where we are dealing with inputs to products which may not be lawfully zero-rated, it would make no practical difference in terms of fiscal receipts whether VAT was levied on those inputs or they were zero-rated leaving VAT to be levied only at the stage of final consumption of the finished product. Because of the deduction system, all input taxes are in effect neutralized; VAT only bites at the last stage in the commercial chain. Such a system is, of course, excluded by the 6th Directive, VAT having been conceived in a different way.

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as indicated below, it is perhaps not important to seek to isolate which factor predominates in the institution of zero rates. Further, the Commission accepts that for the purposes of Article 28(2) of the 6th Directive, Member States have a margin of discretion in determining their own social policies and, as such, a margin of discretion in determining what measures are justified by social reasons (paragraph A 13 of the United Kingdom Defence). Equally, it is accepted that the Commission may not challenge measures taken in pursuance of a social policy unless it can be shown that the social policy is not sufficiently clearly defined or that the measures in question are either not justified by or disproportionate to the social reasons advanced. The extent of this margin of discretion and the compatibility of measures taken in pursuance thereof are, of course, subject, in the final analysis, to adjudication by the Court of Justice which may define, within the context of that margin of discretion, the Community content contained in the notion of "clearly defined social reasons". Further, but subject to paragraph 21 below, it is accepted that a measure which in itself fulfils these criteria may not be called in question because it may incidentally benefit a category of consumer which does not require that social benefit. The example given by the United Kingdom is the zero rating of food which benefits poor and rich alike.

7. Benefit to the final consumer

There would not appear to be any difference of view between the Commission and the United Kingdom as to the definition of final consumer. Although the Court has not had occasion to define this term expressly, it is indeed implicit in the judgment in case 89/81, Staatssecretaris van Financiën v. the Hong Kong Trade Development Council, 1982 ECR 1227 at paragraphs 9 and 10, that the final consumer is the person who acquires the goods or services without having any right of deduction such that he himself must bear the cost of the VAT. However, there is a fundamental disagreement

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way in which the exemption with refund mechanism as laid down by Article 17 last indent of the 2nd Directive was intended to operate. If an exemption with refund is operated at the stage of final consumption, no VAT is charged on the final sale. Nor is there any hidden VAT because (a) the VAT as an input tax on the retailer on his purchases is refunded and (b) all previous input taxes have been deducted in the normal course of the operation of the VAT system. If a zero rate system is instituted, in order for it to produce the equivalent effect of an exemption at the final stage, combined with a refund of all VAT burdening the product at that stage, the same inputs which would be deducted under the refund system may be eligible for a zero rate. Hence, fulfilment of the two criteria laid down in the 2nd and 6th Directives on this subject may be regarded as fulfilled at the stage of the initial inputs of the end product, itself the subject of a zero rate. Thus the real dispute centres on the question of whether we are dealing with a bona fide input for a product which is itself zero rated. Such a view would exclude a supplier of raw materials which may benefit from a zero rate, himself benefitting from the same zero rate on his supplies. Equally it excludes the zero rating of inputs to a final product which may not benefit from Article 28(2).

In assessing whether something can be treated as an input to a final product for the purposes of Article 28(2), the Commission submits that the question of "remoteness" has to be considered. The Commission interprets "inputs" as including products which enter directly into the manufacture of the zero-rated final product. In the Commission's submission, products or services which, albeit related in an overall economic sense to a finished item, do not enter directly into the production and distribution chain, cannot be regarded as inputs for the purposes of zero rating. For example, the Commission would not accept that

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farmers' boots could be zero rated because they form part of the overall production chain, viewed in economic terms, of food. In the Commission's view, such a zero rate would be an unreasonable extension of the system instituted by Article 28(2). For a zero rate to be extended up the chain of manufacture from the finished product to alleged inputs, there has to be a clear and tangible link between those inputs and the finished item.

10. Replies to arguments advanced by the United Kingdom in Part A of its Defence, not otherwise dealt with above

a) It is not contested that the word "only" in the English text of Article 17 last indent of the 2nd Directive is a gloss upon the original language texts. However, for the reasons set out above in paragraphs 8 and 9 above, in the Commission's view this is without significance.

b) The Commission does not agree with the United Kingdom view of Article 17 of the 2nd Directive in that it is said to form part of the general rule. Article 28(2) of the 6th Directive and Article 17 of the 2nd Directive both make provision for the institution of transitional provisions which are diametrically oppsoed to the regime established by these directives. In providing that some goods and services may be supplied free of any incidence of VAT, the provisions in question established a major derogation to the general principle that all deliveries of goods and services are to be taxed. To claim that such a transitional provision forms part of the general rule is simply to distort the plain meaning of the text to which the United Kingdom itself attaches a certain significance. Thus, the Commission maintains its view that, as a derogation to the general rule of universal taxation, the provisions of Article 28(2) of the 6th Directive and Article 17 of the 2nd Directive ought to be strictly construed.

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However, for the resolution of this case, it is perhaps not necessary to dwell on the precise scope of particular cannons of interpretation. The Commission is content to consider the relevant provisions on the basis of the ordinary meaning of the words used, taken in the context in which they are found, as suggested by the United Kingdom in paragraph A 11.

c) The Commission agrees with the conclusions of paragraph A 17, i.e. it accepts that the goods and services covered by Groups 2, 7, 8 and 17 may lawfully benefit from a zero rate except to the extent of the objections herein raised.

d) Later in its Defence, the United Kingdom raises the question of whether zero rates may be applied to a wide variety of operations which could be said to have been undertaken in the public interest. Included in this group are projects for the purpose of industrial renewal, health, safety and welfare at work, civil engineering works and what is referred to as the Community sector. The public interest in such expenditure is not at all in doubt - indeed one may suppose that all government expenditure is designed to fulfil some public purpose or other. The question which the Court has to decide is whether a broad public purpose is sufficient to entitle a particular transaction to benefit from a zero rate of VAT. In the submission of the Commission, the notion of "benefit to the final consumer" is used in a much more narrow sense, as indicated above, such that benefits of the type mentioned by the United Kingdom as flowing from measures of general government policy may not be considered for the purposes of Article 28(2).

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PART B: SPECIFIC

11. Group 1 - Food

In the submission of the Commission, none of the contested items can validly be considered as an input in food manufacture, at least for the purposes of the operation of Article 28(2). Each of the items is too remote and does not form part of the direct production and distribution chain of food, even if without, for example, animal fodder, there would be no meat products at all. Such inputs are so remote as not to fulfil the criterion of "benefit to the final consumer". Equally, the Commission would question whether the use of zero rating in this manner for social purposes is proportionate to the ends sought.

12. Group 2 - Sewerage services and water

It is correct that the Commission's challenge to the United Kingdom is limited to services to industry.

13. Sewerage

Group 2 - 1(b) : emptying of cesspools, septic tanks or similar receptacles

The point at issue being whether the provision of such services to industry can be zero rated, discussion of the domestic structure is not germane to this case. The Commission takes note of the explanations given by the United Kingdom as to the way in which mains sewerage services are financed; a special local authority tax of a general nature (a "rate") is levied on all property, on the basis of property values, the revenue of which is used to finance a variety of services operated on a local authority basis. To the extent to which they are funded out of such general taxation, sewerage services are not provided for consideration and as such are outwith the scope of VAT.

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The United Kingdom points out that in some cases, where there is no mains drainage, septic tanks, etc. are used and have to be emptied on a commercial basis. The emptying of septic tanks, etc. on a commercial basis, for consideration, would be a taxable transaction and as such within the scope of the 6th Directive. However, the United Kingdom claims that it is very doubtful if industry relies to any extent on septic tanks. To that extent there should be no difficulty in repealing the offending provision. To the extent that the United Kingdom challenges this conclusion, the Commission would question whether there are any valid social reasons, compatible with the Communitywide nature of VAT, why industry should have its septic tanks emptied, free of VAT, where this has to be done on the basis of payment for consideration. Further, any general public benefit is too remote to qualify under Article 28(2). In this regard the Commission would recall that it has been Community policy for many years that the polluter must pay. This principle also applies to the question of the levying of VAT on appropriate services.

14. Group 2.2 - Water

Again, the precise point of dispute between the Commission and the United Kingdom, in this case, is the zero-rating of taxable supplies of water to industrial concerns. There is indeed a separate question pending concerning the question of whether all supplies are taxable which, however,is not germane to the present case.

15. The Commission does not accept that either of the criteria of Article 17 last indent of the 2nd Directive are met. The zero rate applies to water supplied to industry, irrespective of the uses to which it is put or the products in the manufacture of which it is used. The United Kingdom draws no distinction

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between supplies of water for the purpose of the manufacture of an end product which can validly be zero-rated and the others which may not. In doing so the United Kingdom extends the benefits of Article 28(2) beyond its permitted scope. The United Kingdom asserts that the zero rating of all such supplies fulfils a social purpose. However, no reasons are given why supplies to industry should be so regarded and as such the Commission rejects the claim to the benefit of Article 28(2) of the 6th Directive. It should be noted that the Luxembourg exemption (not zero rate) is based on Article 28(3)(b) and Annex F. Exemptions under Annex F can be applied at the discretion of the Member States; the criteria of social reasons and benefit to the final consumer do not apply.

16. Group 6 - News services

In the case of news services, zero rating extends not only to indsutrial users but also the public. As far as the supply of such services directly to the public is concerned, the Commission accepts that the criteria of Article 28(2) of the 6th Directive are met. As far as supplies to any industry are concerned, where such supplies are directly used in the production of zero-rated goods, the Commission accepts the application of a zero rate at that stage.

17. Group 7 - Fuel and power

The result of this zero rating is that the largest consumers in the land, the industrial users, pay no VAT on their purchase of fuel and power. The only reason advanced to justify this wide exemption is that it would be difficult to administer VAT on the basis of the status of the user. Administrative difficulties alone cannot justify the total exclusion of the whole of industry from the scope of VAT as far as their inputs of fuel and power

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are concerned. With regard to fuel and power generally, in the submission of the Commission, such supplies cannot be considered as a direct input to a zero rated final product. Notwithstanding the link with manufactured products, such inputs are too remote to be able to benefit from the provisions of Article 28(2). The problems relating to the supply of electricity are considered further below (see paragraph 21).

18. Group 8 - Construction of buildings, etc.
- The housing sector

Having regard to the margin of discretion which Member States have in establishing their own social policies (see paragraph 6 above), the Commission does not seek to enter into a discussion of the validity of the broad social policy of the United Kingdom Government as far as housing in general is concerned. Notwithstanding, however, the Commission is unable to accept that the whole of the housing sector may benefit from a zero rate system. With the exception of local authority homes as specified in the United Kingdom Defence, paragraph 8.5.3 (vi), the Commission would submit that the indiscriminate granting of a zero rate to the rest of the housing sector irrespective of the nature of the dwellings concerned constitutes a disproportionate use of the system of zero rating, having regard to the ends sought.

19. The commercial sector, health, safety and welfare, civil engineering works, the Community sector

The tenor of the arguments advanced in these sections is that there is a public interest in the renewal and extension of the industrial and, in some cases, in the "social" infrastructure of the country and that the levying of VAT on that would hinder development. The Commission does not at all contest that such developments are in

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the public interest. However, it would question whether one can qualify this interest as "social" as that term is used in the VAT directives. We are here confronted with a variety of aspects of general economic and development policy. Even when one can point to a genuine social reason, such as the impact of new building on health and safety at work, the Commission would submit that the total exemption of all non-domestic building as a means of achieving this is disproportionate to the ends sought. Further, for this whole sector, any benefit to the final consumer, as these terms are used in the 6th Directive, is too remote to qualify for relief under Article 28(2).

20. Protective boots and helmets for industrial use

The question for consideration here is whether the sale of protected boots and helmets to industry for use by employees can be zero rated. Having regard to paragraph 9 above, the Commission submits that such items may not benefit from Article 28(2). They do not constitute an integral part of any zero-rated final product and as such cannot be regarded as inputs which may benefit from the zero rate attaching to a final product.

21. Zero rating as applied in the United Kingdom: administrative consequences

Under these headings the United Kingdom discusses a number of difficulties which arise for the application of zero rates in the United Kingdom. The United Kingdom points out in particular that zero rating as a system depends for its application upon the imposition of a zero rate throughout the production and distribution chain. More particularly, they point out that it is not possible to implement a zero rate system in the way it is applied in the United Kingdom (and also, the Commission supposes, in Ireland) unless it is known at the very beginning of the chain that the end product will be zero rated. The United Kingdom appears to conclude from this that, in the case of a product

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which can be put to a variety of uses, only one of which can be zero rated, all the other uses must also benefit from the zero rate because otherwise the system would be impossible to operate. The Commission rejects this argument as being totally devoid of proportionality and indeed reasonableness. In paragraph 6 the Commission has stated that it accepts that a zero rate which fulfils the stated criteria may not be called in question because it may incidentally benefit a category of goods or consumers not entitled to this benefit. The Commission would submit that the converse is equally true, namely, that where, in general, a group of products or services may not lawfully benefit from a zero rate, this conclusion is not altered by the fact that one or two uses of a product or service are entitled to a zero rate. The United Kingdom may well reply that such a view is too narrow and gives rise to great administrative difficulties and indeed to some inequities. The Commission's answer must be that it is the United Kingdom which is seeking to utilize a derogation in a way which was never envisaged. Further, if a permitted use of zero rating proves too cumbersome to operate, the Member State in question is obliged to implement the 6th Directive, even if that means abandoning the zero rating in question. It would, after all, be possible in those cases to give an exemption with refund at a precise final stage and thus achieve the same desired social result.

22. As far as electricity supplies are concerned and the difficulties which the United Kingdom envisages because of mixed use, the Commission would submit that these are largely specious. Electricity is supplied direct from manufacture to end users. There are no intermediary stages of production and distribution and as such there is no essential difficulty in taxing or not,

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depending on the quality of the user. In so far as the question of mixed use is concerned, this is not the only place in the 6th Directive where this problem arises and it is solved elsewhere by means of estimations. The Commission refers to Articles 5(6) and 6(2) of the 6th Directive, where the problem of mixed use of goods and services as between professional and private use is dealt with. The same problem arises with respect to deductions - Article 17 paragraph 5. Further, the Commission would not accept that the installation of separate meters in small businesses and residential premises is too cumbersome a procedure to be contemplated because too costly. Millions of households have undertaken the expense necessary to have extra night meters installed in order to take advantage of low cost night supplies of electricity. The Commission can see no valid reason why the same system cannot be adopted in respect of that proportion of electricity supplies which are liable to VAT. In any event, when it deems it appropriate, the United Kingdom also requires the taxation of the taxable element in a package of supplies, only one of which is zero-rated: e.g. mixed supplies in relation to news services where photographs are involved; see VAT Leaflet 701/18/84 annexed to the United Kingdom Defence, paragraph 3.

23. Conclusions

This case, together with case 415/85, raises the fundamental question of interpretation in the VAT domain. It is true that certain of these questions can be presented as having no practical consequences. The Commission would not accept that way of looking at the matter, even in those instances where, in relation to zero-rated final products, there is no difference in fiscal receipts whether one zero rates the inputs or levies a positive rate and deducts. In the Commission's view, the long term effects on the evolution of Community fiscal policy are considerable. In the Commission's view zero rates constitute one of the stumbling blocks on the path towards a

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uniform rate of VAT. It is not the purpose of this case to seek to have the Court institute such a rate. However, the Commission does seek a declaration of the correct interpretation of Article 28(2) since this will facilitate the advancement of general Community policy in an otherwise difficult area.

The Court will bear in mind that, taking the lists of zero rates applied in the United Kingdom as a whole, the Commission has contested only those where the question of whether the criteria of Article 28(2) of the 6th Directive are fulfilled is most acute. Thus, while all zero rates constitute an impediment to the development of the Common Market through the difficulties they raise for the abolition of fiscal frontiers and for the completion of the internal market, the Commission has limited its objectives in this case and, in the parallel case against Ireland, to those instances where, in its view, the limits of the derogation have been overstepped. It will be for the Council of Ministers, in the last resort, to decide on a timetable for the phasing out of the others.

For these reasons, but subject to paragraph 16 hereof, the Commission maintains its conclusions as stated in paragraph 19 of its Application.

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D.R. GILMOUR

Agent for the Commission

LIST OF ANNEXES

COMMISSION OF THE EUROPEAN COMMUNITIES

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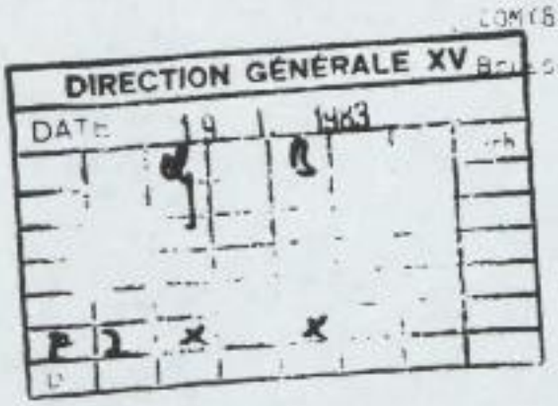
Brussels, 17 January 1983



REPORT FROM THE COMMISSION TO THE COUNCIL

on the transitional provisions applicable under the common system of VAT, submitted in accordance with Article 28 of the Sixth Council Directive of 17 May 1977

So as to facilitate the move towards the final form of the common system of VAT, Article 28 of the Sixth Directive lays down a number of transitional provisions relating to:

I. Article 28(2)

1. maintenance of reduced rates and exemptions with refund of input tax (zero-rating);

II. Article 28(3)

1. the freedom to continue to tax transactions which will have to be exempt under the final arrangements;

2. the freedom to continue to exempt transactions which will have to be taxed under the final arrangements;

3. the freedom to maintain or grant the right to opt for taxation;

4. the freedom to derogate from the principle of immediate deduction;

5. the freedom to derogate from the arrangements whereby supplies are treated as taxable transactions and certain amounts received are not included in the taxable amount;

6. the freedom to take the difference between the selling price and the purchase price as the taxable amount for certain real property transactions;

7. the freedom to continue to exempt without repayment of input tax the services of travel agents.

These various provisions will each be examined in turn.

I - MAINTENANCE OF REDUCED RATES AND EXEMPTIONS WITH REFUND OF INPUT TAX (Article 28(2))

Article 28(2) allows the Member States to maintain at the latest until fiscal frontiers between Member States are abolished "reduced rates and exemptions with refund of the tax paid at the preceding stage which are in force on 31 December 1975, and which satisfy the conditions stated in the last indent of Article 17 of the Second Council Directive of 11 April 1967".

This reference to the Second Directive means that such rates may be

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final consumer" and "where the total incidence of such measures does not exceed that of the reliefs applied under the present system".

With regard to reduced rates, if one supposes (a necessarily arbitrary assumption) that only rates of less than 5% may entail refund of input tax, it is evident that, on 31 December 1975, only Luxembourg and the Netherlands had made use of this derogation.

Reduced rates of less than 5% were subsequently introduced in Italy; the Commission has to verify whether they comply with the basic rules laid down in the Sixth Directive, under which each reduced rate must be so fixed that the amount of value added tax resulting from the application thereof is such as in the normal way to permit the deduction therefrom of the whole of the value added tax deductible under the Directive ("compensation rate" rule).

However, the main problem is that of zero-rating.

Annex I to this report lists the cases of zero-rating in force on 1 October 1982 by Member State. A look at this list shows that the scope of zero-rating is completely different in each of the five Member States in which it is applied. In Belgium, Denmark and Italy, zero-rating involves only a relatively small part of the VAT base, while in Ireland and the United Kingdom it involves more than one third (some 33 % of consumption by households in Ireland and some 35% in the United Kingdom is relieved of VAT through zero-rating). In Belgium, Denmark and Italy zero-rating is generally simply an ad hoc measure introduced in specific instances with limited objectives in mind (for example, in order to reduce costs for the press); in Ireland and the United Kingdom, the large-scale use of zero-rating reflects a tax policy which is being pursued for historical, political and social reasons that are not easy to dismiss, especially psychologically, despite the economic and technical considerations set out below.

The Commission has had to check whether certain cases of zero-rating conform with the conditions laid down in paragraph 2 of Article 28 of the Sixth VAT Directive. Infringement procedures have been initiated against three Member States.

The application within the country of exemption with refund of the VAT paid at the preceding stage (zero-rating) presents several drawbacks, both generally in terms of the effectiveness of this system of taxation, and with regard to Community harmonization in this area. The reasons are that:

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- at national level, the complete remission of tax for an economic sector by means of zero-rating inevitably increases the burden of VAT on sectors which are subject to it and thus aggravates the distortions created by differential rates in the allocation of resources;

- at Community level, if a category of activities is zero-rates in one Member State, traders in the same sector, or consumers, will claim the same benefit in other Member States;

- in terms of management, the refunds which have to be made to taxable persons as a result of zero-rating entail high administrative costs, which are not in any way offset by revenue;

- as regards the collection of VAT own resources, zero-rating at national level not only tends to weaken the very notion of own resources by making it necessary to provide for financial compensation, but also disrupts the tax link which own resources are supposed to establish between taxpayers and the Community.

As regards the social justification of zero-rating, which is that the remission of tax for large categories of goods and services regarded as being basic necessities (food, clothing, medicines, public transport, etc.,) allows a significant reduction in the tax burden on the least well-off sections of society, it should be noted that several studies on this subject have concluded that even very wide application of this measure provides only a slight benefit to low-income groups, a growing proportion of whose expenditure is on goods or services that are subject to the standard rate or indeed to an increased rate.

There are therefore grounds for wondering whether an active social policy of granting aids or social benefits to persons really in need of them would not be more effective than this rather indiscriminate instrument whose effectiveness is open to doubt.

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In adopting the Sixth Directive, the Council implicitly accepted the Commission's arguments against maintaining and, a fortiori, extending the use of zero-rating, since Article 28 provides that:

- until a date which shall be fixed by the Council, acting unanimously on a proposal by the Commission but which shall not be latter than the abolition of fiscal frontiers, Member States may continue to apply zero rates which satisfy the conditions stated in the second Directive and which were in force on 31 December 1975;
- on the basis of a report from the Commission, the Council must every five years review the zero rates applied by Member States and, acting unanimously on a proposal from the Commission, must where appropriate adopt the measures required to ensure their progressive abolition.

The Commission indicates the following possible ways of progressively narrowing the scope of zero rates.

In Belgium, Denmark and Italy, the existing zero rates can probably be abolished without undue difficulty, especially if direct financial assistance could be granted, at least on a provisional basis, in their place.

In the case of Ireland and the United Kingdom, the problem is obviously much more difficult, since at present the whole of the population benefits, to a degree that varies with the socio-economic group from the remission of tax on a large proportion of consumption.

Looking at the problem simply in technical terms, a solution for Ireland and the United Kingdom and one which would necessarily have to be spread over a long period might be along the following lines:

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- gradual narrowing of the scope of zero-rating, for example by restricting it during an initial stage to foodstuffs alone, excluding clothing, footwear, etc., and then, during a second stage, to basic foodstuffs alone (bread, milk, meat, etc.);

- gradual increase in the taxation of the goods and services which would thus be excluded from the scope of zero-rating; during an initial period, the rate of tax could be set at a fairly low level, though one which would be sufficient to allow deduction of input tax ("compensation rate"); subsequently, this special rate would be increased to the level of the reduced rate or the standard rate in one or more intermediate stages;

- gradual reduction in the level of the rate or rates of VAT, parallel to the process of narrowing the scope of zero-rating, where a Member State wished to maintain the total yield of VAT at the same level. Another possibility would be to keep VAT rates unchanged so as to provide some latitude for reducing the burden of other direct or indirect taxes.

The Commission envisages putting forward appropriate proposals on the above lines in light of the discussion wich will be held on this report in the Council.

II - OTHER TRANSITIONAL PROVISIONS

1 - FREEDOM TO CONTINUE TO TAX TRANSACTIONS WHICH WILL HAVE TO BE EXEMPT UNDER THE FINAL ARRANGEMENTS (Article 28(3)(a) and Annex E to the Sixth Directive)

2 - FREEDOM TO CONTINUE TO EXEMPT TRANSACTIONS WHICH WILL HAVE TO BE TAXED UNDER THE FINAL ARRANGEMENTS (Article 28(3)(b) and Annex F to the Sixth Directive)

These two sorts of derogation, though producing opposite results, will be looked at together, since the way in which they must be treated is determined by the same set of problems.

Pursuant to Article 28(3) of the Sixth Directive, Member States may, during the transitional period initially set at five years from 1 January 1978:

(a) continue to subject to tax the transactions exempt under Article 13 or 15 set out in Annex E to the Directive;

(b) continue to exempt the activities set out in Annex F under conditions existing in the Member State concerned.

The total number of derogations is 15 in the case of Annex E and 27 in the case of Annex F.

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The two tables given in Annex II to this report indicate which Member States have made use of each of these options.

A brief look at the tables shows that some of the options provided for in Annex E have not been used by the Member States and are thus no longer available. These are as follows:

E - 8: the services of intermediaries relating to the negotiation of credit guarantees or any other security for money and the management of credit guarantees;

E - 13: the supply of goods and services relating to aircraft used for reward on international routes;

Under Article 28(4), the freedom to continue to tax or not to tax certain transactions is granted for a transitional period of five years. Before the end of this period, the Council, acting on a proposal from the Commission, must decide on the maintenance or abolition of the derogations. The derogations in question may be divided into the following three categories, chiefly applying criteria based on financial impact:

a) - slight financial impact of the derogation;

b) - relatively significant financial impact of the derogation;

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c) - very significant financial impact.

The various derogations listed in Annex E (exempt transactions under the final scheme) may be borken down as follows into these three categories:

A - slight impact

E 1 (supply of parcel post services)

E 3 (services supplied by independent groups of persons)

E 4 (services linked to sport or physical education supplied by non-profit-making organisations)

E 5 (cultural services supplied by bodies governed by public law)

E 6 (supply of transport services for sick or injured persons by ambulance)

E 10 (management of investment funds)

E 12 (supply of goods dispatched or transported by a purchaser not established within the territory of the country).

B - moderate impact

E 9 (the services of intermediaries relating to transactions in transferable securities)

E 15 (services of travel agents for journeys outside the Community)

C - serious impact

E 2 (services supplied by dental technicians)

E 7 (services supplied by public ratio and television bodies)

E 11 (supply of buildings that are not newly constructed)

The various derogations listed in Annex F (taxed transactions under the final scheme) may be broken down as follows:

A - slight impact

F 1 (admission to sporting events)

F 3 (supply of services by means of agricultural machinery)

F 4 (supply of greyhounds and thoroughbred horses)

F 7 (transactions carried out by blind persons or workshops for the blind)

B - moderate impact

F 6 (services supplied by undertakers and cremation services)

F 12 (supply of water by public authorities)

F 15 (safekeeping and management of shares, etc.)

C - serious impact

F 2 (services supplied by authors, artists and members of the liberal professions)

F 5 (telecommunications services supplied by public postal services

F 9 (treatment of animals by veterinary surgeons

A - slight impact

F 8 (supply of goods and services for cemeteries commemorating war dead)

F 11 (services of experts in connection with insurance claims)

F 13 (management of credit and credit guarantees)

F 14 (debt collection)

F 18 (supplies of goods and services relating to commercial inland waterway vessels)

F 19 (supplies of some used capital goods)

F 20 (supplies of recuperable material and fresh industrial waste)

F 21 (goods for the fuelling and provisioning of private boats)

F 22 (goods for the fuelling and provisioning of aircraft for private use)

F 24 (transport of goods on the Rhine and Moselle)

B - moderate impact

F 26 (transactions concerning gold other than gold for industrial use

C - serious impact

F 10 (transactions of hospitals)

F 16 (supplies of buildings and land)

F 17 (passenger transport)

F 23 (supplies of goods and services relating to aircraft used by State institutions)

F 25 (supplies of goods and services relating to warships)

F 27 (services of travel agents relating to journeys within the Community)

It may be seen that the number of derogations falling into each of the three categories is as follows:

ANNEX E

slight impact	moderate impact	serious impact
7	2	3

ANNEX F

slight impact	moderate impact	serious impact
14	4	9

This breakdown shows that the great majority of the derogations come under the heading "slight impact". Nevertheless, in Annex F, there is a relatively large number of derogations involving "serious impact". There is some tendency in Member States to end the derogations provided for in Annex F, mainly as a result of the growing budgetary difficulties which most of them are facing. These difficulties should have a favourable influence on the standardization of the basis of assessment for VAT.

In discussing the abolition of the various derogations, another factor to be taken into consideration is the extent to which competition is distorted, since a number of the derogations do in fact generate distortions of competition within the Community (for example, the derogation relating to transactions concerning gold, the derogation relating to passenger transport and those relating to travel agents).

Irrespective of the financial and competitive criteria mentioned above, it should nevertheless be observed that certain classes of service in Annexes E and F have an essentially social character. This is especially the case with some of the classes of services belong to Annex F (principle of taxation at the definitive stage)., in particular F 6, 7, 8 and 10.

3 - FREEDOM TO MAINTAIN OR GRANT THE RIGHT TO OPT FOR TAXATION (Article 28(3)(c) and Annex G to the Sixth Directive)

So as to obviate or mitigate the economic disadvantages caused by exemptions, several Member States made legislative provision for the right to opt for taxation in certain specific cases. The rights of option in respect of transactions which will in any case have to be taxed at the end of the transitional period are being maintained on the basis of paragraph 1(b) of Annex G to the Directive; for the purposes of the common system of VAT, such options should not cause any particular difficulties.

A much more differentiated view must be taken of the other rights of option allowed under the Directive but relating to transactions which are or will have to be normally exempted: this category covers the rights of option referred to in paragraph 2 of Annex G - which were allowed to be maintained "until at the latest the end of three years from the date the Directive comes into force".

By contrast, paragraph 1(a) of Annex G allows Member States freedom to

i.e. transactions which will in any case have to be exempted at the end of the transitional period. This freedom, which is itself transitional, is difficult to justify from the point of view of the common system of VAT. However, it should be noted that the cases in which this freedom is actually used are exceptional and of minor importance; it should therefore be possible to abolish this transitional provision fairly rapidly.

4 - FREEDOM TO DEROGATE FROM THE PRINCIPLE OF IMMEDIATE DEDUCTION (Article 28(3)(d))

Only France has made use of the freedom to derogate from the principle of immediate deduction. In France, the input tax on goods not constituting fixed assets and on services is deducted from the tax payable by the taxable person in respect of the month following that during which the right to deduction arose.

Under French legislation, "fixed assets" includes goods of any nature acquired or produced by an undertaking for permanent use as working equipment or means of operation (land, buildings, plant, transport equipment, patents, licences, etc.).

This time lag of one month obviously affects the cash position of firms, who have to finance the tax for a longer period than in the normal case where immediate deduction is applied.

A rough calculation based on figures for 1974 showed that the additional economic burden on French firms amounted to FF 650 million.

This figure would have to be multiplied by at least two to bring it up to date, taking account of the effects of inflation and, above all, the rise in interest rates. The figure is of course approximate, but gives a fair idea of the comparative disadvantage which this rule imposes on French firms compared with firms in other Member States in which immediate deductibility is the general rule.

The abolition of this derogation could be accompanied by technical arrangements designed to spread its effects over time.

FREEDOM TO DEROGATE FROM THE PRINCIPLE THAT CERTAIN SUPPLIES ARE TREATED AS TAXABLE TRANSACTIONS AND CERTAIN AMOUNTS RECEIVED ARE NOT INCLUDED IN THE TAXABLE AMOUNT (Article 28(3)(e))

This involves three sorts of derogation which may be applied during the transitional period :

(a) derogation from Article 5(4)(c), i.e. the right not to consider as supplies "the transfer of goods pursuant to a contract under which commission is payable on purchase or sale";

(b) derogation from Article 6(4), i.e. the right not to consider certain persons taking part in a supply of services as having received and supplied such services themselves;

(c) derogation from Article 11 A(3)(c), i.e. the right to include in the taxable amount of taxable transactions repayments for expenses paid out by the seller for the account of the purchaser.

These derogations are made use of in national legislations in the following manner :

- all three cases in French legislation;
- (b) and (c) in Danish legislation;
- (a) and (b) in United Kingdom legislation.

Given the very limited extent to which use is made of these derogations within the Community abolishing them is unlikely to create any major difficulties.

6 - FREEDOM TO TAKE THE DIFFERENCE BETWEEN THE SELLING PRICE AND THE PURCHASE PRICE AS THE TAXABLE AMOUNT FOR CERTAIN REAL PROPERTY TRANSACTIONS (Article 28(3)(f))

This provision, which covers "supplies of buildings and building land purchased for the purpose of resale by a taxable person for whom tax on the purchase was not deductible", mainly applies to taxable persons dealing in buildings that are not newly constructed or to land whose acquisition is outside the scope of value added tax.

This freedom to tax only the margin is used solely in France. However, various factors must be taken into account in assessing the case for it :

- under the final system, the supply of buildings that are not newly constructed will be exempt (Article 13 B (g));
- taxpayers may be allowed to opt for the taxation of the abovementioned supply of buildings (Article 13 C(b));
- many countries currently exempt the supply of building land under the transitional provisions (Article 28(3)(b) and Annex F to the Sixth Directive);
- this freedom meets the same concerns as those underlying the proposal for a Seventh Directive on the common system of value added tax to be applied to used goods.

Consequently, the Commission considers that this freedom should be maintained as long as the application of VAT to immovable property is governed by transitional provisions.

7 - FREEDOM TO CONTINUE TO EXEMPT WITHOUT REPAYMENT OF INPUT TAX THE SERVICES OF TRAVEL AGENTS (Article 28(3)(g))

The freedom to derogate during the transitional period from the provisions of Articles 17(3) and 26(3) concerning travel agents is used in Luxembourg (though not in the case of travel agents acting in the name and for the account of the traveller), Ireland and Denmark.

In the Netherlands, the special scheme for travel agents provides for exemption of foreign travel organized by such agents. In certain cases, however, the exemption does not exclude repayment of input tax.

This sort of freedom merely adds a further derogation to those already included in Annex E (point 15) and Annex F (point 27) to the Sixth Directive and mentioned previously under points 2 and 3 of this report.

The Commission would underline the paradoxical nature of this situation during the transitional period, the Council having seen fit to provide for a special scheme for travel agents, set out in Article 26 of the Sixth Directive.

The only progress which has been achieved in this matter is that a uniform place for taxation and taxable amount have been determined, but progress is slim if one bears in mind that some member countries continue to tax the remuneration which travel agents receive for journeys made outside the Community (this is the case in Germany and Belgium), whereas other member countries continue to exempt the remuneration which travel agents receive for journeys made within the Community (this is the case in Denmark, France, Ireland and the Netherlands).

Since the establishment of a genuine common system of VAT in respect of the activities of travel agents is a matter of considerable importance, not only in the context of tax harmonization, but also and especially from the point of view of other Community measures such as the drive to developtourism, it is desirable that these derogations should be abolished as soon as possible, despite the difficulties which might be involved.

A N N E X I

ZERO-RATING OF GOODS AND SERVICES IN MEMBER STATES' VAT LEGISLATION

(Situation at 1 July 1982)

ANNEX I

Some Member States apply zero-rating within the country to the following transactions:

ITALY

- The supply of daily newspapers ;
- the supply of land not liable to be used as building land ;
- the supply of pasta products, bread and milk of a kind used for human consumption (1) ;
- certain transactions carried out in connection with assistance to victims of earthquakes in the south of Italy (temporary measure for the period from 1.1.1981 to 31.12.1981, extended until 31.12.1982 and authorized by the Council (2).

BELGIUM

- The supply of daily and weekly newspapers.

IRELAND (3)

- The carriage of goods in the State in execution of a contract to transfer the goods to a place outside the State ;
- animal feeding stuff (excluding feeding stuff for domestic pets) ;
- fertilizer which is supplied in units of not less than 10 kilograms ;
- services provided by the Commissioners of Irish Lights ;

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(1) Zero-rating introduced after 31.12.1975. Infringement proceedings initiated by the Commission.

(2) Decision 81/890/EEC of 3.11.1981 (OJ No L 322, 11.11.1981, p. 40), Decision 82/424/EEC of 21.6.1982 (OJ No L 184, 29.6.1982, p. 26).

(3) Some of the items listed are being examined to see whether they comply with the provisions of Article 28(2).

- food and drink of a kind used for human consumption (excluding certain products such as alcoholic beverages, manufactured beverages, ice cream and confectionery) ;
- medicine of a kind used for human oral consumption ;
- medicine of a kind used for animal oral consumption (excluding medicine for domestic pets) ;
- seeds, plants, trees, etc., of a kind used in order to produce food ;
- books (excluding newspapers, periodicals, catalogues, etc.) (1) ;
- articles of personal clothing and footwear (excluding articles of clothing made of fur skin) ;
- fabrics and other articles of a kind used in the manufacture of clothing ;
- invalid carriage, crutches, orthopaedic appliances and other artificial parts of the body (excluding artificial teeth) (1) ;
- sole and upper leather of a kind supplied for the manufacture and repair of footwear, heels, etc. ;
- coal, gas, electricity, candles and hydrocarbon oil of a kind used for heating or lighting.

UNITED KINGDOM (2)

- Food of a kind used for human consumption and animal feeding stuffs, with the exception of certain prepared products such as ice cream, chocolates, manufactured beverages or beverages chargeable with any excise duty, and pet foods ;
- seeds or other means of propogation of plants comprised in the above paragraph ;

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(1) Zero-rating introduced after 31.12.1975. Infringement proceedings initiated by the Commission.

(2) Some of the items listed below are being examined to see whether they comply with the provisions of Article 28(2).

- live animals of a kind generally used as, or yielding or producing, food for human consumption ;
- sewage services ;
- water other than distilled water ;
- books, newspapers, journals, periodicals, music, maps, etc. ;
- the supply of magnetic tape and tape recorders to the Royal National Institute for the Blind ;
- the supply to a charity of wireless receiving sets solely for gratuitous loan to the blind ;
- the publication in any newspaper, journal or periodical of any advertisement, and the supply of services for the purpose of securing such a publication ;
- the supply of information to newspapers ;
- coal, gas, electricity, hydrocarbon oil (except that on which a customs or excise duty has been or is to be charged) ;
- construction of buildings (i.e. the granting, by a person constructing a building, of a major interest in the building, and the supply, in the course of the construction, alteration or demolition of any building, of any services other than the services of an architect, etc.) ;
- the supply, by a person supplying the services mentioned above, of certain materials, excluding any work of repair or maintenance ;
- the transport of passengers in any vehicle, ship or aircraft carrying not less than 12 passengers, or by the Post Office, or on any scheduled flight ;
- the transport of passengers or freight to or from a place outside the United Kingdom ;
- the supply of certain caravans ;
- drugs, medicines, medical and surgical appliances, etc. (excluding hearing aids, dentures, spectacles, etc.) ;
- the supply by a charity of any goods which have been donated for sale ;
- articles designed as clothing or footwear for young children ;
- protective boots and helmets for industrial use.

DENMARK

- The supply of newspapers published at least once a month ;
- the transportation within the country of goods coming from a foreign country ;
- subscriptions for foreign periodicals from a foreign publisher on behalf of a subscriber.

A N N E X II

Temporary derogations from the rules on exemption or taxation laid down in the Sixth VAT Directive

Table No. 1 : Temporary derogations from the rules on exemption (Annex E to the Sixth Directive)

Table No. 2 : Temporary derogations from the rules on taxation (Annex F to the Sixth Directive)

ANNEX II

Table No 1

TRANSACTIONS REFERRED TO IN ANNEX E. (EXEMPT TRANSACTIONS UNDER THE FINAL SCHEME)	COUNTRIES THAT HAVE MAINTAINED TAXATION
1. Parcel post services	Denmark
2. Services supplied by dental technicians ; the supply of dental prostheses	Germany Belgium Ireland
3. Services supplied by independent groups of persons exempt from or not subject to VAT	Belgium France Luxembourg Ireland
4. Services linked to sport or physical education supplied by non-profit-making organizations	Germany United Kingdom
5. Cultural services supplied by bodies governed by public law	Denmark Ireland United Kingdom
6. The supply of transport services for sick or injured persons in ambulances	France United Kingdom
7. The supply of services by public radio and television bodies	Denmark Italy
8. The supply of services by intermediaries relating to the negotiation of credit guarantees or any other security for money and the management of credit guarantees	—
9. The supply of services by intermediaries relating to transactions in transferable securities .	United Kingdom
10. Management of investment funds	Ireland United Kingdom
11. The supply of buildings that are not newly constructed	Denmark France (estate agents) Ireland Italy Netherlands (on option according to criteria prior to the Sixth Directive)
12. The supply of goods dispatched or transported by a purchaser not established within the territory of the country	Denmark Ireland

Table No 1
(continued)

TRANSACTIONS REFERRED TO IN ANNEX E. (EXEMPT TRANSACTIONS UNDER THE FINAL SCHEME)	COUNTRIES THAT HAVE MAINTAINED TAXATION
13. The supply of goods and services in respect of aircraft used for reward on international routes	-
14. Goods supplied to approved bodies which export them as part of their humanitarian activities	Denmark Ireland
15. The services of travel agents for journeys outside the Community	Germany Belgium Luxembourg

Table 2

TAXED TRANSACTIONS UNDER THE FINAL SCHEME (TRANSACTIONS REFERRED TO IN ANNEX F)	COUNTRIES THAT HAVE MAINTAINED EXEMPTION
1. Admission to sporting events	Denmark France Ireland Luxembourg
2. Services supplied by authors, artists and members of the liberal professions	Belgium Denmark France Netherlands
3. Supply of services by means of agricultural machinery	France
4. Supply of greyhounds and thoroughbred horses	Ireland
5. Telecommunications services supplied by public postal services	Germany France Ireland Italy (only telegraph) Luxembourg Netherlands
6. Services supplied by undertakers and cremation services	Denmark Ireland Italy Netherlands United Kingdom
7. Transactions carried out by blind persons or workshops for the blind	Germany Denmark France Netherlands
8. The supply of goods and services for cemetries, etc. commemorating war dead	Belgium France Luxembourg
9. Treatment of animals by veterinary surgeons	Belgium Netherlands Ireland
10. Transactions of hospitals	Belgium, Ireland and the United Kingdom exempt the whole of this sector but consider that the exemption falls under Article 13
11. Services of experts in connection with insurance claims	France Netherlands

Table no. 2
(continued)

TRANSACTIONS REFERRED TO IN ANNEX F (TAXED TRANSACTIONS UNDER THE FINAL SCHEME)	COUNTRIES THAT HAVE MAINTAINED EXEMPTION
12. The supply of water by public authorities	France Ireland Luxembourg
13. Management of credit and credit guarantees	Denmark Germany Luxembourg
14. Debt collection	-
15. The safekeeping and management of shares, etc.	Denmark Germany Luxembourg
16. Supplies of new buildings and building land	Belgium Denmark Germany Luxembourg
17. Passenger transport	Virtually all Member States, but in particular : Denmark and Ireland
18. The supply of goods and services relating to commercial inland waterway vessels	Belgium
19. Supplies of some used capital goods	France
20. Supplies of recuperable material and fresh industrial waste	Belgium France
21. Goods for the fuelling and provisioning of private boats proceeding outside the national territory	United Kingdom
22. Goods for the fuelling and provisioning of aircraft for private use	United Kingdom
23. The supply of goods and services relating to aircraft used by State institutions	Belgium Denmark Italy
24. The transport of goods on the Rhine and the canalized Moselle	France
25. The supply of goods and services relating to warships	Belgium Denmark Italy Netherlands

Table No. 2
(continued)

TAXED TRANSACTIONS UNDER THE FINAL SCHEME (TRANSACTIONS REFERRED TO IN ANNEX F)	COUNTRIES THAT HAVE MAINTAINED EXEMPTION
26. Transactions concerning gold other than gold for industrial use	France Luxembourg
27. The services of travel agents for journeys within the Community	Denmark France Ireland Netherlands

CONFIDENTIAL

Prime Minister informed

CDP
4/3

Qz.04805

MR POWELL

EUROPEAN COMMUNITY: VAT ZERO RATES

Following the discussion in OD(E) on 13 February, the Chancellor of the Exchequer has decided to answer an arranged Parliamentary Question and issue a press notice tomorrow about the Commission's challenge to the United Kingdom on zero rates on certain goods and services. The goods and services under challenge are listed in the draft press notice. We have proposed to the Treasury that at the end of the press notice they should add that "The Commission is not challenging the zero rating of food in the shops" since otherwise we consider the press might misunderstand the point and create unnecessary difficulty for the Government.

I am sending a copy to Sir Robert Armstrong.

D F Williamson

D F WILLIAMSON

3 March 1986

CONFIDENTIAL

RP2.52

CONFIDENTIAL

878

cc M Williamson
M Holroyd
M Jay

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

27 February 1986

Colin Budd Esq
Private Secretary to the
Secretary of State for Foreign and
Commonwealth Affairs

Dear Colin,

VAT ZERO RATES: PROCEEDINGS AGAINST THE UNITED KINGDOM UNDER ARTICLE 169 OF THE EEC TREATY

At OD(E) on 13 February, it was decided to make an early public statement about the Government's intention to contest the Commission's challenge of the UK's zero rating of a number of goods and services. The Chancellor was asked to show the statement in advance to directly concerned colleagues and I enclose a copy of a draft Parliamentary Question and Answer, together with briefing and a draft Press Notice which will be issued on the day the Question is answered. If you are content, the Chancellor would like the Question answered on Tuesday 4 March. So unless I hear to the contrary the question will go down on Monday 3 March.

I am copying this to the Private Secretaries to the Chancellor of the Duchy of Lancaster, Secretaries of State for Energy, Wales, Northern Ireland, Ministry of Agriculture, Fisheries and Food, Environment, Scotland, Trade and Industry to the Solicitor General, the Chief Whip and Sir Robert Armstrong.

Yours sincerely,

Philip Wynn Owen.

P WYNN OWEN
Assistant Private Secretary

DRAFT ARRANGED PARLIAMENTARY QUESTION

To ask Mr Chancellor of the Exchequer if he will make a statement on the current position on the difference of view between the EC Commission and Her Majesty's Government regarding the zero rating of certain goods and services

The EC Commission has applied to the European Court of Justice for a declaration against the United Kingdom that the zero rating of certain goods and services is incompatible with the Sixth VAT Directive, as not being for clearly defined social reasons or for the benefit of the final consumer. The Government does not accept this contention and will defend the issue before the European Court. It is unlikely that the case will be heard, at the earliest, before the end of the year.

DRAFT PRESS NOTICE

VAT : UNITED KINGDOM ZERO RATES : REFERENCE TO EUROPEAN COURT

The Minister of State, Treasury, announced today the Government's position with regard to the reference by the EC Commission to the European Court of Justice of the infraction proceedings on certain supplies currently zero-rated in the United Kingdom.

In reply to a Parliamentary Question:

> "To ask Mr Chancellor of the Exchequer if he will make a statement on the current position on the difference of view between the EC Commission and Her Majesty's Government regarding the zero rating of certain goods and services"

the Minister of State, Treasury, Mr Peter Brooke, gave the following Written Answer:

"The EC Commission has applied to the European Court of Justice for a declaration against the United Kingdom that the zero rating of certain goods and services is incompatible with the Sixth VAT Directive, as not being for clearly defined social reasons or for the benefit of the final consumer. The Government does not accept this contention and will defend the issue before the European Court. It is unlikely that the case will be heard, at the earliest, before the end of the year."

The Commission's challenge covers a wide range of supplies of goods and services as follows:-

- animal feedstuffs, seeds, live animals yielding food for consumption - (all supplies)
- sewerage services and water - (supplies to industry)
- news services - (all supplies)
- fuel and power - (supplies other than to final consumers)
- construction, buildings, etc - (supplies other than to final consumers "within a social policy")

- protective clothing and footwear - (supplies to employers)

The Commission are now challenging the zero rate in the UK

Note to Editors

1. The EC Commission first wrote to the United Kingdom on this issue in October 1981, prior to their commencement of infraction proceedings which led to the issue of their Reasoned Opinion in September 1984. The Government replied rebutting the Commission's assertions. Its view has not altered since then.

2. In his 1985 Budget Statement, the Chancellor of the Exchequer referred to the Commission's challenge. Having announced his intention not to make any further extensions of the VAT base during the lifetime of this Parliament, he added: "This is, of course, a field in which European Community law has to be reckoned with and where we are bound by our Treaty obligations. But as the House will be aware, where we are currently under challenge, we are vigorously fighting our case."

3. Provided that they were in existence before the end of 1975, zero rates are permitted in Community legislation where the supplies are made "for clearly defined social reasons and for the benefit of the final consumer". Correspondence at official level has failed to obtain from the Commission their definitive position on these criteria. Should the Commission's case be upheld in the European Court, in whole or in respect of individual items, the United Kingdom would be obliged to tax the supplies in question at a positive rate. The Court's judgment in the case could be expected some three months after the hearing.

ZERO RATES INFRACTION PROCEEDINGS : GENERAL BRIEFING

1. **When will the case be heard at the European Court?**

Probably not before the end of this year. There is at present a logjam of cases waiting to be heard in the European Court and this one will take its turn.

2. **When will the Court deliver its judgment?**

It is expected to be some three months or so after the case is heard (which itself is not expected to be before the end of this year).

3. **Will the Commission's statement of case and the United Kingdom's pleadings be made public?**

The Court hearing will be held in public, but the prior submissions to the Court are confidential to the parties involved.

4. **What is the UK Government's view?**

The Government's view has not changed throughout the various stages which have culminated in reference to the European Court. It does not accept the Commission's contention and will contest the case vigorously.

5. **What would be the effect if UK were to lose the case at the European Court?**

The Government would have to study the terms of the Court's decision; but, if the zero rating of the supplies which have been challenged were ruled to be illegal, the Government would feel bound to impose taxation on them at a positive rate.

6. **How long has the Commission maintained its view on UK zero rates?**

The assertion that the zero rating of certain supplies was illegal was first raised by the Commission in correspondence in 1981. Following informal discussion, the Commission issued in September 1984 its 'Reasoned Opinion' which is the formal document setting out why the Commission considers that an aspect of the member state's legislation conflicts with Community Law.

7. **What is the Community law in question?**

The Sixth VAT Directive which was agreed by member states in 1977 and came into force in the UK in 1978. Article 28 permitted the continuation of zero rates in force at the end of 1975 provided that they were 'for clearly defined social reasons and for the benefit of the final consumer'.

8. **What is wrong with the UK zero rates?**

All of them were in force in 1975 but the Commission claims that certain of them are not restricted to the benefit of the final consumer in so far as they cover goods and services supplied to businesses.

9. **What is a 'final consumer'?**

There is no definition in Community law for this purpose. Private individuals are clearly covered but there is dispute as to whether the term may be interpreted widely to include indirect as well as direct benefit to the final consumer.

10. **Did the UK agree the Sixth Directive?**

The UK agreed, as did all other member states. The Sixth Directive permitted member states to continue to apply zero rates which met certain criteria. None of the UK's zero rates was challenged by the Commission at the time when we agreed to the Directive, and we had no indication from the Commission at that time that any of them were unacceptable.

11. **What businesses would be worst hit?**

Businesses in sectors exempt or partly exempt from VAT which could not recover tax charged on construction, fuel and power, etc. The finance and insurance industries in particular; but public and health authorities could also be affected.

12. **Would private individuals be hit at all?**

Perhaps marginally if irrecoverable tax incurred by businesses could not be absorbed. Otherwise, only if the Commission's case on construction includes and is successful with regard to any form of housing. The Commission have failed to clarify this aspect in their case.

13. **What would be the effect on the Retail Price Index?**

Negligible.

14. **Will this mean paying more money to the Community?**

No. Payments are already made to the EC Budget in respect of items zero rated. The Commission has stated that additional payment to the Community is not at issue in the case.

15. **How much revenue would be raised?**

Most businesses could recover tax on the supplies concerned. If the current rate of 15% were to be applied to non-domestic construction, it could raise as much as £300m in a full year from exempt or partly-exempt businesses, while fuel and power and news services could raise about £30 million.

16. **Would tax have to be charged at 15%?**

No. The UK Government would decide the appropriate rate or rates if the present zero rating of particular supplies was declared illegal by the European Court.

17. **Is the UK being singled out?**

Ireland which also makes extensive use of zero rates has received a Reasoned Opinion. All member states have been challenged on other VAT matters.

18. **Do other member states zero rate these items?**

No, except for Ireland. Items zero-rated in the UK are generally taxed at reduced rates in other member states.

ZERO RATES INFRACTION PROCEEDINGS : BRIEFING ON INDIVIDUAL GROUPS

1. FOOD

What is covered?

The challenge is **not** related to food in the shops. It relates to live animals; animal feeding stuffs; plants, seedlings etc for growing food or animal feeding stuffs. These are essentially products which will **become** food and which are normally purchased by farmers and not private individuals. Farmers registered for VAT recover any tax charged.

2. SEWERAGE SERVICES AND WATER

What is covered?

Sewerage services and water (other than specialised packaged water eg distilled water), insofar as these are supplied to businesses. Most business users could recover any VAT charged.

3. NEWS SERVICES

What is covered?

The supply of news information to newspapers or the public. No distinction is drawn between business and private users and the overwhelming bulk in value is for business users; much of the tax would therefore be recoverable.

4. FUEL AND POWER

What is covered?

Coal and other solid fuels, oil, gas and electricity **for business users**. The Commission's allegation specifically excludes these fuels when supplied to final consumers. Most businesses would be able to recover the tax.

How would business users be identified?

There would be administrative problems in taxing only business users and this would be examined in detail if the need arose.

5. CONSTRUCTION OF BUILDINGS

What is covered?

The challenge is thought to apply essentially to the construction of new buildings in the non-domestic sector (offices etc); but it is uncertain whether the Commission may have in mind also some forms of housing. They have been asked to clarify their position but have not done so.

What housing could be covered?

In the Government's view no valid distinction for VAT purposes could be drawn or operated between different types of housing. All housing is of social importance.

What would be the effect on business?

There would be increased costs in the exempt private sector, notably the financial sector and also on bodies such as universities, charities and private voluntary schools and hospitals. Applying VAT at 15% to new commercial sector construction could raise up to about £300 million in revenue.

Could there be a low rate for construction?

The adverse effects of taxation could obviously be mitigated by a reduced rate and EC law would allow this. It would, however, involve administrative complications for businesses and the tax authorities. These and other factors would have to be examined in detail should the need arise.

Would rents be affected?

Most rents are exempt from VAT and would probably remain so; but the increased cost of constructing new commercial buildings would feed into rents.

What about sales of existing buildings?

The zero rate applies only to the sale of the freehold or long lease on a new building by the person constructing it. Sales of existing buildings are exempt.

Would jobs be at risk?

If, because of an additional burden of irrecoverable tax, the private sector reduced its requirements for new construction, then there could be consequential effects on employment in the industry.

6. CLOTHING AND FOOTWEAR

What is covered?

Only protective boots and helmets sold to employers. This would have little impact since practically all businesses where protective clothing is necessary could recover the VAT.

What about sales to employees and the general public

The Commission's case does not apply to them.

CONFIDENTIAL

file. ECL

bc PC.

10 DOWNING STREET

From the Private Secretary

4 December 1985

VAT REGISTRATION THRESHOLD INFRACTION PROCEEDINGS

The Chancellor minuted the Prime Minister on 28 November suggesting that she might raise with M. Delors the infraction proceedings which the Commission are proposing to take against the United Kingdom over what they consider the excessive level of our VAT registration threshold.

In the event the Prime Minister raised the matter in the Plenary Session of the European Council and delivered herself of some stern words to the Commission. These should be reflected in the record which is being prepared of the meeting based upon the Foreign Secretary's notes.

I am copying this letter to Colin Budd (Foreign and Commonwealth Office) and to David Williamson (Cabinet Office).

(Charles Powell)

Mrs. Rachel Lomax,
H.M. Treasury.

CONFIDENTIAL

SFW

1/010

CONFIDENTIAL

Prime Minister
I will take a copy to Luxembourg
CDP
29/6

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

VAT REGISTRATION THRESHOLD INFRACTION PROCEEDINGS

I think it would be helpful for you to raise with M. Delors when you see him at the European Council next week the question of the infraction proceedings which the Commission are proposing to take against the United Kingdom over what they consider the excessive level of our VAT registration threshold. I discussed the question with Arthur Cockfield last week, but he claims that he has no longer any power to hold the proceedings up.

If you do have the opportunity to speak to M. Delors in Luxembourg, you may like to draw on the following arguments:

- glad that we are to have the opportunity at this Council to discuss again the question of deregulation. Know that we both attach great importance to the question of reducing the administrative burdens on small and medium sized businesses.

- but on one point in particular affecting the United Kingdom, Commission is pursuing policy that would actually increase burden on large number of businesses. This concerns the maximum permitted VAT registration threshold.

- Commission have launched infraction proceedings against UK because they claim we have indexed our threshold (as we are entitled to do) from too high a base.

Commission formula would leave UK with threshold of around £14,500, rather than £19,500 as at present.

- Keeping threshold high is way UK has chosen to deal with problem of minimizing burden on small businesses. Other member states use different methods, but most recognise that some special treatment is needed. One way is no more 'communautaire' than another. Member states should have the flexibility to tailor their regimes to their individual circumstances.

- Want to ask you, in the light of the work now being done on deregulation, to at least suspend these infraction proceedings until deregulation policy is fully formulated. Unless you do so they will continue of their own momentum.

- Would not be any danger of this being seen as a climbdown by the Commission. More a pragmatic recognition that you are dealing with re-assessed priorities for business in the light of your own deregulation report.

- For Commission to press proceedings in these new circumstances would certainly leave very bad impression in UK. Risks making them look both legalistic and vindictive.

The Commission are also thinking about changes to the Community legislation governing VAT thresholds. Their proposals would also be very unwelcome to the UK. If time permits, therefore, you might like to raise this point as well, on the following lines:

- Also understand that Commission are considering new proposals on VAT registration threshold which would remove the possibility of further indexation of those thresholds above the new limit, which itself would be very much lower than the UK's present threshold.

- Hope that, if this is the case, you will feel able to reconsider. Important that this flexibility should be retained, to allow member states to tailor regimes to their own circumstances.

- Issue has no effect on Community's own resources, nor does it distort international competition.

BACKGROUND

Present VAT registration threshold and infraction proceedings

Under the 1977 Sixth VAT directive, the maximum VAT registration threshold is fixed at 5,000 ecus (c £3,000), except for those member states who already had a larger threshold in 1977. They are allowed to retain and to index their thresholds. On the basis of this, the UK threshold has been progressively increased to £19500.

The particular point on which the Commission have instituted infraction proceedings is the base year from which that indexation has taken place. The UK has indexed its threshold from the £5,000 it was first set at in 1973, whereas the Commission claim it should be indexed from a later year. Their formula would result in a threshold of about £14500. Arthur Cockfield has stalled proceedings for some time, partly by citing the work being done on deregulation, but he now says that he cannot delay things any further.

Deregulation

Following your initiative at last March's European Council and the discussion at Milan, deregulation is to be discussed again in Luxembourg. The Commission have not been making as much progress with setting up a monitoring system as the member states, especially the UK, would like. Delors, however, shares our concern that the administrative burden on small and medium businesses should be reduced wherever possible. So far as VAT is concerned, our policy is to take as many as possible out of the VAT net altogether. Other member states have different methods of dealing with the problem, such as special accounting or collection regimes, but almost all have special arrangements of some sort.

New Commission proposals

Separately, the Commission have proposed that the EEC maximum VAT threshold should be raised. Indexing the present figure would produce about 12000 ecus. The Commission have not yet made a formal proposal, but Arthur Cockfield tells me that he could certainly not get support for a figure above 20000 ecus, and would probably find it difficult to go above 15000 ecus. In addition, the indexation provision from which we have benefitted in the past would be dropped or very severely restricted. (The present UK threshold is equivalent to about 35000 ecus).

N.L.

28 November 1985

FCS/84/321

CHANCELLOR OF THE EXCHEQUER

VAT Exemption Limit

1. Thank you for your minute of 26 November enclosing a revised draft reply to the Commission, and a draft personal letter to Christopher Tugendhat. Taken together they make a very strong case. The quotation from Christopher Tugendhat's letter to John Purvis MEP, is particularly telling. I have one amendment to propose to the draft letter to the Commission (see attachment).

2. I wonder if we might also quote back at the Commission the passage in its Annual Economic Report - which was warmly endorsed at the Dublin European Council - which said that:

> "reductions in the tax burden on employment and enterprise .... should now be a leading component of a strategy to strengthen European economic recovery" (COM(84)587 final, p 34).

This could be related to the references elsewhere in the report to the sharp rise in the numbers of new firms in the UK, and to evidence that small businesses have now become an important factor in job creation (p 105).

3. As regards the suggestion that your letter might raise the possibility of re-examining the policy implications of the Directive itself, I agree that it makes sense to keep this point in reserve until we know how Christopher and the Commission react to your letters and whether they are prepared to drop the case.

/4.

4. I am sending copies of this minute to the Prime Minister, members of OD(E), the Attorney General, the Solicitor General and Sir Robert Armstrong.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
7 December 1984

A N N E X

Paragraph 7 of the revised draft refers to interference in the United Kingdom's internal taxation policy. This might lead the Commission to focus on issues of competence and national sovereignty, instead of concentrating on the practical force of our case. Our point would be sufficiently made if the sentence were amended to read:

> "In these circumstances, the current pressure to reduce the limit appears to my authorities to be unnecessary, and likely to hinder rather than advance the prospects for further fiscal harmonisation."

6.7

CONFIDENTIAL

1. CP to see

2 Prime Minister (2)

The letter at X has been revised and made more forceful. No need to read again. But you might like to see the Chancellor's personal letter at Y

AT 28/11

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

FOREIGN SECRETARY

VAT EXEMPTION LIMIT

X 1 I attach a revised version of the draft reply which I suggest UKRep in Brussels might send to Christopher Tugendhat in reply to his letter of 4 September to you about the present VAT registration exemption limit. This takes account of the comments made in your minute of 13 November, Michael Havers' of 5 November, and the Prime Minister's views as recorded in the minute of 14 November from her Office.

Y 3 1 2. I also enclose a draft of the personal letter which, subject to your views, I intend to send to Christopher Tugendhat as soon as the formal response has been despatched.

3. I am copying this letter to the Prime Minister, members of ODE, the Attorney General, and Sir Robert Armstrong.

(N.L.)

26 November 1984

(X)

DRAFT LETTER FROM UK PERMANENT REPRESENTATIVE TO THE EC TO COMMISSIONER TUGENDHAT

VALUE ADDED TAX: REGISTRATION EXEMPTION LIMIT

I have the honour to refer to your letter of 4 September addressed to the Secretary of State for Foreign and Commonwealth Affairs in which you record the Commission's view that the limit of £18,700 currently applied to the exemption from registration for value added tax in the United Kingdom contravenes Article 24 of the Sixth Council Directive on VAT.

Before dealing with the purely legal arguments set out in your letter, it is important to recall the negotiations which led to the adoption of the Directive, and to emphasise the political and practical consequences of applying the Commission's interpretation of Article 24.

The purpose of the exemption limit is to exclude from the tax those small businesses who would have the greatest difficulty in complying with its legal requirements, and whose control would require an expenditure of resources by the fiscal authorities quite disproportionate to the revenue involved. Throughout the protracted negotiations on the draft Sixth Directive, the United Kingdom made it clear that it was of the utmost importance to the efficient administration of the tax, and to its public and political acceptability, that the Government should remain free to increase the exemption limit from time to time up to the maximum needed to maintain the real value of the original limit of £5,000 (which applied at the beginning of the tax on 1 April 1973). It was only on the understanding that Article 24 would not restrict the right to revalorise the limit in full that the United Kingdom was able to accept the Article and, indeed, the Directive as a whole. The interpretation which the United Kingdom intended to adopt was made perfectly clear at the meeting of COREPER on 4 February 1976, and although the Commission's representative on that occasion stated that it was "more desirable" that the base date for revalorisation should be the date on which the Directive entered into force,

it is significant that he neither disputed the United Kingdom's interpretation nor proposed an alternative text to put the matter beyond doubt. Had there been any suggestion that the Commission would ultimately seek to impose its views by means of infraction proceedings, the United Kingdom might well have decided to revalorise the limit shortly before the Directive came into force on 1 January 1978, a course of action which would have been entirely consistent with the view now adopted by the Commission.

The Commission was, at the very least, content to allow an ambiguity to remain in the text of Article 24, and it is in the view of the United Kingdom morally and politically inadmissible for the Commission to attempt to exploit that ambiguity at this late stage without demonstrating that there are overriding grounds of Community policy for interfering with the system which has hitherto operated without challenge since 1 January 1978.

Reducing the limit from £18,700 to £14,110 in accordance with the Commission's demand would have unacceptable consequences for the administration of the tax in the United Kingdom. An estimated additional 174,000 businesses would be required to register, and a further 600 VAT officers would have to be recruited to maintain present standards of control. The marginal cost of collection of the tax in respect of these businesses would be excessive in relation to the likely yield.

Small business interests in the United Kingdom would rightly see the change as running counter to the declared policies of successive United Kingdom Governments and of the Community itself, to encourage the birth and expansion of small businesses as an essential ingredient in the effort to overcome high levels of unemployment. The effect of the administrative burden of accounting for VAT on those small businesses who would be required to register because of the change would be disproportionately high when compared with the position of their larger registered competitors. The weight of this burden on small businesses, which you recognised in your speech on behalf of the Commission to the Congress of the Confédération Fiscale Européene at Aachen

on 30 September 1982, would be particularly onerous for vulnerable new businesses, but would also have a restrictive effect on the expansion of a sector which has great growth potential.

The United Kingdom is not aware that a reduction in the exemption limit would produce any tangible benefits at a Community level. The present exemption has no effect on the United Kingdom's VAT own resources contribution, and causes no significant distortion in intra-Community trade. In these circumstances, the current pressure to reduce the limit appears to my authorities to be an unnecessary interference with the internal taxation policy of the United Kingdom, and one likely to hinder rather than to advance the prospects for further fiscal harmonisation.

The United Kingdom rejects the legal arguments put forward in your letter of 4 September against its interpretation of Article 24. It is not clear from earlier correspondence whether the Commission believes that the base date for revalorisation of the limit should be 17 May 1977, the date on which the Directive was adopted by the Council, 1 January 1978, the date on which it came into force in the United Kingdom, or 1 January 1979, the date on which it finally came into force in all Member States. The United Kingdom sees nothing in the text of Article 24 to require the adoption of any of these dates in preference to one in 1973, which, for the reasons explained in earlier correspondence, is more consistent with the concept of maintaining the real value of the original limit. The reference in Article 24 to the "date on which this Directive comes into effect" relates clearly and specifically to the conversion rate for the 5,000 ECU threshold which determines whether or not an individual Member State is entitled to revalorise in accordance with the Article. It has no relevance to the determination of the base date for revalorisation itself.

The United Kingdom is therefore unable to accept the Commission's contention that it is in breach of its Community obligations by maintaining the real value of the VAT exemption limit in force in 1973. My Government hopes that in the light of the considerations set out in this letter the Commission will not feel it necessary to pursue the matter further.

CONFIDENTIAL AND PERSONAL

(Y)

DRAFT PERSONAL LETTER FROM CHANCELLOR TO COMMISSIONER TUGENDHAT

I understand that Michael Butler has replied on behalf of the Government to your letter of 4 September to Geoffrey Howe about the UK's VAT exemption limit. I am writing to underline the enormous political and economic difficulties which would quite unnecessarily be caused if I were to contemplate reducing the limit to the level you propose, or even freezing it at its present level.

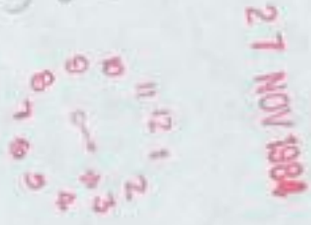
Your proposal that our exemption limit should be cut from £18,700 to £14,110 would, as you know, result in a substantial number of smaller businesses having to register and require an extra 600 VAT officials, at a time when we are trying to remove unnecessary administrative burdens from small b;usinesses to enable them to grow and create more jobs. And as you recognised in your speech to the CCFE in Aachen in September 1982, the VAT machinery imposes a heavy burden in terms of accounting invoicing the preparing tax returns on small firms. Yet, I would find it hard to point to any compensating benefits other than a purely token gesture in the direction of fiscal harmonisation. It is just such apparently empty and potentially damaging gestures which make it so difficult for us to secure public understanding of the Community's broader purpose.

I also find it hard to understand why the question of our exemption limit was not raised until 5 years after the Sixth Directive came into force in the UK, particularly when the method of revalorisation we intended to use was made clear to the Commission and other Member States during the discussions on article 24. We have been given no indication hitherto that our system of revalorisation was thought by the Commission to conflict with the Directive. You yourself implicitly confirmed that the UK's action was in line with the Directive when in your letter of March 1982 to John Purvis (then MEP for Mid Scotland and Fife) you commented that "the relatively high threshold of £15,000 which now applies in the UK is in conformity with the terms of the Directive". This was consistent with your reply on 3 August 1981 to the Written Question by Mr Tuckman and Mr Schnitker; yet the Commission now seek to argue that the correct value in March 1982 should have been not £15,000 but £11,865.

To embark on formal infraction proceedings in these circumstances would create political and economic difficulties for the Government, serious problems for small traders in the UK, embarrassment for the Commission, and no discernible practical benefit to the Community. I very much hope, therefore, that the Commission will accept in the light of the arguments in Michael Butler's letter that this is not a matter which calls for further action on their part.

I am sorry to have to write in these terms, but it is an issue on which the Prime Minister and Geoffrey Howe feel as strongly as I do that the Commission is set on a needlessly provocative course.

EOW PR: VAT Zero Rate
Feb 82



CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

14 November 1984

VAT EXEMPTION LIMIT

The Prime Minister has seen the Chancellor's minute of 29 October to the Foreign and Commonwealth Secretary, the latter's reply of 13 November and the Attorney General's letter of 5 November. She agrees with the line which the Chancellor is suggesting be taken in rejecting the Commission's arguments. She endorses, also, the suggestions made by the Foreign and Commonwealth Secretary for toughening up the statement, and agrees that we should make it clear that if the Commission is not prepared to drop the proceedings we would want to look seriously at the policy implications of the Directive itself.

I am copying this letter to the Private Secretaries to members of OD(E), Henry Steel (Law Officers' Department) and Richard Hatfield (Cabinet Office).

ANDREW TURNBULL

David Peretz Esq.,
HM Treasury.

CONFIDENTIAL

10 DOWNING STREET

Prime Minister (2)

To note that Treasury and FCO are now getting on with the task of challenging the Commission's arguments on VAT exemption limits.

FCO's suggestions are (for once) helpful.

AT

13/11

FCS/84/296

CHANCELLOR OF THE EXCEHQUER

VAT Exemption Limit

1. Thank you for your minute of 29 October enclosing a draft reply to Christopher Tugendhat's letter of 4 September. I agree with the line you suggest we take in rejecting the Commission's arguments. It would be absurd to require 174,000 small businesses to register for VAT, and to take on 600 extra VAT officers. We must get the Commission to think again. To this end I have the following suggestions.

2. Over the years in which this has been under discussion there has been a growing realisation of the importance for job creation of small enterprises - of exactly the kind that would suffer if our general case was not accepted. The political impact of the arguments in the fifth paragraph should in my view be strengthened by mentioning examples of the kinds of business likely to be affected by a lower exemption limit, and by giving chapter and verse of the enterprise policies (both our own and of the Community) with which this would conflict.

3. The third sentence of the final paragraph could be misinterpreted by the Commission as an indication that we are prepared to discuss a compromise. It might be preferable to delete the third and fourth sentences, leaving the Commission with the firm statement of our position in the first two sentences.

4. At the same time I would not wish to drop the idea of a high level approach to try to persuade the Commission to drop its infraction proceedings. The best way of doing this, I would suggest, might be for you to write personally to Christopher Tugendhat, reinforcing the main points in our

/formal

formal reply and pointing up in particular the contradiction between the Commission's challenge and our policy of improving the supply side by lightening unnecessary burdens on business - a policy to which the Commission is equally committed. You might also wish to make it clear that if the Commission is not prepared to drop the proceedings we would want to look seriously at the policy implications of the Directive itself. This would be consistent with the Prime Minister's suggestion that we should, if necessary, seek to have the existing VAT Directive amended. It should also improve our chances of carrying the matter over for further discussion with the new Commission. If the issue were brought by the Commission to the European Court our case, as you know, would not be legally strong. The worst outcome from our point of view would be a Court judgement requiring us to impose the full burden of the Commission's proposals on small traders.

5. I have seen the Attorney General's letter of 5 November and am content with the amendments he proposes.

6. I am sending copies of this minute to the Prime Minister, members of OD(E), the Attorney General, the Solicitor General and Sir Robert Armstrong.

Foreign and Commonwealth Office

13 November 1984

GEOFFREY HOWE

ELOW PSL: VAT zero rating

Yes SL

CF

pps pse ?

With the compliments of

the Attorney-General

Attorney General's Chambers,
Law Officers' Department,
Royal Courts of Justice,
Strand. W.C.2A 2LL.

01 405 7641 Extn. 3201

CONFIDENTIAL

CE 86

ROYAL COURTS OF JUSTICE
LONDON, WC2A 2LL

01-405 7641 Extn

5 November, 1984

Dear Geoffrey

VAT EXEMPTION LIMIT FOR SMALL TRADERS

I have seen the minute of 29 October 1984 from the Chancellor of the Exchequer to you concerning the above matter.

Whilst I am generally content with the proposed letter, I would suggest that the amendments set out in the annexe to this letter be made in view of the attitude adopted by the United Kingdom at the meeting of COREPER of the 4 February 1976 and in the letter from UKREP to the Commission of the 4 May 1983, where the United Kingdom argued that the base date was the 23 June 1973 (as opposed to the 1 April 1973, which is the current contention). The changes I have suggested will leave the general approach of the letter unaltered but will avoid drawing undue attention to the United Kingdom's change of attitude.

Copies of this letter go to the Prime Minister, other members of OD(E), and Sir Robert Armstrong.

Yours ever Michael.

The Rt Hon Sir Geoffrey Howe QC MP
Secretary of State for Foreign and Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
London SW1A 2AL

CONFIDENTIAL

Proposed Amendments to Draft Letter from

UK Permanent Representative to the EC

to Commissioner Tugendhat

Page 1: Paragraph 3 line 12: Insert brackets around the phrase "which applied at the beginning of the tax on 1 April 1973".

Page 2: Paragraph 1 line 8: Delete the words "rather than 1 April 1973".

Page 3: Paragraph 2 line 10: Delete "1 April" and insert "one in".

Page 3: Paragraph 3 lines 3/4: Delete "on 1 April" and insert "in".

2.24

CONFIDENTIAL

cc CST
FST
MST
EST
Mr Lord
Mr Monger
PS/C&E
Mr Harris - C&E

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Await FCS reply

FOREIGN SECRETARY

VAT EXEMPTION LIMIT

Since OD(E) decided on 8 October that we should explore with the Commission the scope for a compromise on their demand that we should reduce our existing VAT registration limit from £18,700 to £14,110, the Prime Minister has indicated that she disagrees with this conclusion. As you know, on balance I share the Prime Minister's veiws, but no doubt as Chairman of OD(E) you will be responding in due course. In the meantime, our best tactic seems to be to play for time in the hope that we may be able to rally support from other Member States for our position, and that the new Commission will be prepared to adopt a less doctrinaire stance than the existing one.

2. The attached draft reply to Christopher Tugendhat's letter of 4 September, while rehearsing the legal objections to the Commission's line, accordingly places a heavy emphasis on the practical and political difficulties which would be caused, both domestically and in the context of future fiscal harmonisation, by conceding the Commission's unrealistic and legally doubtful case.

3. If you and the other recipients of this letter are content, I should be grateful if you could arrange for Sir Michael Butler to write to the Commission on the lines suggested.

4. I am copying this minute to the Prime Minister, other members of OD(E), the Solicitor General, and Sir Robert Armstrong.

(N.L.)
29 October 1984

DRAFT LETTER FROM UK PERMANENT REPRESENTATIVE TO THE EC TO COMMISSIONER TUGENDHAT

VALUE ADDED TAX: REGISTRATION EXEMPTION LIMIT

I have the honour to refer to your letter of 4 September addressed to the Secretary of State for Foreign and Commonwealth Affairs in which you record the Commission's view that the limit of £18,700 currently applied to the exemption from registration for value added tax in the United Kingdom contravenes Article 24 of the Sixth Council Directive on VAT.

Before dealing with the purely legal arguments set out in your letter, it is important to recall the negotiations which led to the adoption of the Directive, and to emphasise the political and practical consequences of applying the Commission's interpretation of Article 24.

The purpose of the exemption limit is to exclude from the tax those small businesses who would have the greatest difficulty in complying with its legal requirements, and whose control would require an expenditure of resources by the fiscal authorities quite disproportionate to the revenue involved. Throughout the protracted negotiations on the draft Sixth Directive, the United Kingdom made it clear that it was of the utmost importance to the efficient administration of the tax, and to its public and political acceptability, that the Government should remain free to increase the exemption limit from time to time up to the maximum needed to maintain the real value of the original limit of £5,000 which applied at the beginning of the tax on 1 April 1973. It was only on the understanding that Article 24 would not restrict the

right to revalorise the limit in full that the United Kingdom was able to accept the Article and, indeed, the Directive as a whole. The interpretation which the United Kingdom intended to adopt was made perfectly clear at the meeting of COREPER on 4 February 1976, and although the Commission's representative on that occasion stated that it was "more desirable" that the base date for revalorisation should be the date on which the Directive entered into force rather than 1 April 1973, it is significant that he neither disputed the United Kingdom's interpretation nor proposed an alternative text to put the matter beyond doubt. Had there been any suggestion that the Commission would ultimately seek to impose its views by means of infraction proceedings, the United Kingdom might well have decided to revalorise the limit shortly before the Directive came into force on 1 January 1978, a course of action which would have been entirely consistent with the view now adopted by the Commission.

The Commission was, at the very least, content to allow an ambiguity to remain in the text of Article 24, and it is in the view of the United Kingdom morally and politically inadmissible for the Commission to attempt to exploit that ambiguity at this late stage without demonstrating that there are overriding grounds of Community policy for interfering with the system which has hitherto operated without challenge since 1 January 1978.

Reducing the limit from £18,700 to £14,110 in accordance with the Commission's demand would have unacceptable consequences for the administration of the tax in the United Kingdom. An additional 174,000 businesses would be required to register, and a further 600 VAT officers would have to be recruited to maintain present standards of control. The marginal cost of collection would be excessive in relation to the likely yield, and small businesses would rightly see the change as running counter to the declared enterprise policies of successive United Kingdom Governments and of the Community itself.

The United Kingdom is not aware that a reduction in the exemption limit would produce any tangible benefits at a Community level. The present exemption has no effect on the United Kingdom's VAT own resources contribution, and causes no significant distortion in intra-Community trade. In these circumstances, the current pressure to reduce the limit appears to my authorities to be an unnecessary interference with the internal taxation policy of the United Kingdom, and one likely to hinder rather than to advance the prospects for further fiscal harmonisation.

The United Kingdom rejects the legal arguments put forward in your letter of 4 September against its interpretation of Article 24. It is not clear from earlier correspondence whether the Commission believes that the base date for revalorisation of the limit should be 17 May 1977, the date on which the Directive was adopted by the Council, 1 January 1978, the date on which it came into force in the United Kingdom, or 1 January 1979, the date on which it finally came into force in all Member States. The United Kingdom sees nothing in the text of Article 24 to require the adoption of any of these dates in preference to 1 April 1973, which, for the reasons explained in earlier correspondence, is more consistent with the concept of maintaining the real value of the original limit. The reference in Article 24 to the "date on which this Directive comes into effect" relates clearly and specifically to the conversion rate for the 5,000 ECU threshold which determines whether or not an individual Member State is entitled to revalorise in accordance with the Article. It has no relevance to the determination of the base date for revalorisation itself.

The United Kingdom is therefore unable to accept the Commission's contention that it is in breach of its Community obligations by maintaining the real value of the VAT exemption limit in force on 1 April 1973. My Government hopes that in the light of the considerations set out in this letter the Commission will not feel it necessary to pursue the matter further. If, however, the

FCO suggest omitting [ ]

Commission continue to be unable to accept the United Kingdom's position in this matter, I am instructed to say that in view of the serious political, economic and commercial implications, my authorities would wish to propose further discussions with the Commission at a high political level before the Commission consider the issue of a Reasoned Opinion under Article 169 of the Treaty. I should be glad to arrange such discussions if the Commission agree that they would be helpful.]

Ecn Pol 2/82

VAT ZERO RATES

CONFIDENTIAL

OD(E) FS Ch/Ex S/DTI M/Ag. MinState(FCO)

10 DOWNING STREET

From the Private Secretary

18 October 1984

VAT Registration Exemption Limit: OD(E) 84 8th Meeting

The Prime Minister has seen the Foreign Secretary's minute of 16 October reporting on the OD(E) discussion. She feels strongly that the attempt by the Commission to cut back the value in real terms of the VAT registration exemption limit in the UK should be vigorously opposed. Rather than settle for a compromise which would freeze the current limit in money terms she feels we should raise this question afresh with the new Commission and if necessary seek to have the existing VAT directive amended.

I am copying this letter to the Private Secretaries to other Members of OD(E), Michael Reidy (Department of Energy), John Ballard (Department of the Environment), Steve Godber (Department of Health and Social Security), Henry Steel (Law Officers Department) and Richard Hatfield (Cabinet Office).

Andrew Turnbull

Len Appleyard Esq
Foreign and Commonwealth Office

CONFIDENTIAL

10 DOWNING STREET

From the Private Secretary

OD(E)(84) 8th Mtg.

Prime Minister (1)

OD(E) discussed two VAT issues. The Government's response on zero rates has been sabbed.

On the registration limit, OD(E) decided, contrary to the Chancellor's original advice, to seek a compromise of freezing the limit in money terms for a few years. However, the Foreign Secretary, perhaps because he is now aware of your concern on this issue, is now swinging towards challenging the Commission on the VAT Directive.

Agree UK should go back to Commission to make clear our total opposition to the Directive and to seek amendment of it?

Yes very

AT 17/10

much so

PM/84/161

PRIME MINISTER

Value Added Tax: OD(E)(84) 8th Meeting

1. At its meeting on 8 October, the Sub-Committee on European Questions of the Defence and Oversea Policy Committee considered how to respond to challenges by the European Commission to certain VAT zero rates and to the level of the VAT registration exemption limit for small traders.

2. On VAT zero rates, the Commission issued a Reasoned Opinion on 4 September in which they alleged that a number of our zero rates, mainly for certain supplies of goods and services to business users, contravene the Sixth VAT Directive. The most sensitive items affected are construction, where payment of VAT would have a major financial impact on the industry; fuel and power; animal feeding stuffs and live animals yielding food for human consumption, where the Reasoned Opinion could be misrepresented as part of an attack on zero rating of food. Supplies to the final consumer would not generally be affected, although there is some uncertainty about the Commission's intentions in respect of domestic construction and of metered water supplies.

3. OD(E) recognised that the Chancellor might in some circumstances want to make extensions to the VAT base but agreed that it was unacceptable for his choice of fiscal measures to be dictated by the Commission. The Sub-Committee agreed that

/there

there was no alternative but to reject the Reasoned Opinion and to be prepared, if necessary, to contest the matter before the European Court. The Solicitor General confirmed earlier advice by the Law Officers that our prospects of success are not good. The proceedings would be likely to take about two years. Since the Commission's action is likely to become public - the CBI in fact already has a copy of the Reasoned Opinion - OD(E) agreed that a public statement should be issued, making it clear that the Commission is not attacking all VAT zero rating en bloc and setting out the Government's attitude. I believe that you have already approved a draft text submitted to you by the Chancellor.

4. On the VAT registration exemption limit, the Sixth VAT Directive permits us to uprate it in line with prices, and the present limit of £18,700 is consistent with the movement of prices since 1 April 1973, when the limit was introduced at £5,000. The Commission has not yet issued a Reasoned Opinion against us but in a warning letter under Article 169 of the EEC Treaty they argue that the base date for uprating should be 1 January 1978, when the Sixth Directive was adopted in the United Kingdom. Compliance with the Commission's view would mean a reduction in the limit to £14,110.

5. OD(E) was firm that a reduction in the limit should be rejected. At the same time we had to take account of advice from the Law Officers to the effect that we could expect to lose if the matter went to the European Court. Such an outcome, after proceedings which will certainly take a couple of years, could compel us to reduce the limit in a pre-electoral period. We therefore agreed that the right course would be to follow up earlier indications that the Commission might be prepared to compromise on the basis of freezing the limit until it could again be uprated from an agreed base date.

/OD(E)

OD(E) felt that the implications of a solution along these lines would be considerably less difficult than those of an adverse Court judgement if we could secure no reduction in our current limit; we could also expect to get a significantly more favourable base date than the Court would be likely to allow.

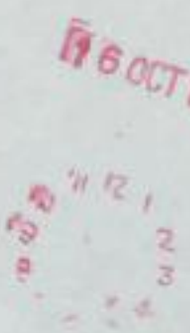
6. I have since considered all this further, and concluded that we should keep open the possibility of raising this question afresh with the new Commission. There may also be a case for refusing to accept that the existing VAT Directive is immutable, and thus for lobbying the Commission and other Member States in favour of amending it. In so doing we could point out to our partners that amendment would offer them the chance to seek an increase in their current exemption limits, and could remind them as necessary that they too could expect clear economic benefits from such increases, with only minor adverse consequences in terms of revenue.

7. I am copying this minute to members of OD(E), to the Secretaries of State for Energy, Environment and Social Services, to the Solicitor General and to Sir Robert Armstrong.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
16 October 1984

CLOSED PA: VAT Zero Rates
Res 82



MFJAGF

CONFIDENTIAL

10 DOWNING STREET

cc CO
DTI
CDLO
LPSO
MOD
LPO
FCO
LCO

From the Private Secretary

15 October 1984

Threatened Infraction Proceedings on VAT Zero Rates

The Prime Minister has seen your letter to me of 12 October and has agreed the draft press release announcing that the Government cannot accept the views expressed in the "reasoned opinion".

I am copying this letter to the Private Secretaries to other members of OD and to Richard Hatfield (Cabinet Office).

Andrew Turnbull

David Peretz Esq
HM Treasury.

CONFIDENTIAL

CONFIDENTIAL

Qz.03984

MR BUDD, PS/FOREIGN AND COMMONWEALTH SECRETARY

VALUE ADDED TAX ISSUES DISCUSSED IN OD(E) ON 8 OCTOBER

We understand that the Prime Minister has expressed a view on the VAT registration limit. In these circumstances the Foreign and Commonwealth Secretary, as chairman of OD(E), may wish to inform her of the discussion there. I attach a draft minute for this purpose.

D F Williamson

D F WILLIAMSON

12 October 1984

Draft minute from the Foreign and Commonwealth Secretary to the Prime Minister

VALUE ADDED TAX: OD(E)(84) 8th MEETING

1. At its meeting on 8 October, the Sub-Committee on European Questions of the Defence and Oversea Policy Committee considered how to respond to challenges by the European Commission to certain VAT zero rates and to the level of the VAT registration exemption limit for small traders.

2. On VAT zero rates, the Commission issued a Reasoned Opinion on 4 September in which they alleged that a number of our zero rates, mainly for certain supplies of goods and services to business users, contravene the Sixth VAT Directive. The most sensitive items affected are construction, where payment of VAT would have a major financial impact on the industry; fuel and power; animal feeding stuffs and live animals yielding food for human consumption, where the Reasoned Opinion could be misrepresented as part of an attack on zero rating of food. Supplies to the final consumer would not generally be affected, although there is some uncertainty about the Commission's intentions in respect of domestic construction and of metered water supplies.

/3.

3. OD(E) recognised that the Chancellor might in some circumstances want to make extensions to the VAT base but agreed that it was unacceptable for his choice of fiscal measures to be dictated by the Commission. The Sub-Committee agreed that there was no alternative but to reject the Reasoned Opinion and to be prepared, if necessary, to contest the matter before the European Court. The Solicitor General confirmed earlier advice by the Law Officers that our prospects of success are not good. The proceedings would be likely to take about two years. Since the Commission's action is likely to become public - the CBI in fact already has a copy of the Reasoned Opinion - OD(E) agreed that a public statement should be issued, making it clear that the Commission is not attacking all VAT zero rating en bloc and setting out the Government's attitude. The Chancellor of the Exchequer is submitting to you separately the text of the proposed statement.

4. On the VAT registration exemption limit, the Sixth VAT Directive permits us to uprate it in line with prices, and the present limit of £18,700 is consistent with the movement of prices since 1 April 1973, when the limit was introduced at £5,000. The Commission has not yet issued a Reasoned Opinion against us but in a warning letter under Article 169 of the EEC Treaty they argue that the base date for uprating should be 1 January 1978, when the Sixth Directive was adopted

in the United Kingdom. Compliance with the Commission's view would mean a reduction in the limit to £14,110.

5. OD(E) was firm that a reduction in the limit should be rejected. At the same time we had to take account of advice from the Law Officers to the effect that we could expect to lose if the matter went to the European Court. Such an outcome, after proceedings which will certainly take a couple of years, could compel us to reduce the limit in a pre-electoral period. We therefore agreed that the right course would be to follow up earlier indications that the Commission might be prepared to compromise on the basis of freezing the limit until it could again be uprated from an agreed base date. OD(E) felt that the implications of a solution along these lines would be considerably less difficult than those of an adverse Court judgement if we could secure no reduction in our current limit; we could also expect to get a significantly more favourable base date than the Court would be likely to allow.

6. I am copying this minute to members of OD(E), to the Secretaries of State for Energy, Environment and Social Services, to the Solicitor-General and to Sir Robert Armstrong.

3.12

CONFIDENTIAL

Prime Minister

Agree Chancellor's press notice stating UK's refusal to accept Commission position on VAT zero rates?

AT 12/10

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

I will put papers to you separately next week on the VAT limit for small traders.

12 October 1984

Andrew Turnbull Esq
10 Downing Street

Agreed MT

Dear Andrew

THREATENED INFRACTION PROCEEDINGS ON VAT ZERO RATES

The draft put to Sir Geoffrey is attached. AT

Minute attached

The Foreign Secretary is minuting the Prime Minister separately about the conclusions reached at OD(E) on Monday. But there is one specific point on which the Chancellor believes we need to take early action. The EC Commission has sent us a reasoned opinion contesting the legal validity of certain aspects of our VAT zero rates. OD(E) on Monday agreed to reject the Commission's case and, if necessary, fight it at the European Court. OD(E) also agreed that a press notice should be issued as quickly as possible outlining the scope for challenge and indicating HMG's rejection of it. The Chancellor was asked to clear this press notice with the Prime Minister. I attach a draft.

The Chancellor thinks it important for this to issue on Monday next week if at all possible. We understand that the Sunday papers may carry leaks from Brussels. These could easily lead to embarrassing uninformed publicity and the Chancellor believes it important to pre-empt that as far as possible by making a clear statement. The Commission's challenge is relatively limited, and we should emphasise this before the story gets around that all our zero rates are under fire.

The Chancellor would be grateful for the Prime Minister's early agreement to the issue of the press notice.

I am copying this letter to the Private Secretaries of other members of OD(E) and to Richard Hatfield (Cabinet Office).

Yours ever
David

D L C PERETZ

DRAFT TREASURY PRESS RELEASE

1. The EC Commission has taken the formal step of sending the UK Government a 'Reasoned Opinion' under Article 169 of the Treaty of Rome alleging that certain aspects of the VAT zero rates in force in the United Kingdom are contrary to the provisions of the Sixth VAT Directive which established Community rules for the structure and coverage of VAT.

2. The Reasoned Opinion is not a general attack on the UK zero rating system. It questions the application of specific zero rating groups to goods or services frequently supplied to the business sector.

3. The United Kingdom Government was given until early November to consider the Reasoned Opinion. A full response will be given after detailed consideration of the arguments but it is the view of Treasury Ministers that our zero rates accord with the provisions of the Directive which was adopted in 1977. We therefore cannot accept the views expressed in the Opinion.

4. Under the Directive Member States were permitted to retain zero rates in existence at the end of 1975 provided that they had been implemented 'for clearly defined social reasons and for the benefit of the final consumer'. Insofar as zero rates cover supplies made to businesses and not to the general public, the Commission considers that they are not in accordance with the Sixth Directive, a view which the UK Government does not accept.

5. The items which are under challenge are as follows :-

? (i) Live animals of a kind used for food; animal feeding stuffs; food producing seeds and plants;

(ii) Sewerage services and water, but only where a specific charge is involved - services provided through a water rate are outside the scope of VAT;

/(iii) Newspaper

(iii) Newspaper advertisements and news services (but not newspapers);

(iv) Fuel and power (coal, gas, electricity, oil) when supplied to businesses, ie domestic consumption is not under challenge ;

(v) Construction of buildings and associated services, other than housing 'within a social policy' a term which the Commission does not define;

(vi) Protective boots and helmets for industrial use insofar as sold to businesses and not private persons.

Notes

1. It has long been known that the Commission is unhappy about the legality of certain of the zero rates although the point was not raised until several years after agreement on the provisions of the Sixth Directive. So far the question has been considered only in informal contact between the UK Government and the Commission.

2. The issue of the Reasoned Opinion does not necessarily mean that the alleged breach of the Sixth Directive will be put to the European Court of Justice for decision. It is, however, the first formal step in that procedure. It will be for the Commission to decide in the light of the response by the United Kingdom Government whether to apply to the Court for a judgment on the issue.

3. The challenge to our zero rates does not carry any implications for the amount the UK pays in respect of VAT to the EC Budget. Provision already exists for compensation payments to take account of zero rating.

BF 10.2.84

See SS/Environment to Ch/Ex
31.1.84

- ~~Rep~~ Chase Tsy.
Andrew wants to see Tsy response.

10/2 Andrew

Margaret O'Mara from the Treasury said that the Chancellor of the Exchequer met with SS/Environment and that a written reply to SS/Environment's letter would be forthcoming

Sue
10.2.84

Now AT 10/2

City Design

ECNO

CONFIDENTIAL

B/F with Treasury response AT 1/2

2 MARSHAM STREET
LONDON SW1P 3EB
01-212 3434

My ref:

Your ref:

31 January 1984

Dear Nigel,

VAT ZERO-RATES: POSSIBLE INFRACTION PROCEEDINGS

You will know of the strong and continuing campaign being undertaken by the construction industry over the threat to the current zero-rating for new construction, arising from the risk of EC infraction proceedings. This was most recently the subject of correspondence between Barney Hayhoe and Bruce Chivers, President of the National Federation of Building Trades Employers, with Barney's reply of 1 December.

Bruce Chivers has now written to me, saying that he is not "fully satisfied" with Barney's assurances. You should be aware that this has also been raised with me on a number of occasions, most recently when I met the Group of Eight in December, when I assured them of my total support, and said that the Government had no intention of giving way. It was also raised with me this month when I met the Building Industry Supper Club, with some feeling.

You will know that the effect of any changes on the exempt financial services sector and on the construction industry would be considerable - possibly some £200m to £250m per annum - and I do not believe the industry, as it struggles to recover, could stand that. (You will know that both BMP and NEDO are already calling into question the continuance of the current recovery.)

This was discussed by colleagues in March, and it was agreed that Customs and Excise officials would try and prolong negotiations with the Commission for as long as possible, and would only be prepared to offer concessions on newspaper advertising and on news services. They were instructed to continue to resist Commission pressure in other areas. At the same time, the question was to be raised at a political level with Christopher Tugendhat, and you and the Foreign Secretary would report to colleagues in due course.

I hope that you will continue to resist the Commission's arguments but I also wonder whether more might be done to reassure the industry, and to satisfy them of the Government's determination to look after their interests.

CONFIDENTIAL

I appreciate that Barney is going as far as he feels he can, but I wonder if another look might not be taken at this. More generally, I would also be grateful if you could let me know how you see matters developing, what the outcome of any discussions with Christopher were, and whether you feel that there is yet any need for colleagues to have another look at this.

I am copying this to Geoffrey Howe, other Members of OD(E), and to Sir Robert Armstrong.

Yours ever
Patrick

PATRICK JENKIN

The Rt Hon Nigel Lawson MP

CONFIDENTIAL

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

B J P Fall, Esq
Private Secretary to the
Secretary of State for
Foreign and Commonwealth
Affairs

11 March 1983

Dear Brian,

VAT ZERO-RATES

Your Minister should be aware of two recent and potentially confusing developments on our VAT zero-rates.

The Commission have now produced a report reviewing the transitional provisions of the Sixth VAT directive. This suggests that VAT zero-rating in the UK should be progressively reduced until it applies only to basic foods. ... The background is explained in the attached note.

As it points out, no action can be taken by the Council to end our zero-ratings without a unanimous decision. We cannot be forced to change, and we continue to regard zero-rating as an important part of our VAT system.

Where confusion may arise is in relation to the separate question of challenges to the legality of some of our zero-rates. Ministers have been discussing this in OD(E). That both issues have come to the fore at the same time is pure coincidence as they are entirely different. General enquiries from eg trade associations about either ... issue should be answered along the lines of the attached press statement. Specific problems should be referred to Customs and Excise for advice.

I am copying this letter to all Private Secretaries of Cabinet Ministers.

Yours sincerely,

Jill Rutter

JILL RUTTER
Private Secretary

CONFIDENTIAL

CONFIDENTIAL

VAT ZERO RATING: THE EC DIMENSION

Note by HM Customs and Excise

Our VAT system is now to a large extent based on Community law and in particular the Sixth VAT Directive. The main text of the Directive does not provide for the general use of the zero rate to relieve consumer expenditure from tax. However, Article 28 of the Directive provides for certain temporary derogations and one of these allows us to continue to use the zero rate subject to certain conditions. We have been operating on this basis since 1978, when the Directive came into effect.

Although the ultimate objective of the Directive is to abolish the use of zero rating of consumer expenditure, the terms of the derogation require a unanimous decision of the Council to achieve this. We are therefore protected and cannot be forced to relinquish any of the zero rates which are permitted under the terms of the derogation.

The Commission have recently produced the report on the operation of the derogations which is required by the Directive every five years. In it, they have suggested that our zero rates should be progressively reduced over a long period of time until only the zero rating of basic foods remains. However they do not recommend it with any great force and they are well aware that a unanimous decision of the Council would be required to implement their views.

This report is not a formal proposal for action. Such proposals

may follow after the Council's discussion of the report if the Commission see fit. We believe, however, that they will not see any advantage in making a proposal on zero rating which they know the UK will block. Certainly they are in no doubt of our views on zero rating and that it is of the utmost political importance to us. As far as public reaction in the UK is concerned, therefore, we can be reassuring, in the knowledge that we can block any attempt in the Council to end our zero rating.

There is another issue relating to zero rates which is mentioned in the Commission's report. The transitional provision allowing continued use of the zero rate lays down certain conditions. These provide that zero rating can only be allowed for social purposes and for the benefit of the final consumer. For a period of two and a half years now, the Commission have been contending that the way in which our zero rating was applied to some items did not comply with these criteria (the Annex gives details of the Commission's opinion). They have threatened to take us to the European Court on this issue and have taken the first formal steps of the procedure which they must go through before a reference to the Court. (The whole process, including the Court reference, is known in EC jargon as "infraction proceedings".)

One option which is still open to us is to reach an agreement with the Commission which would lead them to halt their action in return for some very limited concessions on our part. Confidential discussions between officials have already taken place to explore this option but no conclusion had been reached before the publication of the report. The report itself makes matters more difficult by making an oblique reference to such proceedings in respect of zero rating. If the reference is taken up by trade associations concerned with the items on the list in the Annex it will cause them additional concern and they may well confuse the two issues of the review of derogations and infraction proceedings.

It is important to make sure that these two are clearly separated.

In the eyes of the Commission the two questions are totally different. The first concerns the duty which the Commission sees itself as having under the Sixth Directive to achieve the gradual elimination of those zero rates which are allowed on a transitional basis by the Directive. In other words they are concerned with the elimination over a long timescale of what might be called "legal" zero rating. On the other hand, the infraction proceedings are directed against what they see a "illegal" zero rating. The timescale if these two processes are totally different. The derogations review is very much a long term matter, whereas the reference to the Court could come about relatively quickly and the timing is within the control of the Commission.

PRESS STATEMENT

VAT ZERO RATES: COMMISSION REPORT

1. The EC Sixth VAT Directive, which came into effect on 1 January 1978, provides for a common VAT base to be applied by all the Member States of the Community. Article 28 provides for certain transitional provisions which, amongst other things, permit the UK to continue to tax certain goods and services at the zero rate. The Commission is required, after 5 years, to make a report to the Council on the continued use of the transitional provisions and this report has now been made. The report is not a formal proposal by the Commission.

2. In respect of zero-rating, the report suggests that it should be progressively phased out until only the zero-rating of basic foods is left. This is only the Commission's view. Change could only come about if the Commission made a formal proposal to that effect and the Council unanimously agreed to it. The UK Government has always made it clear that it sees zero rates as an integral part of our VAT system. It considers that the Commission's arguments take insufficient account of the social, political and economic consequences of the changes suggested. The UK cannot be forced to make changes in its zero rates and it will take every opportunity to make it clear to the Commission and our partners that it is not the right time for radical change.

3. The Commission's report is concerned with all the permitted exceptions to the Sixth Directive and not only with zero rates. We have made use of some other exceptions and the continued need for these will be examined in the course of the general review of exceptions. As with zero rates, any change needs the unanimous agreement of the Council and cannot be imposed on Member States.

4. The Commission's report also indicates that they have some doubts about the legality of some of the UK's zero rates. This is a quite different point from the review of derogations and has been the subject of discussion between Customs and Excise and Commission officials. The basic point at issue is the Commission's contention that the appropriate criteria permitting zero rating allow only supplies to non-business consumers to be relieved. We are trying to convince the Commission that their views, which are based on a limited and impractical interpretation of the Directive, are not correct. The timetable of further developments in this area is quite separate from, and unconnected with, the review of derogations.

ANNEX

Group 1 - Food

General items No 2 - Animal feeding stuffs
3 - Seeds or other means of propagation of plants comprised in items 1 or 2.
4 - Live animals of a kind generally used as, or yielding or producing food for human consumption.

Group 2 - Sewerage Services and Water

All items insofar as supplies to industry are included.

Group 3 - Books, etc

All items, unless supplies for schools or for use in schools. It should be noted that this group was not mentioned in the Commission's letter of 16 June 1980.

Group 5 - Newspaper Advertisements

All items

Group 6 - News Services

Group 7 - Fuel and Power

All items insofar as not supplied to the final consumer

Group 8 - Construction of Buildings, etc

All items insofar as the zero-rate is not restricted to buildings by and for the final consumer within a social policy.

Group 11 - Caravans and Houseboats

All items insofar as not restricted to permanent main residences; eg Caravans for hire could not be admitted for zero-rating

Group 17 - Clothing and Footwear

Item No 2 Protective boots and helmets for industrial use insofar as sold to employers.

N.B.P.M.

01 211 6402

The Rt Hon Francis Pym MC MP
Secretary of State for Foreign
and Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
London
SW1

21st January 1983

Dear Francis

VAT ZERO RATES: POSSIBLE INFRACTION PROCEEDINGS will require to be raised

Thank you for copying to me your minute of 18 January to Tom King about the possibility of infraction proceedings before the European Court over zero-ratings for VAT in the UK.

It might be helpful if discussions take place informally between the Commission and Customs officials before OD(E) meets to discuss tactics over this issue. This is on the clear understanding that energy would not feature as one of the possible concessions.

I do, of course, have a clear interest in the outcome and would wish to be party to any Ministerial discussions.

Yours ever
Nigel

NIGEL LAWSON

ECON POL : VAT ZERO RATES : FEBRUARY 1982

JF
Econ Pol Feb 82

Econ Pol (4)

SECRETARY OF STATE FOR THE ENVIRONMENT

2 MARSHAM STREET
LONDON SW1P 3EB

Prime Minister
To note
AR 23/3.

My ref: H/PSO/11226/82
Your ref:

22 March 1982

AR 25/3

Dear Peter

Thank you for copying to me your letter of 12 February to Peter Carrington about VAT zero-rating and the possibility of infraction proceedings being initiated by the EC Commission.

I can see that there is a danger of becoming too alarmist about the Commission's letter and I fully support the approach which you are proposing. There are however several areas within my responsibility upon which the threat of positive rating impinges, and which, I believe, lend support to your general line.

The main area of concern is how the positive rating of much construction work would be viewed by the industry. I appreciate that for the most part it would not mean higher building costs because companies registered for VAT purposes could offset the tax paid to a builder against the VAT due to Customs from the goods and services which they have supplied. I also accept that exempt and partially exempt sectors - like banking and insurance - where there is more of a problem, will probably find financial mechanisms for getting round any change in the VAT position. Nevertheless it would inevitably effect cash flow, would be perceived by the construction industry as further evidence of the Government's lack of concern about its plight, and if it put up the cost of even a small proportion of commercial and industrial building, would be seen as running counter to all that we have been doing to stimulate development and private sector investment particularly in inner cities and enterprise zones. You well know my views about the need to do what we can to help the construction industry through this difficult period and I hope therefore that we shall resist the Commission's attack in whatever way possible.

In the longer term I am equally concerned about the review later this year of derogations under the Sixth VAT Directive. I should most strongly oppose any move to positive rate construction not currently so rated, especially if it were proposed to extend it to housing. As you know there has been growing concern in the UK that because we enjoy a more favourable VAT regime in the housing sector than most of our European partners the review might result in both the positive rating of alterations and even of house-building generally. You may recall that this was referred to in the Construction Industry's Joint Taxation Committee's 1982 Budget Memorandum. Similar disquiet has been expressed in the Trade Press and Arthur Jones has now written to John Stanley to express concern about the risk of the review leading to a positive charge of VAT on all new buildings.

Any move of this kind would clearly seriously hinder our housing objectives and would be very damaging to the Government's relationships with the construction industry. I cannot stress too strongly therefore my view that we must ensure that nothing is done which would work against our policy of encouraging home ownership and stimulating housebuilding.

There are also certain areas of the activities of the water authorities which would be affected. I hope that any proposal that charges for water and sewerage services to industry should no longer be zero rated will be resisted on two grounds. First, the cost to the economy: in England and Wales the water industry collects an estimated £850m per year for non-domestic customers. If a positive rate of VAT is levied as required by the Commission industry would be faced with finding another £127m per year, which would presumably be passed on in the form of higher prices for goods and services with a direct impact on the retail price index. Secondly, there will be great difficulty and hence a significant administrative cost in correctly identifying which customers are liable to pay VAT, particularly in the small business and commercial sectors where rating lists cannot be relied on to show whether or not trading is carried on. Moreover, many commercial and industrial consumers have a valid argument for resisting VAT since they may not be using water in any productive process but under the Public Health Act they are required to provide sanitation for their staff and customers. In equity they are no different from the domestic consumer who receives the same service but whose bill is zero-rated. If water authorities had to identify cases where this arose, or had to adjudicate, this would add to the administrative burden. Water services charges of any kind are already largely resented in many circles and such a move will only serve to focus yet more attention on their unpopularity.

Finally, for the sake of completeness, I have an interest that we should continue to maintain the line that caravans and houseboats that are used as permanent main residences should remain zero-rated. According to our estimates there may be about 67,000 such mobile homes and about 5,000 residential houseboats in England and Wales.

I am copying this letter to Peter Carrington and to the other recipients of yours.

23 MAR 1982

MICHAEL HESELTINE

The Rt Hon Sir Geoffrey Howe QC MP

2F

e

CONFIDENTIAL

(2)

Prime Minister

A.J.C. 4/3

Econ Pol

DEPARTMENT OF EDUCATION AND SCIENCE

ELIZABETH HOUSE, YORK ROAD, LONDON SE1 7PH

TELEPHONE 01-928 9222

FROM THE SECRETARY OF STATE

L.a. MR 5/3.

The Rt Hon The Lord Carrington KCMG MC
Secretary of State for Foreign and
Commonwealth Affairs
Foreign and Commonwealth Office
Whitehall
London SW1H

4 March 1982

Dear Peter.

VAT ZERO RATING

I have seen your recent exchange of correspondence with Geoffrey Howe about Christopher Tugendhat's letter on VAT Zero rates, and the Prime Minister's comments on the desirability of persuading the Commission that taking infraction proceedings on this matter would be a political mistake.

You mentioned in your letter of 18 February the likely public reaction to any attempt to make books liable for VAT, and I am sure that any move in this direction would have a particularly damaging effect on attitudes to the Community among those concerned with education, in its broadest sense, and all scientific and cultural activities. The assurance that schools would be exempt would not prevent a very critical response from this vocal and influential section of public opinion. Paul Channon, who as Minister for the Arts has special responsibility for libraries and information services, endorses this view and has expressed particular concern about the position of libraries. I understand that Customs & Excise officials think libraries will be able to reclaim in full any VAT paid, but we need to be very clear about this, and about how the Commission's proposal would affect all other purchasers of books, as well as authors, publishers and booksellers. The market in this field, especially for specialist books, is already unstable and at a time when public sector libraries are having to reduce their book purchases substantially any further loss of sales could have far-reaching consequences.

I am copying this letter to the Prime Minister, members of OD(E), the Secretaries of State for Environment and Energy and to Sir Robert Armstrong.

Yours ever,
Keith

(2)

Prime Minister

A. F. C. 15/2

FCS/82/28

CHANCELLOR OF THE EXCHEQUER

VAT Zero Rating

1. Thank you for your letter of 12 February about Christopher Tugendhat's letter on VAT zero rates. I have also noted the Prime Minister's comments, recorded in her Private Secretary's letter of 15 February to yours. I regard this as a potentially very embarrassing affair, particularly from the point of view of public opinion in this country.

2. I agree that, given our doubts about the strength of our legal case, it is important that we take action on a political level to make the Commission drop the idea of infraction proceedings. I am grateful for the copy of the aide memoire prepared for Nicholas Ridley and will of course be ready to make the appropriate points myself in Brussels if a suitable opportunity arises. I understand that it is planned that you should write to Christopher Tugendhat yourself putting the political case against a change. I very much support such a plan. I shall also be interested to learn the outcome of Nicholas Ridley's talk with Christopher Tugendhat on 15 February.

3. I agree that we should also be ready to respond quickly and effectively to any leak of the Commission's plans. Accordingly, I am instructing my officials to liaise with yours over a suitable press line which should be agreed in advance and kept ready for immediate release should the need arise.

4. You ask if there are any further arguments to be added in support of our political case. I think the aide memoire enclosed with your letter covers the ground well. But we might perhaps make greater impact in the following ways:

(i) we could stress how fundamental the issue is to us; we could remind the Commission that one of the arguments against British membership of the Community has always been the fact that by joining we would be abandoning our national right to tax (or not to tax) as we thought fit; and that we have hitherto been able to counter this by showing that although VAT is theoretically applicable to everything we have the right not to levy it (ie by zero rating) if we so choose. But the Commission's present approach would in effect deprive us of this right and could reopen the whole controversy, both in Parliament and in the country as a whole;

(ii) we could draw attention to specific ways in which the Commission's proposals would affect public opinion. In particular, if books were liable for VAT we would certainly face the prospect of damaging anti-Community publicity, which would have a seriously negative impact on public attitudes to the Community in this country, which are at last beginning to show signs of improvement.

5. I would of course be willing to make these points in writing to the President of the Commission. But it would seem to me to be sensible to wait and see what reaction there is to Nicholas Ridley's informal approach and to your letter to Christopher Tugendhat first.

6. I am copying this letter to the recipients of yours.

(CARRINGTON)

18 February 1982

Foreign and Commonwealth Office

OD(E)
(HMT)
AGO
DTde
MAFF
LPS
FCO

10 DOWNING STREET

From the Private Secretary

15 February 1982

VAT ZERO RATES: POSSIBLE INFRACTION PROCEEDINGS

The Prime Minister has seen the Chancellor's letter of 12 February to the Foreign and Commonwealth Secretary and has commented that she very much agrees that our approach to this problem in the future should be one of persuading the Commission that taking infraction proceedings on the basis described in the third paragraph of the Chancellor's letter would be a political mistake.

I am sending a copy of this letter to the Private Secretaries to Members of OD(E), the Secretaries of State for the Environment, Education and Science and Energy and to Sir Robert Armstrong.

A. J. COLES

John Kerr, Esq.,
HM Treasury.

Prime Minister

A.J.C. 12/2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

12 February 1982

The Rt. Hon. The Lord Carrington, KCMG, MC
Secretary of State for Foreign and Commonwealth Affairs

I agree very much with the despatch note

VAT ZERO RATES : POSSIBLE INFRACTION PROCEEDINGS

.... You will see from the attached letter from Commissioner Tugendhat that the EC Commission are considering taking infraction proceedings in respect of certain aspects of our VAT zero-rating system. In effect the Commission are claiming that we do not have authority in Community law to do more than zero-rate supplies to final consumers. In most cases this would mean that suppliers of currently zero-rated goods or services would have to decide whether they were making the supply to a final consumer or not and apply the zero-rate or a positive rate appropriately. In some cases, this view has led the Commission to conclude that whole zero-rating Groups (or items within Groups) need to be withdrawn and the zero-rating ended.

My purpose in writing to you is to tell you what is happening so that you are in a position to make our points in Brussels if an opportunity presents itself. Alternatively you may find, if the news leaks, the need to deal with domestic representations. It is particularly important in this context, I think, not to allow an unduly alarmist view of the Commission's proposal to prevail. They have not suggested that all our zero-rates must be abolished, merely that they are technically deficient in respect of supplies
.... other than to final consumers. The attached note goes into more detail on this general issue and also explores the effects in certain particular cases mentioned in the Commission's
.... letter. I also attach an aide-memoire to which Nicholas Ridley will speak when he sees Commissioner Tugendhat on 15 February. You may find this useful in similar circumstances.

/The response

The response to the Commission's case has been discussed interdepartmentally in EQO(L) and I am afraid I must tell you that the consensus is that our legal case is not strong. Customs and Excise are preparing a reply which will make the best of what points we have, but our interests clearly lie in the direction of persuading the Commission to drop the case. The political arguments in favour of this are strong. 1982 is the year in which the Commission must review derogations from the 6th VAT Directive and propose any changes. In this context zero-rating is a very important issue and it should be obvious to the Commission that to attack our zero-rating provisions on this technical level will not encourage a sympathetic attitude from the United Kingdom to any other proposals for change.

Our approach to this problem in the future will therefore be to persuade the Commission that taking infraction proceedings on this basis would be a political mistake. In this we expect to have the support of the Irish Government, to whom a similar letter has been sent, and also the Italians, who are also in breach of the Directive on zero-rating, although in a different way. Customs and Excise will continue to argue the technical issues at official level. If we cannot persuade the Commission to withdraw, we might at least hope to delay a reference to the European Court by these tactics.

I would of course be grateful for any additional arguments which you or your officials can provide in support of our objective.

I am copying this letter to the Prime Minister, Members of OD(E), the Secretaries of State for the Environment, Education and Energy, and Sir Robert Armstrong.

GEOFFREY HOWE

ANNEX 2

COMMISSION
OF THE
EUROPEAN COMMUNITIES

Brussels, 19. X. 1981
SG(81) D/ 12445

My Lord,

Under Article 2(1) of the Sixth VAT Directive of 17 May 1977 (O.J. No L 145, 13.6.1977, p.1) the supply of goods or services by a taxable person acting as such shall be subject to value added tax. Under Article 12(3) the standard rate of VAT shall be fixed by each Member State as a percentage of the taxable amount. Paragraph 4 of the same article permits the supply of goods or services at reduced rates. Each reduced rate shall be so fixed that the amount of VAT resulting from the application thereof shall be such as in the normal way to permit the deduction therefrom of the whole of VAT deductible under Article 17 of the Directive.

However, Article 28(2) of the Directive allows the temporary maintenance of reduced rates and exemptions with refund of the tax paid at the preceding stage which were in force on 31 December 1975 and which satisfy the conditions laid down in the last indent of Article 17 of the Second VAT Directive of 11 April 1967 (O.J. No 71, 14.4.1967, p. 1303). The main conditions mentioned in that indent are that such measures must be taken for clearly defined social reasons and for the benefit of the final consumer.

The United Kingdom's VAT legislation, as laid down in the Finance Act 1972 as amended, sets out in Schedule 4 a list of 17 groups of zero-rated items. Examination of these items by the Commission services led to the conclusion that not all of them are in conformity with the provisions of Article 28 of the Sixth VAT Directive.

./.

His Excellency

The Right Hon. Lord CARRINGTON
Secretary of State for
Foreign and Commonwealth Affairs
Foreign and Commonwealth Office
Downing Street
LONDON SW1A 2AL

On 16 June 1980, therefore, the Director General for Financial Institutions and Taxation wrote to the United Kingdom Permanent Representative, listing a number of items which are zero-rated in the United Kingdom, but which are not considered to be covered by Article 28(2) of the 6th Directive. The list included certain items which had been introduced after 31 December 1975.

In his reply of 25 November 1980 the United Kingdom Permanent Representative refused to accept that the United Kingdom's legislation on zero rates contravenes Community law, making the following points:

(a) The Purchase Tax in force prior to VAT had relieved a wide range of goods on social grounds; the attempt to maintain as far as possible the scope of this relief had resulted in the introduction of a broad range of zero-rates for the benefit of final consumers on social grounds. This was still the case. Moreover, the position of the United Kingdom had been discussed during the negotiations of the 6th Directive and had been accepted by the other Member States when they agreed to the Directive's provisions on zero-rates.

(b) There was a significant similarity between zero and reduced rates. Reduced rates being a regular feature of VAT systems in the majority of Member States, the United Kingdom VAT system was not so different from that of other Member States. Moreover, the Community's own resources were not affected by the zero rates.

(c) The implicit definition of the final consumer in the United Kingdom VAT system was broad.

(d) A distinction between use by private individuals and business would create additional administrative complications for the Government and extra compliance costs for a very large proportion of businesses.

./.

The Commission has re-examined the matter in the light of that letter and accepts that the adjustments made after 31 December 1975 are covered by the statement written into the minutes of the Council when the Sixth Directive was adopted. For the other items, however, the United Kingdom's arguments have not changed the Commission's conclusions substantially. The following points are relevant.

ad a) When the Council adopted the 6th Directive, it was known, of course, that a wide range of zero-rates was applied in the United Kingdom. It was for this reason that Article 28(2) recognized the possibility of maintaining temporarily zero-rates, provided that they fulfil the conditions set out in Article 28 of the 6th Directive and Article 17 last indent of the 2nd Directive. It was not accepted in the 6th Directive that United Kingdom zero-rates could continue as they were, but only to the extent that they fulfil these specific conditions.

ad b) As to the alleged similarity between zero-rates and reduced rates, the Commission would refer to Article 12 of the Sixth Directive. This article only makes provision for reduced rates and stipulates that each reduced rate shall be fixed so that the amount of VAT resulting from the application thereof shall be such as in the normal way to permit the deduction therefrom of the whole of the VAT deductible under the provisions of Article 17. This is to avoid businesses becoming net VAT creditors vis-à-vis the Treasury, which is in fact the situation in respect of many United Kingdom businesses operating in the fields mentioned in Schedule 4 of the 1972 Finance Act. Independently of the fact that zero rates are not mentioned in Article 12, these conditions are manifestly not met by zero-rating.

./.

As to the Community's own resources, the Commission accepts the argument that they are not affected by the existence of zero-rates in the United Kingdom. However, this point is not relevant in the context of the correct application of the provisions of Article 25(2) of the 6th Directive.

ad c) In the view of the Commission the condition concerning the benefit to the final consumer is only fulfilled when goods and services are directly supplied to that consumer. Therefore zero-rates are only admissible for transactions at the last stage. The notion of the final consumer, i.e. the person who ultimately bears the burden of the tax, is part of the VAT Directives and has to be applied in that context, so that there is no longer room for a national definition.

ad d) The administrative difficulties which could arise if a distinction had to be made as to whether a supply is to a final consumer or for professional use would not justify a departure from the VAT system. It should be recalled that zero-rates can only be maintained as a transitional measure, and that the ideal way of coping with any administrative difficulties arising from a distinction between supplies according to the status of the purchaser would be the adoption of the definitive system.

In conclusion, the Commission considers the following items of Schedule 4 as not being covered by Article 28(2) of the Sixth VAT Directive:

Group 1 - Food

General items No 2 - Animal feeding stuffs

./.

3 - Seeds or other means of propagation of plants comprised in items 1 or 2.

4 - Live animals of a kind generally used as, or yielding or producing food for human consumption.

Group 2 - Sewerage Services and Water

All items insofar as supplies to industry are included.

Group 3 - Books, etc.

All items, unless supplies for schools or for use in schools. It should be noted that this group was not mentioned in the Commission's letter of 16 June 1980.

Group 5 - Newspaper Advertisements

All items.

Group 6 - News Services

Group 7 - Fuel and Power

All items insofar as not supplied to the final consumer.

Group 8 - Construction of Buildings, etc.

All items insofar as the zero-rate is not restricted to buildings by and for the final consumer within a social policy.

./.

Group 11 - Caravans and Houseboats

All items insofar as not restricted to permanent main residences; e.g. Caravans for hire could not be admitted for zero-rating.

Group 17 - Clothing and Footwear

Item No 2 Protective boots and helmets for industrial use insofar as sold to employers.

In these circumstances the Commission considers that the United Kingdom has failed to fulfil the obligations incumbent on it under the EEC Treaty.

Consequently, the Commission, in accordance with the provisions of Article 169 of the EEC Treaty, requests the Government of the United Kingdom to submit its observations on the matter within 2 months of receiving this letter.

The Commission reserves the right to deliver, if necessary, the reasoned opinion in accordance with Article 169 of the EEC Treaty on receipt of these observations. The Commission also reserves the right to deliver the reasoned opinion in the event the observations requested have not reached it within the necessary time-limit.

Yours faithfully,

FOR THE COMMISSION

Christopher TUGENDHAT
Vice-President

T ZERO RATES: POSSIBLE INFRACTION PROCEEDINGS

ANALYSIS OF EFFECTS OF COMMISSION'S LETTER OF 19 OCTOBER 1981

Note by HM Customs and Excise

1. The Commission's general position is that the Second and Sixth VAT Directives authorise zero-rates which apply only to supplies of goods and services made directly to final consumers. The impact of a change of this kind would be that suppliers of these items - principally in the public sector - would have to decide whether the person to whom they were supplying the goods and services was a final consumer or not. (In the Commission's view a final consumer cannot be in business.) Some form of mechanism would have to be set up to make the choice and continue its effects in the case of repeat supplies. The suppliers would naturally be concerned that final consumers did not find themselves charged with tax at a positive rate. This Department would have to monitor the introduction and operation of such arrangements and this would cause considerable additional control problems.

2. Quite apart from the increased costs of such arrangements to traders, the change would have an effect on their business customers. Every purchaser would have to pay an additional amount of tax, which would have to be financed. In very many cases, however, the VAT credit mechanism would ensure that this amount would be offset against the purchaser's own VAT payments, or would be repaid by this Department. Two areas of business would, however, suffer permanent financial loss. These are:

(a) Sectors having significant exempt outputs - eg banking, insurance, property.

(b) Small traders who are not registered.

The Commission recognise that the effects on most traders would not be significant in economic terms, but there is some reason to believe that

of the reasons for their action is a desire to see a greater burden of hidden tax on (a) above. They are concerned about the international distortions of competition in these sectors which result from our extensive zero-rating. The argument is theoretically correct in isolation but is not as important as the Commission suggests in the context of other distorting factors, some of which are a permanent part of the 6th Directive.

3. The Commission's conclusion from its general argument is that the following Groups of Schedule 4 to the Finance Act 1972 should be amended to exclude from zero-rating all supplies not made to final consumers:

Group 2 Sewerage Services and Water

Group 7 Fuel and Power

Group 17
Item 2 Protective boots and helmets for social use.

The effects here would be those described in paragraphs 1 and 2 above.

Food and agriculture. (Group 1 General Items 2, 3, 4).

4. The Commission have suggested withdrawal of the zero-rating for animal feeding stuffs, food seeds and live animals for food, as in their view these items are not supplied to final consumers.

5. This would have an adverse impact on small farmers who were not registered for VAT, since they would not be able to reclaim tax they had paid on purchases of these items. Taxation would also have cash-flow implications for registered farmers. If their outputs remained predominantly zero-rated as human food, the farmers would receive a monthly repayment of tax from Customs and Excise, and the net effect would be a cash-flow gain or loss depending on how long a period of commercial credit was extended by their suppliers. On the other hand if the farmer's output was predominantly positively-rated, the effect would be to transfer any financing burden (or benefit) to the food processing sector.

There would also be a direct effect on the final consumer if the Commission's proposals were adopted. Home grown food and livestock may not form an important part of the total economy but they do exist and would be burdened with tax in these circumstances.

Books etc (Group 3)

7. The Commission have proposed (rather inconsistently) that only books supplied for use in schools should be zero-rated. We shall press very firmly the view that books supplied to final consumers should still be zero-rated.

Newspaper advertisements (Group 5)

8. The Group is designed very much for the benefit of trade and industry except for the publication of small ads. It is difficult to avoid the conclusion that Items 2 and 3 (preparation and associated services) should be withdrawn. Financing difficulties in the taxable sector should present little problem although there would be an additional tax burden on the exempt and partly exempt sectors. If we are to make a concession of this sort, thought needs to be given to its tactical use.

News Services (Group 6)

9. This is perhaps the least defensible of the Groups which the Commission have suggested should be withdrawn. Although the law specifically provides for supplies for the public to be relieved, there can be no doubt that the overwhelming effect of the Group is to relieve supplies to newspapers, which are in any case entitled to take credit for all input tax charged to them. Serious consideration should be given to ending the relief if it will help to persuade the Commission to withdraw their case.

Construction of Buildings etc (Group 8)

10. The Commission have suggested that the zero-rate should be restricted to "buildings by and for the final consumer within a social policy". The meaning of this is not entirely clear, but it appears

t. lead to the zero-rating of domestic housing only, since it is only for this purpose that the operation of a social policy could be argued. The impact of such a change might be significant for the construction industry, since the additional tax which they would be required to charge would stick with the banking, insurance and property sectors - all large purchasers of new property. It has not yet proved possible to estimate the amounts of additional tax involved. Not all the tax would stick, since these sectors have some taxable as well as exempt outputs, which would enable them to take some tax credit. Much would also depend on the corporate structure of the sectors and how this was influenced by any change in tax structure. In addition it is possible that changes in the way property deals were to be financed would alter under the stimulus of tax changes.

Caravans and houseboats. (Group 11)

11. The Commission's view here is that relief should be limited to permanent main residences. We have already told them that this is the purpose of the relief, and we shall continue to do so. Essentially the point is whether such caravans and houseboats should be treated like houses or like mobile caravans. We have chosen the former and will continue to defend this choice.

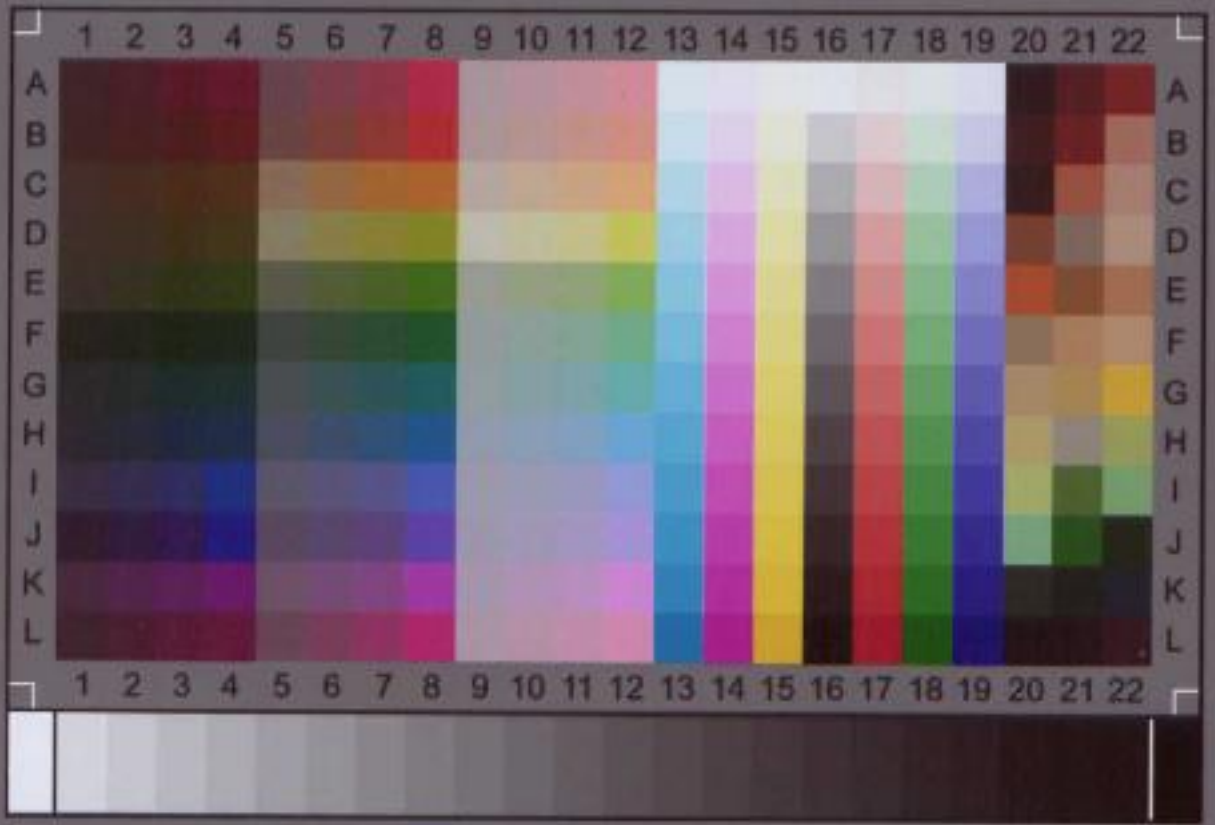
AIDE MEMOIRE FOR THE CHANCELLOR TO USE IN SPEAKING TO MR TUGENDHAT ABOUT INFRACTION PROCEEDINGS ON VAT ZERO RATES

1. We believe there are reasonable arguments in support of our practice, particularly in respect of our major zero rates. If we accept the Commission's views a large number of people will have to alter their systems for no practical effects. We accept that some additional tax may stick with certain exempt sectors, but this is scarcely significant in contrast with the administrative and political upheaval which will be caused by any change.

2. Zero-rating is a very sensitive subject in the UK. The negotiations leading up to the derogations were very difficult, and the resulting compromise a delicate one. The derogations are due to be reviewed later this year. This will give the opportunity for a study of the effects of zero rates.

3. The issue is so important that we would have to defend the case at the European Court if the Commission press their views. We do not feel that this would be desirable for either the UK or the Community. The impact of such a Court case on the UK electorate's view of the Community would be very damaging. They would see it as an attack on our zero-rating; the technical arguments would not be understood.

4. The Community is a dynamic body which must be seen to be able to adapt to the needs of the real world. Zero rates do not lead to significant distortions of competition, they are not barriers to trade, and they have no effect on the Communities' own resources. We are prepared to discuss the Commission's views of our zero rates to see if there is room for a negotiated settlement. The Community should solve its problems in the light of political and practical considerations rather than resort to the European Court.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