

Alternative method of VAT collection

Summary of responses

December 2017

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Foreword

This government believes that the emergence of the digital economy has been a fundamentally positive development for consumers and businesses alike. It has brought unprecedented connectivity and instant information exchange. In retail, this has meant that we can now purchase almost anything at a click, from luxuries to everyday essentials, from internet sellers based anywhere in the world.

In welcoming and supporting the digital economy, we also need a tax system that adapts to the economic changes being driven by it. It should be as straightforward as possible for businesses who want to comply to contribute their fair share.

Our tax system must also be capable of combating those businesses operating digitally who are unwilling to play by the rules. The Public Accounts Committee highlighted how important this is in its recent report, published in October 2017, focussing on online VAT fraud.

In online retail, between £1 billion and £1.5 billion in VAT was lost in 2015-16 due to the problem of some traders failing to comply with the obligation to charge VAT to UK consumers on online sales of goods stored in the UK at the point of sale. Such traders not only deprive the Exchequer of a significant amount of revenue but also obtain an unfair competitive advantage over the honest majority of compliant businesses.

The UK is leading the way internationally in addressing this challenge and will continue to do so. The UK is the first country to have introduced joint-and-several-liability for online marketplaces in relation to the unpaid VAT of sellers operating on their platforms. At Autumn Budget 2017 we extended and strengthened these rules along with further action to tackle online VAT fraud.

Building on the momentum generated, this call for evidence was announced at Spring Budget 2017. It sought stakeholder input on the possibilities for a 'Split Payment' model of VAT collection from online sales made by overseas traders. This would allow VAT to be transferred in real time to the Exchequer at the point of sale without any involvement from the seller, thus removing the challenge of enforcing compliance.

Respondents have provided valuable perspectives on who should be responsible for performing any split and the potential costs to relevant parties, as well as key insights about e-commerce and payments industry business models. Building on these responses, we will set out plans for further engagement with industry stakeholders with a view to a full consultation in due course.

1. Introduction

Background

- 1.1 In March 2017 HM Revenue & Customs (HMRC) launched a call for evidence asking for views on proposals for an alternative method of VAT collection and, in particular, how payment technology could be harnessed to extract VAT from online purchases from overseas sellers at the point of purchase.
- 1.2 This document provides a summary of the responses and sets out the government response.

Context for the call for evidence

- 1.3 There has been a large increase in online shopping in the UK in recent years, with many goods sold to UK consumers by overseas sellers using online marketplaces. To satisfy consumer demand for rapid delivery, overseas sellers now routinely store their goods in the UK.
- 1.4 The growth in shopping via online marketplaces has resulted in significant losses of VAT revenues. HMRC estimate that the losses from businesses selling goods to UK consumers via online marketplaces was £1-1.5 billion of VAT in 2015-2016.
- 1.5 The government announced new measures at Budget 2016 to strengthen HMRC's powers to tackle this issue. As of September 2016, HMRC can direct overseas businesses to appoint a tax representative in the UK and can make online marketplaces jointly and severally liable for the VAT of overseas businesses who do not comply with UK VAT rules. In addition, the Fulfilment House Due Diligence Scheme (FHDDS) will open for registration on April 1st 2018.
- 1.6 The government wants to ensure that VAT collection mechanisms reflect the evolving retail environment. VAT collection has not changed significantly since it was introduced in 1973. There have been significant technological advances in the payment industry, which open up the possibility of different approaches to VAT collection, helping to reduce fraud.
- 1.7 The call for evidence sought views on an alternative method of collecting VAT for online business to consumer sales involving an overseas trader, particularly seeking evidence on the technical feasibility of extracting VAT in real time using payment technology and depositing it with HMRC. This is often referred to as Split Payment.
- 1.8 The call for evidence included a series of questions designed to help structure responses and included diagrams about HMRC's understanding of the payment cycle.

Responses to the call for evidence questions

1.9 This document sets out the questions asked in the call for evidence and provides an overview of the responses for each question. Some responses were not specifically attributed to any particular question so we have grouped the responses under the most relevant question.

Structure of the response document

1.10 The response document is presented in the following sections:

- Section 1 is an introduction to the background and context behind the call for evidence
- Section 2 summarises the responses to the call for evidence.
- Section 3 sets out the government response and next steps.
- Annex A lists the organisations that responded to the call for evidence or met with HMRC to discuss it.
- Annex B lists the questions asked in the call for evidence
- Annex C lists the design principles

2. Responses

Overview of responses

Question 1: Please indicate what type of organisation/individual you are.

- 2.1 Twenty responses were received in total. All respondents were connected with the payment industry in some way – banks, building societies, card issuers, merchant acquirers, an online marketplace, software developers and trade associations with a direct interest in split payment. We also received a response from a trade association representing the finance and banking industry body whose members had contributed to their joint response.
- 2.2 Generally, the majority responded positively to the proposals, or were cautiously positive as long as certain challenges could be overcome.
- 2.3 In addition to these written responses, HM Treasury and HMRC officials met with a number of stakeholders during the call for evidence process to discuss the proposals. These discussions and interactions are ongoing.
- 2.4 The government is grateful to all the businesses and organisations that took the time to respond to the call for evidence and for their continued engagement and support on this issue.

Alternative VAT collection mechanism

International examples of split payment mechanism

Question 2: We are interested in any experiences you may have had in countries that operate a split payment mechanism where taxes are extracted in real time. We would like to understand when it works well and when it doesn't work well.

- 2.5 The call for evidence asked for any experiences respondents may have had of countries that operate a tax withholding mechanism similar to split payment. The call for evidence referenced schemes operating in the Dominican Republic, Ecuador and Argentina.
- 2.6 We received information about the system in Argentina, where merchant acquirers are required by law to withhold 1% of the transaction value from VAT registered merchants. Respondents also provided information suggesting that this withholding mechanism has resulted in some merchants not accepting card payments. Reference was also made to the proposed introduction of a tax on

digital platforms which is planned to be collected through credit cards in Argentina.

- 2.7 Respondents commented that each of the countries operating a withholding system had a different operational approach, with few similarities between them. The responses highlighted some common problems with withholding as implemented by the countries referenced in the call for evidence. They cited problems such as cash flow, invoicing and costs of implementation and administration. Respondents to this question, whilst recognising the potential benefits of withholding for tax administrations, also commented that it could lead to behaviour changes in sellers and consumers, such as a move away from card payments towards less traceable forms of payment. Overall, respondents commented that these countries did not really provide comparable examples for the UK of how split payment could work in a cross border (business to consumer) e-commerce environment.
- 2.8 Respondents also highlighted other countries known to have, or which are thinking of introducing, some form of split payment. The identified countries were Spain, Italy, Poland, the Czech Republic and Costa Rica.

Using existing payment technology

Question 3: We understand that fees and other payments are extracted in the payment cycle. Please provide evidence of how this is done and your thoughts on whether you think the same technology to extract fees could be adapted to extract VAT.

- 2.9 Generally respondents focused their answers on the existing processes around fees and charges rather than the technology used to extract the fees. Respondents did not explicitly articulate whether or not existing technology could be adapted to extract VAT. However, information was provided to suggest that application programming interface (API) technology already exists within the Payment Service Provider function, which allows extraction of taxes and which could be exploited in the future in the context of split payment VAT.
- 2.10 Some respondents highlighted forthcoming changes for the payment sector, such as the Payments Services Directive 2 (PSD2), which will introduce the ability for third parties to initiate payments directly from a customer's bank account. This should allow retail payments to be made through interbank payment systems such as Bacs Payment Schemes Limited, rather than by card based systems, and so any proposed split payment model would have to consider this within the design. Plans by the Payments Strategy Forum to create a single consolidated operator for all the interbank payment systems were also referenced by respondents.

Split payment feasibility

Design Principles

Question 4: Do you think these are the right design principles for a split payment model? Is anything missing or is there anything that should be excluded? If you think the design principles should be different please provide evidence on alternatives.

- 2.11 The proposed design principles were outlined in the call for evidence and are reproduced at Annex C. They include maintaining simplicity for the seller, ensuring a level playing field, and reducing the opportunity for fraud.
- 2.12 Some respondents thought the overarching principles were right or broadly right. Others felt they should be expanded, in particular it was suggested it should be clear who will bear the costs of developing and implementing any new technology, and that the benefits, in terms of additional revenue collected should significantly outweigh the implementation costs. It was also suggested it should be for HMRC to develop the split payment technology product, as this would provide central ownership of the process, rather than a more piecemeal approach. Another common suggestion was that the responsibility for ensuring the correct amount of tax is paid should remain with the merchant, and although the payment sector could facilitate the tax collection on HMRC's behalf it would not be appropriate for the ultimate liability to fall on any operator within the payment cycle.
- 2.13 A number of respondents suggested that the scope of split payment should be wider, and not restricted only to overseas sellers, whilst others suggested exemptions for small businesses below a certain threshold.

Payment Cycle

Question 5: If you are an organisation that plays a part in a payment cycle but you are not captured in our illustrations in Annex C it would be helpful if in your response you outlined how you interact with the payment cycle.

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Question 6: Please can you comment on our understanding of how the payment cycle works and whether it is correct. Please provide evidence about any gaps or misunderstandings.

- 2.14 The call for evidence included payment cycle flow diagrams. Respondents were asked to comment on our understanding of how the payment cycle works.
- 2.15 Some respondents thought the payment cycle model presented in the call for evidence did not accurately capture their approach and provided additional information illustrating how the payment cycle operates from their perspective.

Respondents highlighted that the example in the call for evidence only illustrates card payments, and that HMRC needed to be mindful and alert to expected changes in the payment landscape facilitated by PSD2 and other initiatives supported by the Payment Strategy Forum (such as Open Banking). There is likely to be an increase in the use of electronic push payments or instant payments as a result.

- 2.16 Some respondents commented that the description of the payment cycle in the call for evidence lacked some clarity and explained that under EU rules, card schemes are required to ensure separation between the scheme and the processing parts of the business. HMRC's definition in the call for evidence appeared to combine the scheme itself (the rules and regulations) and the processing operation. It was also suggested that rather than using the card scheme as a descriptor a more accurate descriptor would be an interbank payment processor.

The mechanics of split payment

Question 7: Please can you comment on our assumptions about how a split payment model could work. We welcome evidence about the best way of exploiting payment technology to extract VAT from payments in real time to deliver a sustainable model for the future. Please provide as much technical detail as possible.

- 2.17 Respondents were asked to consider how split payment could work in practice. A number of possibilities were suggested, but most respondents explained that extracting the right VAT amount could not be done accurately using the data currently available within the payment cycle. Any model would need to rely on the merchant or another third party providing detailed transactional information. Many said that there is no single and simple technological solution, and that developing new IT systems would incur costs which would likely be passed on to consumers, or possibly bypassed altogether by merchants accepting other forms of payments. Some respondents suggested that HMRC might want to consider the possibility of providing some form of commercial incentive to offset costs incurred in development.
- 2.18 Additionally, respondents explained that the payments landscape is constantly changing, including some newer methods of payment not involving a bank account. Several respondents stressed that a split payment model must seek to encompass all these alternative forms of payments as fully as possible.

Question 8: Based on your own understanding and experience of the payment cycle, at which point do you think the VAT split should take place?

- 2.19 Respondents were asked to consider where the VAT split should take place in the payment cycle, and we received different opinions. Some favoured a split at the point of sale while others favoured a split at the point of payment – after a transaction is authorised and the monies received – as only at that point is

there certainty the transaction will go ahead. A minority favoured a split performed by the merchant acquirer, although others said merchant acquirers do not have the all the information needed to facilitate this. Some respondents expressed the view that the split should be earlier in the payment cycle – at the card issuer or bank account holder stage – as they are more likely to be UK based and so within the UK's jurisdiction. This approach would also ensure non-card payments are captured.

- 2.20 Respondents also expressed the view that (for sales made through online marketplaces) the marketplace is the point in the transaction cycle where most information about the transaction is known, and potentially the best place to make the split. Others commented that currently there is no standard definition of a 'marketplace', and HMRC would have to consider this carefully if they wanted to proceed with this model.
- 2.21 Some alternative proposals were also proposed. Several suggested some sort of 'fixed rate' model, whereby only a proportion of the VAT is split. This could be done at one of several stages in the cycle, from the card issuer to the merchant acquirer, or even by the merchant's bank once it has received the funds. A small number suggested that HMRC could publish a list of known non-compliant traders which could be cross-checked by a party in the payment cycle (although exactly where would still need to be determined) to identify which transactions should be split.
- 2.22 A small number of respondents drew our attention to specific technological products they themselves had designed or were in the process of designing which could operate alongside the payment industry to act as enforcement tools irrespective of the split payment model in operation. These ideas included using third-party data to identify transactions on which no tax had been charged, assigning personal VAT numbers to consumers, who would then be responsible for remitting the VAT amount to HMRC and a real-time inter-governmental data-sharing infrastructure to identify and prevent cross-border fraud.

Challengers and enablers

Question 9: What are the key challenges, from your perspective, to the development of a split payment model for VAT? Please provide evidence about the challenges you have identified and any solutions you think might help in overcoming those challenges.

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Question 10: Are there any enablers or new developments in the sector that would facilitate the development of a new collection mechanism for VAT? Please provide evidence about any new developments or technological advances in the payment sector that are relevant to this issue.

- 2.23 The call for evidence asked for respondents to provide information about challengers and enablers in the development of split payment. Some felt a split payment model would not eliminate fraud completely, if the system partially relied on information provided by the overseas sellers, because a tax authority could have difficulty in auditing offshore suppliers to establish if correct liability is being applied to the goods being sold. Similarly, some commented that split payment in itself would not help overseas sellers know whether UK VAT is due or not. Others felt that human intervention will always be needed to prevent fraud and that technology does not provide the whole solution.
- 2.24 Respondents also commented on the commercial market impact and requested that HMRC, in assessing options, consider that a single solution is unlikely to be suitable across the whole of the complex market, and that introducing new collecting methods could be onerous for businesses. Others pointed out that split payment could create an un-even playing field if not implemented in the right way. Sellers outside the scope of split payment would not be required to account for VAT until the VAT return becomes due, whereas those within the scope of split payment would pay the VAT to HMRC immediately and so would not have the same cash-flow advantages. The market could also be distorted if only some types of payment were captured, rather than all.
- 2.25 Another key challenge raised by many respondents was that of determining the VAT liability of each transaction. It was felt that HMRC should clarify whether the amount split out should represent the full VAT element of each transaction, with adjustments only necessary in the case of errors or other problems, or whether it should be a partial payment of the total VAT due which would require a reconciliatory payment at the end of each VAT period.
- 2.26 Many respondents commented that any participant in the payment cycle not based in the UK may not fall under UK jurisdiction, making the enforcement of any split payment model more challenging.
- 2.27 A small number of respondents felt that no method would be able to significantly address the problem without a wider, international-level review of the general VAT treatment of cross-border movements of goods.
- 2.28 By way of mitigating these challenges, one suggestion was the introduction of a model similar to that used for business to consumer supplies of telecommunications, broadcasting and electronic services to identify transactions that should fall within the scope of split payment. Others suggested bringing all online sales into the scope of the existing VAT Flat Rate Scheme, with a corresponding input tax block, which would eliminate the need to share data within the payment cycle, and removes the need for detailed transaction information.
- 2.29 To counter the challenge of jurisdiction, a common suggestion was to introduce a requirement on marketplaces, which are within the UK's jurisdiction, to only use a payment services provider that agrees to operate a split.
- 2.30 Some respondents felt there were several enablers currently available on the market, but noted that constant innovation adds to the challenge. All felt,

however, that it was imperative that HMRC provided clear guidance and instructions and the process for correcting errors was clearly set out in legislation, regardless of the model.

Card schemes

Question 11: *Do you see a role for the card schemes in ensuring payment sector participants adhere to any future UK split payment legislation?*

- 2.31 In general, the majority of respondents thought that card schemes would have a part to play and that they already play a significant part in the regulation of the payment sector, but some concerns were expressed. Some felt that where card operators were outside the UK the monitoring role of the card scheme was less possible. Others commented that the clarity required for reporting obligations, risks and responsibilities in the enforcement of tax obligations could pose problems. Some respondents commented that the card schemes would not have the correct information to facilitate the split. There were some concerns around capability, functionality and the IT costs involved, with one response in particular questioning whether there would be advanced approval from HMRC on new accounting systems.
- 2.32 Others commented that compliance should be delivered through the marketplace or the card schemes, as putting the requirement for splitting on the merchant acquirer could cause a distortion in the market between UK-based and non-UK-based acquirers. Some expressed the view that there may need to be a change of the current contractual position between card schemes and merchant acquirers.
- 2.33 Respondents felt that the potential costs and impacts associated with split payment may lead acquirers and issuers to choose other card schemes that don't support split payment. It was acknowledged by some respondents that the card schemes could extract the VAT at a point in the transaction cycle between the card issuer and merchant acquirer, if they had enhanced data about the nature of the transaction. This would address the majority of current transactions but as instant payments increase, it potentially becomes more difficult for the Payment Service Provider to know the nature of the transaction.

Other comments

Question 12: *Is there any other evidence you would like to submit as part of this call for evidence?*

- 2.34 Some respondents provided more general thoughts on VAT split payment and on other associated issues not explicitly related to split payment but of relevance to overseas sellers selling to UK consumers. Some respondents

suggested that HMRC should not purely focus on overseas sellers but should also consider broadening the scope of split payment to either UK online sellers or all UK sellers. Respondents also felt consideration should be given to scenarios where the wrong amount of VAT is extracted and how this would be resolved.

- 2.35 Respondents commented on the impact of split payment on the payment sector and the need for HMRC to recognise there is already significant change happening and any further changes need to take this into account. Respondents advocated a long lead in time to minimise disruption and provide sufficient time for businesses to make the changes.
- 2.36 Some respondents raised concerns about potential situations that may occur. One example is the question of how refunds should be dealt with, and which party would be expected to refund the VAT element of the transaction if it had already been deposited with HMRC. Another is the case where an overseas individual purchases an item to be sent to a UK resident as a gift.

3. Government response and next steps

- 3.1 The government is very grateful to all those who contributed their views to the call for evidence and to those who continue to support this important work.
- 3.2 The government remains of the view that a feasible split payment model for VAT, which would allow VAT to be extracted from online payments in real time, would help to reduce the VAT gap. Stakeholders have highlighted the issues and complexities associated with its implementation, but are broadly positive and agree that, although it presents challenges, split payment is feasible.
- 3.3 The government sees this as an important step in tackling non-compliance by some overseas sellers trading through online marketplaces, following on from other measures already introduced or announced. The government also recognises the potential split payment has to transform the collection of VAT more broadly in the future.
- 3.4 There is continued and sustained interest internationally, within the Organisation for Economic Development (OECD) and the European Union (EU) about the future of VAT collection in the digital age, including alternative collection mechanisms such as split payment, and the UK is playing a leading role in this work.
- 3.5 The responses we have received have helped us identify potential options for a split payment model. We are currently conducting user research with UK consumers in order to understand more deeply the context of use of online shopping channels and any potential changes there may be for UK consumers. We also intend to extend this research activity to both overseas and UK-based sellers in order to develop further insights to inform our model development process.
- 3.6 Running in parallel to the user research activity, we will continue to develop and test these insights over the coming months through a process of internal evaluation and on-going engagement with the payment sector and marketplaces, most likely in the form of collaborative workshop-style sessions with those who have expressed an interest in participating.
- 3.7 These sessions are planned for early 2018. The output will be used to inform the potential options for a split payment model.
- 3.8 The government intends to consult on these options next year. We will continue to have direct engagement with all stakeholders with an interest in split payment. We welcome direct contact from any stakeholder who wishes to engage with us in this important, transformative work to help shape the development of the split payment models.

Annexe A: List of stakeholders consulted

The following organisations sent responses to the call for evidence:

- The Association of Accounting Technicians
- The Association of International Courier & Express Services
- Amazon
- American Express
- Barclays Bank plc
- The Chartered Institute of Taxation
- Creatoi
- DAGTVA
- Fexco
- Global Payments
- Lakeshore Data Management Limited
- Nationwide
- Netsweeper

- Osborne Clarke LLP
- PwC LLP
- Taxmen Limited
- UK Finance
- VATFRAUD.org
- Visa Europe
- Vodafone Group Services Limited

Annexe B: List of questions

Question 1: Please indicate what type of organisation/individual you are.

Question 2: We are interested in any experiences you may have had in countries that operate a split payment mechanism where tax are extracted in real time. We would like to understand when it works well and when it doesn't work well.

Question 3: We understand that fees and other payments are extracted in the payment cycle. Please provide evidence of how this is done and your thoughts on whether you think the same technology to extract fees could be adapted to extract VAT.

Question 4: Do you think these are the right design principles for a split payment model? Is anything missing or is there anything that should be excluded? If you think the design principles should be different please provide evidence on alternatives.

Question 5: If you are an organisation that plays a part in a payment cycle but you are not captured in our illustrations in Annex C it would be helpful if in your response you outlined how you interact with the payment cycle.

Question 6: Please can you comment on our understanding of how the payment cycle works and whether it is correct. Please provide evidence about any gaps or misunderstandings.

Question 7: Please can you comment on our assumptions about how a split payment model could work. We welcome evidence about the best way of exploiting payment technology to extract VAT from payments in real time to deliver a sustainable model for the future. Please provide as much technical detail as possible.

Question 8: Based on your own understanding and experience of the payment cycle, at which point do you think the VAT split should take place?

Question 9: What are the key challenges, from your perspective, to the development of a split payment model for VAT? Please provide evidence about the challenges you have identified and any solutions you think might help in overcoming those challenges.

Question 10: Are there any enablers or new developments in the sector that would facilitate the development of a new collection mechanism for VAT? Please provide evidence about any new developments or technological advances in the payment sector that are relevant to this issue.

Question 11: Do you see a role for the card schemes in ensuring payment sector participants adhere to any future UK split payment legislation?

Question 12: Is there any other evidence you would like to submit as part of this call for evidence?

Annexe C: Design Principles

- VAT split payment should increase tax efficiency for both businesses and HMRC
- The split should be initiated at a point in the payment cycle by one of the participants and be driven by payment technology
- VAT split payment should be simple for the seller
- VAT split payment should be invisible to the UK consumer, who will continue to pay by whichever method the consumer chooses, for example credit or debit card or by using a payment service provider
- UK consumers' rights will not be affected
- There should be significantly less opportunity for fraud as the VAT will be extracted in real time in the payment cycle and later deposited with HMRC
- VAT split payment will be in UK legislation (set out in statute)
- VAT split payment should be proportionate and fair and every effort will be made to ensure a level playing field for all sellers to UK consumers
- Every effort should be made to ensure VAT split payment is cost efficient to build, implement and maintain