

## Summary: Intervention & Options

<b>Department /Agency:</b> <b>HM Revenue &amp; Customs</b>	<b>Title:</b> <b>VAT Flat rate scheme (FRS): Impact Assessment of changes to the flat rate percentages in January 2010.</b>	
<b>Stage:</b> Final	<b>Version:</b> 1	<b>Date:</b> 7 December 2009
<b>Related Publications:</b>		

**Available to view or download at:**

<http://www.hmrc.gov.uk/better-regulation/ia.htm>

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**What is the problem under consideration? Why is government intervention necessary?**

Businesses using the FRS apply a flat rate percentage to their turnover to arrive at their VAT liability. The rate used is dependent upon the business sector and is set by reference to net VAT payable by businesses in each sector.

The flat rates were recalculated in 2008 to take account of the reduction in the standard rate of VAT and to provide a more up to date reflection of net VAT liabilities in each sector. They now need to be amended again to reflect the reversion of the standard rate to 17.5%. This impact assessment covers options for revising the flat rates.

**What are the policy objectives and the intended effects?**

The policy objective is to ensure that the flat rate percentages reflect the standard rate of VAT, as well as current business patterns. This will maintain equality of treatment between businesses that use the FRS and those that do not.

**What policy options have been considered? Please justify any preferred option.**

- A. A straight mathematical calculation to reflect the change in the standard rate of VAT.
- B. Option A plus technical changes to reflect up to date business patterns. This is consistent with the approach previously adopted in recalculating the rates and better achieves the policy objective of maintaining equality of treatment with non-scheme users. For these reasons it is the preferred approach.

**When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?**

The flat rates are reviewed annually and so the effect of the change will be assessed in late 2010.

**Ministerial Sign-off** For final proposal/implementation stage Impact Assessments:

*I have read the Impact Assessment and I am satisfied that (a) it represents a reasonable view of the expected costs and impact of the policy, and (b) the benefits justify the costs.*

Signed by the responsible Minister:



Date: 7 December 2009

## Summary: Analysis & Evidence

<b>Policy Option: B</b>	<b>Description: Option A plus technical adjustments to reflect more up to date information on sectoral VAT liabilities.</b>
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<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups' Businesses may expect their flat rates to return to pre-December 2008 levels. The rates will actually be set higher for about 31% of scheme users. This may encourage some of the affected businesses to leave the scheme and revert to normal accounting. If a business does choose to leave the scheme, it will lose the benefit of the admin savings that the scheme provides.
	<b>One-off (Transition)</b>	<b>Yrs</b>	
	£ 100,000 – 500,000	1	
	<b>Average Annual Cost (excluding one-off)</b>		
	£ 200,000 – 900,000		
<b>Total Cost (PV)</b>			£ 2m – 8m
Other <b>key non-monetised costs</b> by 'main affected groups'			

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups' Some flat rates will be set lower than they were before 1 December 2008, which may encourage businesses within these sectors to join the scheme. Businesses using the scheme save an estimated £45 in admin burdens at today's prices.
	<b>One-off</b>	<b>Yrs</b>	
	£ 0		
	<b>Average Annual Benefit (excluding one-off)</b>		
	£100,000 – 300,000		
<b>Total Benefit (PV)</b>			£1m – 2m
Other <b>key non-monetised benefits</b> by 'main affected groups' The corrections address unfair advantages that otherwise develop in favour of businesses eligible to use the FRS, in those sectors where latest VAT payment data suggest the existing flat rate is too low, and against FRS users who would have difficulty in using normal VAT accounting, in those sectors where latest data suggest the existing rate is too high.			

**Key Assumptions/Sensitivities/Risks** There is little evidence for how sensitive businesses are to rate changes when deciding whether to join or leave the Flat Rate Scheme. As a consequence, the costs and benefits are given within a wide range.

Price Base Year 2010	Time Period Years 10	<b>Net Benefit Range (NPV)</b> £-1m to -5m	<b>NET BENEFIT (NPV Best estimate)</b> £-3m
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What is the geographic coverage of the policy/option?				UK
On what date will the policy be implemented?				1 January 2010
Which organisation(s) will enforce the policy?				HMRC
What is the total annual cost of enforcement for these organisations?				£0
Does enforcement comply with Hampton principles?				Yes
Will implementation go beyond minimum EU requirements?				No
What is the value of the proposed offsetting measure per year?				£ N/A
What is the value of changes in greenhouse gas emissions?				£ N/A
Will the proposal have a significant impact on competition?				No
Annual cost (£-£) per organisation (excluding one-off)		Micro N/A	Small N/A	Medium N/A
Are any of these organisations exempt?		No	No	N/A

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)			(Increase - Decrease)
Increase of	£200k – 700k	Decrease of	£100k – 200k
<b>Net Impact</b>			£100,000 – 500,000

Key: Annual costs and benefits: (Net) Present

## Evidence Base (for summary sheets)

### 1 The problem and the need for intervention.

- 1.1 The FRS is an optional scheme that was introduced in 2002 and is available to businesses with a turnover not exceeding £150,000. The aim of the scheme is to simplify the way businesses account for VAT, so that less time is spent keeping VAT records and calculating the VAT due.
- 1.2 Businesses using the flat rate scheme apply a flat rate percentage to their VAT-inclusive turnover. The percentage applied is determined by the trade sector best describing the activities of the business. There are 55 sectors with rates currently varying from 2% to 12%. These percentage flat rates are designed to reflect the net tax payable by businesses in the same sector not using the scheme.
- 1.3 The flat rates were recalculated in 2008 to take account of the reduction in the standard rate of VAT and to provide a more up to date reflection of sectoral VAT liabilities. As the standard rate will revert to 17.5% on 1 January 2010 the rates need to be amended again.
- 1.4 This impact assessment covers the options for revising the flat rates.

### 2 Policy objectives and intended effects

- 2.1 The policy objective is to ensure that the flat rate percentages reflect the standard rate of VAT, as well as more up to date business patterns. This will maintain equality of treatment between businesses that use the FRS and those that do not.

### 3 The options

- 3.1 Option A – This is a straight mathematical calculation to reflect the reversion of the standard rate of VAT.

Option B – This is the same calculation as option A - but includes technical adjustments to reflect more up to date business patterns.

This is the preferred option, as it is consistent with the general approach to recalculating the rates and best achieves the policy objective of maintaining equality between those businesses which use the scheme and those which do not.

### 4 Costs and benefits

- 4.1 There are currently c190,000 businesses using the FRS, each enjoying an administrative saving of approximately £40 against the Standard Cost Model (SCM), which is based on 2005 prices. At today's prices, this is approximately £45.

HMRC is subject to quantified targets to reduce one aspect of compliance costs in particular; the admin burden on business of disclosing information to HMRC or to third parties. This burden is assessed through the 'Standard Cost Model', an activity-based costing model which identifies what activities a business has to do to comply with HMRC's obligations, and which estimates the cost of these activities, including agent fees and software costs.

- 4.2 The costs and benefits under **Option A** are estimated to be zero, because.

- The Flat Rates are being adjusted to reflect the standard-rate of VAT increasing from 15% to 17.5% only and businesses which currently benefit from using the scheme will continue to do so. Overall, these rate changes should not cause businesses to join or leave the flat rate scheme.
- Changing the flat rates was part of the standard rate change measure. Any compliance costs incurred by FRS users in dealing with two separate rates are therefore included in the standard rate change impact assessment.
- This option was rejected because it fails to take the opportunity to reflect the most up to date data which can ensure fairness between people in and outside the scheme.

#### 4.3 The annual costs and benefits under **Option B** are estimated as follows:

- Because the flat rates are averages of the VAT liability per sector, some businesses pay more tax under the scheme than they would otherwise, and some pay less. When these averages are recalculated, individual businesses' position against the average will change and some, who will pay more as a result of the new sector averages, will find that they are paying more tax in the scheme than outside it, so they may choose to leave the scheme. Conversely others will find themselves paying less under the scheme and may choose to join it.
- The £45 saving does not change for those that remain on the scheme, but the overall administrative burden will decrease or increase by £45 times the net number of businesses who join or leave the scheme.
- We would expect usage of the scheme to increase in sectors experiencing a relative rate decrease, and the usage of the scheme to reduce in sectors experiencing a relative rate increase. The magnitude of these changes is difficult to predict, although upper and lower bound estimates can be made..
- We can estimate how much VAT would be paid by some businesses using FRS if they used normal VAT accounting based on historical VAT return data. We take these businesses as being representative of each sector.
- In order to ascertain an upper bound for the number of businesses **leaving** the scheme in sectors experiencing a relative rate rise, it was assumed businesses will leave the scheme if anything we estimate they gain from the scheme is less than the rate rise or if their rate increases above the strict arithmetical equivalent of the change in the standard rate and we estimate they already use the scheme at a VAT loss.
- In order to ascertain a lower bound for the number of businesses **leaving** the scheme, we estimated the number of current "winners" (whose actual rate is lower than their sector average) and the proportion of them who would become "losers" after their sector rate increase, and then applied this fraction to the number of users in the sector.
- The decrease in FRS usage as a result of relative rate increases is estimated to be between 5,000 and 19,000.
- We examined the distribution of net VAT paid relative to turnover for eligible businesses not using the flat rate scheme by sector. Combining this information with the current take up rate of the scheme and the relative change in rates, we estimated an upper bound for the number of businesses **joining** the flat rate scheme in sectors experiencing a relative rate reduction. This was based on the assumption that no businesses would use the flat rate scheme if they would pay more VAT as a consequence, making use of scheme highly sensitive to rate changes.
- Given the admin burden saving of FRS, the sensitivity to rate changes amongst VAT users is likely be less than assumed above. The upper bound figure for potential gainers was therefore halved to arrive at a reasonable lower bound for the increase in businesses joining.

- The increase in FRS usage as a result of relative rate reductions is estimated to be between 3,000 and 6,000
- Once we have upper and lower bound estimates for the changes in FRS usage, we can apply the average annual admin burden saving of £45 to arrive at the average annual benefits and costs of the technical corrections.
- The admin burden baseline figure is calculated in the same way, but using £40 per businesses (2005 prices) and reducing the resulting value to reflect that the population of VAT registered businesses was less in 2005.

#### 4.4 The one-off costs of Option B are estimated as follows:

- Businesses leaving the Flat Rate Scheme will incur one-off compliance costs as a result of familiarisation, extra book keeping checks and potentially IT system changes.
- Businesses which start a new VAT return on 1st January are likely to leave the scheme on this date if they leave as a direct consequence of an increase in their flat rate. The average one-off compliance costs beyond what they would incur as part of the standard rate change are estimated to be £4 for familiarisation and £18 for IT system changes. Businesses leaving the scheme will also have one-off book keeping costs associated with checking sales are correctly ascribed to before or after they left the scheme. For businesses which opt to leave on 1st January, these checks would need to be carried out as part of the standard rate change and are therefore not additional one-off compliance costs for this measure.
- Most businesses which do not start a new VAT return on 1st January and leave the scheme will still have to deal with using two flat rates prior to leaving. These businesses will have one-off book keeping costs associated with dealing with two flat rates and one standard rate; as opposed to just dealing with two flat rates if they remain on the scheme. These businesses are estimated to have average one-off compliance costs of £7 for book keeping or outsourced accounting.
- Around 40% of VAT registered businesses start a new VAT return on 1st January.
- The upper bound one-off compliance cost (based on 19,000 businesses leaving the FRS) is therefore estimated to be
  - One-off cost =  $(£4 + £18) \times 19,000 + £7 \times 19,000 \times 60\% = £500,000$ .
  - The same calculation based on 5,000 businesses leaving FRS yields a one-off cost lower bound of £100,000.

#### 4.5 Calculation of Net Present Value figures.

- The net present values have been calculated to a ten year horizon, discounting estimated future costs and benefits at a rate of 3.5%. The impacts were capped at a ten year horizon as this is common for measures with indefinite impacts.

#### 4.6 Rounding of figures.

- Annual and one-off costs and benefits have been rounded to the nearest £100,000.
- The 2005 Admin Burdens baseline figures have also been rounded to the nearest £100,000.
- All Net Present Value figures are rounded to the nearest £1,000,000.

## **5. Implementation**

5.1 Implementation of the changes will include legislative amendments and guidance for both businesses and HMRC staff. The changes will be incorporated into the standard rate change publicity and will take effect from 1 January 2010.

## **6. Impact tests**

6.1 The scheme was introduced after consultation and we continue to examine the needs of small businesses, consulting where appropriate. However, the flat rates have been revised on this occasion to reflect the wider change in the standard rate of VAT. Therefore, this is a necessary change.

6.2 The scheme is specifically designed by HMRC to aid small businesses. The changes will therefore impact on small businesses in the UK that currently use or are considering using the scheme. The scheme is available to businesses with annual turnover not exceeding £150,000. A business must leave the scheme if its total income in the previous year exceeds £225,000, although it may continue to use the scheme if it can show that its income will not exceed £187,500 in the coming year.

6.3 These changes will not affect the ongoing administrative burden reductions for businesses using the scheme, which are the main rationale for the scheme.

6.4 The change does not directly or indirectly limit the range of suppliers, or limit the ability of suppliers to compete. It also does not limit suppliers' incentives to compete vigorously.

6.5 Initial screening indicates that this change will not have a significant impact on:

- legal aid
- the Human Rights Act
- emissions of greenhouse gases or other environmental impacts
- health and well being
- race equality
- disability equality
- gender equality
- rural proofing

## **7. Caveats and risks**

7.1 Although the costs are based on estimates of business behaviour, they are believed to be broadly indicative of how scheme users will react to the increase in flat rates.

7.2 Estimates of the reduction in usage of the scheme in sectors receiving a rate increase are based on the assumption that businesses which would pay less VAT using standard VAT accounting than when using the Flat Rate Scheme after a rate increase will leave the scheme. If this is not the case and a significant number of businesses decide to remain on the scheme in order to enjoy the reduced administrative burden of the Flat Rate Scheme, then the additional admin burden resulting from the changes will be less.

## Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

**Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.**

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

## Annexes

The 'Standard Cost Model' (SCM) has been used to derive an estimate of the costs to business of complying with HMRC obligations to disclose information to HMRC or to third parties. The SCM considers which activities a business has to do to comply with an HMRC obligation, how many businesses have to comply, and how often they need to comply. The SCM considers the burdens applying to different sizes of business.

The SCM estimates the costs of using agents; the costs of undertaking work in-house; and the costs of actually transmitting the information. The SCM does not consider one-off costs or transitional costs. The SCM does not consider costs which a business would have incurred anyway had the relevant HMRC obligation not existed. It considers the costs which apply to a normally efficient business and the costs to businesses which comply. The SCM does not consider wider compliance cost issues, such as the costs of business uncertainty, cash flow costs, or the costs of deciding whether or not to do something.

The Impact Assessment template requires SCM figures to be presented in May 2005 prices, as admin burden reduction targets relate to a May 2005 baseline. The Impact Assessment also uplifts those figures to current day prices.