HM Treasury

Technical note on the withdrawal of the VAT Retail Export Scheme and tax-free airside sales

Introduction

HM Treasury and HMRC's consultation on duty-free and tax-free goods arising from the UK's new relationship with the EU ran from 11 March to 20 May 2020. 73 formal responses were received and officials held 12 individual and roundtable meetings with many of the businesses and industry bodies who responded during the consultation period. Again, the Government would like to thank stakeholders for engaging in this consultation during a challenging period.

The consultation response, published on 11 September, sets out in detail the rationale for the decision to withdraw the VAT Retail Export Scheme (VAT RES) and tax-free airside sales. As we have received a large amount of correspondence following the announcement, we have formulated this technical note to expand on this document and to respond to issues raised by stakeholders.

HM Treasury, HMRC officials and the Exchequer Secretary to the Treasury have also met with industry bodies to discuss the rationale for these changes and, where appropriate, these meetings will continue in the coming weeks. The Government continues to invite further views and ideas which help meet the Government's objectives in this area but is clear these changes will apply from 1 January 2021.

The VAT Retail Export Scheme

The consultation explored a broad number of options for the VAT RES, including the potential withdrawal of the scheme. It also discussed the Government's concerns with the operation of the scheme. In particular, paragraph:

- 4.21 references the possibility of abolition of VAT RES.
- 4.23 then contains an open question on the impacts of abolition.

The Government did not have the choice of maintaining the VAT RES as it is today. The choice was between extending the VAT RES to EU residents or removing it completely as World Trade Organisation (WTO) rules specify that goods bound for different destinations must be treated the same.

International tourism and the high street

Many industry stakeholders have raised concerns that the withdrawal of the VAT RES will damage both the UK high street and international tourism. The Government recognises the contribution that the VAT RES has made to international tourism and retail in the UK, which was acknowledged in the original consultation document. However, the scheme is very costly. In 2019, HMRC estimate VAT RES refunds cost around £0.5bn for around 1.2m non-EU visitors at UK exit points. In 2019 the ONS estimate there were 1.7 EU passengers (24.8m) for every non-EU passenger (16.0m) to the UK[1]. This implies an extension to the EU could significantly increase the cost of the scheme by up to an estimated £0.9bn. This would result in a large amount of deadweight loss by subsidising spending from EU visitors which

[1] https://www.ons.gov.uk/peoplepopulationandcommunity/leisureandtourism/bulletins/overseastravelandtourism/previousReleases

already happens without a refund mechanism in place, potentially taking the total cost up to around £1.4bn per annum.

Regarding the impact on the high street, the removal of the scheme will clearly change the implicit price for some goods currently purchased by non-EU visitors who take these items home in their luggage – although these visitors will still be able to purchase items VAT-free if retailers ship them direct to visitors' overseas addresses. This 'shop and ship' arrangement will also be available to EU residents from 1 January 2021. At the margin, this may of course affect demand for these goods and could impact incentives for a small proportion of non-EU residents to visit the UK. However, based on ONS passenger estimates and the 1.2m visitors who used the VAT RES in 2019, HMRC estimate that fewer than one in ten non-EU visitors use the VAT RES. VAT refunds are also less likely to be a significant pull factor for lower value purchases, and for higher value purchases passengers will be much more likely to be liable to pay the relevant import taxes in their destination country if the goods breach personal allowance limits.

Stakeholders have also told us that they expect these changes will lead to job losses. The Government recognises the challenge all businesses face and is spending billions of pounds supporting people, families and the economy during the COVID-19 pandemic. The Chancellor announced the Winter Economy Plan on 24 September. This includes an extension to the temporary 5 per cent reduced rate of VAT on goods and services supplied by the tourism and hospitality sectors from 12 January to 31 March 2021. This alone provides continued support for the cash flow and viability of over 150,000 businesses and protection for 2.4 million jobs in the tourism and hospitality sectors. This is in addition to the 100% business rates holiday for many businesses, which is worth over £10bn, and a £1,000 jobs retention bonus for bringing furloughed employees back to work. The Winter Plan also provides further support to businesses and jobs over the coming months, not least through the Job Support Scheme which will protect millions of jobs.

International comparisons

The VAT RES is a requirement of EU law so all Member States have to operate an equivalent VAT RES. It is also the case that many non-EU countries have an equivalent scheme. However, there are notable exceptions, including New Zealand and Canada (who use a Goods and Services Tax) and the USA (who do not have a country wide system). These countries remain popular tourist destinations without this type of tax-free shopping available to overseas visitors.

Evidence and analysis

The Government considered the views and evidence submitted by stakeholders as part of the consultation, in addition to the effect of these changes on the Exchequer, economy, retailers and passengers, alongside other Government objectives and priorities. The independent Office for Budget Responsibility (OBR) will also set out their assessment of the fiscal impact at the next forecast, which the Chancellor has asked them to prepare for in November. As part of this, HMRC will make behavioural assumptions which they believe to be central to these changes, which the OBR sign off, and these will be incorporated into the OBR's assessment of the fiscal effects. They will also be looking at this package in the round – including the effects of extending duty-free sales – alongside the substantial support provided to the economy and retail industry.

Tax-free airside sales

In terms of tax-free airside sales, the consultation did state that the Government was initially minded to extend tax-free sales to EU passengers. We therefore appreciate the final decision will have come as a disappointment. However, the consultation document also discussed the Government's concerns with the operation of the scheme and asked about the impacts of abolishing airside tax-free sales. In particular, paragraph:

- 4.26 asks an open question about whether the Government should extend airside tax-free sales.
- 4.27 question asks specifically about views and impacts of abolishing airside tax-free sales.

International tourism and the aviation sector

Tax-free airside sales are not a requirement of EU law and EU Member States have varying policies regarding tax reliefs in airports. In the UK, the current rules that allow tax-free airside sales are not set out formally in legislation and have historically been permitted through an extra statutory concession (ESC). Following a 2005 Judgement from the House of Lords , which limited HMRC's discretion to provide tax reliefs through an ESC, the legal scope for any ESC has been very limited. As such, the ESC for tax-free airside sales, as it stands, could not be amended. The ESC, as drafted, should only apply to non-EU bound passengers and cannot be amended to apply to EU bound passengers. Therefore, under WTO rules, whereby all passengers must be treated equally, the ESC cannot apply from the 1 January 2021.

The consultation asked whether the Government should implement new legislation to permanently allow this relief and extend it to the EU. In a similar vein to the VAT RES, the choice was between removing the ESC and instead legislating to enable airside tax-free sales to non-EU and EU-bound passengers or removing it completely as a result of WTO rules. HMRC estimate that around £150m of VAT is not charged as a result of tax-free airside sales. As with the VAT RES, extending the relief to the EU would significantly increase the cost of the scheme and result in a large amount of deadweight loss by subsidising spending from EU-bound passengers which already happens.

The withdrawal of tax-free airside sales follows significant consultation with industry and the Government considered the views and evidence submitted by stakeholders as part of the consultation in making the decision to not pursue this legislation. The Government also raised concerns that the benefit is not always passed on to consumers and while the Government acknowledges the steps industry has taken since the ESC received media coverage in 2015, in some instances the Government's concern remains. The concession is also not consistent with international tax norms, for example, where snacks and drinks are consumed in the airport or goods are brought back into the country by UK residents with tax unaccounted for.

Stakeholders have told us that withdrawing the ESC that permits tax-free airside sales will damage UK airports, and that this currently forms part of airport operators and retailers revenue and financing. The Government recognises the challenges the aviation sector is facing as it recovers from the impacts of COVID-19 and has supported the sector throughout the pandemic, and continues to do so, including schemes to raise capital, flexibilities with tax bills, and financial support for employees (including the recently announced Job Support Scheme). The Government has also extended the temporary 5 per cent reduced rate of VAT on goods and services supplied by the tourism and hospitality sectors from 12 January to 31 March 2021, which will support the hospitality and tourism sectors.

Regional airports and International rail

At the same time as removing this concession from 1 January 2021, the Government has decided to extend duty-free sales to EU-bound passengers for the first time in over 20 years. This will be a significant boost to all airports and international rail terminals in England, Scotland and Wales, including smaller regional airports and rail hubs which have not been able to offer duty-free to the EU before. According to data from the Civil Aviation Authority[2], in 2019, 24 out of 29 airports in the UK had significantly more flights to the EU than non-EU destinations, with intra-EU travel clearly making up the majority of passenger travel from the UK.

Some stakeholders have also raised concerns that international rail terminals in GB will lose out from the removal of tax-free sales, as they expect retailers in EU train stations to offer duty-free and tax-free sales to passengers travelling to GB. However, EU law does not currently allow duty-free sales in international rail terminals and the Government is not aware of any announcements from the EU in this area. As mentioned above, 'airside' tax reliefs (which could theoretically be available at other exit points) are not a requirement of EU law, with varying policies found throughout the EU.

[2] https://www.caa.co.uk/Data-and-analysis/UK-aviation-market/Airports/Datasets/UK-Airport-data/Airport-data-2019/