HOUSE OF COMMONS LIBRARY

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VAT registration

By Antony Seely

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Summary

VAT is charged on the supply of all goods and services made in the course of a business by a taxable person, unless they are specifically exempt. All businesses must register for VAT if their turnover of taxable goods and/or services is above a given threshold, which is currently £85,000.[1] Registered businesses may apply to be deregistered for VAT if their turnover falls below a second, lower threshold, which is currently £83,000.

Generally VAT is charged either at the standard rate - currently 20% - or the zero rate.[2] VAT is charged on the additional value of each transaction, and is collected at each stage of production and distribution. A business pays VAT on its purchases - known as input tax, and charges VAT on its sales - known as output tax. It will settle up with HM Revenue & Customs for the difference between the two. In the end the cost of the tax is borne by the final consumer.

Reforming the registration threshold has been considered on two occasions in the last few years: by the Labour Government in the early 1990s, and by the Coalition Government in the context of its decision to increase the standard rate of VAT to 20% in January 2011. However, neither of these reviews resulted in any major changes.

For its part the current Government has taken the view that, "the UK's current registration threshold achieves a reasonable balance between competing interests and reduces the administrative burden on the smallest businesses."[3] In the 2017 Budget, as in previous years, the registration threshold was increased in line with inflation.[4]

In the Autumn Statement in November 2016 the Government announced that it had asked the Office for Tax Simplification (OTS) to carry out a review on aspects of the VAT system.[5] One of the issues the OTS was asked to consider was, "the issues and impacts which would be involved if the VAT registration threshold were either higher or lower than at present."[6]

The OTS published an interim report in February 2017, asking for views on a number of questions; the authors noted that the registration threshold "seems to be having a distortionary impact on business population with an unusual number of businesses reporting turnover at levels just below the [annual turnover limit]" and asked if there might be "simplification benefits in having, for example, a tiered regime, or offering tax reliefs to reduce the cliff edge impact as many EU states have done?"[7] The OTS published a final report on 7 November 2017.[8]

In its report the OTS looked at a variety of options for setting the registration threshold and recommended that, "the Government should examine the current approach to the level and design of the VAT registration threshold, with a view to setting out a future direction of travel for the threshold, including consideration of the potential benefits of a

1 With effect from 1 April 2017 (HMRC, *VAT registration thresholds*, April 2017)
2 A reduced rate of 5% is charged on a small number of supplies; for more details see, HMRC, *VAT rates on different goods & services*, May 2017.
3 PQ10779, 19 October 2015; see also, PQ54208, 30 November 2017
4 The threshold was increased by £2,000 in line with inflation by Order (SI 2017/290). See also, HMRC, *VAT: registration thresholds: tax information & impact note*, 8 March 2017.
5 *Autumn Statement*, Cm 9362, November 2016 para 4.43
6 OTS press notice, *OTS publishes VAT review terms of reference*, 8 December 2016
7 OTS, *Review of Value Added Tax: Progress report and call for evidence*, February 2017 pp4-5
8 OTS press notice, *OTS publishes its first review of VAT*, 3 November 2017. The OTS also produced a follow up briefing following press reports on their proposals.

smoothing mechanism." Although the report noted that there was a case for substantially cutting the threshold, it also noted the downside to doing this:

> Reducing the threshold from £85,000 to £43,000 (for example) would impact between 400,000 and 600,000 businesses. This would reduce the unregistered business population and competitive distortions, and make it harder for businesses seeking to evade VAT to remain undiscovered. It would also raise between £1bn and £1.5bn a year.
>
> However, it would increase compliance costs for a large number of businesses and involve additional costs for HMRC in managing this increased population of registered businesses. It should be noted that significant changes to the VAT threshold would have implications going much wider than the simplification of VAT, including impacts on economic growth and productivity, on pricing, and the impact of VAT on those in different income brackets.[9]

In his Autumn Budget statement in November 2017 the Chancellor Philip Hammond welcomed the report, but did not announce any major changes to the threshold:

> I am grateful to the Office of Tax Simplification for its recent report on the VAT registration threshold. At £85,000, the UK's VAT threshold is by far the highest in the OECD. By contrast, in Germany it is just £15,600. I note the OTS conclusion that it distorts competition and disincentivises business growth. I also note the concerns of the Federation of Small Businesses about the cliff edge of the threshold. But such a high threshold also has the benefit of keeping the majority of small businesses out of VAT altogether, so I am not minded to reduce the threshold, but I will consult on whether its design could better incentivise growth, and in the meantime we will maintain it at its current level of £85,000 for the next two years.[10]

On 13 March 2018 the Government published a call for evidence to "seek views on whether the design of the VAT threshold could better incentivise small business growth."[11] Subsequently, as part of the 2018 Budget the Government confirmed that "the responses to the call for evidence did not provide a clear option for reform", so that it would "look again at the possibility of introducing a smoothing mechanism once the terms of EU exit are clear"; in the meantime the registration threshold would be "maintained at the current level of £85,000 for a further 2 years until April 2022."[12]

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9 *Value added tax: routes to simplification*, November 2017 p9
10 HC Deb 22 November 2017 c1055
11 Spring Statement – consultations, Written statement HCWS541, 13 March 2018. The deadline for responses was 5 June 2018.
12 *Budget 2018*, HC 1629, October 2018 para 3.70. see also, HMT, *VAT registration threshold: Summary of responses*, October 2018.

1. The registration threshold: a short history

When VAT was first introduced in April 1973 the registration threshold was set at £5,000. In 1978, it was doubled to £10,000, and has been increased each year since 1980. Clearly the choice of a threshold will always represent a balance between the need to minimise the burden of tax collection, and the disadvantages from widening the existing exemption. As the then Chancellor, Anthony Barber, explained in his Budget Statement in March 1972, when VAT was first introduced, "there are two considerations: the loss of revenue, and the need to ensure equity as between small and large businesses in competition with each other."[13]

In the 1990 Budget, the threshold was set at £25,400, which was in line with the increase in inflation since 1973. In the 1991 Budget the then Chancellor Norman Lamont announced that the threshold would be increased to £35,000:

> Accounting for VAT can be an onerous duty for small traders. When VAT was introduced, we exempted firms with the lowest turnovers from registration. Since then, the registration threshold has been indexed. European Community constraints have meant that, in the past, we have not been able to increase the threshold by more than the rate of inflation.
>
> At the end of last year, however, we pressed the case with the Commission to increase the VAT threshold. It responded very positively, and I therefore feel able to go far beyond indexation and to increase the turnover limit for registration by no less than 40 per cent. to £35,000, taking it to its highest level in real terms since the introduction of VAT in 1973.
>
> This will benefit up to 150,000 traders. The cost of raising this threshold will be £25 million in the first year, rising to £40 million in 1993/94.[14]

The scope of VAT across all Member States is determined by EU VAT law – and under the terms of the EC sixth VAT directive, which was agreed in 1977, increases in the registration threshold should be no greater than the rate of inflation.[15] It is not at all clear quite why the European Commission agreed to this exemption, though perhaps it was a 'political' agreement. As a result the UK came to have the highest registration threshold in the EU, and this remains the case.[16] The Treasury's call for evidence on the registration threshold, published in March 2018, gives figures for thresholds across the OECD, noting that

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13 HC Deb 21 March 1972 cc1373-1374

14 HC Deb 19 March 1991 c170

15 under Article 24(2)(c) of the sixth EC VAT directive (77/388/EEC 17 May 1977). These provisions are now consolidated in the principal VAT directive (2006/112/EC); article 286 allows for States to increase the registration threshold in line with inflation.

16 European Commission, *VAT thresholds applied by Member States*, April 2018. Further information on aspects of the VAT regime in each Member State is on the Commission's site.

the UK has the highest, "more than double the average in the EU and the OECD which is around £29,000 for both."[17]

Following this change, the Conservative Government argued consistently that increasing the registration threshold was a better way to help businesses than introducing a reduced rate of VAT on certain activities. In the November 1993 Budget, the Chancellor increased the registration threshold to £45,000, as one of a series of measures to help small businesses, so that up to 75,000 traders would be able to opt out of VAT altogether.[18]

Following the increase in the threshold in November 1993, the then Conservative Government ruled out any further substantial increases in the threshold, to say £100,000, as this would seriously contravene EU VAT law.[19] The *Financial Times* observed "the UK knows it cannot push Brussels too far. Any radical departure from this ad hoc system of back door deregulation would be resisted in Brussels unless there was a political will to change the system throughout Europe."[20] Notably the Public Accounts Committee published a report on business compliance costs at this time in which it made a number of recommendations for cutting the burden of VAT, but this did not include changes to the registration threshold.[21]

Other commentators suggested that these changes had resulted in the threshold being too high. In a Budget submission in early 1998, the Federation of Small Businesses argued to an "in-depth review of the registration limit set in the UK", because businesses whose turnover just exceeded the threshold were "often unlikely to be able to increase its prices [to take account of VAT] … this leads to a lack of investment for the future, involvement in avoidance schemes to keep below the registration limit, and in some cases evasion of VAT."[22]

17 *VAT registration threshold: call for evidence*, 13 March 2018 para 1.5, Chart A1
18 HC Deb 30 November 1993 c 934
19 HC Deb 21 March 1995 c108W
20 "Call for higher VAT thresholds in Europe", *Financial Times*, 8 November 1994
21 *The Cost to Business of Complying with VAT Requirements*, 11 July 1994 HC361 1993-94 pp v-x
22 Federation of Small Businesses, *A fairer Budget*, January 1998 pp 16-17

2. The Labour Government's approach to setting the threshold

In the 1998 Budget the Labour Government confirmed that the revenue authorities would review "the VAT thresholds and their impact on competition between registered and unregistered businesses."[23] A consultation paper was published in July that year; in a press notice the department noted, "the VAT registration threshold has, for some time, been set at a high level with the aim of keeping down the administrative costs of small businesses. Historically, this approach has been broadly welcomed. More recently, however, the counter argument has been heard that a high threshold distorts competition, particularly for those businesses trading close to the turnover level at which registration is required."[24] The consultation paper raised the possibility of lowering the threshold:

> While, in the past, the main thrust of representations has been to increase the threshold, more recently there have been indications of increasing concern about the effect of the threshold on competition between registered and unregistered businesses. In particular, businesses in the service sector trading just above the threshold have voiced concern about the extent of trade which they consider is being lost to unregistered businesses.
>
> Those firms operating above the registration threshold must charge VAT, whereas those operating below it need not. However, those firms which do not register for VAT are not allowed to reclaim the VAT on their costs. For businesses outside the service sector, the inability to reclaim input VAT would tend to cancel any price advantage obtained from not having to charge VAT, but this is rarely the case for service sector businesses. A large proportion of their costs are, by definition, direct labour costs and since such costs do not bear VAT, the balance of financial advantage is tipped much more in the direction of those operating below the threshold for registration …
>
> Reducing the threshold would help to address the issue of competitive distortion between registered and unregistered businesses. For example, a reduction in the threshold to £45,000 would bring up to 55,000 additional businesses onto the register, while a reduction to £35,000 would lead to an increase of some 250,000 businesses. While there would still be a distortion around the new threshold, the lower the threshold was set, the less significant that distortion might be. More registrations would lead to additional administrative costs both for traders and Customs but there would be advantages as well. VAT registration would, in many circumstances, allow businesses to reclaim VAT on their business purchases and goods on hand at the time of registration.

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23 HM Customs & Excise Budget press notice C&E 8, 17 March 1998

24 HM Customs & Excise press notice 17/98, 10 July 1998. Responses were invited by 12 October 1998. HM Customs was merged with the Inland Revenue in April 2005 to form HM Revenue & Customs (HMRC).

> This could be significant for many businesses. Indeed there are already in the region of 300,000 voluntarily-registered businesses on the VAT register who benefit from the ability to reclaim VAT. These registered businesses would not, of course, be affected by a reduction in the registration threshold. A reduction in the threshold would also be expected to raise extra revenue for the Exchequer. If a registration threshold reduction was phased in, this would, by definition, delay the benefits, but have the advantage of giving businesses more planning time.[25]

At this time the *Financial Times* suggested that the small business community was divided on how the threshold should be reformed,[26] and the results of the consultation exercise - published in March 1999 - appear to have borne this out.

In its summary of responses HM Customs & Excise discussed the question whether the threshold distorted competition:

> **Distortion of competition**
>
> One of the aims of the consultation exercise was to establish whether there is a problem in practice with the distortion of competition between registered and unregistered businesses, and if so, whether this is caused by the existence or level of the threshold.
>
> Of the 216 respondents, 108 (50%) believed that competition between registered and unregistered businesses is distorted. Most of these (80%) were service providers or trade bodies representing the service sector, in particular the removals, hairdressing, market traders, tourism and construction industries. VAT registered businesses argued that customers will often prefer to buy from unregistered suppliers who can offer a lower price. To try to compete, some said they offer the same low price but absorb the VAT element in their profits. A small number were concerned that such pressures also affected the quality of the goods or services supplied.
>
> Conversely, 34 (16%) were doubtful or disagreed that the level of threshold causes severe or widespread distortion of competition. These included a number of business involved in tourism and in the antiques trade, as well as several accountants, the Union of Independent Companies, the Institute of Directors and some regional Chambers of Commerce. Some believed that the issue is exaggerated by a small number of service businesses who trade close to the threshold and whose customer base is wholly or mainly unregistered.
>
> Some argued that registered businesses are larger and in practice they will therefore be competing in a different market from the unregistered trader. Others felt that any unfair competition was caused more by shadow economy traders seeking to evade taxation rather than by the threshold.
>
> The Chartered Institute of Taxation also points out that the unregistered trader is at a competitive disadvantage when he supplies a registered customer as prices will need to reflect the VAT incurred on their inputs which they are unable to recover.
>
> Of the 108 who felt that there is a real problem, the majority (65) considered that this is caused by the existence of a threshold,

25 HMCE, *Review of VAT registration threshold*, July 1998 para 6-7, 12-14

26 "Threat to extend VAT to small businesses", *Financial Times*, 11 July 1998

> although 6 of these believed that the problem is exacerbated by its current level of £50,000. Many argued that changing the level of the threshold would merely alter the point at which distortion of competition occurs and that it is those currently trading close to the threshold or "at the margins" who will press for changes to the system ...
>
> **Conclusions**
>
> Distortion of competition was perceived to be a real problem by many contributors. However, views were divided as to how the problem should be addressed. Many also believed that VAT registration imposes unfair administrative and financial burdens on business and that the threshold acts as a barrier to growth, employment and training opportunities. There was no overwhelming majority in favour of any of the options floated in the consultation document. Many declared themselves in favour of financial and administrative easements, but further work would be needed to develop specific and more detailed options.[27]

In the 1999 Budget, the Labour Government announced that the threshold would be increased broadly in line with inflation by £1,000 to £51,000, from 1 April 1999, noting that this decision took "account of written responses from business and their representatives [to the consultation exercise]" and that HM Customs & Excise would "be working further with business to explore whether it is possible to cushion the impact of VAT registration on growing businesses."[28]

The consultation paper had also raised the possibility of introducing a differential threshold:

> It would be possible to set a lower threshold for **service** businesses than for those selling goods. This could, on the face of it, offer the benefit of addressing more directly the area in which the distortion of competition is felt most acutely, while retaining the compliance benefits in those areas where there is less competitive imbalance. Such a system is already operated in Ireland and Greece. However, a system of this kind would further complicate the operation of the tax and, in particular, would have drawbacks for those businesses supplying a mix of goods and services.[29]

In the event there was little interest shown in this proposal,[30] and it was dropped:

> **Mr. Bob Russell:** To ask the Chancellor of the Exchequer if he will make it his policy to raise the VAT threshold for businesses in the service sector.
>
> **Dawn Primarolo:** No. A differential threshold for service traders would further complicate the VAT system and create uncertainty, thereby increasing compliance costs for business and administrative costs for Government. Recent consultation on the

[27] *Review of VAT registration threshold: Summary of representations*, March 1999 paras 7-10 & 44
[28] HM Customs & Excise Budget press notice C&E8, 9 March 1999
[29] *Review of VAT registration threshold*, July 1998 para 16
[30] Only 2% of respondents favoured it, 8% opposed it, and 89% made no comment (*Review of VAT registration threshold, summary of representations*, March 1999 paras 34-35).

> effect and level of the threshold revealed only minimal support for such a change.[31]

Subsequently the registration threshold rose in line with inflation, although, as noted in a written answer in March 2010, the UK threshold continued to be one of the highest across the EU:

> **Dr. Cable:** To ask the Chancellor of the Exchequer if he will make an assessment of the effects on small and medium-sized enterprises of increasing the value added tax registration threshold to £200,000; and if he will make a statement.
>
> **Mr. Timms:** The UK has one of the highest VAT registration thresholds in the European Union. Under existing agreements any increase is limited to maintaining the value of the threshold in real terms. Changing the registration threshold to £200,000 would have significant effects on competition between registered and unregistered businesses, on burdens on businesses and HM Revenue and Customs and on revenues.[32]

The Labour Government also made some changes to simplify VAT and encourage companies to register.

First, in the 2002 Budget it announced an optional **VAT flat-rate scheme**, under which businesses would not be required to account for VAT on every purchase and sale that they made, but could calculate their VAT payment as a percentage of their total turnover, provided their turnover was under a set amount. A number of changes to the scheme were announced in the 2003 Budget, including an increase in the turnover ceiling from £100,000 to £150,000.[33] Full details of the scheme are published online.[34]

In October 2007 the Public Accounts Committee published a report on new businesses' tax obligations, in which it found only 16% of firms eligible to use the scheme were doing so (110,000 – though 705,000 would be eligible to join, by end March 2006). It recommended the department should make more efforts to publicise it and other related VAT schemes for SMES.[35] In response the Labour Government said:

> The Department continues to work on simplifying the guidance to make the choice as simple as possible for businesses … as well as developing tools like the 'VAT Scheme Selector' on businesslink.gov.uk. But the Department acknowledges that awareness of the VAT schemes remains is disappointingly low at around 50 per cent. Significant efforts have been made since 2005 to increase awareness of the VAT simplification schemes. This has included a range of advertising campaigns in the trade and national press, including in conjunction with the British Chamber of Commerce.[36]

Second, in the 2003 Budget a **'VAT incentive scheme'** was announced to help businesses which needed to register for VAT. This one-off

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31 HC Deb 24 June 1999 c 459W
32 HC Deb 1 March 2010 c924W
33 HM Customs & Excise Budget Notice CE9, 9 April 2003
34 *VAT Notice 733: Flat rate scheme for small businesses*, April 2017. As discussed below, the scheme was reformed in 2017.
35 *Fifty third report: Helping newly registered businesses meet their tax obligations*, HC 489 2006-07, 25 October 2007 p15, p6
36 *Treasury Minutes*, Cm 7276 December 2007 p38

exercise allowed businesses to notify their liability to register outside the statutory time limits without incurring a penalty, provided they paid any arrears of tax in full, and furnish all returns and payments on time for the twelve months after registration.[37]

The scheme was introduced from 10 April and ran until 30 September 2003; some details of the initiative were given in the department's annual report for that year:

> The VAT Incentive Scheme was launched on Budget Day in April 2003. Designed as a one-off exercise, the scheme ran for six months to the end of September. It aimed to encourage those businesses that should be VAT registered, but were not, to come forward and register. The scheme allowed businesses to notify their liability to register outside the statutory time limits but without incurring a belated notification penalty.
>
> Between April and September, some 3,800 belated applications to register were received. We have already identified arrears in the region of £20 million, and this is likely to rise further when the final figures are calculated. For those who failed to respond to the Incentive Scheme, a further exercise is being undertaken. The work involves cross-matching data from the Inland Revenue against the VAT register and aims to identify unregistered businesses with a turnover in excess of the VAT threshold.[38]

37 HM Customs & Excise Budget Notice CE23, 9 April 2003
38 *Annual Report and Accounts 2002-03* HC52 18 December 2003 p 21

3. The Coalition Government's approach

In the Coalition Government's first Budget in June 2010, the Chancellor, George Osborne, announced that the standard rate of VAT would be increased to 20% from 4 January 2011. In the weeks before the new standard rate took effect the Federation of Small Business (FSB) argued that this change would hit small companies harder, as they would be most likely to pass on the full cost of the tax rise to their customers.[39] The FSB published some research which had made the case for substantially increasing the registration threshold to £90,000 – so that companies falling out of registration could save on compliance costs and receive a cash boost by not having to charge VAT on their sales.[40]

This issue was also raised by respondents to a review of small business taxation carried out by the Office for Tax Simplification (OTS). The establishment of the OTS was also announced in the Government's June Budget, when the Chancellor proposed setting up an independent body to review the tax system. In July Treasury Minister David Gauke announced the OTS's first two pieces of work would be to look at the existing structure of tax reliefs and at small business taxation.[41]

Just prior to the 2011 Budget the OTS published reports on both of these issues – and in its paper on simplifying the tax system for small business, noted that many respondents raised concerns about the compliance costs of smaller businesses being VAT-registered:

> A good number of those we speak to have called for an increase in the threshold, perhaps to £100,000, to exclude more businesses from VAT. At the same time, sometimes in the same meeting, some will call for the limit to be reduced radically, so that what they see as unfair competition is reduced as is the risk of small businesses not keeping proper records. It has to be said that there are more 'raisers' than 'lowerers'.
>
> On balance we think the registration threshold should stay as it is, though it is an area that is worth further study. As is well known, the UK's registration threshold is the highest in the EU; a number of other member states have minimal registration thresholds.[42]

In the 2011 Budget the Government simply increased the threshold in line with inflation for the coming tax year,[43] though, in response to the OTS's report, the Chancellor requested the OTS to look at improving tax administration for small business. In a letter to the OTS setting out this work programme, Treasury Minister David Gauke explained that one of the purposes to this review would be to examine and present "small businesses' experience of tax administration and their interaction with HMRC at key stages of their annual cycle, together with specific

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[39] "VAT threat to small business", *Financial Times*, 11/12 December 2010

[40] FSB press notice, *Increase in VAT thresholds could create up to 35,000 jobs in small firms*, 8 December 2010

[41] HC Deb 20 July 2010 c8WS. Details of the OTS's work is collated online.

[42] *Small business tax review*, March 2011 para 4.63

[43] *Budget 2011* HC 836 March 2011 para 2.159; see also, HC Deb 10 October 2011 c141W

consideration of the issues involved in starting a new business."[44] The OTS did *not* review the threshold itself as part of this work,[45] though it made some recommendations for improvements to the flat rate scheme, and 'stagger dates' (the date on which a business makes a quarterly payment of VAT):

> **VAT stagger dates and Flat Rate Scheme**
>
> 7.6 Currently businesses are allocated a "stagger date" (the quarterly VAT return periods) when they register for VAT. They can choose to have this changed by writing in after the initial allocation is made and many businesses choose to do this so that the stagger date coincides with the business accounting period end. Some businesses are unaware of this option which could make matters easier for them. The current process means that both the business and HMRC are involved in changes, which would be unnecessary if the stagger date choice was part of the registration process.
>
> 7.7 Similarly, if businesses wish to use the Flat Rate VAT Scheme (FRVS) from the date of registration they have to apply on a separate form, ideally after they have received their VAT registration number. This process seems an unnecessary extra step for small businesses, which could in our view become part of the VAT registration process.
>
> 7.8 In the case of both stagger dates and the FRVS, applying for both as part of the registration process and having both in place from the date of VAT registration is a simplification, which would provide benefits both to businesses and to HMRC. Furthermore, it would raise the profile of the FRVS scheme for new small businesses which might otherwise be unaware of it.
>
> 7.9 **The OTS recommends that when a business applies for VAT registration, as part of the registration process, the business should be able to choose, if it wishes, the stagger date for its VAT returns and also to indicate that it would like to use the VAT Flat Rate Scheme.** The OTS understands that this change will be incorporated into the new VAT online process from the autumn, but **recommends this should similarly apply to paper registrations.[46]**

In turn, as part of its response to the OTS review, published alongside the 2012 Budget, HMRC confirmed "from November 2012 the Online Tax Registration Service will include VAT and businesses will be able to request their accounting period (stagger) and apply to use the Flat Rate Scheme as part of the registration process."[47] (The Government first proposed that HMRC would introduce an online system for VAT registration in March 2011, and made provision to this effect in the *Finance Act 2012*.[48])

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[44] *Letter from Exchequer Secretary to Michael Jack*, Chairman, OTS, 9 May 2011

[45] HC Deb 6 December 2011 c299W

[46] *Small business tax review: HMRC administration*, February 2012 pp33-4

[47] HMRC, *Response to the OTS's Small business tax review: Final report - HMRC administration*, March 2012 pp8-9

[48] *Budget 2011*, HC 836 March 2011 para 2.164 & *Budget 2012*, HC 1853 March 2012 para 2.195. Provision was made under schedule 29 of *FA2012*.

4. Recent developments

4.1 Reforms to the Flat Rate Scheme

Following the OTS review there was less comment about the level of the registration threshold, which was increased each year in line with inflation.[49] Treasury Minister David Gauke set out the Government's position in answer to a PQ in October 2015:

> **Asked by Ben Howlett :** To ask Mr Chancellor of the Exchequer, if he will review the level of existing VAT thresholds for small businesses.
>
> **Answered by: Mr David Gauke :** The UK has chosen to maintain a high VAT registration threshold, and it is currently the highest in the EU (at £82,000 from 1 April 2015). We believe that the UK's current registration threshold achieves a reasonable balance between competing interests and reduces the administrative burden on the smallest businesses. The Government may not increase this threshold further, aside from maintaining its value in line with inflation, without the consent of the European Commission and the unanimous agreement of all EU Member States.[50]

In the 2016 Budget the Government announced that the threshold would be increased in line with inflation, by £1,000 to £83,000.[51]

As noted above, in 2002 the then Labour Government introduced the VAT Flat Rate Scheme (FRS), with the purpose of simplifying the VAT compliance requirements of smaller businesses. Businesses would not be required to account for VAT on every purchase and sale that they made, but could calculate their VAT payment as a percentage of their total turnover, provided their turnover was under a set amount.

In his Autumn Statement in November 2016 the Chancellor Philip Hammond announced that the Government would "shut down inappropriate use of the VAT flat rate scheme that was put in place to help small businesses."[52] The *Autumn Statement* gave some details:

> **VAT Flat Rate Scheme** – The government will introduce a new 16.5% rate from 1 April 2017 for businesses with limited costs, such as many labour-only businesses. This will help level the playing field, while maintaining the accounting simplification for the small businesses that use the scheme as intended. Guidance which has the force of law, published today, will introduce anti-forestalling provisions.[53]

At this time HM Revenue & Customs published a technical note on this measure,[54] and the next month a draft of the secondary legislation to implement it. Following consultation, an amended version of this Order

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49 *Budget 2012*, HC 1853, March 2012 para 2.180; *Budget 2013*, HC 1033, March 2013 para 2.179; *Budget 2014*, HC 1104, March 2014 para 2.175; *Budget 2015*, HC 1093, March 2015 para 2.154

50 PQ10779, 19 October 2015

51 *Budget 2016*, HC 901 March 2016 para 2.149; HMRC, *VAT: revalorisation of registration and deregistration thresholds: tax information & impact note*, 16 March 2016

52 HC Deb 23 November 2016 c907

53 *Autumn Statement 2016*, Cm 9362 November 2016 para 4.51

54 HMRC, Tackling aggressive abuse of the VAT Flat Rate Scheme, December 2016

was introduced and approved (SI 2017/295). As the explanatory memorandum to the Order explains, the FRS was being aggressively marketed as a method for businesses with limited costs to obtain an unfair cash advantage over their competitors:

> **What is being done and why**
>
> 7.1 The FRS is a simplification scheme, not a tax allowance. It is designed to reduce administrative burdens for small businesses by simplifying the accounting requirements for VAT.
>
> 7.2 VAT rules require businesses to offset the VAT on costs against VAT on sales to produce a net VAT payable to HMRC. To save small businesses from having to do this, the FRS sets specific flat rates for business sectors as a proxy for the amount of net VAT for a normal business in that sector.
>
> 7.3 However, where businesses with limited costs register for VAT and use the FRS, this results in a large cash advantage. This is because they use the flat rate appropriate to their trade sector but have significantly lower costs than most small businesses in that sector.
>
> 7.4 Of the 411,000 businesses that use the FRS, we estimate that 128,000 have limited costs. There has been a significant growth in the number of self-employed people registering for and exploiting the FRS. We believe this is due to the aggressive marketing of the scheme by some agents. HMRC received 30,000 extra applications in bulk between January 2016 and August 2016.
>
> 7.5 When the measure is introduced, businesses using the FRS or considering joining the FRS will need to consider whether they are a 'limited costs' business. For some businesses this will be obvious; others will need to complete a simple test to determine whether they must use the new 16.5% rate. Businesses using the FRS will be expected to ensure that, for each accounting period, they use the appropriate flat rate percentage.
>
> 7.6 The new 16.5% rate will remove the cash advantage for those businesses that have limited costs. These changes will create a more level playing field for all small businesses, while keeping VAT accounting simple for the small businesses that use the FRS. The measure will deliver £700m over the 6 year scorecard period. We introduced tertiary legislation in VAT Notice 733 on 23rd November 2016 to prevent forestalling by those abusing the scheme.[55]

HMRC published an impact assessment, which said a little more about the cohort of businesses affected by the new rules:

> **Impact on business including civil society organisations**
>
> This measure is expected to have a negligible one-off impact on FRS businesses that will need to familiarise themselves with the new rules, but there will be an on-going cost of applying the new test … To support businesses we will introduce an online tool that will enable both current and prospective users of the FRS to determine whether they must use the new 16.5% rate.
>
> Businesses using the new rate will pay more tax than previously if they continue to use the FRS. We estimate that approximately 4,000 businesses may decide to switch to standard VAT accounting, as this could mean they pay less VAT. If businesses

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[55] *Explanatory memorandum to the VAT Amendment Regulations SI 2017/295*, March 2017 p2

> make this decision, the compliance cost of switching to standard VAT accounting may be about £180 per business.
>
> Alternatively, some businesses may choose to de-register from VAT. Almost two thirds of the FRS population consists of businesses under the compulsory VAT registration threshold and if their financial gain from the FRS is greatly reduced then many of them may decide to de-register. If businesses make this decision, their administrative burdens may reduce by about £390 per business on average.
>
> For some businesses, it will be very clear whether the value of goods they purchase is above the test threshold. However, many will be close to the threshold and will need to complete the test to determine whether they are a limited costs business. These businesses will incur an administrative burden of about £65 per business.
>
> It is likely that a large proportion of FRS users are employing an accountant or a tax advisor who would carry out the test as part of their service. The administrative burden will only increase for a small proportion of FRS businesses whose costs are close to the test threshold, do not employ an accountant and do not wish to de-register. This is estimated to be around 24,000 businesses.[56]

There does not appear to have been much comment on this measure in the House,[57] or by other stakeholders, though in March 2017 the Chartered Institute of Taxation published correspondence with HMRC on the operation of the new rules.[58]

4.2 The OTS review of VAT

In the 2016 Autumn Statement the Government also announced that it had asked the Office for Tax Simplification (OTS) to carry out a review on aspects of the VAT system.[59] One of the issues the OTS was asked to consider was, "the issues and impacts which would be involved if the VAT registration threshold were either higher or lower than at present."[60]

The OTS published an interim report in February 2017, asking for views on a number of questions. The authors noted that the annual registration threshold – which was then £83,000 – appeared to be having a distortionary impact on business population "with an unusual number of businesses reporting turnover at levels just below the threshold", and asked if there might be "simplification benefits in having, for example, a tiered regime, or offering tax reliefs to reduce the cliff edge impact as many EU states have done?" A longer extract is reproduced over the next three pages:[61]

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56 HMRC, *VAT: tackling aggressive abuse of the Flat Rate Scheme – tax information & impact note*, December 2016

57 With the exception of a couple of PQs – see PQ HL5973, 24 March 2017, and, PQ 5973, 21 March 2017.

58 CIOT, *VAT Flat Rate Scheme – Changes*, 10 March 2017

59 *Autumn Statement*, Cm 9362, November 2016 para 4.43

60 OTS press notice, *OTS publishes VAT review terms of reference*, 8 December 2016

61 *Review of Value Added Tax: Progress report and call for evidence*, February 2017 pp4-5. The threshold rose to £85,000 on 1 April 2017.

Office for Tax Simplification, *Review of VAT: Progress report*, February 2017

Identifying the implications of the level of the registration threshold

We have been specifically asked to look at the issues and impacts which would be involved if the VAT registration threshold were either higher or lower than at present.

The current VAT registration threshold of £83,000 (approx. €97,000 following recent falls in Sterling) is significantly higher than the EU average of around €30,000. Furthermore, HMRC data indicates that 44% of businesses registered for VAT actually operate below the threshold.[1]

Some of the reasons that we've been told drive this:

- start-ups in transition:
  - those expected to grow quickly so for simplicity register for VAT alongside all other initial company formation registrations
  - those claiming a high amount of input VAT, on high capital expenditure for example, and the cash-flow benefits outweigh any administrative burden. This especially applies to those that incur VAT on services as this can only be reclaimed if the business registers for VAT within six months
- B2B businesses that will be at a financial advantage
- businesses that want to appear larger than they actually are
- businesses that simply do not know that VAT registration is optional below the threshold
- businesses that receive advice from non-qualified advisers to register (for example traders in umbrella companies that are given a generic set of advisory materials upon joining)
- businesses that previously traded above the threshold but are now trading under and choose not to (or do not know that they can) deregister

We expect there are others and we do not yet know how the 44% is distributed, but it implies:

- for many traders VAT is simple enough so they elect to use it; and/or
- the additional complexity and burden is outweighed by the advantages of registration (for example, making a net gain from VAT repayments and perceived improvements in the business's reputation).[2]

Countries adopting a VAT or goods and services tax (GST) more recently generally set lower a registration threshold than the UK. But Singapore has a GST[3] registration of S$1million (approx. £500,000) and so totally excludes all small businesses.[4]

Notes :

[1] HMRC VAT Factsheet 2015/16, sheet 2.7

[2] We have also received submissions and comments from small businesses that refer to VAT as straightforward and the simplest of all the taxes they deal with. One showed us their very simple spreadsheet method that seemed to consume minimal time, something we will return to in the Making Tax Digital section (p20).

[3] Singapore's GST system has some other differences compared to UK VAT. It applies a rate of 7% to all goods and services excluding only the provision of financial services, sale and lease of residential properties, and the import and local supply of investment precious metals. Non-domestic supplies are out of scope.

[4] We note that the UK could not increase the threshold above inflation under EU law.

The £83,000 threshold seems to be having a distortionary impact on business population with an unusual number of businesses reporting turnover at levels just below the threshold.

It is possible for some businesses, especially self-employed service workers[5] to live a relatively comfortable life off profits made on turnover below the threshold.

Several stakeholders we spoke with cited examples of businesses actively managing their businesses to stay below the threshold through:

- refusing to take on another contract until the year end
- physically closing their store, restaurant or B&B for a month or two each year
- deciding against taking on a part time employee or apprentice

There is also the risk of traders simply declaring a false, lower turnover through suppressing sales or business splitting, something HMRC have experience of.

Invariably these are 'B2C' businesses and so entering the VAT system is seen as bringing a '*VAT penalty*', through having to charge VAT and so increase prices or absorb it. While traders are entitled to take as much time off as they wish, would fewer do so to such an extent, if they didn't face a large VAT penalty for continuing to trade?

Alternatively would this be solved by a much lower threshold like most EU and many non-EU states, so that any established business would be subject to VAT and the competitive disadvantage removed?

Against this, how would the small businesses drawn into VAT through a lower registration threshold manage? Would the admin burdens and general complexity of being in the VAT 'net' outweigh any levelling of the playing field?

It may be thought that this is not strictly a simplification issue. But if changing the threshold would make for an easier businesses environment and remove a 'cliff edge' that would clearly be a simplification.[6]

Taking that a bit further, we also have to consider the implications of a higher threshold (though as we have already noted, at present the UK can only raise the threshold in line with inflation). Potentially that would exclude more businesses – so would the simplification gain be worth the risk of more distortion in the marketplace?

We have already had a number of alternative routes suggested to us. Would there be simplification benefits in having, for example, a tiered regime, or offering tax reliefs to reduce the cliff edge impact as many EU states have done?[7]

A key part of our assessment will be whether changing the threshold would have an economic impact, tackle any disincentive to grow and potentially create more jobs. And, of course, we will be assessing the exchequer impact of changes.

Notes :

[5] Likely to have little input VAT to reclaim.

[6] It is beginning to emerge from initial discussions that, unless the change is significant, any increase or decrease might only shift where the threshold impacts are felt, rather than really mitigating problems.

[7] The French system allows a business above the minimum threshold, but below a certain further threshold for up to two consecutive years, to avoid charging VAT.

Questions :

- Why are businesses below the VAT threshold registering – how does that 44% break down?
- What would be the impact of raising the threshold significantly? With and without the option for voluntary registration?
- What would be the impact of reducing the threshold significantly? How would HMRC and businesses who were brought into the VAT net manage?
- In both cases what would be the impact on economic activity?
- Are there any other approaches that could simplify the regime? Does Making Tax Digital [the system of digital tax returns being rolled out from April 2019] have an impact?

In their report the OTS also touched on the change made to the rules for the FRS, and asked respondents to share their views on the effectiveness of this anti-avoidance legislation:

> Flat rate schemes were designed to provide simplicity for small businesses that registered for VAT but were not large enough to engage dedicated expertise to deal with some of the more complicated aspects of 'the simple tax' …
>
> Arguably the greatest simplification benefit of the flat rate schemes is not the simplification of the general VAT calculation, but to escape some of the tax's complexities—partial exemption for example. If a business continues to grow beyond the upper threshold of the flat rate schemes they'll find themselves subject to normal VAT rules and its complexities. As such the flat rate schemes only act as a sticking plaster and do not solve any of the underlying complexity in the VAT regime. The simplification benefit of flat rate schemes has also diminished as modern accounting packages and technology make the general VAT scheme simpler to administer.
>
> Recent anti-avoidance measures may have made them more complicated, following the schemes being looked at as tax saving opportunities rather than simplifying. Perhaps unsurprisingly, many commented on the new limited cost trader tests and cited complexity within its quarterly calculations
>
> (While many are likely to leave the scheme because it no longer offers a tax advantage, some have suggested that traders will leave the flat rate scheme because of complexity. We have also been told that the test is easily avoidable. Could, then, the policy aims be achieved more simply? We also note the new online calculator developed by HMRC to assist taxpayers using this rate.)
>
> **Questions**
>
> - Is it possible to reduce the number of different FRS rates?
> - Will there be a sufficient simplification benefit to require traders to state what scheme they are using on their VAT return?
> - Is it possible to further increase knowledge of schemes up front when traders first register?

- Can measures directed at abuses of the schemes be better targeted? Perhaps by framing eligibility differently?
- Overall, do these schemes still work? Is there still a sufficient simplification benefit to justify their retention or would it be simpler just to simplify particular aspects of the general VAT system? Will Making Tax Digital (MTD) make them less relevant?[62]

The OTS' final report was published on 7 November; a short summary of its recommendations was given in an advance press notice:

> The Office of Tax Simplification (OTS) will shortly publish a report setting out a range of proposals for simplifying VAT. After over 40 years, the tax is showing its age. What was meant to be a simple tax has become highly complex and it has not kept pace with changes in society …
>
> The OTS's core recommendations will include:
>
> - that the government should examine the current approach to the level and design of the VAT registration threshold, with a view to setting out a future direction of travel for the threshold, including consideration of the potential benefits of a smoothing mechanism
> - that HMRC should maintain a programme for further improving the clarity of its guidance and its responsiveness to requests for rulings in areas of uncertainty
> - that HM Treasury and HMRC should undertake a comprehensive review of the reduced rate, zero-rate and exemption schedules, working with the support of the OTS
>
> The most significant issue identified in the report is the VAT registration threshold - the turnover level above which a business must enter the VAT system and charge VAT on its sales. At £85,000 the UK has one of the highest levels in the world.
>
> By enabling many small businesses to stay out of the VAT system the high threshold is a form of simplification, but it's an expensive relief, costing around £2bn per annum, and evidence strongly suggests that many growing businesses are discouraged from expanding beyond this point. The report looks at options for reducing the current 'cliff edge' effect resulting in a very visible bunching of businesses just before the VAT threshold, and an equally large drop off in the number of businesses with turnovers just above the threshold. Also examined are the advantages and disadvantages of lowering or increasing the threshold.
>
> VAT has many 'quirks'. For example, it is well known that a Jaffa cake is a cake (zero-rated) rather than a chocolate-covered biscuit (taxed at 20%). Less well known is that while children's clothes are zero-rated, including many items made from fur skin, items made from Tibetan goat skin are standard-rated. And a ginger bread man with chocolate eyes is zero-rated but if it has chocolate trousers it would be standard rated. VAT zero rates cost over £45bn per annum to maintain. EU law limits options to make changes in this area but there is a longer-term opportunity to significantly improve the efficiency, simplicity and fairness of the UK VAT system.

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[62] *Review of VAT: Progress report and call for evidence*, February 2017 pp13-14. The deadline for responses was 30 June 2017.

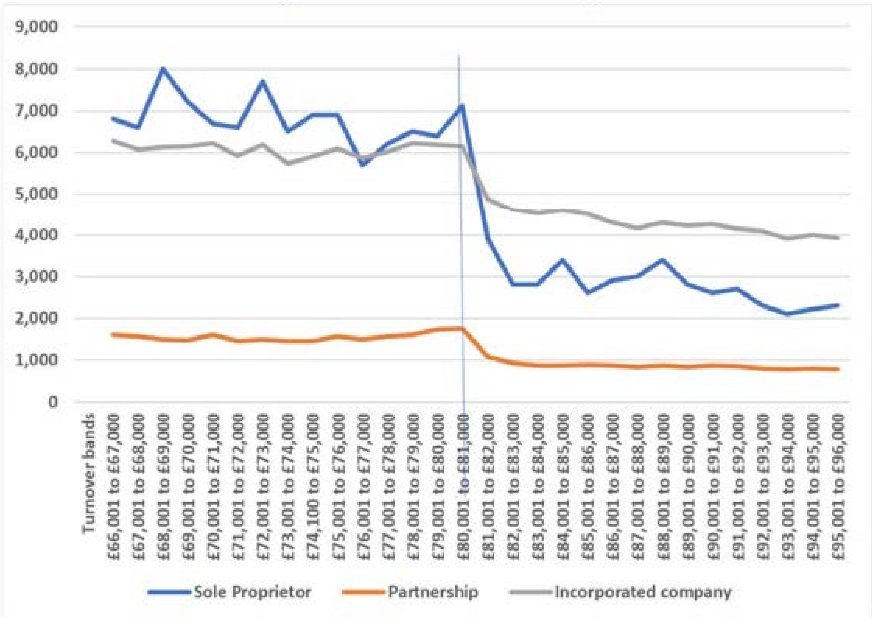
The report also

- makes recommendations for improving the day to day administration of the tax, including better and more accessible guidance and a less uncertain penalty system. This would particularly benefit small businesses
- considers specific areas of technical difficulty, including the partial exemption regime, the capital goods scheme, the option to tax and other special schemes.[63]

On the operation of the registration threshold, the report argued that "there is clear evidence, from academic analysis of HMRC data and from submissions to this review, that the high level of the threshold is having a distortionary impact on business growth and activity":

> There is currently significant 'bunching' of businesses whose turnover is just below the threshold (see Chart 1), particularly businesses with lower levels of inputs relative to supplies to consumers - such as labour-intensive businesses, and businesses operated by sole proprietors - for whom this bunching effect has the appearance of a cliff edge.[64]

Chart 1: Numbers of entities by turnover band around the registration threshold



Source: HMRC data from 2014/15, when the threshold was £81,000.

The partnership and incorporated figures are an analysis of 100% of relevant data. The sole proprietors figure is based on a sample of taxpayers from the survey of personal incomes (SPI), grossed to represent the full Self Assessment population. This means that unlike the other two series in the chart, the Sole Proprietor series is affected by sampling variability. A consequence of this is that it is not as smooth across the income bands as it would be if it were based on 100% data.

> The bunching in front of the threshold and the very significant fall-off in business numbers immediately after it, reflects the significance to a business of crossing the threshold, as when this happens all a businesses' supplies to customers potentially increase in sale price by up to 20%. For example, compare a business with a turnover of £84,000 which is not registered for VAT with a VAT-registered business having a turnover of £85,000.

63 OTS press notice, *OTS publishes its first review of VAT*, 3 November 2017
64 The term 'sole proprietor', in this context, refers to unincorporated businesses other than partnerships. These may have one or more employees

> If VAT applied to the whole of the turnover, the VAT-registered business would be liable for an additional £17,000[65]). Evidently, many businesses will not be able to pass this increase on to customers, especially when competing with unregistered businesses. Meanwhile, others fear the administrative impact of VAT registration.
>
> Bunching arises from two main factors. Firstly, some businesses limit expansion – for example by not taking on an extra employee, or an extra contract, or closing their doors for a period, to keep their turnover below the threshold. This is an entirely legal practice. Second, some businesses deliberately suppress their recorded takings and then report a turnover below the threshold. This practice is illegal.
>
> More broadly, the fact that many taxpayers are spending time considering these issues and the impact on their business, and adapting their behaviour to avoid either the economic or administrative consequences of entering the VAT system, is itself an undesirable complexity in terms of the 'user experience' of VAT as well as being potentially economically distortive.[66]

The report went on to consider "the impact of either raising or lowering the threshold, both by small or larger amounts[67]" …

> **Smaller changes to the threshold**
>
> **Freezing** the threshold is one option. If the government had maintained the existing threshold in 2017/18 (rather than increasing it in line with inflation as has become the norm) 4,000 extra business would potentially have been required to register in that year, with an increase in revenue to the public purse of approximately £10m and a consequent increase in the administrative costs of those businesses. (If the freeze were continued into future years the numbers brought into VAT and the revenues involved would continue to grow.)
>
> **Reducing** the threshold a little would mean that a few thousand additional businesses would be required to register, increasing their tax compliance costs. Either freezing or slightly reducing the threshold would have limited impact on competitive distortions however, because only a small number of businesses would be affected relative to the overall UK business population, and the behavioural consequence might only be to shift the point at which bunching occurs.
>
> **Increasing** the threshold by a small amount – say £2,000 - would mean that approximately 12- 15,000 fewer businesses would be required to register. This would produce some administrative savings for those businesses, but again have limited impact on competitive distortions. Tax revenue would be reduced by between £30-50 million in the first year, increasing over time.[68] As with small reductions, the behavioural consequence might only be to shift the point where bunching occurs. However, the revenue

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[65] (85,000 x 20% = 17,000). In practice the net figure is likely to be less (in some cases significantly less) as the newly-registered business will be able to recover VAT on its purchases, which it was unable to do before registration.

[66] *Value added tax: routes to simplification*, November 2017 pp6-7

[67] Our understanding is that EU law might permit a lowered threshold but may not currently allow for a significant increase or the introduction of a new graduated tax relief.

[68] Note that these figures reflect the current bunching effect which might be expected to shift as the threshold moved.

and administrative impacts would, clearly, be greater if the threshold were raised or lowered by a more substantial amount.

Significant changes to the threshold

Raising the threshold significantly, for example to £500,000,[69] would potentially impact around 800,000 businesses. Of those, between 400,000 and 600,000 businesses might choose to deregister, while 200,000-400,000 might choose to remain voluntarily registered.[70] This would simplify the tax obligations for businesses that chose to deregister, reduce VAT-related competitive distortions between registered and unregistered small businesses, and reduce the administrative burden on those businesses.

However, raising the threshold to such a high level would cut the funds available for public services by between £3bn and £6bn a year. It would also have potential behavioural consequences. For example, the presence of many more unregistered businesses in the marketplace could well encourage some of them to operate in the hidden economy, reducing their compliance with - and payment of - other taxes. Competitive distortions would also be shifted upwards so medium-sized businesses would be in competition with many more unregistered businesses in total, some of which would be of substantial size.

Reducing the threshold from £85,000 to £43,000 (for example) would impact between 400,000 and 600,000 businesses.[71] This would reduce the unregistered business population and competitive distortions, and make it harder for businesses seeking to evade VAT to remain undiscovered. It would also raise between £1bn and £1.5bn a year.

However, it would increase compliance costs for a large number of businesses and involve additional costs for HMRC in managing this increased population of registered businesses. It should be noted that significant changes to the VAT threshold would have implications going much wider than the simplification of VAT, including impacts on economic growth and productivity, on pricing, and the impact of VAT on those in different income brackets.

… and other possible mechanisms to smooth the transition to being VAT-registered:

Given that any threshold creates an incentive to operate below it, the OTS has also considered ways in which the distortive effect of a threshold might be reduced by introducing some form of smoothing mechanism.

Options considered included:

- smoothing the cash impact of becoming registered
- smoothing the administrative impact

69 This is approximately the registration threshold in Singapore (1 million Singapore $). Singapore is an example of one of the highest VAT registration limits globally. This figure is used for illustrative purposes only.

70 These numbers are based on an analysis of VAT returns between the threshold and £500,000, and include assumptions about the percentage of businesses within each trade sector making supplies to other businesses or otherwise likely to benefit from being registered. The calculation assumes that such businesses would wish to remain voluntarily registered.

71 £43,000 was the starting point for higher rate income tax when this report was prepared – it is used here for illustrative purposes only.

> - smoothing both cash and administration
> - a time-limited reduction in the VAT Flat Rate Scheme rate for newly-registered businesses and a financial taper.[72]
>
> Any such mechanism could be considered to increase the overall complexity of the system, but it could also offer businesses a way to pass more easily across the threshold and as a result have a positive impact on economic growth and productivity. Developing a workable mechanism that balances the risk of fraud, revenue loss and potential complexity against the benefits of smoothing entry to the VAT system and reducing business burdens is challenging, but the OTS considers there is merit in examining this for the future.[73]

Most commentary on the report focused on the possible Exchequer gain from a substantial cut in the registration threshold,[74] although, as noted above, the authors looked at a number of other issues, including the VAT Flat Rate Scheme, mentioned above:

> 1.48 Approximately 31% of all eligible businesses use the Flat Rate Scheme.[75] Users report that the benefits experienced are generally in line with their expectations, with around 60% finding that the scheme saves time and administrative burdens and 41% reporting a financial benefit.
>
> Of those which didn't use the scheme, approximately 30% were unaware of it or didn't understand it, while 20% were advised not to use it by an accountant: the remainder either thought it was not relevant or gave no particular reason for not using it.
>
> 1.49 The FRS is expected to continue to be available under Making Tax Digital (MTD), with accounting software facilitating simplified record-keeping. The FRS helps those who are registered by simplifying accounting for VAT but does not reduce the financial impact of having to charge VAT to customers who are not able to recover it.
>
> 1.50 It is clear that businesses value this administrative simplification. HMRC may be able to further increase usage of the scheme by publicising its benefits, to help potential users understand how it might ease the administrative burden that they fear from VAT registration.
>
> 1.51 A larger reduction in the first year of registration or a continuation of it into the second or third year of registration might encourage more businesses to grow above the threshold. This would need to be at a level that was attractive but not so high that it encouraged abuse of the scheme or had a significant revenue cost.
>
> 1.52 For example, using the current FRS thresholds, one possibility would be for a newly registered business with taxable income below £150,000 to benefit from a reduction of 5% in the rate of VAT they would otherwise be required to pay under the scheme in the first year of registration, 3% in the second, and 1% in the

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[72] Our understanding is that many of these would not be possible under present EU law.

[73] *op.cit.* pp 7-9

[74] For example, "Hammond risks small business backlash with Budget shake-up of VAT", *Financial Times*, 10 November 2017; "Boost for small businesses as Philip Hammond scraps rates rise", *Times*, 6 November 2017

[75] There are more than 410,000 current users known to HMRC. HMRC, *VAT Factsheet 2015/16*, October 2016

> third. This would clearly have a revenue cost: it has not been practical to estimate the potential cost at this time.
>
> 1.53 In the UK, just over 40% of businesses survive their first five years, with the highest drop-off rates occurring in the first three years.[76] Support for businesses in their first three years would be targeted at their most vulnerable period.
>
> 1.54 A major advantage of using the FRS to reduce the financial impact of registration is that it is an existing scheme that is popular with businesses and generally well-understood.
>
> 1.55 Any reduction applied to existing FRS rates would benefit all businesses, not just those making B2C supplies. However, the reduction would apply to established rates for business sectors, which take account of the proportion of business to business (B2B) supplies in the sectors concerned. Attempting to apply the reduction only to individual businesses making mostly B2C supplies would be administratively difficult and resource intensive for both HMRC and businesses. The percentage reduction for businesses with limited taxable inputs might need to be lower than for other businesses, to reduce the risk of abuse.[77]

At this time HMRC published some research commissioned from Ipsos MORI on business behaviour associated with VAT registration, which also found evidence of businesses taking action to keep their turnover below the registration threshold:

> HM Revenue and Customs commissioned Ipsos MORI to conduct quantitative and qualitative research into business behaviours and experiences associated with VAT registration. The research consisted of a telephone survey of 2,009 businesses, followed by qualitative research with 40 businesses who agreed to be re-contacted …
>
> Overall, **20% of unregistered borderline businesses admit to having taken some action to remain under the threshold and outside the VAT system**. Businesses restricted their turnover in several different ways (sometimes illegally), with the most common being closing the business or stopping advertising (47% of those restricting turnover admitted this), refusing or turning down work (21%), asking customers to purchase materials (16%), reducing prices of products to ensure the VAT threshold is not reached or splitting the business by operating as a separate legal entity or artificially separating the business by product or service (both 10%). Most unregistered borderline businesses felt they would find it difficult to increase prices to cover VAT charges (78%) and this was perceived as a major barrier among those taking part in the qualitative research.
>
> Most businesses restricted their turnover to remain outside the VAT system because they **expected VAT registration to negatively affect their profit, or their competitiveness** if the cost was passed on to their customers. Businesses with a higher proportion of business-to-consumer sales and low input costs perceived a substantial financial impact. The qualitative research also found that restricting business activity often involved considerable effort and monitoring of turnover, and turning down work could impact on a business' reputation. Some businesses felt frustrated that they were not able to grow without incurring this financial impact. Several measures were suggested to reduce the

76 ONS, Business Demography 2015
77 *Value added tax: routes to simplification*, November 2017 pp24-5

> financial shock for businesses, from simply increasing the VAT threshold to full redesigns of the system.[78]

In his Budget statement on 22 November the Chancellor Philip Hammond gave the Government's response to the OTS' report. Mr Hammond acknowledged the case for cutting the registration threshold, but he went to note that it delivered certain benefits, so that, pending a consultation exercise on its operation, the Government would freeze the threshold for the next two years:

> I am grateful to the Office of Tax Simplification for its recent report on the VAT registration threshold. At £85,000, the UK's VAT threshold is by far the highest in the OECD. By contrast, in Germany it is just £15,600. I note the OTS conclusion that it distorts competition and disincentivises business growth. I also note the concerns of the Federation of Small Businesses about the cliff edge of the threshold. But such a high threshold also has the benefit of keeping the majority of small businesses out of VAT altogether, so I am not minded to reduce the threshold, but I will consult on whether its design could better incentivise growth, and in the meantime we will maintain it at its current level of £85,000 for the next two years.[79]

The Chancellor set out his position at more length in a letter to the OTS, when he also addressed the wider issue raised in the report as to the complexity of the current structure of VAT reliefs:

> The government's ability to amend the scope of the various rates and exemptions is limited to some extent by EU law at present. It is clear that the current rates structure is the root cause of much of the complexity in the VAT system, imposing administrative burdens on businesses and often confusing consumers. I agree that there is merit in a review of the current system of VAT rates and reliefs in the longer term, and HMRC and HM Treasury officials will continue to engage with the OTS on this subject.[80]

Freezing the registration threshold is forecast to raise £105m in 2019/20, rising to £170m by 2022/23.[81]

On 13 March 2018 the Government published its call for evidence to "seek views on whether the design of the VAT threshold could better incentivise small business growth."[82] The deadline for responses was 5 June 2018. To encourage a wide range of responses, stakeholders were invited to write, email or complete an online survey.[83]

Although the paper did not make any specific proposals, in its discussion of possible policy solutions it underlined the fact that a

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78 HMRC, *Behaviours and experiences in relation to VAT registration – Research Report 446*, 16 November 2017 pp2-3

79 HC Deb 22 November 2017 c1055

80 HM Treasury, *Letter from the Chancellor to the Office of Tax Simplification (OTS)*, 22 November 2017

81 *Autumn Budget*, HC 587, November 2017 p29 (Table 2.1 – item 55); HMRC, *VAT: maintain thresholds for 2 years from 1 April 2018 – tax information & impact note*, 22 November 2017

82 Spring Statement – consultations, Written statement HCWS541, 13 March 2018; see also, "Hammond to launch review into problem with VAT", *Financial Times*, 11 March 2018.

83 HMT, *VAT registration threshold: call for evidence*, 13 March 2018; see also, Chartered Institute of Taxation press notice, *VAT threshold: CIOT welcomes 'big, broad consultation'*, 13 March 2018.

number of factors needed to be considered, including the level of the threshold itself:

> At the moment, the threshold is a simple cliff-edge between exemption and taxation. A business turning over £85,000 per year does not have to register for VAT. A business turning over £85,001 must register for VAT, and therefore account for and pay VAT liabilities to HMRC. There are ways to smooth the transition for businesses from one to the other.
>
> In considering potential solutions to this issue, we might need to also consider potential impacts they might have on the tax system. The VAT system is already described as complex, and any intervention should not disproportionally increase complexity. Any reform should also be efficient and thus targeted at the businesses most in need. Whilst the government has made significant progress since 2010 in restoring the public finances to health, borrowing and debt remain high. Any potential solution also needs to be considered in line with the current fiscal position. Lastly, any changes to the design of the threshold should be announced well in advance to allow small businesses to adequately prepare.
>
> A discussion around the design of the threshold must necessarily include the level of the threshold. Although it is likely, as the OTS say, that threshold effects would occur at any level, that does not mean that the growth disincentives described earlier will be the same at every level. Differences in business demographics, in economies of scale and in relative cost of tax administration may lead to variance in the size of any threshold effects at different levels of the threshold.
>
> [Finally] … there may be a link between the design of the threshold and the size of the hidden economy. This must also be considered.[84]

4.3 Budget 2018

The Chancellor presented the Government's 2018 Budget on 29 October. In his Budget speech Mr Hammond announced that the Government would continue to look at options for reforming the registration threshold, but in the meantime, it would be frozen at £85,000 for another two years:

> In the period since the last Budget, we have explored all avenues to address the cliff-edge effect of VAT registration, but our options are restricted by EU law. We will continue to work on this issue as our future VAT regime becomes clear over the years ahead, and in the meantime, to give small businesses certainty and in response to representations from my hon. Friend the Member for Mid Worcestershire (Nigel Huddleston), the Federation of Small Businesses and others, I will leave the threshold unchanged for a further two years.[85]

The decision to freeze the threshold until 2022 was estimated to raise £60m in 2020/21, rising to £130m in 2021/22.[86]

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84 HMT, *VAT registration threshold: call for evidence*, 13 March 2018 para 4.1-4
85 HC Deb 29 October 2018 c661
86 Budget 2018, HC 1629, October 2018 p38 (Table 2.1 – item 58); HMRC, *VAT: maintain thresholds for 2 years from 1 April 2020*, 29 October 2018

The Government published a summary of the responses it had received, noting that the exercise had not provided "a clear option for reform", and that the Government would "look again at the possibility of introducing a smoothing mechanism once the terms of EU exit are clear."[87] An extract from this summary is reproduced below:

> It is clear that the current design of the threshold does lead to some businesses managing their turnover so as to remain below the registration threshold, i.e. 'bunching', which is most predominant in low-cost service sectors such as hospitality.
>
> Businesses argued that the complexities of VAT and the administrative requirements are a cause for concern. The complexity of VAT, frequency that returns must be submitted and the amount of time spent on compiling the information required for those returns were some of the most common complaints about the current VAT system.
>
> The financial and administrative burdens of VAT registration are readily apparent. While VAT administration is a cause for concern among some UK businesses, it is the financial implications of becoming VAT-registered that is the main reason why businesses wish to remain below the threshold. Concerns regarding competition with unregistered businesses and facing a large VAT bill, particularly for low-cost service businesses, are a barrier to small business growth.
>
> Businesses recognised the benefits of the smoothing mechanisms proposed in the call for evidence. Concerns were highlighted about the potential for making the VAT system more complex as a consequence. Many respondents also felt that the proposed mechanisms did not go far enough to resolve the issues surrounding VAT-registration, namely the financial implications of becoming a registered business. The FRS was highlighted as particularly useful for businesses, however, many felt that the April 2017 reforms to the schemes negated its usefulness. They suggested that a return to the pre-April 2017 rules would help businesses smooth their entry into the VAT system. It must be remembered however, that the FRS was reformed to prevent VAT avoidance through the use of the scheme.
>
> The responses to this call for evidence have not presented a clear solution to the problems surrounding the VAT registration threshold. We do not consider there to be a lead option for reform. The government recognises that the introduction of a smoothing mechanism to ease the financial burden of VAT registration would be welcomed by some stakeholders, providing it does not increase complexity.
>
> EU law, which we are currently bound by, means that the UK would require a derogation, granted by the EU Commission, to introduce a new smoothing mechanism. One of the criteria for acceptance would be revenue neutrality, so a mechanism that reduces the financial burden may only be possible in conjunction with a reduction of the threshold. We will not be implementing a smoothing mechanism at this stage.
>
> Nevertheless, while concerns about the threshold remain, the government will continue to monitor and evaluate the design of the threshold and simplification schemes. The government will also look again at the possibility of introducing a smoothing

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87 *Budget 2018*, HC 1629, October 2018 para 3.70

> mechanism once the terms of EU exit are clear. At this stage, and as announced at Budget 2018, the government is not minded to either increase or decrease the VAT threshold. So to provide businesses with certainty, the VAT registration and deregistration thresholds will be frozen at £85,000 and £83,000 respectively for a further period of two years up to 31 March 2022.[88]

In January 2018 the European Commission published proposals to amend the EU-wide VAT rules to reduce the compliance costs faced by SMEs (COM/2018/021). In its call for evidence the Government noted that it was anticipated these changes would come in from July 2022, but, depending on the nature of the UK's exit from the EU, they might have implications for the UK:

> 1.15 The government triggered Article 50 on 29 March 2017 to start the process of leaving the European Union. Until exit negotiations are concluded, the UK remains a full member of the European Union and all the rights and obligations of EU membership remain in force. During this period the government will continue to negotiate, implement and apply EU legislation. The outcome of these negotiations will determine what arrangements apply in relation to EU legislation in future once the UK has left the EU.
>
> 1.16 The EU Commission recently published its SME VAT proposal which aims to help reduce VAT compliance costs for new businesses. The proposal sets the direction of travel for SMEs and VAT and is not due to be implemented until July 2022. The Commission's proposal will first have to be discussed, amended and agreed (unanimously) by each government of the individual Member States. As with all EU legislation current and proposed, the application of the SME proposal once the UK has left the EU will be determined by the negotiations.
>
> 1.17 The key parts of the proposal include:
>
> - the VAT threshold that Member States currently apply only to businesses established in that Member State will be extended to small businesses established in other Member States
> - this national threshold will be capped at €85,000 (approximately £75,000), so significantly below the current UK threshold of £85,000
> - there will be a EU-wide threshold of €100,000 (approximately £89,000), so that if a business's total supplies in the EU reaches this threshold, they will no longer be able to benefit from any national thresholds
> - small businesses up to a turnover of €2,000,000 (approximately £1,770,000) will benefit from simplification schemes targeted at removing interim payments and increasing the length of the return periods to a year. …
>
> 4.5 [The EU SME proposal], as well as suggesting the changes outlined in the introduction (1.14-1.17), seeks to introduce a smoothing mechanism by which businesses would be allowed to exceed the threshold by 50% for a single year (this may end up as within that calendar year) without registering. If they go over this 50% cushion, they must register, and if they exceed the threshold

88 HM Treasury, *VAT registration threshold: Summary of responses*, October 2018 pp20-21

> by less 16 than 50% for more than 12 months, they must register. Under the proposal, graduated reliefs[89] … would no longer be permitted.
>
> 4.6 As well as the national thresholds, the proposal sets out a €100,000 (£89,000) registration threshold for 'union turnover', designed to make sure businesses that sell up to the threshold in many EU Member States have a total cap above which they cannot be exempt.
>
> 4.7 The proposal introduces simplification measures for all registered businesses that turn over up to €2,000,000 (£1,770,000) – they will benefit from simplified invoicing, the option of filing annual VAT returns, not having to make interim payments, and simplified obligations relating to storage of invoices.[90]

In its call for evidence the Government asked for views on the likely impact of the EU proposal, and if there were any elements to it that were particularly attractive or unattractive. In turn, responses "showed that there is some support for these proposals, from both the business community and representative bodies. The support was not unanimous however, with some respondents voicing their concerns over the potential for added complexity to the VAT system."[91]

In December the European Scrutiny Committee published a report on this proposal, following the completion on 14 November of the draft Withdrawal Agreement by the UK and the EU. To give a little context, the Withdrawal Agreement provides for a transition period, also described as the 'implementation period', to bridge the period between the date of the UK's exit from the EU, set for 29 March 2019, and the entry into force of the new, yet to be negotiated, UK-EU partnership arrangements. The transition is to run until the end of December 2020, with the possibility of extension for up to two years. During this period the UK would continue to apply EU law, with a few exceptions, as if it were a Member State, though the UK will have no institutional representation and no role in decision-making.[92]

As Treasury Minister Mel Stride confirmed, in a letter to the Committee on the continued application of EU VAT law to the UK, "the Withdrawal Agreement sets out that during the Implementation Period, the UK will no longer be a Member State of the EU, but market access will continue on current terms. Accordingly, common rules will remain in place until the end of the Implementation Period, meaning businesses will be able to trade on the same terms for the duration of this period."[93]

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89 As noted elsewhere "Some EU Member States relieve small businesses just above the registration threshold from facing the full VAT burden. Finland applies a graduated relief to small businesses – they pay 0% VAT at €10,000 turnover and 100% VAT at €22,500 with a gradually increasing rate in between. Similarly, in the Netherlands, businesses with a VAT bill of €1345 pay 0% and businesses with a VAT bill of €1883 to pay 100%, with businesses in between paying an increasing proportion of that bill" (para 4.10).

90 HMT, *VAT registration threshold: call for evidence*, 13 March 2018 p5, pp15-16

91 HMT, *VAT registration threshold: Summary of responses*, October 2018 para 4.3

92 For details see, *The UK's EU Withdrawal Agreement*, Commons Briefing paper CBP8453, 7 December 2018.

93 Letter from Financial Secretary to EU Scrutiny Committee, "EU legislative proposals on VAT", 5 December 2018

In its report on the EU SME proposal, the Committee noted that over the year negotiations between the Member States had resulted "in some initial changes to the draft legislation but not as yet to any fundamental alterations to the proposed VAT registration threshold or allowing companies from other Member States from making use of the SME exemption."[94] Given this, the Committee went on to argue, there was a possibility that if this proposal came into force during the transition period, the UK *might* be forced to cut its VAT registration threshold, without recourse to any veto over changes to EU tax law:

> The draft Withdrawal Agreement, ratification of which remains uncertain, would create a post-Brexit transitional period potentially lasting until December 2022. If the Agreement is ratified and the Directive took effect during the transition, the Treasury would have to transpose it into UK law. This could have significant implications for small businesses. It is particularly concerning in this regard that the UK will lose its veto over the proposal on 29 March next year, but it could nevertheless apply here in full.
>
> In terms of the practical effect, having to transpose the Directive could mean that the Government would be under a legal requirement to lower the VAT registration threshold for SMEs by nearly £10,000, as the UK limit is currently above the upper threshold of £76,700 proposed by the European Commission (and to which, so far, the remaining Member States have not objected).
>
> Any new EU legislation would, for the duration of the transition, override the UK's discretion to legislate in breach of the Directive. UK application of the Directive would also mean that British SMEs could make use of the VAT exemption when selling into any of the remaining Member States for the duration of the transition (and vice versa).[95]

As the *Financial Times* reported at the time, "the Commons European scrutiny committee's report is one of the first concrete examples of Britain having to follow EU rules following Brexit after losing its voice in European discussions."[96]

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94 European Scrutiny Committee, *Forty-ninth report of 2017-19*, HC 301 xlviii, 24 December 2018 – see, "6: VAT: exemptions for small businesses" pp48-56
95 *op.cit.* para 6.5-6
96 "UK faces prospect of lowering VAT threshold after Brexit", *Financial Times*, 24 December 2018

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