



HM Treasury

# VAT registration threshold: call for evidence

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March 2018



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# Foreword

Small businesses are the backbone of the UK economy. They provide almost half of all private sector jobs, and account for more than a third of our national income.

The government's Industrial Strategy sets out how we are building a Britain fit for the future – an ambitious plan to boost the productivity of the UK economy.

Small Businesses have a key role to play. We need to do more to make the most of the untapped potential of our small businesses right across the country.

The Industrial Strategy spelled out that the government is investing in the skills, industries and infrastructure of the future. This call for evidence will explore a further possible challenge to small business growth and productivity: the design of the VAT threshold.

The UK has a high VAT threshold for a reason. It has the benefit of keeping the majority of small businesses out of VAT altogether, therefore helping our small businesses avoid the administrative burden of accounting for VAT.

However, there is growing anecdotal, academic and data-based evidence that the cliff-edge nature of the VAT threshold acts as a disincentive for small business owners who want to expand.

This call for evidence continues the debate that the Office of Tax Simplification (OTS) started in exploring whether this barrier to growth can be reduced, to ensure our small businesses can reach their true potential.



Mel Stride, Financial Secretary to the Treasury.

# Chapter 1

## Introduction

- 1.1 If the taxable turnover of a business in a 12 month period exceeds the Value Added Tax (VAT) registration threshold (currently £85,000 until March 2020) that business must register and account for VAT. Taxable turnover is the total of everything a business sells that is not specifically exempt from VAT.
- 1.2 The threshold is a simplification measure that keeps businesses with a turnover at or below the threshold from having to register and account for VAT. This tax simplification benefits around 3.5 million businesses, over half of the UK business population.
- 1.3 Businesses with turnover below the threshold can choose to register for VAT, and there are approximately 1 million voluntarily registered businesses. Only around 1.2 million businesses (out of about 5.7 million total businesses) are above the VAT threshold.
- 1.4 Businesses that are registered for VAT must charge VAT to their customers at the applicable rate. They are also entitled to recover VAT on their costs. They then pay over the net amount, which is the amount collected from their customers minus VAT incurred on costs, to HMRC.
- 1.5 The UK threshold of £85,000 is the highest in the EU and the OECD, more than double the average in the EU and the OECD which is around £29,000 for both. (See Chart A:1 in Annex)
- 1.6 The VAT threshold exempts businesses from VAT, and therefore costs the Exchequer money each year. In 2017/2018 it is forecast to cost £2.1 billion.

### Recent history of the VAT threshold

- 1.7 The threshold has increased almost every year in line with RPI inflation from 1980 to 2017. Uprating in line with inflation ensured the value of the threshold was maintained in real terms (see Chart A:2 in annex).
- 1.8 Business views on the threshold are divided. Some argue that having a high threshold has the benefit of keeping the majority of small businesses out of VAT altogether, avoiding all the administrative requirements that accompany

the tax. Others consider that a lower threshold would reduce distortions of competition.

- 1.9 In December 2016, the Chancellor requested that the Office of Tax Simplification (OTS) examine the 'issues and impacts which would be involved if the VAT registration threshold were either higher or lower than at present'.
- 1.10 The OTS report on routes to simplification for VAT<sup>1</sup> was published on 7 November 2017. Their main finding regarding the UK threshold was that the relatively high level of the threshold has a distortionary impact on business growth. This is because of the phenomenon of 'bunching', where small businesses deliberately limit their turnover to remain below the threshold. It is also possible that by not investing, upskilling or innovating so as to remain under the threshold, small businesses may be limiting their productivity. (See **Chart A:3 in annex**)
- 1.11 The OTS report 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 smoothing mechanism'.
- 1.12 At Autumn Budget 2017, the Chancellor recognised that the UK had by far the highest threshold in the OECD and concerns about the cliff edge nature of the threshold. However, he noted that a high threshold has the benefit of keeping the majority of UK businesses out of VAT altogether. He announced that the government was not minded to reduce the threshold, but instead would consult on whether the design of the threshold could better incentivise growth. In the meantime, the threshold will remain at £85,000 for 2 years from April 2018.

## This call for evidence

- 1.13 This call for evidence is split into three chapters.
- the first explores in more detail how the threshold might currently affect business growth
  - the second looks in more detail at the burdens created by the VAT regime at the point of registration, and why businesses might manage their turnover to avoid registering
  - the third considers possible policy solutions, based on international and domestic examples

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<sup>1</sup> [The Office of Tax Simplification: Routes to Simplification for VAT.](#)



## EU and the threshold

- 1.14 VAT is a Europe-wide tax and the UK is limited in what it can currently change about the VAT threshold due to EU law. The UK cannot increase the threshold in real terms, nor meaningfully alter its design, without unanimous agreement of the other Member States.
- 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<sup>2</sup> 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

The proposal will be considered in more detail in chapter 4.

## Who should respond to this call for evidence?

The government welcomes views from anybody that is interested in this topic, and is particularly interested in responses directly from small VAT registered and un-

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<sup>2</sup> The EU VAT SME proposal is available [here](#).

registered businesses that trade near the threshold, and their representative bodies. Sectors likely to be particularly interested may be:

- Tourism
- Construction
- Accommodation
- Food
- Tradespeople
- Professional, scientific and IT services

The above list is by no means exclusive and the government would welcome responses from all interested parties.

This call for evidence asks questions pertinent to all the UK, and the government is interested in any differing regional impacts of the threshold.

The deadline for responses to this consultation is 5 June 2018.

Please send your responses to this call for evidence to the email address [vatthreshold@hmtreasury.gsi.gov.uk](mailto:vatthreshold@hmtreasury.gsi.gov.uk).

In order to make small businesses' engagement with this call for evidence as easy as possible, the questions in this consultation have been streamlined into a SurveyMonkey questionnaire, which can be completed via this [\[link\]](#). We estimate that it will take approximately 7 minutes to complete.

### **Data Protection**

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury.

HM Treasury will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

## Chapter 2

# The current VAT threshold and the impact on business growth

- 2.1 There are several reasons why the presence of a VAT threshold might affect small business growth. These include the fact that firms have to start accounting for and paying VAT once they cross the threshold. Accounting for VAT requires businesses to spend time and money ensuring that they meet their legal obligations, and charging VAT provides businesses with another cost which they must absorb or pass on to their customers.
- 2.2 The case made in favour of a higher VAT registration threshold is that it helps to encourage growth because it keeps small businesses free from the burden of accounting for and charging VAT for longer. While this exemption for small businesses makes it easier to start up, there is evidence that the VAT threshold provides a brake on growth, as businesses approach it.
- 2.3 As highlighted in the OTS report and recent research by Ipsos MORI, some businesses manage their turnover both legally and illegally to avoid VAT registration. This table gives examples:

**Table 2.A: Methods of businesses managing their turnover below the threshold**

Legality	Method	Example
Legal	Closing early in the day or season	A tourist business near a beach may have a very successful August, with the result that they shut in September.
Legal	Turning down work	A plumber may stop advertising, or simply turn down requests for work.
Illegal	Splitting the business	A husband and wife artificially split their café business in two so that both halves turnover less than the threshold.
Illegal	Undeclared cash in hand	A trader may not include cash in hand payments in the business accounts, in which case direct taxes may well be evaded as well.

- 2.4 A key consideration when exploring this effect is understanding the sub-threshold population.

- 2.5 Ipsos MORI research<sup>1</sup> suggests that 20% of unregistered businesses that operate just under the threshold take steps to restrict their turnover. The actual percentage may well be higher as businesses may be unwilling to admit to illegally suppressing turnover.
- 2.6 Research suggests that whilst growth does slow as firms approach the threshold, it accelerates once they finally pass it.<sup>2</sup> This suggests that for some firms the effects of the threshold are temporary. However, there are many businesses that will never cross the threshold.
- 2.7 For example, there is a larger group of about 850,000 unregistered businesses that turn over between £25,000 and £50,000. Many of these businesses, will be labour only tradespeople, often providing services to the public. It's perfectly possible for a business such as this to be successful and operate under the threshold, and the OTS suggest that staying below the threshold is built into the business model in some sectors.
- 2.8 VAT registration requires regular reporting and payment of tax. The OTS note that having a high proportion of businesses under the threshold and therefore unregistered could well encourage more businesses to operate in the hidden economy, reducing their compliance with other taxes. Research indicates that increasing the perception of monitoring and auditing can have a positive impact on tax compliance<sup>3</sup>. Increasing the proportion of businesses that are registered, and therefore monitored from the perspective of another tax, may improve tax compliance in general.
- 2.9 The OTS similarly suggest that reducing the threshold would make it harder for businesses seeking to evade VAT to remain undiscovered. At the moment, because so many of the smallest businesses can legitimately remain under the threshold, it is relatively easy for businesses which illegally evade VAT to feel that they can stay under the radar (although in reality HMRC has a number of ways of targeting these evaders).
- 2.10 In addition to impacting the growth of businesses under the threshold, there is likely to also be an impact on those above the threshold. Businesses just above the threshold may be unable to compete with unregistered businesses which are similar in nature but have to charge their customers VAT. This hampers the ability of the registered businesses to grow. This effect is seen anecdotally in many sectors.
- 2.11 If small businesses are restricting their growth, then they may also be hindering their productivity. It is likely that if businesses are suppressing their turnover to stay below the threshold, they may be limiting the natural size of their business:
- small businesses may not choose to invest in skills and capital as the growth this investment brings would push them over the threshold

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<sup>1</sup> [Behaviours and experiences in relation to VAT registration](#), IPSOS MORI 2017. p2

<sup>2</sup> 'Small firm growth and the VAT threshold: Evidence for the UK' – Liu, Lockwood and Guo – July 2017

<sup>3</sup> Income tax evasion: A Theoretical Analysis. Michael G Allingham and Agnar Sandmo, 1972. Published in the Journal of Public Economics 1 (1972) p323-338

- businesses may choose not to exploit new product lines or customer groups because the benefits of doing so are negated by registering for VAT
- businesses may spend a great deal of time managing their affairs to stay under the threshold, which is an unproductive use of their time
- businesses may adopt less efficient business models to ensure that they stay under the threshold. An example might be a tradesperson who asks customers to acquire the goods that the tradesperson then installs

2.12 Research indicates that structural thresholds exist outside of VAT, for example in the French economy where the bulk of labour regulations only bite for businesses consisting of 50 employees or above. This creates a bunching effect with businesses clustered just below the 50 employee mark. The research notes that this forces economic output and productivity down, and incentivises businesses to try to find ways round the threshold, for example by splitting their business to make sure each entity does not exceed 50 employees. Although the method of limiting the size of the business is different in relation to the VAT threshold, where businesses manage turnover rather than employee count, it is likely that the negative effect on output and productivity could be the same.<sup>4</sup>

### Questions

- 1 What experience or knowledge do you have of small businesses managing their turnover to remain below the VAT threshold?
- 2 Are there, in your experience, particular types, regions or sectors of businesses where this is particularly prevalent?
- 3 What is your experience of competition challenges faced by registered traders just over the threshold, compared to unregistered businesses? If challenges exist, what effect do they have on the ability of registered businesses to grow?
- 4 As the OTS suggest, does the current threshold contribute to the size of the hidden economy, and how?
- 5 In your experience, does the current threshold have any effect on growth and/or productivity? If so, how significant is that effect?

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<sup>4</sup> [Why small isn't always beautiful: labor regulations and firm growth](#). Luis Garicano (LSE), Claire LeLarge (Banque De France), John Van Reenen (MIT), 5 January 2017.

# Chapter 3

## Why do businesses restrict their turnover to remain under the threshold?

- 3.1 Before we consider potential solutions to ensure that businesses can continue to grow through the threshold, we need to understand why businesses restrict turnover to avoid or delay crossing the threshold. These reasons can be categorised into two groups: administrative and financial.
- 3.2 Despite the following discussion of disincentives to register for VAT, evidence from voluntarily registered businesses suggests that there are powerful incentives to register as well, particularly for businesses making supplies to other VAT-registered businesses. 'Financial reasons', for example the ability to reclaim VAT on purchases, were cited by 17% of voluntarily registered businesses as the main reason for registering for VAT. A further 17% listed their main reason for registering as to 'help business growth/image'.<sup>1</sup>

### Administrative burden of VAT registration.

- 3.3 The administrative burden that accounting for VAT creates for small businesses takes up their time and money, shifting these resources away from the main activities of the business.
- 3.4 Approximately 1 million businesses that operate under the VAT threshold are voluntarily registered for VAT and therefore choose to incur the administrative costs of VAT, because that cost is outweighed by benefits of registration. This represents about 46% of the VAT registered population. The Association of Accounting Technicians believes that VAT registered small and micro businesses in the main cope with and manage VAT very well.<sup>2</sup> According to the 2016 HMRC small business survey, 73% of small businesses thought that their tax affairs were generally easy to deal with.<sup>3</sup>
- 3.5 Compliance costs for VAT may be low but they are not negligible. One survey found that for UK SMEs, over 40% of all financial costs of tax

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<sup>1</sup> [Behaviours and experiences in relation to VAT registration](#), IPSOS MORI 2017

<sup>2</sup> [AAT response to the OTS interim paper on Value Added Tax](#), June 2017. p4

<sup>3</sup> Of which, approximately 52% were VAT registered: From the [2016 Individuals, Small Business and Agents Customer Survey](#) p66

compliance and 50% of time costs are due to VAT<sup>4</sup>, and research from the Federation of Small Businesses suggest that their members find VAT to be the most time consuming tax to deal with.

- 3.6 There may be a distinction between perception of the administrative burden of VAT and the reality. According to recently published independent Ipsos MORI research, the additional administrative burden was the most commonly anticipated drawback of registering for unregistered businesses, although the majority of registered small businesses disagree that the administration of VAT is too much of a burden.
- 3.7 The diverse VAT rate structure is also a possible factor here. There are 3 different rates of VAT: zero, reduced and standard, as well as certain activities that are exempt. The OTS considered the different VAT rates as part of their review of VAT and recommended that the government further examined the issue. In his response to the OTS review the Chancellor recognised the merit in a review of the current system of VAT rates and reliefs in the long term.
- 3.8 The government's ability to amend the scope of the various rates and exemptions is limited to some extent by EU law. Although there may be opportunities to make changes to the VAT system in the future, there will be no immediate changes to our relationship with the EU until we have left. The UK remains a member of the EU with all of the rights and obligations that membership entails. This includes the application of EU VAT rules.
- 3.9 Simplification measures already exist to lessen the administrative burden of VAT placed on SMEs, such as:
- the 9 box VAT return is itself a simplification
  - the Flat Rate Scheme (FRS), for VAT registered businesses with turnover of £150,000 and below, allows users to pay a fixed flat rate of VAT to HMRC. The flat rate used depends on the sector the business operates in. Flat rate businesses charge their customers the normal rate, and are unable to recover input tax. The flat rate reflects the typical proportion of VAT that would be due from a business in that sector using standard VAT accounting. The FRS is used by approximately 360,000 businesses
  - the Annual Accounting Scheme (AAS) (for VAT registered businesses with turnover of £1.35m and below) requires businesses to submit only a single VAT return a year, and allows businesses to make more regular interim payments towards their VAT liability. The AAS is used by about 17,000 businesses
  - the Cash Accounting Scheme (for VAT registered businesses with turnover of £1.35m and below) allows businesses to account for VAT when they pay cost or receive a payment rather than on the date of the invoice. This helps the businesses manage their cashflow. This scheme is used by many small businesses

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<sup>4</sup> John Hasseldine and Ann Hansford "The compliance burden of VAT: further evidence from the UK" 2002.

- 3.10 Once a business is registered we'd like to understand what aspect of VAT administration is the most burdensome. HMRC and the Treasury's own data reveals that the majority of the administrative burden comes from the submission of VAT returns. Ipsos MORI research indicates the same. The EU Commission indicate that is the complexity and changing nature of legislation<sup>5</sup>, whilst the FSB have cited that it is 'correctly calculating the proportion of VAT owed'.<sup>6</sup>
- 3.11 From April 2019, Making Tax Digital (MTD) for VAT will become mandatory for businesses with a turnover above the VAT registration threshold. This means they will have to use MTD compliant software to submit their VAT returns. This software will connect directly to HMRC and ensure greater accuracy, reducing error and reducing burdens, particularly for those who do not use software now.
- 3.12 It is possible that in the short term, until MTD is embedded, MTD could add to the bunching effect highlighted earlier. In the longer term it could pave the way to further reforms and simplifications of the VAT system and administrative burden reductions, for example when combined with direct taxes.
- 3.13 Around the world, there is a huge variety of simplifications that nations afford their small businesses when it comes to VAT or Goods and Services Tax (GST). Many nations, as well as exempting fewer businesses from VAT/GST by having a lower threshold, also do not exempt businesses from administrative obligations. For example, in the Netherlands, all businesses have to register, account for and charge VAT. However small businesses with a total VAT bill of €1345 or below do not have to pay it.
- 3.14 The European Commission, in its EU SME proposal, suggest that all small businesses up to a turnover of €2,000,000 (£1,770,000) should be able to benefit from year-long VAT periods and should not be required to make interim payments.

### Questions

- 6 Does the administration of VAT discourage businesses from registering?
- 7 If so, what are the main aspects of VAT administration that are putting businesses off registering?
- 8 For businesses that have gone from being unregistered to registered, is there a difference between the perception and reality of VAT administration? Was the administration easier or harder than anticipated?

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<sup>5</sup>From the EU Commission's impact assessment accompanying their VAT SME proposal e.g. p21.

<sup>6</sup>[Taxing Times: Routes to Reform for Small Businesses as Taxpayers, Federation of Small Businesses 2018](#), p23



- If harder, why was that? (For example, a struggle to understand what your obligations were, or you made mistakes).
- If easier, why was that? (For example, received the right support from HMRC, at the right time).

9 How well do current simplification schemes address these issues?

10 Ipsos MORI research suggests that dealing with VAT returns are likely to be the most time consuming aspect of VAT administration. What is it about VAT returns that are particularly time consuming for small businesses?

11 Will new technology, such as the introduction of MTD, facilitate changes or simplifications in VAT administration? If so, what are they, and what changes would you like to see in response?

## Financial and competition burden of VAT registration

- 3.15 VAT registration often imposes a financial cost on businesses. Registered businesses must charge VAT on the supplies they make which they then pay over to HMRC, after deducting input tax that they incur on their costs.
- 3.16 When a previously unregistered business registers for VAT, they then have to charge VAT to their customers. They can either add the full amount of VAT to prices, which is likely to damage the business' competitiveness, or they can keep their prices the same, and absorb the cost of VAT, which makes the business less profitable. Out of these options, Ipsos MORI suggest that approximately a third of businesses respond to VAT registration by increasing prices to some extent, whilst the remaining two thirds absorb all the VAT cost in their profitability.<sup>7</sup>
- 3.17 We understand that there are two main factors in understanding which businesses are most likely to be affected by the financial burden of VAT: The first are businesses that sell mainly 'business-to-consumer' (B2C), such as a corner shop or café. Consumers, because they are not able to recover the VAT they are charged, pay the VAT inclusive price. Unregistered businesses can offer more competitive prices to customers because they do not have to charge VAT, and therefore an uneven playing field exists. This contrasts with business to business (B2B) sellers, whose customers are likely to be able to recover VAT on purchases and will therefore focus on the VAT exclusive price.
- 3.18 The second type of businesses likely to be the most affected are those in sectors that incur limited VAT on costs to set off against their VAT liability. This is likely to be common in the services sector, where the main input is labour which is not subject to VAT. Those businesses on registration have to

<sup>7</sup>Behaviours and Experiences in relation to VAT Registration, IPSOS MORI p24

charge and pay to HMRC the full rate of VAT on services they provide, but are unable to reclaim much VAT because of their limited costs.

- 3.19 Research by academics Liu & Lockwood provides evidence that it is indeed in these sectors that the 'bunching effect' is the most prominent<sup>8</sup>.
- 3.20 To some extent these two effects can be seen in the way that the FRS works: B2C and limited costs businesses are likely to have a higher flat rate that represents a higher typical VAT liability in those sectors.

### Questions

12 In your experience, what are the sectors, if any, that are particularly affected by the financial costs and competitive disadvantages of registration discussed in paras 3.15–3.20?

13 In your view, do these financial costs and competitive disadvantages lead to businesses managing their turnover to remain below the threshold? How significant is this effect on SME growth?

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<sup>8</sup> VAT notches, Voluntary Registration, and Bunching: Theory and UK Evidence, Li Liu and Ben Lockwood, 2016.

# Chapter 4

## Policy solutions: design of the threshold

- 4.1 It is possible that the threshold effects outlined in previous chapters could be moderated by the design of the threshold. 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.
- 4.2 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 disproportionately 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.
- 4.3 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.
- 4.4 As alluded to earlier, there may be a link between the design of the threshold and the size of the hidden economy. This must also be considered when reading this section.

### The European Union SME proposal

- 4.5 The 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 by less

than 50% for more than 12 months, they must register. Under the proposal, graduated reliefs (see 4.10) 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.

### Questions

- 14 What in your view would be the likely impacts of the EU's proposal on the administration of VAT for SMEs, and how in particular will it help incentivise SME growth?
- 15 Are there constituent parts of the proposal which are particularly attractive or unattractive? If so, what are they and why?

## Administrative smoothing

- 4.8 The OTS suggested two administrative options for easing the business journey from not having to do any VAT accounting, to full VAT accounting:
- extend the first period for which a business has to account for and pay their VAT obligations to 6 months (currently likely to be 3 months). This is similar to the approach taken by New Zealand, which allows small businesses that turn over up to NZ\$500,000 to file 6 monthly GST returns, as opposed to their standard 1 or 2 monthly returns
  - apply the threshold test over 2 years rather than 1. The test would be whether the taxable turnover of a business increased over £170,000 over 2 years rather than £85,000 in 1 year

### Questions

- 16 Do you think the mechanisms described in paragraph 4.8 would help businesses better manage the administration of VAT, upon registration? If so, would the positive effect be significant?
- 17 Would any of these solutions be sufficient to change the behaviour of businesses that take measures to remain under the threshold?

18 Are you aware of any simplification schemes from around the world, that work particularly well? If so what are they?

## Financial smoothing

- 4.9 The cliff edge nature of the VAT threshold is to some extent a global problem, faced by all countries with a VAT or GST. Therefore, we would be interested to hear your views on how effective international examples are at smoothing the transition between exemption and taxation.
- 4.10 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.
- 4.11 Some countries apply different thresholds for different sectors. For example, France and Ireland have a lower threshold for businesses that supply services than for businesses that supply goods. As discussed earlier, services businesses often have non-taxable labour as their main costs, and therefore setting a lower threshold for those businesses is an attempt to recognise the different effects the threshold has on those sectors.
- 4.12 Australia does not apply its threshold to taxi drivers, who must all register and pay VAT. The EU SME proposal may also allow Member States to set different thresholds for different sectors.
- 4.13 The OTS suggested a smoothing mechanism whereby businesses would be allowed a form of relief on their first VAT bills, decreasing over time. They also suggested a reduction in the FRS rate that small businesses have to pay in the first years after registration.
- 4.14 A common suggestion is that the VAT system should work more like the income tax system with increasing rates applicable as turnover increases. This would work something like a system of flat rates for small businesses, with a business on registration having to pay over to HMRC a lower rate of VAT. This rate would increase as turnover increases until at some turnover point the business has to pay over the full rate of VAT to HMRC.
- 4.15 The above examples are by no means exhaustive, and we would be interested to receive suggestions, real world or thought up, of mechanisms that smooth the transition from exemption to taxation.

## Questions

- 19 What is your experience of the type of mechanisms outlined in paragraphs 4.10–4.15? Would they be effective in incentivising business growth in the UK? If so, how and why?
- 20 In your view, are there any other solutions that could work? What are they and why would they work?
- 21 The EU Commission SME proposal introduces the idea of essentially two thresholds. The first, lower threshold exempts small businesses from the financial obligations of VAT. The second, higher threshold exempts slightly larger businesses from some of the administration of VAT. What do you think about this proposal?
- 22 Assuming the UK has the freedom to do so, would increasing or decreasing the threshold simply move the threshold problems or alleviate them?

# Chapter 5

## Summary of questions

### **The current VAT Threshold and the impact on business growth**

- 1 What experience or knowledge do you have of small businesses managing their turnover to remain below the VAT threshold?
- 2 Are there, in your experience, particular types, regions or sectors of businesses where this is particularly prevalent?
- 3 What is your experience of competition challenges faced by registered traders just over the threshold, compared to unregistered businesses? If challenges exist, what effect do they have on the ability of registered businesses to grow?
- 4 As the OTS suggest, does the current threshold contribute to the size of the hidden economy, and how?
- 5 In your experience, does the current threshold have any effect on growth and/or productivity? If so, how significant is that effect?

### **In your experience, does the current threshold have any effect on growth and/or productivity? If so, how significant is that effect? Administrative Burden**

- 6 Does the administration of VAT discourage businesses from registering?
- 7 If so, what are the main aspects of VAT administration that are putting businesses off registering?
- 8 For businesses that have gone from being unregistered to registered, is there a difference between the perception and reality of VAT administration? Was the administration easier or harder than anticipated?
  - If harder, why was that? (For example, a struggle to understand what your obligations were, or you made mistakes).
  - If easier, why was that? (For example, received the right support from HMRC, at the right time).
- 9 How well do current simplification schemes address these issues?
- 10 Ipsos MORI research suggests that dealing with VAT returns are likely to be the most time consuming aspect of VAT administration. What is it about VAT returns that are particularly time consuming for small businesses?

- 11 Will new technology, such as the introduction of MTD, facilitate changes or simplifications in VAT administration? If so, what are they, and what changes would you like to see in response?

## **Financial and Competitive burden**

- 12 In your experience, what, if any, are the sectors that are particularly affected by the financial costs and competitive disadvantages of registration discussed in 3.15-3.20?
- 13 In your view, do these financial costs and competitive disadvantages lead to businesses managing their turnover below the threshold? How significant is this effect on SME growth?

## **EU SME proposal**

- 14 What in your view would be the likely impacts of the EU's proposal on the administration of VAT for SMEs, and how in particular will it help incentivise SME growth?
- 15 Are there constituent parts of the proposal which are particularly attractive or unattractive? If so, what are they and why?

## **Administrative smoothing**

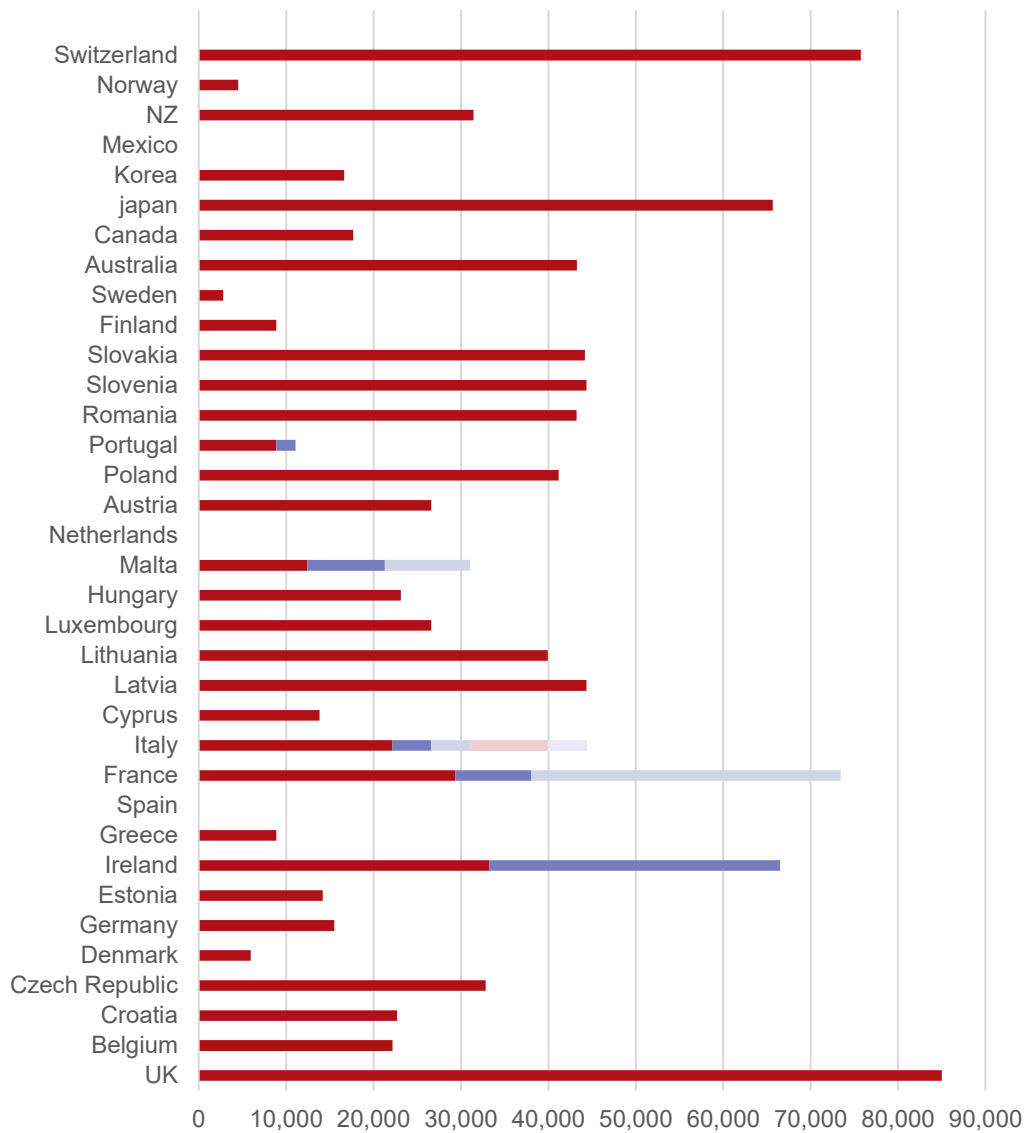
- 16 Do you think the mechanisms described in paragraph 4.8 would help businesses better manage the administration of VAT, upon registration? If so, would the positive effect be significant?
- 17 Would any of these solutions be sufficient to change the behaviour of businesses that take measures to remain under the threshold?
- 18 Are you aware of any simplification schemes from around the world, that work particularly well? If so what are they?

## **Financial smoothing**

- 19 What is your experience of the type of mechanisms outlined in paragraphs 4.10-4.15? Would they be effective in incentivising business growth in the UK? If so, how and why?
- 20 In your view, are there any other solutions that could work? What are they and why would they work?
- 21 The EU Commission SME proposal introduces the idea of essentially two thresholds. The first, lower threshold exempts small businesses from the financial obligations of VAT. The second, higher threshold exempts slightly larger businesses from some of the administration of VAT. What do you think about this proposal?
- 22 Assuming the UK has the freedom to do so, would increasing or decreasing the threshold simply move the threshold problems or alleviate them?



Chart A.1 Comparing VAT thresholds between EU and OECD nations<sup>1</sup>



<sup>1</sup> Portugal, Malta, Italy, France and Ireland have multiple thresholds.

The EU member state thresholds are taken from the [EU website](#), which gives the most recent data at April 2017. The Euro figure is converted to £ sterling using the exchange rate on 2/1/2018 ([Bank of England Spot rate](#)). Data for the OECD Members that are not EU Member States was taken from the 'registration/collection thresholds' table in section D of the [OECD tax database](#). The figures, accurate in January 2018, were converted to Sterling using the exchange rate on 2/1/2018 (Bank of England spot rate). Due to fluctuating exchange rates, this data is approximate.

Chart A.2 UK VAT registration threshold 1980-2017

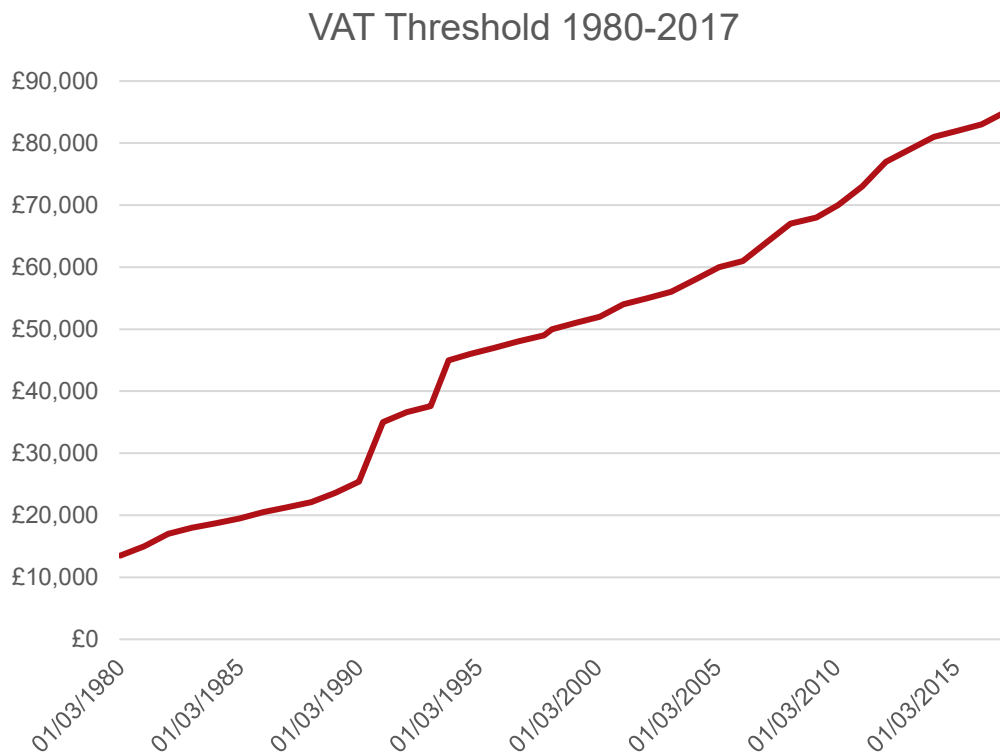
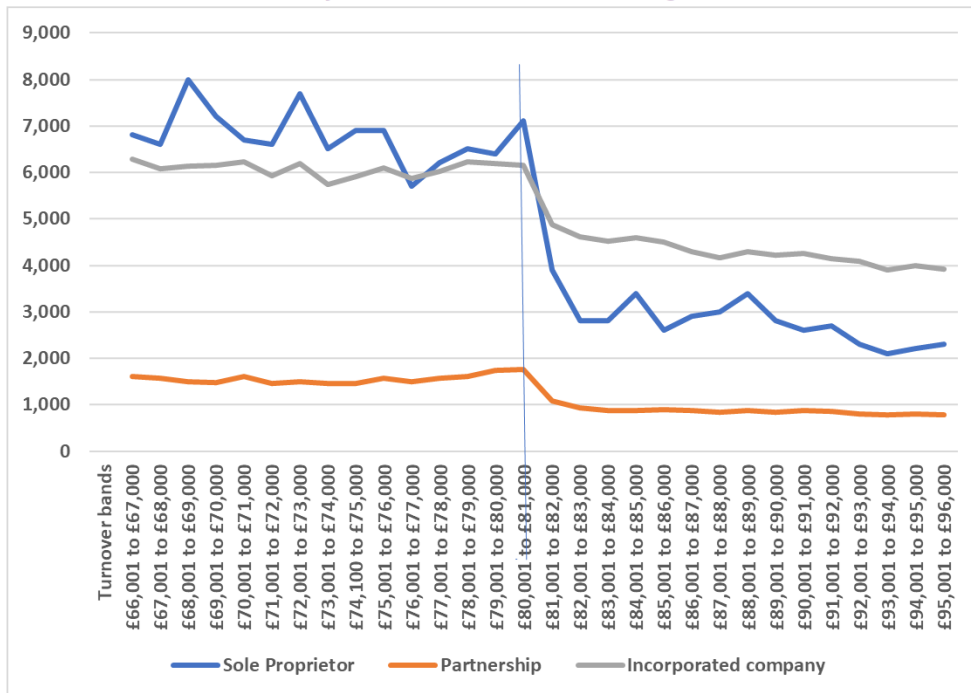


Chart A.3 Observing the bunching effect for different business types

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



Source: HMRC data from 2014/15, when the threshold was £81,000<sup>8</sup>



**HM Treasury contacts**

This document can be downloaded from  
[www.gov.uk](http://www.gov.uk)

If you require this information in an alternative format or have  
general enquiries about HM Treasury and its work, contact:

Correspondence Team

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Tel: 020 7270 5000

Email: [public.enquiries@hmtreasury.gsi.gov.uk](mailto:public.enquiries@hmtreasury.gsi.gov.uk)