

EXPLANATORY MEMORANDUM TO

THE VALUE ADDED TAX (AMENDMENT) REGULATIONS 2017

2017 No. 295

1. Introduction

- 1.1 This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs ("HMRC") and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

- 2.1 The VAT Flat Rate Scheme ("FRS") is a simplified accounting scheme for small businesses. Businesses with limited costs, such as many labour only businesses, currently gain a cash advantage from using the scheme. This measure removes the advantage by introducing a new flat rate of 16.5% for such businesses.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

- 3.1 None.

Other matters of interest to the House of Commons

- 3.2 As this instrument is subject to negative resolution procedure and has not been prayed against, consideration as to whether there are other matters of interest to the House of Commons does not arise at this stage.

4. Legislative Context

- 4.1 The instrument is being made to combat FRS abuse and remove the cash advantage gained by businesses with limited costs. It was not possible to remove this advantage without introducing new legislation.
- 4.2 These regulations amend the Value Added Tax Regulations (SI 1995/2518) by making provisions applicable to flat-rate traders who carry on businesses with limited costs. A new regulation 55KA introduces a flat-rate of 16.5% which must be applied by those who fall within the definition of "limited cost trader". A definition of "limited cost trader" has been added to 55A.

5. Extent and Territorial Application

- 5.1 The extent of this instrument is the United Kingdom.
- 5.2 The territorial application of this instrument is the United Kingdom.

6. European Convention on Human Rights

- 6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

What is being done and why

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

Consolidation

- 7.7 There are no plans to consolidate the VAT regulations.

8. Consultation outcome

- 8.1 On 5th December 2016, FRS draft legislation was exposed for comment for 8 weeks. The informal consultation closed on 30th January 2017. During this time we engaged with representative bodies, to discuss practical aspects of the implementation. We received over 60 letters from businesses and held face to face meetings with business representatives.
- 8.2 This feedback has allowed us to refine our impact assessment, resulting in a small increase in the number of businesses affected and a forecast increase of around £5-£10m a year. The estimated ongoing impact on administrative burden has increased from £1.5m per year to £1.9m per year. We have also updated the statutory instrument to address an emerging avoidance scheme.

9. Guidance

- 9.1 HMRC's *VAT notice 733: FRS for small businesses* will be amended to reflect the changes to scheme. The first amendment was on 23rd November 2016 to introduce anti-forestalling legislation. The second amendment of this notice will reflect the changes to the scheme.
- 9.2 We will also provide an online calculator to assist businesses. This calculator will enable both current and prospective users of the FRS to determine whether the "limited cost trader" rate applies.
- 9.3 HMRC worked with representative bodies throughout the 8 week consultation period to explore the practical implementation of the test and the online calculator. Findings are reflected in guidance and publicity materials.
- 9.4 HMRC will design a compliance plan which will include publicity, prompts and nudges to ensure that the affected population are fully aware of the changes and understand how to apply them.

10. Impact

- 10.1 The impact on business, charities or voluntary bodies is limited to those businesses that operate the FRS. There will be a negligible one-off impact on FRS businesses that will need to familiarise themselves with the new rules. There will also be an on-going cost for some businesses of applying the new test. Businesses using the new rate will pay more tax than previously if they continue to use the FRS. We estimate that 13,000 businesses will choose to switch to standard VAT accounting as this could mean they pay less VAT. Some businesses, if their turnover is below the compulsory VAT registration threshold, will choose to deregister. If a business moves to standard VAT accounting, their administrative costs may increase by about £180. If they choose to deregister, their administrative costs may reduce by about £390. Businesses that continue to use the FRS must determine whether the value of the goods they purchase is above the test threshold. For some businesses, this will be clear; however, those businesses that are close to the test threshold, do not have an accountant and do not deregister will need to complete a simple test. We estimate such businesses will incur an administrative burden of about £65 per year.
- 10.2 The impact on the public sector is negligible.
- 10.3 A Tax Information and Impact Note covering this instrument will be published on the website at <https://www.gov.uk/government/collections/tax-information-and-impact-notes-tiins>.

11. Regulating small business

- 11.1 The legislation applies to activities that are undertaken by some small businesses.
- 11.2 To minimise the impact of the administrative requirements on small businesses an online calculator will be provided.
- 11.3 The basis for the final decision on what action to take to assist small businesses was that, although the changes reduce the administrative savings available to some small businesses, they are necessary to provide a level playing field.

12. Monitoring & review

- 12.1 This measure will be kept under review through communication with affected taxpayer groups. We will monitor the FRS returns submitted following the introduction of the new rate to check that the new rate is being applied correctly. We will follow this with targeted compliance interventions.

13. Contact

- 13.1 Alison Evans at HM Revenue and Customs email: itpt.vatregistration&accountingpolicy@hmrc.gsi.gov.uk can answer any queries regarding the instrument.