



Association of Accounting Technicians response to The Office for Tax Simplification interim paper on Value Added Tax (VAT)

Association of Accounting Technicians

response to the OTS Review of Value Added Tax

1. Introduction

- 1.1. The Association of Accounting Technicians (AAT) is pleased to have the opportunity to respond to the OTS Review of Value Added Tax (VAT), published on 28 February 2017.
- 1.2. AAT is submitting this response on behalf of our membership and for the wider public benefit of achieving sound and effective administration of taxes.
- 1.3. AAT has added comment in order to add value or highlight aspects that need to be considered further.
- 1.4. AAT has focussed on the operational elements of the proposals and has provided opinion on the practicalities of implementing the measures outlined.
- 1.5. Furthermore, the comments reflect the potential impact that the proposed changes would have on SMEs and micro-entities, many of which employ AAT members or would be represented by AAT's 4,250 licensed accountants.

2. Executive summary

- **More than a third of AAT members who responded to the AAT 2017 VAT Survey would like to see the VAT threshold substantially increased.** This survey indicated that 36% of AAT members would like to see a substantial increase in the threshold.
- **Over a third of AAT members who responded to the AAT 2017 VAT Survey would also like definitions and boundaries for existing VAT rates to be carefully examined and complexities reduced or better managed.** There was also considerable support for the exemption schedule to be scrapped (30%) or for the standard rate of VAT to apply to all Vatable items (22%). There was very little support for the current system to be retained as it is.
- **HMRC generally does a good job in providing help and guidance on VAT related matters, especially where issues are straightforward.** However, there is more that could be done, especially where subjective responses are needed. This is because the vast majority of SMEs are unable to obtain much needed certainty in the form of written rulings from their local VAT office, just a few hundred are provided each year for millions of SMEs.
- **Waiving of the smallest VAT penalties may be welcome for many SMEs but an unintended consequence is that many of these companies then fail to appreciate they are in a default position.** AAT therefore suggests that HMRC should closely examine the possibility of VAT penalties more closely mirroring speeding fines. 35% of AAT members who responded to the AAT 2017 VAT Survey support the adoption of a speeding fine type penalty system, although it should be noted this was opposed by 33% of respondents.
- **Making Tax Digital will have considerable implications for VAT accounting rules.** AAT members are evenly split on the likely implication of MTD on VAT rules with 34% thinking they will not make them redundant, 30% thinking they will and 35% not knowing (AAT 2017 VAT Survey). The OTS must take these important developments into account when proposing future changes.

3. AAT response to the consultation paper

- 3.1. The following paragraphs outline AAT's response to the proposals in the interim paper on Value Added Tax. Only those questions or sections where AAT has a comment to make have been listed.

IDENTIFYING THE IMPLICATIONS OF THE LEVEL OF THE REGISTRATION THRESHOLD

Why are businesses below the VAT threshold registering?

- 3.2. As noted in the report there are several reasons why businesses register in advance of their turnover breaching the registration threshold. Self-evidently these are mainly micro-businesses.
- 3.3. Dependent upon their client or customer base, micro-businesses can gain a financial advantage or suffer a financial disadvantage by registering. These financial implications are the main motive driving decisions about registration.
- 3.4. The financial advantage or disadvantage flows from the client base of the business concerned. If the client base is all or mostly VAT registered businesses, micro-businesses are best advised to register voluntarily. They normally do not have to absorb any output tax whilst being able to reclaim input tax which increases profits. The same benefit does not accrue to businesses whose client base is mainly persons who are not VAT registered.
- 3.5. Micro-businesses whose customer base is wholly or mainly made up of non-registered persons are normally best advised not to register until the turnover exceeds the registration threshold. It is often the case that once registered these businesses have to absorb the output tax as due to market forces they are often unable to increase prices. If they increased prices by 20% VAT, they would lose many customers to unregistered competitors.
- 3.6. There is a clear dividing line between those businesses who register or register before the turnover reaches the registration limit, those with customers who may reclaim VAT register, and those whose customers cannot reclaim VAT do not register. Thus, it is reasonable to presume that of the 44% of businesses registered voluntarily most have a customer base which is capable of reclaiming the input VAT incurred.

What would be the impact of significantly raising or reducing the threshold?

- 3.7. Without voluntary registrations, there would be more inequality between similar businesses trading just below and just above the threshold. Although this could be avoided if the threshold was lowered to a very low level i.e. the proposed Making Tax Digital £10k threshold or the current personal allowance etc.
- 3.8. Currently a business making wholly or mainly zero rated sales may register voluntarily and reclaim input tax. Its cost base is then similar or the same as a business which is VAT registered. If food producers and exporters trading below the threshold are unable to register, they must absorb the VAT paid on costs and then this flows through to the customer in form of higher prices. This becomes a hidden tax on food production and exports.
- 3.9. For businesses who face customer resistance to a 20% hike in prices, a significantly higher threshold makes this problem even worse. Decisions to raise the threshold should be centred around the impact on these businesses rather any headline grabbing move to free thousands of businesses from the need to cope with VAT – although again this would be much less of a problem if all businesses were treated equally and exemptions were removed.
- 3.10. As with raising the threshold, the businesses most affected are those with customer bases comprising mainly or wholly of persons who are unable to reclaim VAT. These businesses face the dilemma of how much they can raise prices to recoup the VAT which is due after registration. There is no such dilemma for businesses with customers who may reclaim VAT.
- 3.11. Obviously competition between VAT registered and non-registered businesses could be eliminated by requiring all trading entities to register.

- 3.12. Over two million small and micro-businesses are VAT registered. In the main these cope with and manage VAT very well. This seems to indicate that there would not be significant problems if the threshold is either maintained or lowered.
- 3.13. The *AAT 2017 VAT Survey* showed that 36% of AAT members would favour a substantial increase in the VAT threshold to something similar to Singapore (£500,000) although it should be noted this was closely followed by 32% who wanted the status quo maintained.
- 3.14. The *AAT 2017 VAT Survey* results did clearly demonstrate that support for a reduced threshold was much less prevalent amongst AAT members. Just 4.6% would like to see the VAT threshold reduced to the personal allowance level (currently £11,500) with greater support for a zero threshold as in Spain and Sweden (8.8%) instead.

In both cases what would be the impact on economic activity?

- 3.15. Removing the VAT threshold completely or significantly increasing the threshold would boost productivity as it would mean nobody (no threshold) or fewer businesses (much higher threshold) would stop working to avoid exceeding the VAT threshold.
- 3.16. There is considerable evidence to suggest small firms do not seek to evade or avoid VAT but instead reduce output to fall under the threshold ¹. This clearly has a damaging impact on the productivity of British companies and with the UK being renowned for having poor productivity rates, such considerations should not be dismissed.
- 3.17. Removing the threshold altogether would clearly be a simplification measure too.
- 3.18. Similarly, a significantly increased VAT threshold may also act as a simplification measure by removing the majority of small businesses from the VAT regime – as happens in Singapore which has a threshold of approximately £500,000.
- 3.19. An increase would also inevitably have some positive impact on companies as they would have more time and resources to direct on their primary business focus rather than on the administrative requirements of VAT registration and reporting.

Are there any other approaches which could simplify the regime? Does Making Tax Digital have an impact?

- 3.20. Making Tax Digital (MTD) will have considerable implications from a VAT perspective **but** the nature of that impact remains unclear. Indeed, AAT members are evenly split on the likely implications with 34% thinking they will not make them redundant, 30% thinking they will and 35% not knowing (*AAT 2017 VAT Survey*).
- 3.21. AAT fully supports any attempt to introduce simplification into the overly complex UK tax system. However, other than a few concessions arising out of the August 2016 round of MTD-consultations, an increase in the cash accounting threshold and the deferment to MTD-on-boarding for those with a turnover below £85,000 from a VAT perspective the roll out of MTD represents a lost opportunity.
- 3.22. MTD was initially sold as a way of making tax compliance easier. After significant external opposition, this justification was quietly dropped in favour of arguments around closing the tax-gap. This change in emphasis also seems to imply the VAT simplification is not a priority for HMRC.
- 3.23. If MTD is to deliver on its original promise of making tax-compliance easier, much more work needs to be done. The Office for Tax Simplification (OTS) is ideally positioned to provide insight and recommendations here given its current work on VAT reform and the likely representations it will have received and considered.

¹ *The effect of VAT thresholds on the behaviour of small firms, Finland, June 2015*

MULTIPLE VAT RATES: CAUSES OF COMPLEXITY?

- 3.24. According to the *AAT 2017 VAT Survey*, the largest level of support amongst members was to retain the current system largely as it is whilst examining definitions and boundaries and seeing if the complexities caused can be reduced or better managed (36%). This was followed by scrapping the exemption schedule and making everything taxable at either a standard, reduced or zero rate (30%) and applying the standard rate to everything (22%). By comparison just 11% of respondents think the current system is fit for purpose and should be retained.
- 3.25. To be clear, the default rate of VAT, the standard rate, is fairly straightforward. It is the exceptions which cause the boundary issues and complexities to which the OTS report refers. Suffice to say that reducing the exceptions will reduce the boundary issues.
- 3.26. The categories which give rise to the most boundary issues are easily discernible by reference to HMRC's manuals. Over the years HMRC has written manuals for the trade sectors with the most complexities. These manuals are probably the best available resource for identifying the trade sectors creating the most boundary problems.
- 3.27. In a market economy products are always changing or new ones developed. Some of these will create new boundary issues which will not be apparent until the product is launched. Inevitably VAT legislation will always lag behind market developments.
- 3.28. What is meant by allowing 'more leeway for reasonable trade decisions' is not clear. Without further information AAT is unable to form a view on whether this would help simplify VAT.
- 3.29. With regard to broader definitions for the exempt, reduced and zero rated supplies, this may help as tax legislation is always responding to market changes. This often results in ragged boundaries. AAT proposes identifying some of the most complex areas and reviewing them with the aim of amending definitions so that they are more appropriate to today's market and social needs.
- 3.30. There are two options that AAT would like to see HMRC give serious consideration to.
- 3.31. Firstly, the less radical option of properly establishing if the complexities caused can be reduced or better managed should be given serious attention (as supported by 36% of AAT members) but rather than being ongoing this should be over a time limited period, perhaps a one year timeframe would be most appropriate.
- 3.32. If significant progress is not made, then AAT would like to see HMRC thoroughly explore the implications of applying the standard rate of VAT to all Vatable items as a radical simplification measure. In other words, abolishing the 5% reduced rate, the zero-rate and exemptions (including obscure ones such as the 4% agricultural rate). To ensure fiscal neutrality this would also require a reduction in the standard 20% rate. As noted above, taking such action is supported by almost a quarter of AAT members (22%) according to the *AAT 2017 VAT Survey*.

Partial exemption methodologies, option to tax and capital goods scheme simplification

Partial exemption

- 3.33. AAT is unclear as to where or why partial exemption arises 'unexpectedly' or 'accidentally'. Partial exemption is encountered by businesses which make or plan to make exempt supplies. It seems unlikely that these supplies arise unexpectedly or accidentally.
- 3.34. In AAT's experience the more common mistake is not knowing from when the partial exemption regulations apply. In nearly all cases this is before the exempt income is received. Many persons make the mistake of considering partial exemption when the relevant income is received rather than from when the first VAT bearing related cost is incurred.
- 3.35. In AAT's opinion raising the 'de minimis' limits will not simplify partial exemption. The 'de minimis' limits operate to allow recovery of small amounts of input tax that is attributable to exempt supplies. Only by calculating this input tax can a business know if it is below the 'de

minimis' limits. Accordingly, a business must operate a partial exemption method and use this to quantify the tax which may be recoverable because of the 'de minimis' limits.

- 3.36. In the main AAT members advise SMEs and micro businesses, and these are the great majority of registered businesses. They are varied and often unique and are not suited to sector-specific methodologies.
- 3.37. Special methods could be of more use to SMEs but this option is no longer practical because of the delays and problems encountered when attempting to agree a special method with HMRC. Some of the problems are due to HMRC wanting everything done by correspondence. AAT knows of an example of a special method which took around two years to agree. Agreement came after a meeting with HMRC where wrong inferences by both sides were quickly discussed and resolved. Although much effort had been made to explain the taxpayer's business model, HMRC did not properly grasp what it was until they met the director of the business and had it explained to them.
- 3.38. Perhaps a way forward for smaller businesses would be to allow them to use any fair and reasonable method to calculate the input relating to exempt supplies. This would be subject to a monetary cap and on the condition that full details were forwarded to HMRC and HMRC were allowed a fixed time, of say six months in which to make an enquiry into the method used.

Option to tax

- 3.39. Opting to tax is made more complicated by Parliament not wanting the option to apply to residential accommodation, charity buildings etc. and also an anti-avoidance measure. It is probably the anti-avoidance measure which causes the most problems. These boundary issues will continue to exist with a default system which presumes every commercial building is opted to tax.
- 3.40. The present legislative structure is that commercial rents are exempt unless or until the grantor opts to tax. The proposal would reverse this and in effect make all commercial rents liable to the standard rate of VAT unless it also incorporates an opt-out provision. There would then be as many problems as the opt-in system and if an opt-out was not there, there would be rent increases.
- 3.41. Each option to tax must be notified to and/ as necessary agreed with HMRC. Accordingly, they must have a data base such as suggested by OTS. Better and speedier access to the option to tax records maintained by HMRC would be preferred but this is only possible if the tax office is better resourced and structured in a way which is more suited to what 'customers' want.
- 3.42. The notification process could be improved by HMRC allocating more resources to it. This could rid the system of the delays which are a significant problem for taxpayers.

Capital Goods Scheme (CGS)

- 3.43. CGS does create more burdens due to the scheme covering five or ten intervals - each of which is normally a year. There are computations to be undertaken during each interval and of course the records must be preserved. The preservation can extend to up to eleven or sixteen years due to the need to keep the final year's records for a further six years.
- 3.44. It might be more straightforward if CGS applied to all assets. Businesses are used to keeping an assets register for other taxes and if CGS were applicable to all assets this would form a primary CGS record. Making the CGS adjustment concurrent with trading years would also be useful because they could then be done along with the regular capital allowances claims.
- 3.45. The £250,000 limit was set when the option to tax was in its infancy. CGS now applies to many more properties in part because of opting to tax. Nevertheless, raising the limit is long overdue.

SPECIAL ACCOUNTING SCHEMES

Flat rate accounting scheme ('FRS')

Cash accounting schemes

Annual Accounting Scheme ('AAS')

- 3.46. In the main these three simplification schemes work well. FRS and Cash Accounting are well liked and widely used. Of the three AAS is probably used least but it is a helpful option for some.
- 3.47. The questions which are posed about these schemes are more akin to fine tuning rather than producing any significant simplification of the application or administration of VAT. Preferably they should be considered as on-going developments and dealt with through the normal HMRC consultation groups.
- 3.48. AAT is not convinced that fewer FRS categories would help users. Also, the categories may have to reflect the statistical information collected by HMRC and the Office for National Statistics.

Retail Schemes

- 3.49. The underlying reason for having retail schemes has not changed because the retail trade has not in essence changed. It remains a sector in which there is a very high volume of low value sales and often at different rates of VAT. Quantifying the VAT due on such high volumes of mixed rate sales is the complexity for which retail schemes were designed. For this reason, they remain relevant today.
- 3.50. Nowadays many more retailers are using Scheme F which is recording at the point of sale which sales are liable to which rate of tax. The trend to use Scheme F is likely to continue due to the increased availability of bar coding and modern accounting software. AAT does not think there is a good case for removing the schemes especially when some large retailers continue to use them.
- 3.51. HMRC are consulting on a 'split payments' system for 'on-line business to consumer sales'. Also, MTD requires more regular reporting. On balance, we think it would be better to see these changes through before imposing any system for the direct sending of information from the till to HMRC.

Agricultural flat rate scheme

- 3.52. This is an EU scheme – Directive 112/206, art 295. AAT members have very little experience of this EU scheme because of the small number of businesses which use it. The exact number of businesses using the scheme in the UK is obtainable from HMRC but it is AAT's understanding that it may be as low as 200. Consequently, if it were to be abolished after leaving the EU, very few businesses would be affected.

Tour Operators Margin Scheme (TOMS)

- 3.53. This is another EU scheme - Directive 112/206, art 306. The reason for TOMS is that tour operators often supply transport, accommodation etc. in several EU States. Without TOMS, these operators would have to register for VAT in each EU State in which they supply transport, accommodation etc. The CJEU said in *European Commission v Spain (Case C-189/11) [2013]* that for tour operators the *'normal rules on place of taxation, taxable amount and deduction of input tax would... entail practical difficulties... of such a nature as to obstruct their operations'*.
- 3.54. TOMS was introduced to aid operators putting together cross-border holidays and the like. There are now many more of these today than there were in 1988 when TOMS was first implemented in the UK. It follows that it still helps the sort of tour operator originally targeted.
- 3.55. TOMS is seen by many as being overly complex and difficult to understand. However, as TOMS is governed by EU legislation it cannot be restricted solely to the UK whilst the UK remains a member of the EU. This matter, possible simplifications and alignment with other international rules are all probably best left until Brexit terms are agreed.

VAT ADMINISTRATION, PENALTIES AND APPEAL PROCESSES

Administration

- 3.56. It should be acknowledged that HMRC continue to strive to improve their guidance. Nevertheless, it does not always provide the required answer nor are the search functions good enough. With regard to automatic notifications, the HMRC alert system goes some way to doing this.
- 3.57. No matter how good HMRC's guidance is it will not always provide the answer sought by businesses and their advisers. It cannot do so when a subjective judgement must be made and when this is necessary different persons may come to different conclusions. For example, many brilliant minds scoured whatever guidance was available in an effort to decide whether Jaffa cakes were biscuits or cakes and still reached different conclusions. The litigation relating to this issue in 1991 amply demonstrates that reasonable people considering the same facts can reach differing decisions. When this is clearly so, the decision cannot be a certain one.
- 3.58. Taxpayers are entitled to certainty in respect of their tax affairs. However, with HMRC's increasing centralisation of VAT administration it is now difficult for SMEs and micro-businesses to obtain this in respect of their VAT affairs. While HMRC does give written rulings but they provide only a few hundred per annum for millions of SMEs. In our opinion this system is not fit for purpose.
- 3.59. The importance of being able to agree matters with the tax authorities was addressed by the CJEU. In the case of Radu Florin Salomie, Nicole Vasile Oltean [2015] Case C-183/14 the court said '*...a prudent and well informed trader could not reasonably conclude that such a transaction would not be subject to VAT without having received, or at least sought, express assurances to that effect from the competent nation authorities*'.
- 3.60. Improving the system for agreeing liabilities and other issues with HMRC would provide immeasurable assistance to SMEs and micro-businesses and help to make the administration of the tax more straightforward.

Penalties

- 3.61. The concerns which AAT has with the penalty system are not solely to do with VAT. With this mind, the comments here are confined to matters which are unique to VAT but AAT agrees with those who suggest that the penalty system is too subjective.
- 3.62. The voluntary disclosure system should operate to encourage registered persons to put right careless mistakes or errors. In some ways, the current penalty systems act against this. Many businesses take a pragmatic view that there is perhaps less chance of a penalty if whatever adjustment is necessary is made on a return rather than declared on Form VAT 652. It would be much better and give more certainty to business if they knew that by making a voluntary disclosure in the proper way they would not incur a penalty. Or perhaps with voluntary disclosures HMRC could use its discretion to not levy penalties on voluntary disclosures.
- 3.63. The lowest default penalty is 2% or 5% (VATA 1994, s2(5) (a)& (b)). These penalties are waived if the amount due is less than £400. Although beneficial to SMEs and micro-business, this well intended policy has had some unexpected consequences. When they have to pay nothing, some businesses fail to take seriously that they are in a default situation. It is only when the heavy penalties apply that they take notice. AAT would like to see more research into the unexpected consequences of waiving the small 2% or 5% penalties.
- 3.64. As HMRC will soon abolish default charges they may not want to fine tune the current system now or in the immediate future.

Appeals process

- 3.65. HMRC should always strive to write clear decision letters and do what they can to improve clarity as this is not universally the case at present. However, by itself this is not likely to improve the statutory view process.
- 3.66. Very few AAT members have suggested that they find the statutory review process complex. The problem is probably more to do with communications.
- 3.67. Statute reviews are always done on paper. When reviewing matters from paper, simple misunderstandings often arise and opportunities for compromise are easily missed. No one person or side is to blame for this. Both HMRC and taxpayers do it.
- 3.68. By comparison ADR uses direct negotiations either by telephone or at meeting to resolve disputes. The outcomes by comparison speak for themselves – more agreements are achieved by direct negotiations than reviews done from paper. According to the recent *AAT 2017 VAT Survey*, 23% of AAT members believe more should be done to encourage greater use of ADR in VAT appeals compared to just 6% that don't (70% don't know).
- 3.69. ADR is not always suited to VAT disputes. For example, they are unsuitable to disputes where there can be no compromise (e.g. deciding if a Jaffa cake is a biscuit or a cake) and due to the nature of the tax there are more of these cases in VAT than other taxes. However, businesses will be encouraged to use it more for VAT disputes if the success rate is published and they realise they will have face to face negotiations with HMRC.
- 3.70. In recent years, there have been several changes to the tribunal appeal process. Each change has made it more difficult and costly for SMEs and micro-business to pursue an appeal. ADR is probably the most viable alternative for SMEs and small businesses. More use of professional independent mediators would likely encourage more persons to use this resolution process. However, many SMEs and micro-business will not be able to afford to pay both for an independent mediator and their agent to represent them. They would be more likely to use it if they knew the only costs they would incur would those of their agent.

4. About AAT

- 4.1. AAT is a professional accountancy body with approximately 50,000 full and fellow members and over 90,000 student and affiliate members worldwide. Of the full and fellow members, there are over 4,250 licensed accountants who provide accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types.
- 4.2. AAT is a registered charity whose objectives are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

