CCNO

FCD(1)
cc PS
PS/Mr. Rifkind
Mr. Renwick
@ 7/12

FCS/84/321

CHANCELLOR OF THE EXCHEQUER

VAT Exemption Limit

Will request if reqd.

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."

VAT?

6.93

CC(O)

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

FOREIGN SECRETARY

DWB 19/12

**VAT EXEMPTION LIMIT**

- attached

Thank you for your minute of 7 December suggesting a couple of amendments to the proposed draft letter to the Commission. These have been taken on board in the revised draft attached.

2. The intention is to send both the reply to the Commission and my personal follow-up letter to Christopher Tugendhat, before he leaves Brussels. This will enable him to give a steer to his successor on this issue. We now have little time to meet this deadline, and I should be grateful if UKREP could let my Office know as soon as Sir Michael Butler has sent the formal reply, so that I can send my letter to Christopher without further delay.

3. I am copying this letter to the Prime Minister, members of OD(E), the Attorney General, the Solicitor General and Sir Robert Armstrong.

N.L.

19 December 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, 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 view that small businesses are an important factor in job creation, and that reductions in the tax burden on employment and enterprise should be a leading element in the strategy to strengthen economic recovery, are both points made in the Commission's Annual Economic Report (COM(84)587 final), which was warmly endorsed at the Dublin European Council.

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 unnecessary and 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.