

TAXREP 18/01

EASING THE IMPACT OF VAT: A FLAT RATE SCHEME AND ANNUAL ACCOUNTING

***Memorandum submitted in September 2001 to Customs by
the Tax Faculty of the Institute of Chartered Accountants in
England and Wales in response to a consultative document
issued in June 2001.***

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EASING THE IMPACT OF VAT: A FLAT RATE SCHEME AND ANNUAL ACCOUNTING

A INTRODUCTION

1. We welcome the opportunity to comment on the consultation document issued in June 2001. The proposals for a flat rate scheme and improving annual accounting are in the spirit of our campaign 'Towards a better tax system' and merit serious consideration.

B VAT FLAT RATE SCHEME

General comment

2. We participated in the discussions a year or so ago between Customs and representative bodies on the cliff-edge problems of registration. The ideas outlined in the latest consultative document provide the basis for a scheme that could be of real value to small traders. The scheme is in many respects rough and ready and for those that join it there will be winners and losers. Whilst the proposed flat rate scheme would simplify the work that a trader would have to undertake to discharge his duty to comply with VAT law, the proposed flat rate percentages are such that many businesses may feel that the reduced tax compliance burden will not bring them sufficient fiscal advantage or lack of disadvantage to make it worthwhile joining the scheme.
3. The suggested rates need to be reviewed and there are certain other matters that require developing and clarification before the proposals are taken further; these are detailed below.
4. We would mention also the requirement in Article 24 of the EC Sixth VAT Directive for Member States to consult the Advisory Committee referred to in Article 29 when setting up simplified procedures such as flat rate schemes.
5. We set out below our responses to the questions asked by Customs.

Questionnaire

Q. 3.1 What do you think of these proposed accounting procedures?

A 3.1 The proposed accounting procedures should be adequate to ensure the proper working of the scheme but whether they will save work compared to being registered normally is unclear. The scheme involves applying the appropriate percentage factor to turnover including VAT and inserting the answer in Box 1 of the VAT return. Para 3.3 states that the trader would insert 'the tax exclusive value in Box 6'. We would welcome clarification of whether the figure which is to be inserted in Box 6 is (a) the difference between the tax-inclusive sales invoiced minus the VAT invoiced, or (b) the

difference between the tax-inclusive sales invoiced minus the figure in Box 1. If the answer is (a), then the trader will need to record the VAT element of each sale as well as the tax-exclusive amount. (He may well wish to do this anyway in order to ascertain whether or not the flat rate scheme is fiscally advantageous to him.)

Whilst we appreciate that it is not the function of the VAT system to ensure that traders keep their accounting records up to date, our longstanding concern with accounting for VAT on an annual basis (for example under the annual accounting scheme) is that businesses do not have the external discipline imposed on them of having to update their books at least quarterly. The option of accounting quarterly or annually if in the flat rate scheme (referred to in para 3.4) means that this concern remains valid. We trust that Customs will, in any publicity on the flat rate scheme if it is introduced, stress the need for traders to keep contemporaneous accounting records and the commercial advantages of so doing.

Against this of course is the perception that it is cheaper for businesses whose accounts are prepared by external accountants to have accounts drawn up and VAT and income tax (and PAYE) returns prepared all at the same time in one annual exercise. However, this is unlikely to be practical to carry out for a large number of cases not least because of the relatively short deadline of two months to submit the annual VAT return which will lead to a bunching of work for accountants at what is already a busy time of year.

Paragraph 2.10 acknowledges that businesses have to cope with accounting for VAT on goods and services at different rates or determine whether transactions are subject to VAT. It implies that the flat rate system will eliminate such difficulties. However, it does not address these issues: traders will still have to know about different liabilities and issue VAT invoices where appropriate.

Q. 3.2 What do you think of these proposed eligibility criteria?

A. 3.2 The eligibility criteria are confused by the inclusion of non-taxable turnover. We would welcome clarification of why Customs are proposing the inclusion of non-business income in the total to be taken into account for the eligibility requirements given that Article 24(4) of the EC Sixth VAT Directive does not require this and the likely problems that such a requirement would cause, for example if a sole trader is required to include private investment income in his calculation of eligibility.

We agree that it the scheme should be confined to stand-alone small businesses.

Q. 3.3 What do you think of the proposed flat rate percentages in general?

Q. 3.4 Do you have views on the proposed flat rate percentages for any specific sector?

A. 3.3 & 3.4 Our initial impression was that the percentages are not generous. This has been borne out by examples provided by one of our members who is a sole practitioner dealing with the sort of trader at whom the scheme is aimed. The examples (which are set out in the Annex) indicate that the percentages for some sectors would result in certain traders paying far more VAT to Customs than they do at present.

Whilst the ungenerous rates may be considered a fair penalty to pay for a reduction in compliance obligations, the absence of a fiscal advantage or at least neutrality or, worse, the possibility of fiscal detriment is likely to discourage take up of the scheme.

Although many businesses may be prepared to accept a trade-off between compliance burdens and fiscal cost, the flat rate percentages should be set at such a rate that does not discourage traders from joining the scheme. This would involve ensuring that the rates take into account the gross profit percentages of the various business sectors and typical product mixes.

The rates also need to take into account the pricing disadvantage suffered by registered traders, for example retailers selling to the public, whose turnover is a little over the threshold and who have to add VAT to their prices and who are competing with other traders who are similar save for having a turnover below the registration threshold and so do not have to charge VAT.

Furthermore, in calculating the flat rates the businesses used in calculating the rates should only include those registered traders whose turnover matches the turnover of traders eligible to use the scheme. This is very important if the scheme is not to be undermined by incorrectly set rates. Small traders do not benefit from bulk buying discounts and collaborative pricing deals. The level of rates proposed in Annex A of the consultation paper suggests that they may be distorted by including larger traders in the samples used when setting the rates.

We acknowledge that Customs are bound by the requirement of Article 24(1) of the EC Sixth VAT Directive that the implementation of a flat-rate scheme may not result in a reduction in the overall tax yield. Nevertheless, we recommend that in calculating the flat rates the benefit of the margin for error should be given by reducing the estimated rate.

Q. 3.5 Do you agree with this approach towards subsidiary and main trade categories?

A. 3.5 Customs' suggested approach of one flat rate percentage for each VAT registration is in keeping with the scheme being a rough and ready way of reducing compliance. We can envisage distortions

being caused by the requirement that a single flat rate should apply to all activities when a taxable person carries on more than one business and suggest that taxable persons be allowed to apply more than one rate where there are two or more distinct businesses being carried on.

Q. 3.6 What do you think of these estimated compliance cost savings?

A. 3.6 We would welcome clarification of how the figure of £16 per hour was arrived at. It appears too high to represent the time costs of a business proprietor or a bought-in self employed bookkeeper but too low to represent the time costs of a qualified professional advisor.

Q. 3.7 Do you agree with this approach towards high value capital expenditure?

A. 3.7 The approach towards high value capital expenditure is acceptable. However, the proposals do not cover high value unexpected revenue expenditure some of which may be outside the control of the trader, for example vehicle repairs, repairs to or redecoration of premises (which may be an obligation under a lease), one-off legal or professional fees (possibly incurred owing to a dispute with the tax authorities), and we recommend that Customs consider how these should be treated. We would welcome clarification of whether Customs are intending to accept normal accounting practice, for example set out in FRS 15, which would mean that periodic repairs and maintenance of capital assets would be outside the scheme.

Q. 3.8 Is the £2,000 level appropriate?

A. 3.8 We consider that this figure is appropriate to the necessarily broad-brush approach of such a scheme, provided the flat rate percentages are fixed at rates which take such expenditure into account.

Q. 3.9 What would be the best method of dealing with capital purchases where traders leave the scheme?

A. 3.9 Given that high value capital purchases and related sales are outside the scheme because of their size and capital purchases of less than the threshold are considered de minimis, there appears to be no need for special treatment.

Q. 3.10 What do you think of this approach to intra-community trade

Q. 3.11 Are there any simpler ways of dealing with these transactions?

A. 3.10 & 3.11 In the round, the amount of intra-community trade undertaken by traders for whom the flat rate scheme is appropriate is likely to be negligible. We therefore suggest that traders who use the flat rate scheme be relieved of the obligation to record the details in boxes 2, 4, 8 and 9 of the VAT return, so that the treatment for goods is the same as for services.

Q. 3.12 *What do you think of this approach to reverse charges?*

Q. 3.13 *Are there any simpler ways of dealing with these transactions?*

A. 3.12 & 3.13 We consider that the approach outlined is appropriate.

Q. 3.14 *Do these arrangements sound reasonable?*

A. 3.14 We consider that the approach outlined in the consultative document is acceptable, provided that, as the scheme is intended to be a rough and ready approximation of the VAT due, Customs approach innocent errors by traders in a proportionate manner.

Q. 3.15 *What can be done to maximise participation in the flat rate scheme?*

A. 3.15 Traders are conscious of their bottom line. The flat rate percentages are not generous and businesses may feel that the scheme will not provide sufficient fiscal neutrality to make it worthwhile joining. See general comments and A. 3.3 & 3.4 above.

Q. 3.16 *Who do you think the biggest beneficiaries from this scheme would be?*

A. 3.16 The biggest beneficiaries are likely to be traders with manual record-keeping systems who can tailor their systems to produce the figures required for the VAT return. Potentially it will also be of benefit to businesses which prefer to deal with accounts and returns once a year, although, as mentioned in A. 3.1, we do not recommend that businesses write up their accounting records only once a year. It will obviously be attractive to those who calculate that for their specific circumstances the flat rate percentages make it worthwhile joining.

Q. 3.17 *Are there other issues to be addressed about how the flat rate scheme would work in specific circumstances?*

A. 3.17 The treatment of pre-registration input tax need to be addressed: we suggest that this be treated as outside the scheme and reclaimed on the first VAT return, as happens for traders normally.

The potential mismatch between small capital additions (no input tax relief allowed) and disposals (presumably included in the turnover subject to flat rate percentage) needs to be addressed.

Any proposed adjustment for partially exempt traders needs to be exposed for comment.

The issues in paragraphs 3.20 and 3.21 of the CD need to be worked up into concrete proposals and preferably exposed for comment prior to implementation.

Q. 3.18 If you are a business or represent businesses, would you participate or advise your clients to participate in the scheme? Why?

A. 3.18 We would expect our members to assess the advantages and disadvantages of using the flat rate scheme with reference to the facts and circumstances of individual clients.

C THE ANNUAL ACCOUNTING SCHEME

Q. 4.1 Would this reform help to encourage take-up of the scheme?

A. 4.1 The concern of accountants cited in paragraph 4.4 extends also to the feeling that quarterly accounting for VAT imposes an essential discipline on small businessmen to update their records regularly. Clearly the availability of the scheme in the first year will increase take-up but in view of the concern of accountants referred to it is likely that take-up of the scheme by unadvised businesses would increase by more than advised businesses.

Q. 4.2 Should the reform be limited only to firms with turnover less than £100,000?

A. 4.2 In theory the reform should be available to all businesses eligible for annual accounting. In practical terms, confining it to businesses with turnover less than £100,000 would limit the size of Customs' exposure to tax risk from traders who do not keep proper accounting records or are fraudulent.

Q. 4.3 How should the size of interim VAT payments due from newly-registered businesses be most accurately calculated?

A. 4.3 Without Customs intruding on businesses, the principal method is to accept the proprietor's (and advisor's, if any) estimates. We suggest that Customs issue guidance on what they would expect to see supporting an application by an intending trader showing how traders might arrive at their figures, for example by drawing up cash flow and projected sales and expenditure

forecasts. It would be possible to devise an interest charge which would apply where an estimate is grossly inaccurate.

Q. 4.4 Would this reform help to encourage take-up of the scheme?

A. 4.4 Most traders are conscious of their bottom line and the need for readily-accessible cash. It is likely that businesses with spare cash sufficient to make an interim payment will prefer to retain it for emergencies. Traders might be more amenable to making interim payments if there were some incentive, for example an interest payment. However, many businesses have overdrafts and the interest payment for early payment is likely to be less than that charged by their lenders.

Q. 4.5 What size and frequency of interim payments would be most appropriate?

A. 4.5 If interim payment are compulsory we would suggest quarterly. The most appropriate amount would be one equal to the VAT liability for the quarter, which would have to be based on the proprietor's estimate.

Q. 4.6 Have you any other proposals on the annual accounting scheme?

A. 4.6 We have no other proposals to add to what we have said above.

D OTHER ISSUES

Q. 5.1 Do you have any other comments on the issues raised in this document?

A. 5.1 We have no comments to add to what we have said above.

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EXAMPLES OF EFFECT OF USING THE FLAT RATE SCHEME**A Food retailers (including confectionery, tobacco and newspaper retailers): proposed flat rate: 5.0%**

Example 1: a tobacconist with turnover of £100,000 where all products sold are standard rated and where gross profit margin normally averages 10-15%. Output tax would be £14,893 and input tax on trade purchases could be around £13,106 leaving a normal VAT liability of £1,787 before a full claim for variable input tax on appropriate expenses. Allowing for such expenses, the net liability could reduce to around £1,500 for a full year.

However, if this retailer opted for the flat rate scheme he will be faced with a minimum liability of £5,000 with additional output tax payable under the flat rate scheme on normally-exempt items such as bus passes, rental income, commission from the national lottery, pools, etc.

Example 2: a newsagent with turnover of £100,000 will typically sell goods in the ratio of 70% standard rated and 30% zero rated. Here the zero-rated merchandise is usually newspapers which command a higher margin compared to standard-rated tobacco and confectionery lines.

As things stand, this trader would typically show output tax of around £10,425 with a claim for input tax on such goods for resale of say £9,000, resulting in a liability of £1,425 before input tax on other expenses. Again, under the flat rate scheme this trader would have a minimum liability of £5,000 and potentially face an enquiry from the Revenue on his accounts because of the resultant lower margins.

B Retailers of pharmaceutical, medical goods, cosmetics and toiletries: proposed flat rate: 8.0%

Example 3: Pharmacy retailers: such traders are frequently repayment cases. This arises because medicines are purchased as standard-rated goods but are dispensed against doctors' prescriptions as zero-rated outputs.

A typical small pharmacy is unlikely to join the scheme which would result in his paying extra tax voluntarily.

C Restaurants, takeaways and catering services: proposed flat rate: 13.0%

This is a complex area where the effective rate can vary considerably depending on the mix of catering and takeaway and the resultant output tax. In addition, tax on packing materials and other expenses can be significant; this does not appear to have been taken into account in arriving at the flat rate.

Example 4: A typical small restaurant/caterer with turnover of £100,000 might have a mix of catering comprising 60% zero-rated takeaway and 40% standard-rated takeaway and eat in. This results in output tax of £5,957 before allowable input tax of say £2,000, against a flat rate liability of £13,000.

Even where such a trader has outputs wholly subject to VAT, the flat rate scheme is unlikely to benefit him as the input tax allowance built in to the rate appears on the low side.