



HM Treasury

VAT registration threshold: Summary of responses

October 2018

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Contents

Chapter 1	Introduction	2
Chapter 2	The current VAT threshold and the impact on business growth	3
Chapter 3	Why do businesses restrict their turnover to remain under the threshold?	7
Chapter 4	Policy solutions: design of the threshold	13
Chapter 5	Government response	20

Chapter 1

Introduction

- 1.1 In December 2016, the Chancellor of the Exchequer requested that the Office of Tax Simplification (OTS), as part of their VAT review, examine the 'issues and impacts which would be involved if the VAT registration threshold were either higher or lower than at present'.
- 1.2 The OTS report 'Routes to Simplification for VAT' was published on 7 November 2017. Their main finding regarding the UK threshold was that its relatively high level 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.
- 1.3 At Autumn Budget 2017, the Chancellor recognised that the UK had by far the highest threshold in the OECD (at £85,000) and noted concerns about the cliff-edge nature of the threshold. He announced that he was not minded to reduce the threshold, but instead would consult on whether the design of the threshold could better incentivise growth.
- 1.4 The call for evidence into the current design of the VAT registration threshold was published at Spring Statement 2018. It ran from 13 March to 5 June 2018. We received 51 written responses from a wide range of stakeholders, from members of the public to academics and large representative bodies. HM Treasury and HMRC also held round-table meetings with industry bodies around the UK. Additionally, a SurveyMonkey questionnaire was published, with 895 businesses and individuals taking part.
- 1.5 The call for evidence aimed to understand the issues that businesses face as a result of the current design of the registration threshold and the impact that this has on business growth. There were three main sections to the report: exploring the effects of the current VAT threshold, understanding the reasons why businesses would want to remain under the threshold, and analysing policy solutions to the problem at hand.

Chapter 2

The current VAT threshold and the impact on business growth

2.1 This section sought to explore the effect that the current design of the VAT registration threshold has on small business growth. Questions were aimed at all respondents, however there was no obligation for each question to be answered.

Question 1 – What experience or knowledge do you have of small businesses managing their turnover to remain below the VAT threshold?

2.2 Most of the responses to the call for evidence confirmed the existence of ‘bunching’ (businesses limiting turnover to just below the threshold). However, one accountancy body noted that this phenomenon may not necessarily occur purely because of the disadvantages of VAT registration but also as a result of the additional pressures that businesses face as they grow. Businesses of this size may also be experiencing other burdens such as costs related to hiring staff and the associated responsibilities are potentially a greater concern for businesses than facing VAT registration.

2.3 One representative body stated that low cost service businesses who serve consumers would face a significant hit to their demand by increasing their prices by 20% and are therefore incentivised to stay below the threshold.

2.4 Approximately 50% of unregistered businesses who took part in the SurveyMonkey questionnaire reported that they had limited their turnover to specifically remain under the threshold. This was commonly done through means such as not taking on work for a couple of months, closing the business or taking holidays when they were approaching the threshold. Of these businesses, the majority reported that reluctance to cross the threshold affected their ability to generally improve the profitability of the business. This indicates that the financial impact of VAT registration may contribute to slowing growth among small businesses.

2.5 It was reported that this often seems to be the case for domestic trades, such as household cleaning, in particular, where there is huge pressure to quote the cheapest price possible. It is also noteworthy that the administration of VAT can lead businesses to wish to remain below the threshold. Both the administrative and financial burdens of VAT registration will be covered in detail later on in this report.

Question 2 – Are there, in your experience, particular types, regions or sectors of businesses where this is particularly prevalent?

2.6 This question revealed that this issue is not specific to one particular sector, due to the wide range of businesses who responded. However there are

some industries where this issue is more predominant. One representative body reported that it is more common for businesses supplying mainly services to manage their turnover to stay below the VAT threshold, as they typically have low costs and so cannot reclaim sufficient input tax to cover their outputs.

- 2.7 Others confirmed that this is most prevalent in domestic trades, but business-to-customer (B2C) service sectors, retail and hospitality are also commonly affected. Many responses reported that B2C businesses are unable to pass on the cost of VAT to their customers, and as those in service trades generally have few inputs, they essentially face a large VAT bill.
- 2.8 This question was also asked in the SurveyMonkey questionnaire. Of the businesses who responded by saying that they had limited their turnover to specifically remain under the threshold, there was no conclusive evidence that these businesses were primarily located in a particular region. Based on the SurveyMonkey results this happens most frequently in the South East, but this may be explained by higher population density than in other parts of the UK. The survey also asked participants to state which sector their businesses currently operates in. From these results, it appears that businesses managing their turnover to remain below the threshold is most predominant in accommodation and food service activities.

Question 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?

- 2.9 A common barrier to growth for businesses just above the threshold is the difficulty faced in competing with unregistered businesses. 40% of VAT registered businesses with turnover greater than £85,000 who took part in the SurveyMonkey questionnaire reported that competition from unregistered businesses has a large impact on their businesses. 88% of these businesses said that these difficulties were because of unregistered businesses being able to provide goods and services at a lower cost.
- 2.10 The cliff-edge nature of the current design means that businesses who are just above the threshold face a VAT bill that, for many low-cost service businesses, must either be paid out of business funds or the cost being passed on to customers. With some exceptions, customers will naturally favour a business which provides goods at a lower cost. As a result, if a business is unable to reclaim their input costs, then the business must increase its prices by up to 20% to cover the cost of the VAT bill. This ultimately makes newly-registered businesses less competitive than they were before they became VAT-registered.
- 2.11 One respondent also noted that as many small VAT registered businesses suffer from the complexities of VAT, they will turn to external professional advice to deal with these issues. They reported that these costs place a great strain on their resources and is a cost that unregistered businesses do not have to face.
- 2.12 Another highlighted that the time spent on administration is time that could otherwise be spent serving customers and growing their business; an issue that does not affect unregistered businesses, although many reported

managing their turnover to stay below the threshold, potentially, in part, as a result of the administrative burden of VAT.

Question 4 – As the OTS suggest, does the current threshold contribute to the size of the hidden economy, and how?

- 2.13 Several respondents agreed with the OTS' suggestion that the current design of the threshold contributes to the size of the hidden economy. It was suggested that some small businesses will inevitably be suppressing their declared income to ensure that their business remains below the VAT registration threshold. Most recognised that this problem is exacerbated by the cliff-edge nature of the threshold.
- 2.14 It was argued by one representative body that if the VAT threshold were to be lowered substantially, some small businesses (around the £25-50k turnover range) may find compliance too burdensome given the size of their profits and therefore end up in the hidden economy.
- 2.15 Another reported that a low threshold could contribute to the size of the hidden economy as it might incentivise some businesses to under-declare to remain below the threshold.
- 2.16 Several responses to this question explained that as the sectors which are commonly affected by the issues of VAT registration are typically in the service sector, such as hairdressing, and are usually paid in cash. As such, it is easier for these businesses to suppress their takings and artificially remain below the threshold.

Question 5 – In your experience, does the current threshold have any effect on growth and/or productivity? If so, how significant is that effect?

- 2.17 Responses suggest it is likely that by not investing, upskilling or innovating so as to remain under the threshold, small businesses may be limiting their productivity.
- 2.18 The results of the SurveyMonkey questionnaire revealed that this is, as expected, more of an issue for businesses whose turnover is greater than the VAT threshold compared to businesses who are voluntarily VAT registered or are yet to cross the threshold. As previously stated, roughly 40% of those businesses who took part in the SurveyMonkey questionnaire reported that unregistered businesses had a large impact on their business, mainly because unregistered businesses can provide goods and services at a lower price. The consequential effect that this has on profit margins may prevent businesses from growing at a rate that they otherwise would have done. A much higher proportion of goods businesses compared to service-based businesses reported unregistered businesses having a large competitive impact.
- 2.19 These results were also reflected in the consultation responses with representative bodies and members of the public reporting that the competition challenge faced by newly-registered businesses was one of the key reasons why businesses would want to stay under the threshold. This was identified as being more of an issue for B2C businesses.

Conclusion

- 2.20 There is evidence to suggest that the current design of the VAT registration threshold presents issues for small businesses nationwide that limit their productivity and growth. Businesses who cross the threshold face difficulties competing with unregistered businesses, for example in terms of pricing structure, and therefore many attempt to remain below the registration threshold, through both legal and illegal means. For example, when businesses notice that they are approaching the threshold they may decide to take up a four-day week or reduce the number of staff in order to limit their turnover.
- 2.21 The responses to the call for evidence suggest that low-cost service businesses are most affected by the competition challenges as a result of VAT registration.

Chapter 3

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

- 3.1 The purpose of this section was to understand why some businesses restrict turnover to avoid or delay crossing the threshold, so that potential solutions can be considered. We categorised these reasons into two groups: administrative and financial.
- 3.2 This section also considered the effectiveness of the current VAT simplification schemes, such as the Flat Rate Scheme (FRS) and Annual Accounting Scheme (AAS) among others. We also explored the impact of Making Tax Digital on administration, particularly as a change to the level of the VAT threshold could require more small businesses to comply with MTD.
- 3.3 We recognised that there are also powerful incentives to register for VAT, evidenced by the approximate 1 million voluntarily registered businesses.

Administrative burden of VAT registration

Question 6 – Does the administration of VAT discourage businesses from registering?

- 3.4 The administration of VAT being burdensome and taking up a large amount of time and resources was a theme that was widely echoed in many of the responses to the call for evidence. It was clear that businesses do worry about the administrative burden of being VAT registered and that it could dissuade them from growing their business beyond the £85,000 registration threshold. Feedback from one representative body suggested that a significant proportion of small firms remain below the threshold because they do not want to be weighed down by the complexity associated with complying with VAT.
- 3.5 Another reported that the average time spent on VAT compliance each year is 45 hours with the associated costs being high. Several bodies explained that this burden is likely to be much more acute for smaller businesses that will often have to pay for external advice or those who have a limited management structure. However, government analysis estimates that the average cost of VAT administration for businesses is £300 per annum. This could suggest that the cost of VAT administration is actually fairly manageable for many businesses.
- 3.6 However, many individuals and small businesses who replied to our call for evidence noted that while VAT administration is a burden on their business,

it is a much less important factor compared to the financial implications of VAT when deciding to avoid crossing the threshold.

- 3.7 Some suggested that, while the administration of VAT can take up a significant amount of time, it is not excessive and an organised business should be able to manage the burden, since administering VAT has been made much more manageable with the introduction of relatively low cost online software. Some respondents reported that the administration of VAT was not a worry prior to their registration. This was also evidenced in the SurveyMonkey questionnaire, with only 14% of participants saying that the administration of VAT was the main reason that they wanted to avoid crossing the threshold. The SurveyMonkey also sought to explore businesses' opinions of VAT administration. 36% of participants reported that VAT administration takes up a lot of time and money. Conversely, 42% of businesses who took part in the SurveyMonkey questionnaire described VAT as manageable, but that it still takes up a significant amount of time and money, while 13% did not think that it takes up much time or money at all.

Question 7 – If so, what are the main aspects of VAT administration that are putting businesses off registering?

- 3.8 Responses to this question were mixed; there was no unilateral agreement as to which element of VAT administration was the most time consuming, or puts businesses off registering the most.
- 3.9 Some respondents claimed that the complexities of the current VAT system, such as establishing what VAT rate applies to their supplies, are undermining the competitiveness of the UK tax system. The complexity of VAT is not dependent upon scale and the view from the responses is that it applies just as much to small businesses as it does to large. However, the adverse impact of complexity is especially felt in small businesses particularly if they are not able to afford professional advice. It was argued by one representative group that the resources and funds allocated to tax administration could be better spent on business growth. One accountancy body suggested that improvements to the free guidance published by HMRC would give businesses the certainty they need to grow.
- 3.10 We asked in the SurveyMonkey questionnaire: *What aspect of dealing with VAT returns are particularly time consuming?* Respondents were able to provide more than one answer to this question. Collating and analysing the VAT paid on costs and purchases in the last quarter, the process of checking figures and the frequency which VAT returns must be submitted were the most popular aspects chosen.

Question 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?

- 3.11 Some respondents also claimed that the fear of getting VAT wrong and thus incurring additional costs (penalties received for inaccuracies in returns etc) holds businesses back from growing beyond the threshold. This suggests that while the administration of VAT may be easier to deal with than expected, it is the complexities of the VAT system that are holding businesses back.

- 3.12 One response noted that while the administrative duties that businesses must complete increase as they grow in size, so do their resources. As a result the ability to deal with greater levels of administration improves; for reasons such as being able to afford external advice.
- 3.13 It is worth noting that some businesses who responded to this question in the call for evidence believed that businesses who use IT software to help with their VAT returns find the administration of VAT much less burdensome.

Question 9 – How well do current simplification schemes address these issues?

- 3.14 There are several simplification schemes already in place to try and ease the burden on businesses when they become VAT registered. The most notable of these are the Flat Rate Scheme (FRS), Annual Accounting Scheme (AAS) and the Cash Accounting Scheme (CAS). In addition there are: VAT Retail Schemes, the Agricultural Flat Rate Scheme (although to use this scheme the business will not be VAT-registered) and VAT Margin Schemes (but these are not generally regarded as designed for simplification).
- 3.15 The FRS allows businesses whose turnover is £150,000 and below to pay a fixed flat rate of VAT to HMRC. The flat rate used depends on the sector the business operates in. The FRS was reformed in April 2017 with the effect that 'limited cost traders' (those who spend less than 2% of their sales on goods in an accounting period) can still use the FRS, but their rate is now 16.5% - irrespective of sector. The latest figures for the number of businesses who make use of the FRS report 358,000 users.
- 3.16 The AAS requires VAT registered businesses with turnover of £1.35m and below to submit only one VAT return per year and allows businesses to make more regular interim payments towards their VAT liability. This scheme is utilised by about 17,000 businesses.
- 3.17 The CAS allows businesses whose turnover is £1.35m or below to account for VAT when they pay cost or receive a payment rather than on the date of the invoice.
- 3.18 In short, the view of most of the businesses who provided a response to this question was that the current simplification schemes are useful and to some extent ease the burden of VAT registration for small businesses. Some respondents argued that these schemes could be better communicated and therefore they are mainly used by businesses who can afford external VAT advice.
- 3.19 Of the schemes that are currently in operation, the FRS was the most popular and was highlighted as being particularly attractive to many businesses. One benefit of the FRS was reportedly that it is particularly helpful for businesses who lack a full book-keeping package. However, a commonly-held grievance regarding the FRS was that the recent reforms to the scheme had negated its effectiveness as a simplification scheme. The FRS was reformed when HMRC became aware of some businesses using the scheme to reduce the amount of VAT they paid, rather than as a way to make the administration of VAT more manageable. Some respondents argued that the FRS still has the potential to deliver benefits which could

help smooth the cliff-edge nature of VAT registration. It is worth noting, however, that the FRS is intended to be a means of VAT simplification and not a way for businesses to obtain a cash benefit.

- 3.20 One respondent felt that simplification schemes could be better communicated. They argued that while simplification schemes can help small businesses to reduce VAT administrative burdens, only those who can afford external afford (and therefore hear about the schemes) are utilising them.

Question 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?

- 3.21 The responses to this question were mixed, ranging from those in complete agreement with Ipsos MORI to those suggesting that VAT returns are easy to complete and can be submitted in not much time at all.
- 3.22 Some responses noted that it is the frequency of VAT returns that are particularly burdensome.
- 3.23 One respondent claimed that while the VAT return is authorised and submitted by the business owner, the daily processing of recording sales generally isn't so the VAT return process is made harder as a result of the degree of separation.
- 3.24 In the SurveyMonkey questionnaire we asked the question: what aspect of dealing with VAT returns are particularly time consuming? From the results, businesses view the actual process of collating and analysing the VAT charged on sales and paid on costs/purchases as the most time consuming. One accountancy body expanded on this, noting that the time spent gathering the information to complete VAT returns and its additional record keeping requirements were the most onerous aspects of VAT administration.

Question 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.

- 3.25 A great deal of the respondents to this question were firm in their belief that Making Tax Digital (MTD) will not make the administration of VAT easier to deal with. Some noted the "significant challenges" that small businesses would face, such as purchasing MTD-compliant software. It was noted in one response that the proposed imposition of digital record-keeping and quarterly reporting for most businesses will result in greater administrative complexity and costs, especially for businesses with small turnover. Another respondent suggested that if the rollout of MTD leads to additional challenges in the VAT system, even more businesses may be inclined to manage their turnover to stay below the VAT threshold.
- 3.26 In contrast, the opinion of several representative bodies tended to be more optimistic about MTD. One representative body was optimistic that new technology, if it is developed effectively, can be used to improve the user experience of small firms as taxpayers and go a long way to reduce the administrative burden presented by the VAT system. There was also the suggestion that MTD could actually remove the need for simplification

schemes. One response suggested that the move towards greater use of technology, software solutions in particular, would make tax reporting easier in the future.

Financial and Competitive Burden

Question 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?

Question 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?

- 3.27 The responses were generally in agreement that the sectors that are affected by the financial and competitive disadvantages of VAT registration tend to be B2C traders.
- 3.28 Tourism and hospitality were identified often as the sectors that would be particularly affected as they tend to trade at low margins with high levels of payroll costs. In these cases, the added cost of VAT cannot be passed onto their customers and adds to the incentive for such businesses to manage their turnover to stay below the threshold. The building and construction, catering and hairdressing sectors were identified by one respondent as being affected by the financial disadvantages of VAT registration.
- 3.29 One representative body suggested that the financial and competitive impact of VAT registration depends on the specific circumstances of the business in question, although they felt that B2C traders will generally be affected more. Likewise, it was suggested that the financial costs of registration would be a greater incentive to remain below the threshold if their turnover, post-registration, is unlikely to grow significantly above the threshold.
- 3.30 One accountancy body suggested that, in some circumstances, the financial and competitive disadvantages of VAT registration lead to businesses restricting their turnover, especially if their business is unlikely to grow significantly above the threshold. One respondent noted that the cost of taxation is the most significant reason why businesses would want not want to exceed the threshold or operate in the hidden economy.
- 3.31 Several respondents highlighted that lowering the registration threshold would just serve to amplify these problems as the cost of taxation is the most powerful incentive behind businesses not wanting to exceed the threshold.
- 3.32 One accountancy body suggested that the financial costs of VAT registration are part of the picture of why small businesses make their decision on how much to grow. However, they felt that the full picture is more complex, and the responsibilities and complexities of employing more staff are equally important when it comes to limiting growth.

Conclusion

- 3.33 It is apparent that the administration of the current VAT system can be a deterrent to business growth.

- 3.34 Evidence suggests that the financial and competitive implications of VAT registering are the most significant burden on businesses and hindrance to growth.
- 3.35 Businesses reported the complexity of VAT and associated administrative burdens particularly hinder growth and productivity.
- 3.36 While there are benefits to the various simplification schemes that are currently in operation, such as the FRS, there is still evidence of 'bunching' around the threshold. As this is still the case, despite measures such as these to ease the administrative burden of VAT, it suggests that it is the financial implications of registration that are the most significant cause for businesses managing their turnover.

Chapter 4

Policy solutions: design of the threshold

4.1 This chapter sought to explore the effect of various policy solutions to the design of the VAT threshold. Solutions were proposed which would ease both the administrative and financial burdens of VAT registration while the EU SME proposal was also considered. We also asked respondents for their thoughts on any other policy solutions that might work and received responses from a wide range of stakeholders.

Question 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?

Question 15 – Are there constituent parts of the proposal which are particularly attractive or unattractive? If so, what are they and why?

4.2 The EU SME proposal seeks to introduce a transitional mechanism by which businesses would be allowed to exceed the threshold by 50% for a single year without registering. If they go over the 50% allowance, at any point, they must register. Additionally, if they exceed the threshold by less than 50% for more than 12 months they must also become VAT registered. It also proposes an EU-wide €100,000 (£89,000) registration threshold for ‘union turnover’ (in addition to a threshold cap on national turnover of €85,000) and simplified invoicing for all registered businesses whose turnover does not exceed €2,000,000 (£1,700,000).

4.3 The 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.

4.4 The proposed mechanism to allow businesses to exceed the threshold by 50% in a single year attracted a fair amount of support from the small businesses who responded. Some felt that it would help SMEs deal with a single exceptional trading year and may even deter businesses from managing turnover to avoid registration. One representative body felt that this 50% buffer could stimulate SME growth. One respondent stated that the proposal could go further, and extend the buffer to more than a year. 30% of those who took part in the SurveyMonkey questionnaire felt that this mechanism would help to alleviate the problems caused by the VAT registration threshold.

4.5 On the other hand, some felt that this component of the EU SME proposal would make the VAT system too complex and burdensome, especially for small businesses. It was also noted that this buffer may just prolong the

period of managing turnover to remain unregistered, with businesses potentially winding-down their activity in the second year if they were slightly above the threshold in the first year. Furthermore, one respondent highlighted the fact that the proposal does not go far enough to remove the underlying problem of the VAT system – the administrative and financial burden. They also noted that Schedule 1 paragraph 1(3) VAT Act 1994 already provides a relief for businesses who temporarily exceed the registration threshold.

- 4.6 There were limited responses that covered the other proposed smoothing mechanisms. Some respondents felt that the EU-wide threshold cap of €100,000 would actually increase the burden on small businesses rather than easing the problems that businesses face as more small businesses would be drawn into the VAT system, especially for businesses who make intra-EU supplies. Likewise, some respondents felt that the current design of the UK VAT threshold, with it being higher than other thresholds across the EU is actually a competitive advantage for UK businesses.
- 4.7 Several businesses were in favour of any mechanisms which would genuinely simplify the administrative burden for VAT-registered traders, notably the simplified invoicing for businesses whose turnover does not exceed €2,000,000. One representative body commented that reduced invoicing requirements would benefit small businesses, provided that they continue to track their data on a regular basis. Another respondent noted that there is an inherent danger to allowing businesses to file annual VAT returns without interim payments if they fail to cash manage the VAT they collect efficiently.

Administrative smoothing

Question 16 – Do you think the mechanisms described in paragraph 4.8 (of the call for evidence) would help businesses better manage the administration of VAT, upon registration? If so, would the positive effect be significant?

- 4.8 Paragraph 4.8 suggested the following two administrative smoothing mechanisms:
- extending the first period for which a business must account for and pay their VAT obligations to 6 months.
 - apply the threshold test over 2 years rather than 1. In other words, the test would be whether the taxable turnover of a business exceeded £170,000 over 2 years rather than £85,000 in 1 year.
- 4.9 The response to these smoothing mechanisms was generally positive although most respondents maintained that they don't go far enough to ease the administrative burden of VAT registration. For example, one representative body acknowledged that having a longer period to account for and pay VAT once a business has breached the threshold might ease the initial difficulty of registration. However, they noted that the administrative burden of VAT is an ongoing issue; simply lengthening the time before the first return must be filed would do little to alleviate the long-term problems. Furthermore, while extending the first period for which a business must account for and pay their VAT to 6 months might help with administrative smoothing, it does not give businesses enough time to generate sufficient

turnover to cover the VAT bill that unregistered businesses do not have to face.

- 4.10 While more than 50% of SurveyMonkey participants felt that applying the threshold test over two years rather than one would be of benefit, some respondents noted that it may actually create a greater administrative burden due to businesses needing to keep track of their turnover for a longer period. This would particularly be an issue for businesses who failed to be sufficiently organised throughout the whole period.
- 4.11 Some respondents felt that both of these proposals would be of benefit for businesses who were close to the threshold, although they may not have a significant effect in terms of promoting growth.

Question 17 – Would any of these solutions be sufficient to change the behaviour of businesses that take measures to remain under the threshold?

- 4.12 The responses to this question limited in number and were all based along the same lines: that none of these measures either address, or go far enough to address the fundamental problems that lie behind the VAT system.
- 4.13 Reasons given included the fact that they would not do enough to ease the administrative burden, with some suggesting that they may even worsen the pressure on businesses as a result of compliance.
- 4.14 One respondent commented that since applying the threshold test over two years rather than one does not actually change the level of the thresholds, the impact on businesses would be minimal.
- 4.15 Another representative body told us that they felt that no matter where the threshold is, there will always be businesses who strive to remain under it. This was reinforced by other respondents who claimed that there are already smoothing mechanisms in place, such as the flat rate scheme, and these have done little to reduce the size of the hidden economy.

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

- 4.16 The responses to this question were limited in number.
- 4.17 It was suggested that the rate of VAT on tourism businesses should be reduced. It is worth noting however that a reduction in the rate of VAT is not a simplification.
- 4.18 Some respondents suggested it would be of benefit to UK businesses if we followed other countries in having a very low threshold. They argued that in countries where the VAT registration threshold is very low, businesses are forced to grow beyond the threshold so that they can make a decent living. In turn this would lead to increased productivity and naturally, growth. However, this sentiment was not widespread and the majority of respondents opposed a threshold reduction.

Financial smoothing

- 4.19 The immediate financial implications of becoming VAT-registered, particularly for small businesses, were identified frequently in the call for

evidence and SurveyMonkey questionnaire as one of the main barriers to business productivity and growth.

- 4.20 68% of survey participants identified smoothing the sudden financial impact of VAT upon registration as the area that the government should focus on to incentivise small businesses to grow. One representative body suggested that financial smoothing would reduce the apparent benefit of staying below the threshold to avoid the increased tax bill. In turn, this may promote increased productivity and growth.

Question 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?

- 4.21 The call for evidence provided examples of financial smoothing mechanisms to try and ease the cliff-edge nature of the VAT threshold, including:
- Small businesses just above the threshold being eligible for relief. This would be the simplest smoothing mechanism to implement. For example, businesses would pay 0% VAT if their turnover was £85,000, while those at £100,000 turnover would pay the full amount.
 - Applying different thresholds for different sectors. This would relieve those businesses/sectors who are particularly vulnerable to threshold distortion such as hairdressers, coffee shops and hotels. The amount of relief would need to be high enough that it removes the disincentive to growth provided by registering for VAT, but low enough that it doesn't overly subsidise these businesses.
 - the OTS suggestion to provide relief for businesses on their first VAT bills, decreasing over time.
 - the VAT system working more like the income tax system, with increasing rates as turnover increases.
- 4.22 Smoothing mechanisms trade off simplicity against efficiency. The most efficient smoothing mechanism would ease the VAT burden solely of the businesses which would have not registered for VAT because of the threshold. For example, a targeted smoothing mechanism, such as applying different thresholds for different sectors would have less impact on the Exchequer but would be much more complex to implement – something that businesses are keen to avoid. In contrast, a smoothing mechanism which would be applied to all businesses, would be much easier to implement and simpler for businesses, but there would be a high deadweight cost to the exchequer in terms of the businesses who were already VAT-registered also obtaining relief.
- 4.23 Many respondents felt that while these proposed mechanisms may make life easier for businesses transitioning to VAT, they are relatively complex and so would not be a long-term fix.
- 4.24 The idea for the VAT system to work in a way similar to the income tax system, i.e. a phased VAT rate at different levels of turnover, received a lot of support. Businesses felt that it would be effective in reducing the cliff edge nature of the threshold. However, it must be recognised that this mechanism

could simply lead to multiple levels of 'bunching' rather than eliminating this issue altogether. A phased VAT approach may also lead to much greater complexity in terms of administration, so may not be particularly helpful in terms of improving productivity.

- 4.25 It is worth noting that although businesses and trade bodies welcomed any potential solutions to the financial burden of crossing the VAT threshold, they overwhelmingly advised against any changes that would make the administration of VAT more complicated.
- 4.26 Under the terms of EU law, the UK would have to seek permission from the Commission to introduce a smoothing mechanism to the VAT system. One of the conditions of permission being granted would be a 'revenue neutrality' condition. This means currently that it will not be possible to introduce a smoothing mechanism unless combined with a decrease in the threshold. The government triggered Article 50 on 29 March 2017 to start the process of leaving the European Union. 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 therefore remains a member of the EU with all of the rights and obligations that membership entails. That includes the application of EU VAT rules.

Question 20 – In your view, are there any other solutions that could work? What are they and why would they work?

- 4.27 One of the more widespread suggestions was to reform the FRS. A variety of responses to the call for evidence noted that the April 2017 changes to the FRS negated the benefits of the scheme for small businesses. Some responses suggested having a new version of the FRS, with all new registrants automatically enrolled on the scheme with the flat-rate offered to businesses diminishing over a set period. If this were to be adopted, it could lead to avoidance issues with businesses closing down once they approached the end of the period and re-starting under a different name/registration to make use of the scheme.
- 4.28 Others argued the case for reducing the rate of VAT for labour-intensive service industries. They felt that this would contribute to levelling the playing field with unregistered businesses in those sectors. However, some respondents felt that this may lead to questions of fairness and how to deal with businesses whose operation exists in different fields.
- 4.29 Respondents suggested that businesses should only be liable to VAT on the amount of taxable turnover that exceeds the threshold. They felt that if small businesses were not faced with an immediate 20% bill on their total turnover upon crossing the threshold, the financial implications of registration would be much less severe.
- 4.30 One representative body suggested that although the administrative burden is a substantial problem, the impact on margins and competitiveness is a much greater impediment to growth. They suggested that a system of rebates for various levels of turnover could help to prevent this problem.

Question 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?

- 4.31 Many respondents felt that this proposal would simply contribute extra complexity to the VAT system and stifle growth. It was also mentioned that it would generate compliance issues and would likely lead to ‘bunching’ just below the second, higher threshold. Some respondents also disagreed with this proposal on the basis of fairness.
- 4.32 The responses emphasised that this proposal does not focus on the key issue – the structural issue of the cliff-edge at £85,000 – but rather the administration behind VAT.
- 4.33 It should be noted that the terms of the EU SME Proposal would require a reduction of the UK VAT registration threshold to match the national threshold cap of €85,000. Businesses remain most concerned about a potential reduction to the threshold.

Question 22 – Assuming the UK has the freedom to do so, would increasing or decreasing the threshold simply move the threshold problems or alleviate them?

- 4.34 Above all, the most consistent response regarding the level of the VAT threshold was that a reduction in the threshold would be damaging for UK business and the economy. This was reflected in the responses to both the call for evidence and in round-table meetings held with industry bodies. The UK’s current high threshold compared to the rest of the OECD was seen to be of major benefit for UK business, notably in the tourism industry.
- 4.35 Many responses committed to the view that an increase to the threshold would make it much easier for newly-registered businesses to cope with the administrative and financial implications of registration. For example, if the threshold were to be raised to £100,000, businesses would likely be able to afford the cost of professional advice to cope with the administrative burden, while also being more able to absorb the cost of VAT. One representative body felt that the administrative burden would only be taken out of the equation if the threshold was much higher. The UK is currently unable to increase the level of its VAT registration threshold in real terms, under EU law, but there may be scope to review this in the future.
- 4.36 A threshold reduction did receive some support from the respondents. Some felt that the financial cliff-edge threshold problem could be resolved if the threshold was at a point low enough that meant most UK businesses are registered as there would be no disincentive to growth (from a VAT perspective). One respondent thought that if the threshold were to be lowered, it should only be lowered to a level that means hairdressers and other similar small B2C businesses are not caught up by it. A threshold reduction would see more small businesses challenged by the complexities of VAT however, potentially outweighing the benefits of overcoming the financial cliff-edge.

- 4.37 It is worth considering that any change to the level of the threshold may simply result in the issue shifting. In other words, bunching may just occur at a higher or lower level.

Conclusion

- 4.38 The responses to the call for evidence highlight the fact that, at present, the UK VAT system is inefficient, inhibiting productivity and growth beyond the registration threshold and there are various policy solutions that would somewhat improve the situation. Businesses are keen on easing the financial and administrative burdens of VAT registration, but are very wary of adding even more complexity to the VAT system.
- 4.39 While the UK is bound by EU law, we are unable to either introduce a smoothing mechanism or increase the level of the threshold without a derogation from the Commission. We have also taken on board businesses' concerns regarding added complexity following the introduction of a smoothing mechanism. However, the government will look again at the possibility of introducing a smoothing mechanism once the terms of EU exit are clear.

Chapter 5

Government response

- 5.1 The large number of responses received has provided us with a valuable evidence base to inform policy decisions. The government has received a wide range of ideas and recommendations.
- 5.2 The government has committed to ensuring that the design of the VAT threshold is set at a level which best incentivises business growth and ease the burden of VAT on small-businesses.
- 5.3 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.
- 5.4 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.
- 5.5 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.
- 5.6 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.
- 5.7 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.

- 5.8 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 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.