

What next for VAT? How to levy taxes

Indirect Tax

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As the introduction of VAT on private school fees marks the UK's first significant departure from Article 132, we consider other VAT changes that could be on the horizon.

Taxes have been around for a long time, though the way in which they are levied has changed somewhat over the centuries. In 1203, King John first levied an export tax on the sale of wool – a great way to get his share of the spoils from a roaring trade. It worked so well that he levied more taxes, which ultimately annoyed the barons and resulted in the signing of the Magna Carta. It would probably be a stretch, though, to say that we owe the birth of our civil liberties to the implementation of a simple precursor to VAT.

A brief history

Since then, the tax has gone through a number of changes. Without a distinction between direct and indirect taxation, taxes were levied on corn, coal consumption, tea and even windows. But it wasn't until the first half of the 20th century that a purchase tax first came into existence – a tax on the things that the general public bought and consumed, applied at the point of manufacture and distribution.

Similar to the current way VAT works now, purchase tax was levied on items that were considered luxurious. This was how things stayed until 1973 when the UK made the decision to join the then European Economic Community. Purchase tax was scrapped, and in its place the far more easily administered value added tax was implemented.

The Principal VAT Directive

Starting out at a rate of 10%, VAT was levied on everything except food, housing and fuel. UK businesses incurred VAT on their purchases, charged VAT on their sales and offset the two against each other to calculate their liability, which was then paid over to the treasury. This was a simple system that lacked the width and depth of the current system. Then, in 1977, the EEC brought in the Sixth Directive, which harmonised VAT across the member states and set out new rules for each member to follow.

The Sixth Directive – or as we like to call it in the UK, the Principal VAT Directive (PVD) – has undergone a number of upgrades since 1977. These have allowed for the introduction of new rules, new member states joining the EU and paving the way for more complex trade between member states and the rest of the world. This Directive governs the common system of VAT that all EU member states must follow. It determines what exemptions must apply, what items can be included in the reduced rate and the super reduced rate, and how and where VAT should be levied, as well as other things.

However, in 2016 the UK voted to leave the EU and with that decision the EU ceased to have control over common areas within the UK – its courts, fisheries, agriculture and its VAT system. From 1 January 2021, the PVD ceased to have direct effect over the way in which VAT was administered within the UK market. Although still advisory, the PVD does not apply to UK businesses operating within the UK. Instead, it is the UK government that has control of the VAT system.

The impact of Brexit

Prior to the UK exiting from the EU, the PVD governed the way VAT was applied; however, member states still had the ability to set VAT rates (within reason) and could apply the rules liberally within the confines of the articles. And although they could lobby the commission for changes that would benefit the VAT paying general public, not much could really be done to improve or change the PVD quickly or efficiently. This was why the courts always played a huge role in determining the ever-changing European VAT landscape.

But now that the UK is out of the EU and no longer required to follow the PVD, or the rulings laid down by the European courts (unless it wants to), what sort of changes have we seen?

During the last four years under the Conservatives, the answer so far is not a huge amount. There have been a few minor changes to the way in which we levy VAT, or recover VAT when trading with the EU or the rest of the world – these include changes to VAT on women's sanitary products and some helpful incentives for renewable energy adoption in households. But there hasn't really been much of a divergence away from the PVD. It's been business as usual when it comes to VAT. So, are things about to change?

Signs of change?

With Labour winning the election in July, can we now expect to see them turn their attentions to the UK VAT system and make changes, upgrades or improvements to help benefit the UK taxpayers? Maybe. It hasn't been very long since they came to power and we are already seeing a major change that will deviate the UK away from the EU.

This has come in the form of the introduction of VAT on private school tuition fees. Currently, the PVD exempts the supply of education. Article 132 states that 'the provision of children's or young people's education' shall be exempted from VAT. This would mean that the UK is diverging. However, Article 132 also mentions supplies made by bodies governed by public law or by other organisations 'recognised' by the member state concerned as having similar objectives. There was likely always some wiggle room within Article 132 to remove certain schools from the exemption, although a challenge in the European courts may well have loomed large.

Education aside, it is important to look at the things that the UK and the UK taxpayers really need – and try to guess where we may see future changes that would have the most impact. Labour have announced plans to build 1.5 million new homes in response to a housing stock shortage. However, with the zero rating available on labour and building materials, plus the zero rated sale of the first grant of a major interest in a newly constructed residential property, already in place, there's not many savings to be made.

So, could there be opportunities in relation to existing housing stock? Currently, there is a reduced rating available on conversion from commercial to residential, with the added benefit of the zero rating on the first grant sale. There is also the two-year empty home rule, which allows for the reduced rating on renovations, but no zero rated sale at the end.

Could the legislation be tweaked with so that the two-year rule is reduced to one, and then a special concession for zero rating is made available for these types of newly renovated homes? This could certainly work toward encouraging builders and developers to look at existing housing stock instead of searching for land on which to build.

VAT rates

What about the rates of VAT? The PVD gave us the standard rate, the reduced rate, the super reduced rate and the exemptions. Now that we are out of the EU, could we add any further rates to the list? Here are some changes that might be considered in the coming months.

Luxury travel: One possibility is a special rate for luxury travel – zero rate in standard class and a 10% VAT rate when if you travel in first class. We are already used to train fares increasing every year...

Food: Could we also see a reduction in VAT on food? There is currently a zero rate on most food stuffs and a standard rate on items considered luxurious, such as chocolate digestives. Could there be an opportunity to remove the standard rate and apply a special rate of 10% on all luxury food items? It would certainly help with the weekly shopping bills, especially given the current cost of living crisis.

Green energy: Currently, households pay the reduced rate on their domestic fuel but there is no distinction made between green fuels and fossil fuels. Could a super reduced rate be made available on the supply of green energies? If a household could save 5% on its energy bills, would this encourage the move towards the use of greener fuels and help to reduce the UK's carbon footprint?

Looking forwards

There are lots of things that could be done with UK VAT. VAT is the treasury's third highest earner, and £160 billion in revenue was generated through VAT in 2022/23. With a new government at the helm, it could be time for a review of VAT to decide whether there are ways in which it can be improved, upgraded, better implemented, better administered and made to work more efficiently.