

VAT FOR SMALL BUSINESSES

Briefing paper, January 2024

Published: January 2024

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Federation of
Small Businesses

ACKNOWLEDGEMENTS

This paper was authored by Andrea Macleay, Senior Policy Advisor, Tax and Economics, with support Tony Baron, Policy Champion for Tax, Banking, Finance and the Economy. Special thanks to FSB's media, public affairs and policy teams in Westminster, Scotland, Wales and Northern Ireland, in particular the project team responsible for delivering the report.

WHO WE ARE

The Federation of Small Businesses (FSB) is the UK's grassroots business organisation. We are a cross-party non-profit body that represents small business and self-employed members in every nation and region.

For 50 years, we have been the authoritative voice on policy issues affecting the UK's 5.5 million small businesses, microbusinesses and the self-employed. FSB is the UK's largest business group and leading business campaigner, focused on achieving change which supports smaller businesses to grow and succeed.

We also provide our members with a wide range of vital business services, helping them to start, run, and grow successful businesses through high quality protection and support. This includes 24/7 legal support, financial expertise, training and events, debt recovery and employment/HR advice – alongside a powerful voice heard by governments at all levels.

Our local, national and international activism helps shape policy decisions that have a direct impact on the day-to-day running of smaller businesses. We work for their interests through research and engagement with our members and by effective campaigning - influencing those in power through policy analysis, public affairs, media and public relations activity.

Our policy and advocacy work starts with our expert team in Westminster, which focuses on UK and England policy issues, the UK Government, Parliament and the media. Further to this, our teams in Glasgow, Cardiff and Belfast work with governments, elected representatives and media in Scotland, Wales and Northern Ireland.

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KEY FINDINGS

Barrier to growth

- 38 per cent of small businesses with a turnover between £75,001 and £100,000 say the £85,000 VAT threshold is a barrier to the growth of their business.
- 22 per cent of female small business owners say the £85,000 VAT threshold is a barrier to the growth of their business in comparison to 16 per cent of male small business owners.

Stimulus for business growth

- 19 per cent say a discount applied to the amount of VAT payable after reaching the threshold would be an option to incentivise them to invest and expand in their business.
 - 25 per cent with a turnover between £75,001 and £100,000 say that a discount would encourage them to invest and expand their business.
 - 41 per cent in accommodation and food services and 23 per cent in wholesale and retail state this would encourage them to invest and expand their business.
- 18 per cent say simplifying and reducing the number of VAT rules would incentivise them to invest and expand in their business.
 - 18 per cent with a turnover between £75,001 and £100,000 say this would encourage them to invest and expand their business.
 - 27 per cent of small businesses in manufacturing say this would encourage them to invest and expand their business.
 - 30 per cent in accommodation and food services say this would encourage them to invest and expand their business.
- 18 per cent say a higher VAT threshold, i.e. above £85,000 would incentivise them to invest and expand in their business.
 - 29 per cent with a turnover between £75,001 and £100,000 and 37 per cent with turnover between £100,001 to £150,000 say this would encourage them to invest and expand their business.

- 10 per cent say that providing free Making Tax Digital (MTD)-compliant software would incentivise them to invest and expand in their business.
 - 17 per cent of small businesses in the professional, scientific and technical activities sector state this would encourage them to invest and expand their business.
- 7 per cent say easier application of VAT registration and returns would incentivise them to invest and expand in their business.
 - 10 per cent in the professional, scientific and technical activities sector state this would encourage them to invest and expand their business.
- 6 per cent say switching to a flat rate VAT scheme would incentivise them to invest and expand in their business.

KEY RECOMMENDATIONS

HM Treasury should:

- **Raise the VAT threshold from £85,000 to £100,000 to take into account recent high levels of inflation and to unlock additional economic activity.** Going forward the threshold should be index-linked so it automatically increases with inflation.
- **Apply a smoothing mechanism to reduce the initial impact of net VAT liabilities on small businesses.** The smoothing mechanism would reduce ‘bunching’ under the VAT threshold and unlock additional economic activity. FSB proposes two alternative options that could achieve this aim:
 - **VAT allowance option:** HMRC to allow eligible small businesses to reduce their annual VAT liability by a set amount (i.e. £5,000), similar to the Employment Allowance.
 - **Rebate option:** HMRC to administer a rebate proposal where small businesses with a turnover between £100,000 - £120,000 can apply for a rebate on their net VAT paid. The rebate would reduce the overall VAT liability a small business pays. The rebate amount would decrease as turnover increases.
- **Introduce a VAT-based investment incentive for net-zero related investments.** This could work by allowing a small business to reclaim 150 per cent of the VAT paid on specified green purchases. Such an incentive would provide an incentive for small businesses to invest more in net zero despite the long payback periods, provide fast cash back into the business, and create an incentive for small businesses to register for VAT.

HM Revenue & Customs should:

- **Commit to prompt payment of VAT rebates, to avoid creating cashflow problems for small businesses.** In line with the Prompt Payment Code, HMRC should commit to paying over 95 per cent of VAT rebates for small firms within 30 days.

UK Government should:

- **Simplify the burden of VAT compliance by reviewing the number of VAT goods and services with differing rates.** A comprehensive review of the current zero or low-rate VAT products would ensure that the list is appropriate in an ever-changing market, and could help to reduce complexity and compliance time.

INTRODUCTION

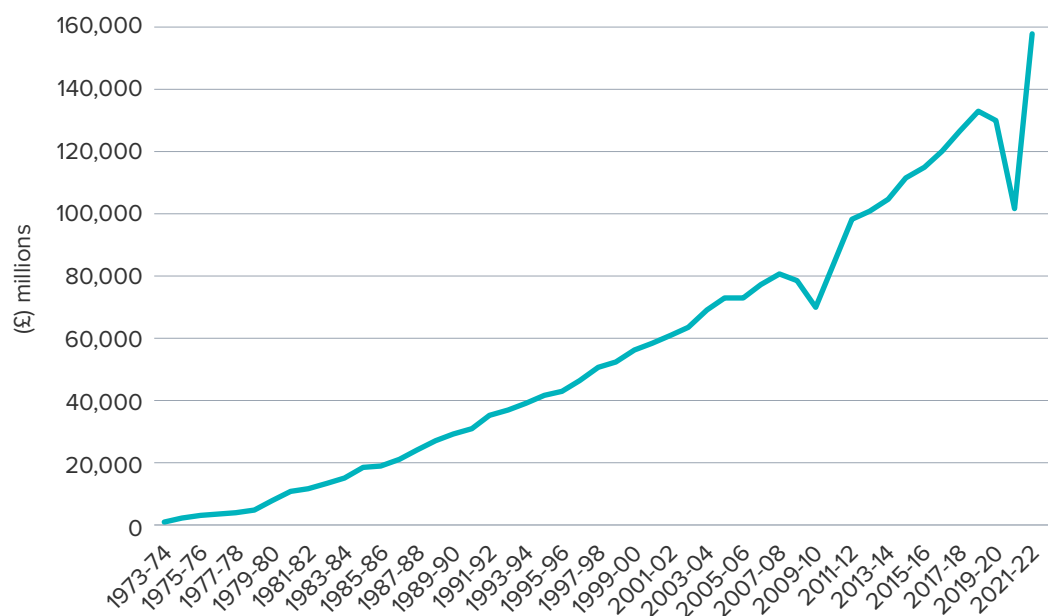
Since the introduction of Value Added Tax (VAT) in 1973, it has become one of the main sources of state revenue, contributing £160 billion to the Government in 2022/23, equivalent to 6.4 per cent of the UK’s total Gross Domestic Product (GDP).

VAT impacts millions of small businesses, with 2.7 million businesses registered for VAT in the UK. The continuous increase in VAT receipts over the last 50 years reflects a growing economy, driven by rising nominal GDP and inflation (Figure 1).

Following a strong recovery after lockdown restrictions were lifted in 2021, VAT receipts increased steeply compared to the pre-covid growth trajectory (Figure 1). The increase in VAT can be attributed initially to the post-lockdown rebound in consumer spending as the UK economy reopened. VAT receipts remained strong despite the cost-of-living crisis and stagnant economic growth over 2022 and 2023 as inflationary pressures increased overall prices and pushed up VAT receipts

Figure 1: Total VAT in the UK since 1973

Source: HMRC, Value Added Tax (VAT) annual statistics 2021 to 2022, table 1: VAT annual and monthly receipts



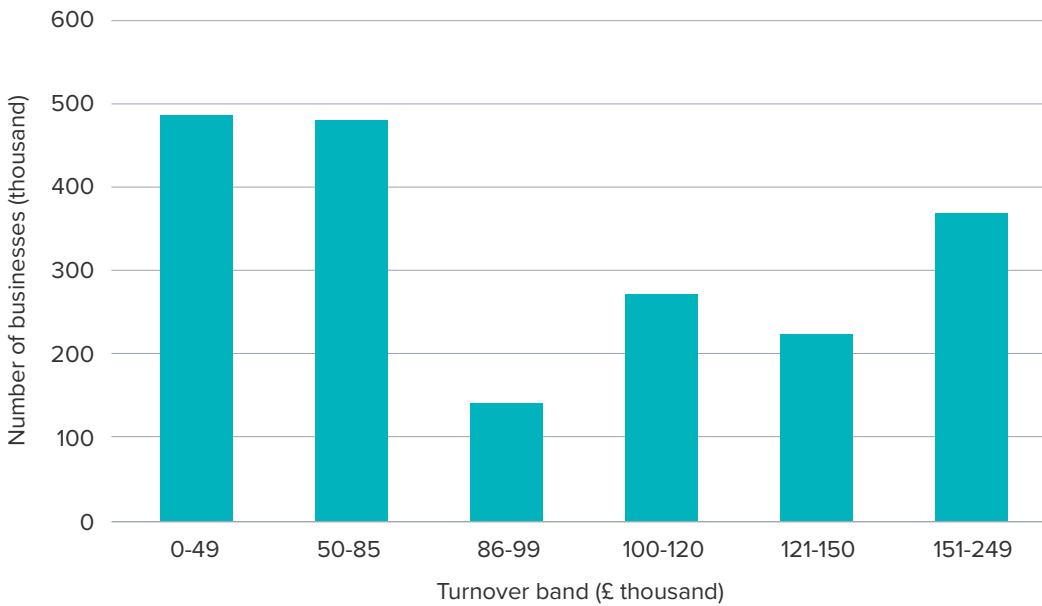
Whilst VAT has earned the Government an estimated £2.7 trillion in revenue over the last 50 years up to 2021-22, it is not without its weaknesses.¹ The cliff-edge is one of the limitations of the VAT system, where evidence

¹ Official Statistics Value Added Tax (VAT) annual statistics, Table 1: VAT annual and monthly receipts, updated 24 January 2023 <https://www.gov.uk/government/statistics/value-added-tax-vat-annual-statistics>

from HM Treasury, HM Revenue & Customs (HMRC) and the Office for Budget Responsibility (OBR) shows ‘bunching’ occurs beneath the current £85,000 VAT threshold (Figure 2). Small businesses are deterred from crossing the £85,000 turnover threshold, where they would face a 20 per cent VAT charge on turnover. The threshold bunching is more pronounced when broken down by business structure, with sole traders having the steepest variation between the number of businesses on either side of the VAT registration threshold.² In 2021, FSB recommended the Government raise the VAT threshold from £85,000 to £100,000 and apply a smoothing mechanism to reduce bunching and unlock additional economic activity.³

Figure 2: Bunching in the VAT turnover distribution at the registration threshold

Source: ONS, Inter-Departmental Business Register, Analysis of VAT and/or PAYE based enterprises in the UK for specified turnover size



Between 2017 and 2023, the number of VAT and/or PAYE based enterprises in the UK grew by 2.1 per cent.⁴ More small businesses have been captured by the VAT threshold which is measured on turnover. The annual rate of inflation reached 11.1 per cent in October 2022, a 41-year high, before subsequently easing. ONS data shows inflation has since fallen

² X, Dan Neidle “This is the worst tax chart ever. It shows the number of businesses in the UK at different turnover levels. <https://t.co/4iFUgmr0c2>” / X (twitter.com) 10 November 2023

³ Federation of Small Businesses, A Duty to Reform, 2021, <https://www.fsb.org.uk/resource-report/a-duty-to-reform.html>

⁴ ONS, Figure 1: Number of VAT and/or PAYE based businesses <https://www.ons.gov.uk/businessindustryandtrade/business/activitysizeandlocation/bulletins/ukbusinessactivity-sizeandlocation/2023#uk-business-data>

to 4.6 per cent in October 2023, still above the 2 per cent Bank of England target.⁵ High inflation should correlate with higher prices, boosting small businesses' turnover.

However, FSB's Small Business Index data collected throughout 2022 and up until Q3 2023 shows a significant percentage of small businesses are recording weaker overall revenues. It is our view that an increase in the threshold to £100,000 would provide relief to small businesses experiencing VAT threshold creep from inflation.

If the VAT threshold were raised to £100,000, there would be some benefit in terms of additional economic activity, as more businesses would be willing to grow and declare more of their revenue, which would increase productivity, capital, and employment in the economy. If those small businesses bunching beneath the threshold were to grow from £85,000 to £100,000, the additional £15,000 could potentially deploy over half a billion pounds of additional capital into the economy.⁶ However, if the threshold were simply to be raised, without any accompanying attempt to smooth the cliff-edge, then the benefits would be limited, as it is likely small businesses would continue to bunch at the new threshold.

In 2017, the Office of Tax Simplification (OTS) published a report on VAT simplification. The report proposed the introduction of a smoothing mechanism to complement any changes in the VAT threshold rate to avoid distortive effects from cliff-edging. The idea was not pursued due to the complexity of the proposal; however, OTS did acknowledge that if businesses could easily pass across the threshold, it would encourage business growth and in turn economic growth and productivity.⁷

To support the smoothing mechanism and ensure VAT as a percentage of GDP remains at stable levels, these reforms could be complemented with a more simplified design. A VAT system that is simpler, more robust, and more efficient could deliver billions in revenue to HMRC, by smoothing the distortion of the cliff-edge and reducing the administration and compliance burden, a double dividend for the Government and small businesses.

The VAT system should balance the need to raise tax revenue against the need to minimise administrative burdens and avoid barriers to growth. Over the last few years, the Government has increased the revenue raised through VAT by extending the threshold freeze, but there has been insufficient focus on removing or reducing the deterrent to grow.

5 ONS Consumer Price Inflation, UK: October 2023 <https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/october2023>

6 Calculation based on OBR 44,000 small businesses bunching beneath threshold times additional turnover

7 Office of Tax Simplification, Value added tax: routes to simplification, November 2017 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/657213/Value_added_tax_routes_to_simplification_web.pdf

THE UK ECONOMY AND VAT

The UK's economy faces weak growth prospects for 2024 onwards, with the medium-term outlook subdued, further highlighting the importance of an effective and robust VAT system to boost growth and productivity. The International Monetary Fund (IMF)'s revised forecast has forecasted the UK's GDP growth at 0.6 per cent in 2024.⁸ Similarly, OBR latest forecasts for GDP growth are also weak, with an outlook of 0.7 per cent in 2024, and 1.4 per cent in 2025.⁹

2022 was a turbulent year for the UK economy, with the tremors continuing into 2023. Small businesses have dealt with several economic shocks from the invasion of Ukraine resulting in inflated energy prices, rising costs of doing business and an increase in interest rates. Figure 3 shows how small business confidence has fluctuated in response to these shocks.

Macroeconomic indicators from the ONS show household consumption for Q2 2023 up 0.5 per cent from Q2 2022, but only a 0.2 per cent improvement compared to the same time a year ago in 2022.¹⁰ The effect of weak household consumption has been strongly felt by the small business community, with two in five (39%) in Q3 2023 reporting a decrease in revenues over the prior three months.¹¹ The relationship between VAT and revenue is dynamic. Improving VAT conditions for small businesses would see competition, reduced consumer prices, economic growth, and improved overall revenue.

The ONS reported business investment in Q1 2023 grew by 3.3 per cent, largely driven by the super-deduction's upcoming expiration, which encouraged some businesses to bring forward investments in technology and machinery.¹² However, the super-deduction was seen as a leading investment incentive by only 4 per cent of small businesses,¹³ meaning that this increased investment is likely to have been concentrated in larger businesses. Investment among small businesses continues to be sluggish, with one in five small businesses (19%) in Q3 2023 expecting to see a decline

8 IMF, United Kingdom <https://www.imf.org/en/Countries/GBR>

9 OBR, Economic and Fiscal Outlook November 2023 <https://obr.uk/efo/economic-and-fiscal-outlook-november-2023/ONS> Consumer Trends, UK January to March 2023, 30 June 2023

10 ONS Consumer Trends, UK January to March 2023, 30 June 2023 <https://www.ons.gov.uk/economy/nationalaccounts/satelliteaccounts/bulletins/consumertrends/aprilto-june2023>

11 Federation of Small Businesses, Small Business Index, Quarter 3 2023 <https://www.fsb.org.uk/resource-report/small-business-index-quarter-3-2023.html>

12 ONS, Business Investment in the UK: January to March 2023, June 2023 <https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/businessinvestment/january-to-march2023revisedresults>

13 FSB, A Duty to Reform, October 2021 <https://www.fsb.org.uk/resource-report/a-duty-to-reform.html>

in their business investment over the next quarter.¹⁴ Now is the time to look at policy levers that have the potential to radically boost growth and investment.

“We have become aware that our business will exceed the £85,000 cliff-edge 20 per cent for VAT registration. We cannot pass on a 20 per cent price hike to our mostly private customers and cannot afford to absorb the cost on top of all the other recent price increases. Having considered many options, we have reluctantly concluded we have to reduce the business turnover. We have written to several of our larger customers to advise them we can no longer accept their business which has resulted in our terminating two part-time staff. The next step will be to close for several weeks.

Over the years I have gone into numerous large companies that were struggling or losing money and turned them into highly profitable businesses. Never have I needed to lower revenue – now in my own business I need to reduce turnover which after all the hard work and investment in more machinery to promote and handle growth is totally outside of my culture and experience”

FSB member, Laundry, South West

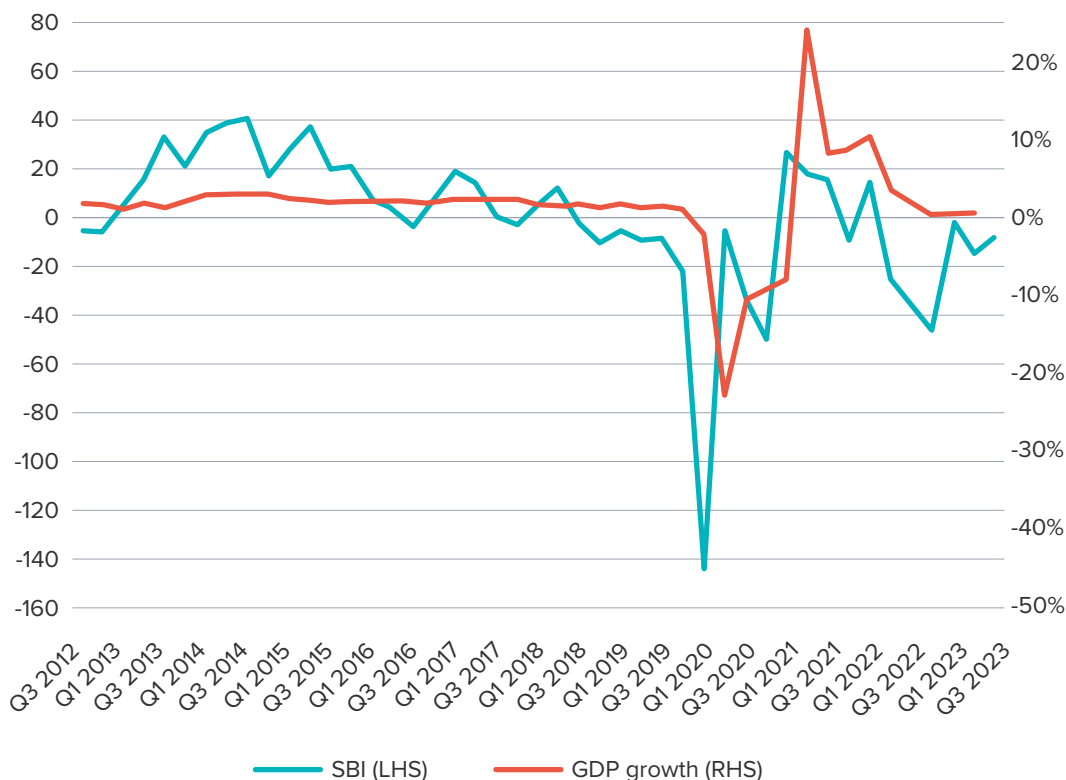
Small businesses’ growth prospects have been significantly impacted by sticky inflation and the consequent tightening of monetary policy. The Bank of England has engineered 14 consecutive hikes in the base rate to reach 5.25 per cent. At the same time, inflation has averaged 9.1 per cent over 2022 and 8.1 percent over 2023 to October, where the rate has fallen to 4.6 per cent. According to the Bank of England, inflation is not projected to fall to its 2 per cent target until end of 2025.¹⁵ This remains a principal concern for small businesses. FSB’s Small Business Index for Q3 2023 found 63 per cent of small firms cite the domestic economy as their biggest barrier to growth. It is likely that aggressive interest rate conditions will continue to squeeze small businesses and their customers.

¹⁴ Federation of Small Businesses, Small Business Index, Quarter 3 2023
<https://www.fsb.org.uk/resource-report/small-business-index-quarter-3-2023.html>

¹⁵ Monetary Policy Summary, November 2023 <https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2023/november-2023>

Figure 3: FSB, SBI against year-on-year UK quarterly GDP growth

Source: FSB, SBI Q3 2012 – Q3 2023



VAT contributions to the economy

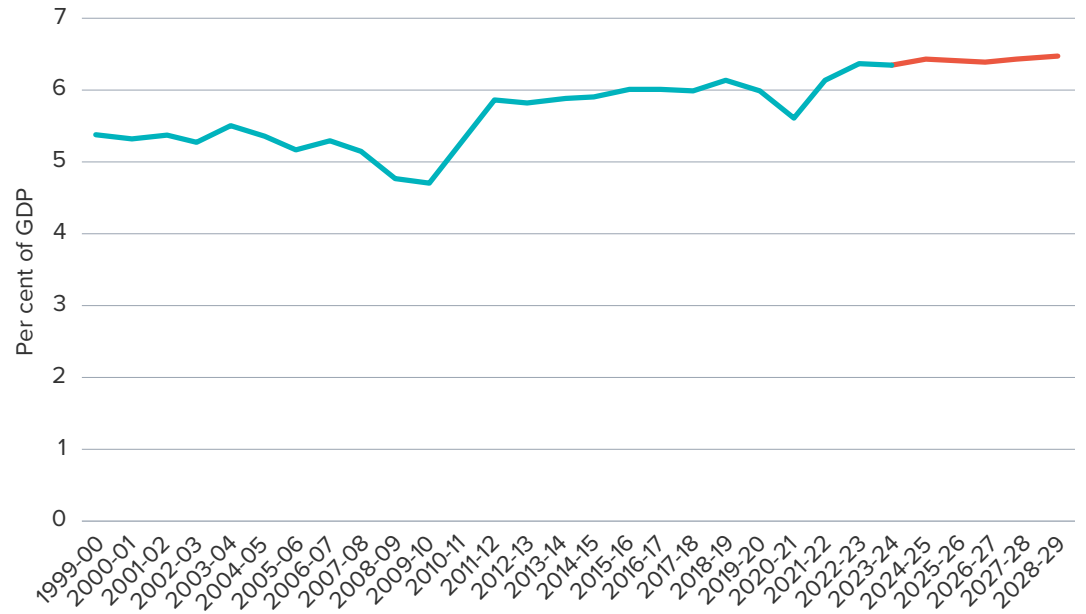
VAT receipts are one of the largest sources of revenue for the Government, contributing 15.3 per cent of total receipts in 2022/23. VAT receipts averaged around 5.2 to 5.5 per cent of GDP in the years leading up to the 2007-09 financial crisis. Following the fallout from the financial crisis, VAT receipts levels dropped down to 4.7 per cent in 2009/10, as consumer spending dropped significantly and the VAT rate was temporarily reduced.

VAT receipts averaged around 6.0 per cent of GDP in the decade following the Global Financial Crisis, reflecting that the main rate was increased back to 17.5 per cent and then 20 per cent in 2011. During the pandemic, VAT receipts dropped once more to 5.6 per cent.

As of the 2022/23 fiscal year, OBR has VAT receipts outturn at 6.4 per cent of GDP. Between 2020 and 2022, VAT receipts increased by 36 per cent (Figure 1), whereas GDP had a weaker overall increase of 11 per cent in the same period. The OBR has forecasted VAT receipts as a share of GDP to remain steady from 2023/24, reflecting that the composition of consumption is expected to shift towards standard-rate goods taxed at 20 per cent (Figure 4).

Figure 4: VAT as a percentage of GDP

Source: OBR, VAT – tax by tax spend



VAT AS A BARRIER TO GROWTH

Overall, almost one in five small businesses (18%) report the VAT threshold is a barrier to growth. This is equivalent to 1.2 million businesses in the UK. This figure doubles for businesses with a turnover between £50,001 - £75,000, with almost two in five (36%) reporting the VAT threshold is a barrier to the growth of their business (Figure 5).

Figure 5: Percentage of small businesses who perceive the £85,000 threshold as a barrier to growth, by turnover

Source: FSB, SBI, Q2 2023



Nearly two in five small businesses (38%) with a turnover between £75,001 - £100,000 cohort reported VAT as a barrier to their growth. Small businesses in this turnover range are affected by the current VAT threshold and the 20 per cent tax liability.

The same proportion of businesses (38%) in the £100,001- £150,000 turnover range acknowledged that VAT is a barrier to growth, suggesting a significant degree of ongoing administrative complexity associated with VAT compliance. As they are VAT-registered, they are mandated to use Making Tax Digital. This finding is corroborated by FSB’s 2021 report, *A Duty to Reform*, which found that the average annual cost of tax compliance for a business that was covered by MTD was £4,562 per year, as compared to £2,960 per year for those businesses which had not switched.¹⁶

The £85,000 VAT registration threshold figure was set in the 2017 Spring

¹⁶ FSB, *A Duty to Reform*, October 2021
<https://www.fsb.org.uk/resource-report/a-duty-to-reform.html>

Budget and is frozen until 2026. This freeze has resulted in an increasing number of firms bunching underneath the VAT registration threshold. OBR has estimated that by the time the threshold freeze ends in 2026, the number of firms bunching just below the threshold will be 44,000, nearly double since the £85,000 threshold was first set.¹⁷

At a sector level, VAT threshold is a barrier to growth for 38 per cent of accommodation and food small businesses. Service sector B2C businesses in areas such as hospitality may resist growing above the VAT threshold, as they will face local competition from non-VAT registered businesses who are able to charge customers cheaper prices.

The total VAT paid varies across small businesses due to differences from input VAT and output VAT. Input VAT is the VAT charged on goods and services purchased by the business which can be reclaimed (e.g. 20 per cent reclaim on eligible inputs) if the business is VAT-registered. Output VAT is VAT charged on sales to customers, where small businesses may pass the 20 per cent VAT rate onto their final sale prices.

However, the reality for many small businesses that cross the threshold and reclaim VAT on eligible input is that many may not be in the position to be able to add 20 per cent to their prices without the risk of jeopardising their customer base and sales. These small businesses often absorb the VAT cost themselves, becoming worse off. This is most likely to affect businesses with little input VAT to claim to offset the output VAT from their goods and services provided.

For example, a VAT-registered small business may run a burger van where it is charged zero per cent VAT on ingredients purchased due to exemptions, therefore input VAT is zero. However, business turnover is £85,000 and the 20 per cent VAT is charged. The business chooses to pass some of this cost onto customers who are charged a higher price. The business also absorbs some of the VAT to remain competitive and keep prices appealing to customers. With a turnover of £85,000 and hitting the threshold, the burger van would lose £17,000 to VAT owed to HMRC and have very little VAT input to claim to offset the VAT owed.

For the burger van to earn £85,000 in income, it would have to increase turnover to £102,000. To do so, it may have to increase opening hours or capacity to boost sales; alternatively, the business could earn the same amount of turnover by reducing operations to have a turnover just below the threshold, deterring business growth.

A flaw in the VAT system is the growing division between small businesses who have large eligible input costs and can reclaim VAT input to offset the

¹⁷ OBR, the impact of the frozen VAT registration threshold, March 2023
<https://obr.uk/box/the-impact-of-the-frozen-vat-registration-threshold/>

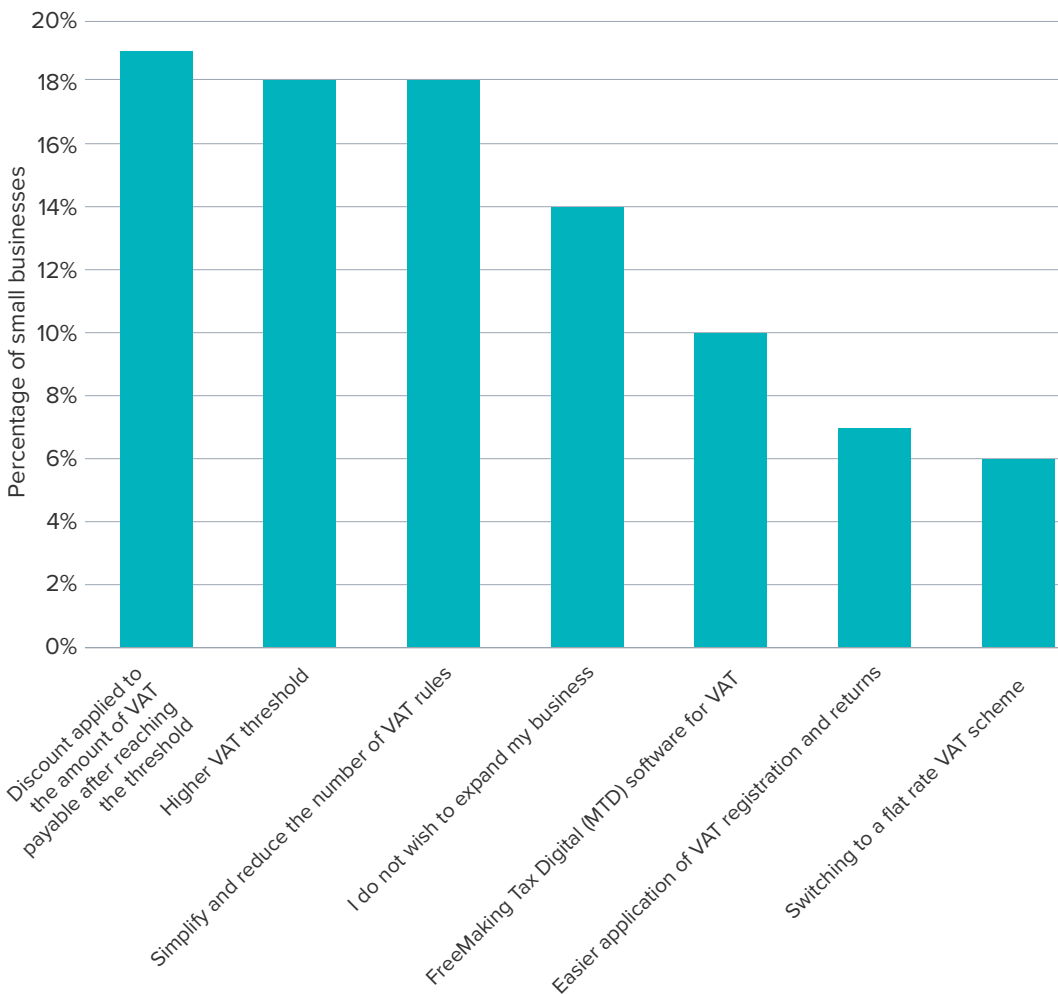
total VAT owed to HMRC compared to small businesses who have little VAT input due to the nature of their industry or the services and products they offer. This highlights the importance of the smoothing mechanism, which could encourage small businesses to increase their turnover and reduce the amount of turnover lost to VAT payments, levelling the playing field.

Overcoming VAT barriers

FSB found that overall, small businesses would be most receptive to investing in and expanding their business if a discount could be applied to the VAT payable. This was the most popular incentive, at 19 per cent of small businesses, closely followed by the simplification and reduction of VAT rules and a higher VAT threshold, both at 18 per cent (Figure 6).

Figure 6: Which of the following would encourage you to invest in and expand your business?

Source: FSB, SBI, Q2 2023



FSB found that for 18 per cent of small businesses, increasing the VAT threshold above the current rate of £85,000 would encourage growth. Small businesses with turnover between £75,000 to £100,000 unsurprisingly saw this as a leading option, with 29 per cent selecting it.

One in five small businesses (19%) reported that a discount being applied to the amount of VAT payable would be an incentive to grow. This option is most popular for small businesses with a turnover between £75,001 to £100,000 (Figure 7). A discount would ease their introduction into the VAT system, and it is also popular among those in the higher turnover categories, who favour a reduction of the tax liability to reinvest the savings into their business.

Simplification and reduction of the number of VAT rules is favoured amongst small businesses who sit just below or above the threshold. Small businesses are preoccupied with survival, having to find and service customers and establish relationships with suppliers, and do not have the time, resources, or expertise to navigate a complex VAT environment. A simplification of the VAT regime would encourage a greater number of businesses, which are currently deterred by the cost of compliance, to become VAT-registered.

Figure 7: Which of the following would encourage you to invest and expand in your business, by turnover size

Source: FSB, SBI, Q2 2023

	£50,001 to £75,000	£75,001 to £100,000	£100,001 to £150,000
Higher VAT threshold, i.e. above £85,000	39%	29%	37%
Discount applied to the amount of VAT payable after reaching the threshold	24%	25%	22%
Simplify and reduce the number of VAT rules	23%	18%	19%
Easier application of VAT registration and returns	11%	7%	9%
Free Making Tax Digital (MTD) software for VAT	16%	9%	10%
Switching to a flat rate VAT scheme	10%	5%	10%

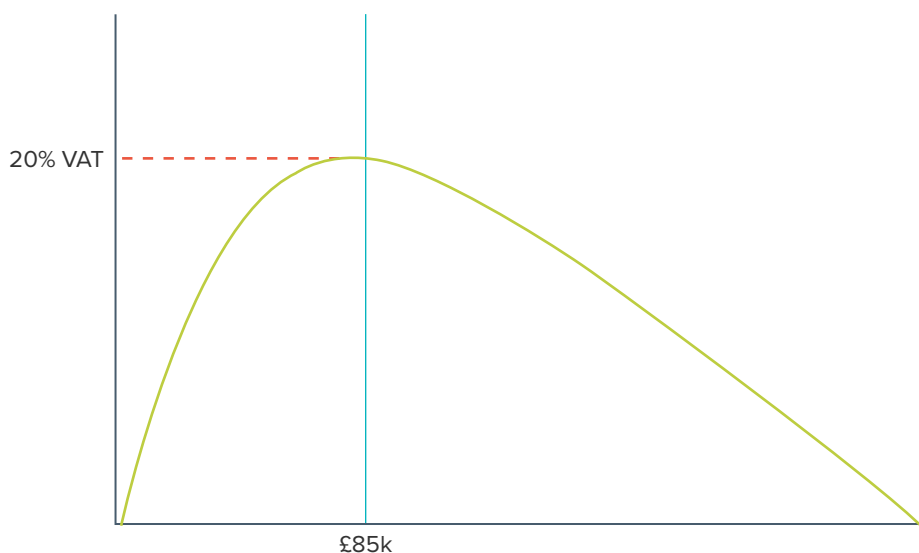
POLICY OPTIONS

FSB proposes two options for a smoothing mechanism which the Government could pursue to address the barriers of the current VAT system. The smoothing mechanism seeks to balance out the trade-off between potential complexity against the benefits of smoothing entry into the VAT registration system and reducing tax burdens on small businesses.

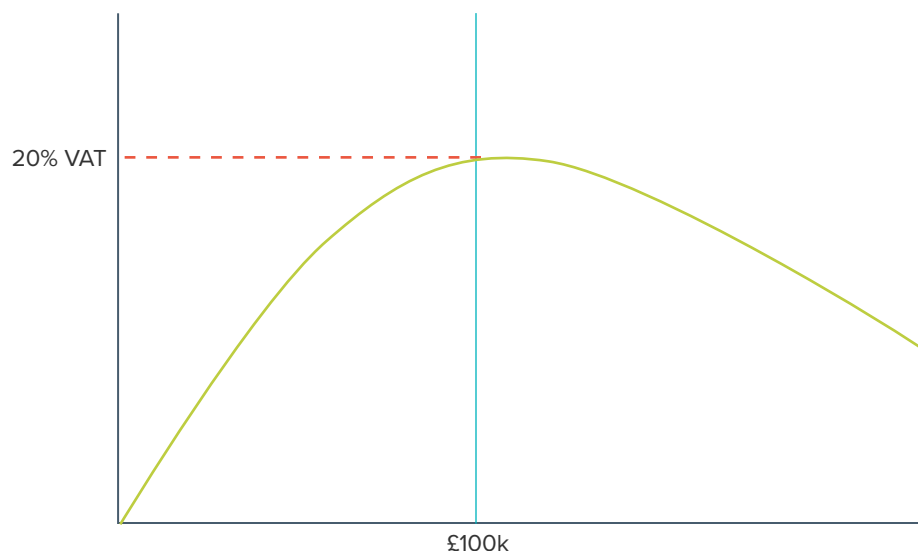
Either option presented below would have the benefit of reducing the incentive to stay below the threshold; however, whilst the smoothing mechanism aims to reduce the cliff-edge under the VAT registration threshold, it cannot eliminate the risk of bunching in its entirety.

Figure 8: Impact of smoothing mechanism on the VAT registration cliff-edge

Source: FSB Economic Analysis



Under the current design of the VAT system, a significant number of SMEs bunch under the £85k VAT registration. The steeper gradient of the curve pre-threshold demonstrates that more small businesses operate with turnover under the threshold, with the number of small businesses more spread out across turnover post threshold.



Under the smoothing mechanism design, a bunching would be less pronounced as SMEs are encouraged to increase turnover with VAT incentives. The smoothing mechanism has made the gradient shallower, and there are fewer small businesses operating under the threshold as the bunching effect is reduced.

FSB proposes two alternative options designed to strengthen the VAT system and encourage small businesses to cross the threshold. These options could be complemented with simplification, to reduce administrative burdens.

- **Option 1** - The VAT allowance lets eligible small businesses reduce their annual VAT liability by a set amount, similar to the current Employment Allowance scheme for National Insurance administered by HMRC.
- **Option 2** - The rebate proposal works in the form of an escalator, where small businesses at certain levels of turnover can apply a rebate on their net VAT paid, allowing them to receive a portion of paid VAT liability back.

VAT allowance

A VAT allowance could provide small businesses with tax relief as they cross the VAT registration threshold. Eligible small businesses would claim a VAT allowance if their VAT owed is within the thresholds, and pay a reduced amount of net VAT to HMRC. The allowance design is based on the existing Employment Allowance, where eligible employers can use the allowance to reduce up to £5,000 of their National Insurance contributions

for the tax year.¹⁸ The benefits of a VAT allowance design would include its familiarity to the Government and to small businesses, making the uptake and transition smoother.

The VAT allowance would have operational similarity that HMRC could use to its advantage, as HMRC administers both the return of overpaid tax and the Employment Allowance. The operational familiarity is not just limited to Government: FSB evidence from 2021 found that, among small businesses who knew about tax reliefs available, 72 per cent of small businesses successfully applied for the Employment Allowance.¹⁹

The Employment Allowance is automatically subtracted by payroll software, which could be imitated with a VAT allowance being automatically subtracted using MTD software. Many accounting software providers operate both payroll and MTD programs.

The design of the VAT allowance must take into consideration the amount, duration and turnover category it would apply to. FSB suggests an initial design whereby all small businesses with previous year turnover between £100,000 and £120,000 are eligible for a VAT allowance of, for example, £5,000, which can be claimed every tax year, with the assumption the VAT registration threshold is set at £100,000. Using previous year turnover reduces the complexity for small businesses to forecast their potential turnover. A smaller amount of £5,000 prevents the allowance from creating an economic distortion between small businesses and customers (Figure 8).

There are risks to guard against, but the risks are not insurmountable. First, there would be a conceptual risk that if a business claims back a large amount of input VAT, then the £5,000 allowance could be greater than that business's net VAT liability. A simple way of guarding against this risk would be to limit the amount that is claimable so that it cannot exceed a small business's net VAT liabilities.

Secondly, with any new tax reform, change presents opportunities for tax avoidance and evasion, which would need to be minimised in the policy design. For example, a taxpayer could fragment its business, so each part of the business falls below the threshold, a practice known as disaggregation. While this risk exists at the moment, it would be even more important to ensure that HMRC is clamping down on it in the future, as there could be an incentive to disaggregate in order to receive multiple allowance payments.

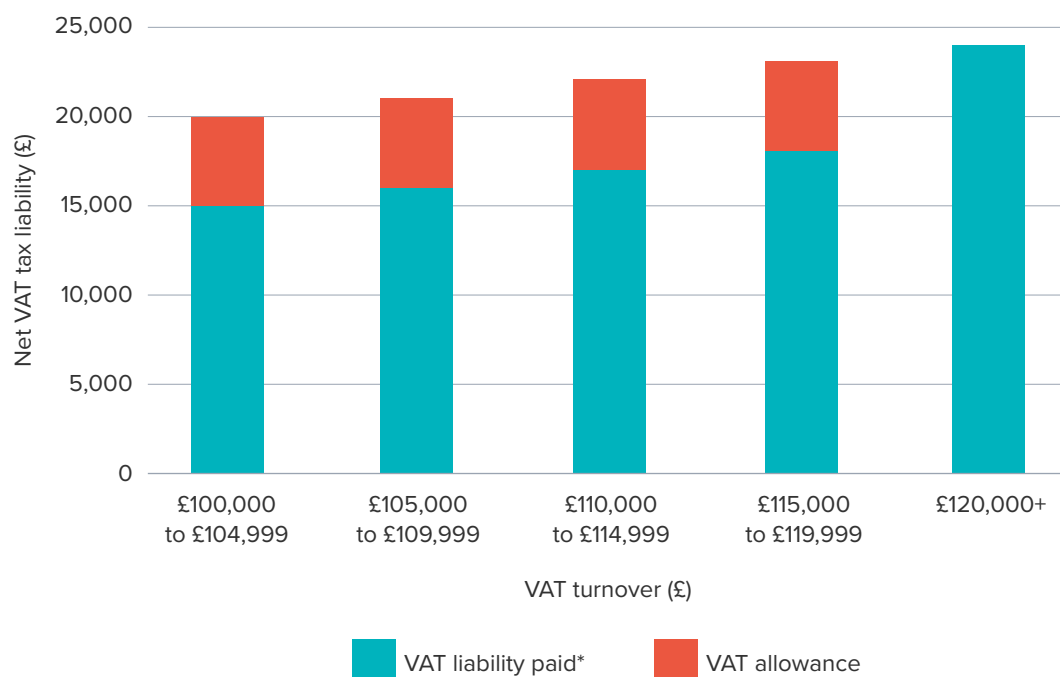
¹⁸ Gov.UK Employment allowance <https://www.gov.uk/claim-employment-allowance>

¹⁹ FSB, Duty to Reform, October 2021

<https://www.fsb.org.uk/resource-report/a-duty-to-reform.html>

Figure 9: £5,000 VAT allowance for small businesses with £100,000 to £120,000 turnover

Source: FSB Economic Analysis



*VAT liability paid is based on the total amount owed to HMRC with the assumption the firm has zero input VAT to reclaim.

Based on ONS figures, FSB estimates 273,000 small businesses in the UK would be eligible to use the allowance. With more encouraged to grow by the policy, this figure is likely to be higher. FSB estimates that per 100 small business that cross the VAT threshold, the VAT allowance could generate an additional £1.5 to £1.9 million in receipts. With the OBR estimation of 44,000 small businesses bunching beneath the threshold, the fiscal revenue generated could be significant.

Figure 10: Example VAT allowance design

Source: FSB Economic Analysis

Turnover	Max. net VAT liability owed*	VAT allowance	Max. total VAT paid
£100,000 - £119,999	£20,000 to £21,000	£5,000	£15,000 to £16,000
	£21,000 to £22,000	£5,000	£16,000 to £17,000
	£22,000 to £23,000	£5,000	£17,000 to £18,000
	£23,000 to £24,000	£5,000	£18,000 to £19,000

*Maximum net VAT owed is total VAT after input VAT reclaimed has been factored into the total amount owed to HMRC. This table is based on assumptions that the firm has zero input VAT to reclaim. If a firm did have input VAT to reclaim, it would reduce their overall maximum net VAT owed.

Recommendation

- **Apply a smoothing mechanism to reduce the initial impact of net VAT liabilities on small businesses.**
 - **VAT allowance option:** HMRC to allow eligible small businesses to reduce their annual VAT liability by a set amount (i.e., £5,000), similar to the Employment Allowance.

Rebate

The second option is a rebate in the form of a stepping VAT discount. The rebate would apply a specified discount to the net VAT owed, with the discount reducing to zero percent as turnover exceeds £120,000. The net VAT is the amount of VAT a small business owes HMRC after any input VAT has been reclaimed.

As with the proposed allowance, the explanation of this option assumes that Government has already implemented FSB's prior recommendation to increase the VAT threshold to £100,000.

There is potential for a rebate program to be smoothly administrated through HMRC; this would however require additional staffing, resources, and funding from the Government. FSB continues to lobby for HMRC's small business services to be improved, and for greater funding and the expertise needed to build up the quality and competence of its operations.

Regardless of whether the other recommendations in this paper are implemented, HMRC must observe timely payments of VAT rebates in order to support cash flow for small businesses. HMRC has stated that VAT repayments will usually be made within thirty days of HMRC receiving a VAT return. FSB calls on HMRC to publish information on the percentage of VAT rebates that are actually paid within this 30-day period. The aim should be to achieve 95 per cent of rebates paid (i.e. money received in the account or cheque received in the post) to small businesses within 30 days, analogous to the timescales set out for payment of invoices in the Prompt Payment Code.

The additional rebate proposed here could be administered through MTD or similar software, where VAT returns are filed quarterly. The software would be able to calculate total VAT owed on the final year on year tax return for the previous year and the rebate amount. Eligibility criteria can be reviewed by HMRC to ensure small business compliance (Figure 10).

Figure 11: Example VAT rebate design

Source: FSB Economic Analysis

Turnover	Maximum net VAT owed *	Rebate discount on net VAT	Maximum Rebate savings	Maximum net VAT liability owed (with rebate)
£100,000 - £109,999	£20,000 - £22,000	20%	£4,000 - £4,400	£16,000 - £17,600
£110,000 - £119,999	£22,000 - £24,000	10%	£2,000 - £2,400	£20,000 - £21,600
£120,000+	£24,000	0%	£0	£24,000

*Maximum net VAT owed is total VAT after input VAT reclaimed has been factored into the total amount owed to HMRC. This table is based on assumptions that the taxpayer firm has zero input VAT to reclaim. If a taxpayer firm did have input VAT to reclaim, it would reduce their overall maximum net VAT owed.

Based on the example above, FSB estimates eligible small businesses can earn a rebate of up to £4,200 on their VAT paid (Figure 10). The maximum discount of £4,200 would only apply in the scenario of a business which has no input VAT to reclaim. For a business with input VAT to reclaim, the absolute value of the rebate would be smaller.

This returned investment can be critical to the success of small businesses, allowing them to (for example) invest in green technology, pay for additional staff, and manage cashflow. Small businesses may, alternatively, pass on the savings through reduced consumer prices.

Recommendation

- **Apply a smoothing mechanism to reduce the initial impact of net VAT liabilities on small businesses.**
 - **Rebate option:** HMRC to administer a rebate proposal where small businesses with a turnover between £100,000 - £120,000 can apply for a rebate on their net VAT paid. The rebate would reduce the overall VAT liability a small business pays. The rebate amount would decrease as turnover increases.

Example Business A:

Earns a turnover of £97,000 for the 2022-23 financial year and pays 0 per cent VAT. Total VAT paid is £0. No discount applied as sits below the £100,000 VAT registration threshold.

- **Total VAT paid is £0.**

Example Business B:

Business B generates a turnover of £107,000 in a financial year. The business has no input VAT to claim and pays 20 per cent VAT on its turnover. A VAT discount of 20 per cent can be applied, because the turnover is within the £100,000 to £109,999 range.

- 20 per cent VAT on £107,000 turnover is £21,400
- No input VAT claimed
- Net VAT is £21,400
- The rebate is 20 per cent of £21,400, which is £4,280
- **Total VAT paid is £17,120**

Example Business C:

Business C generates a turnover of £115,000 in a financial year. The business has £5,000 of input VAT to claim and pays 20 per cent VAT on its turnover. A VAT discount of 10 per cent can be applied, because the turnover is within the £110,000 to £119,999 range.

- 20 per cent VAT on £115,000 turnover is £23,000
- £5,000 input VAT claimed.
- Net VAT, prior to the rebate being applied, is £18,000
- The rebate is 10 per cent of £18,000, which is £1,800
- **Total VAT paid is £16,200**

Example Business D:

Business D generates a turnover of £125,000 in the 2022/23 financial year. The business spent £10,000 on eligible VAT input and reclaims 20 per cent. The business pays 20 per cent VAT.

- 20 per cent VAT on £125,000 turnover is £25,000
- 20 per cent input VAT claimed on £10,000 is £2,000
- Net VAT owed is £23,000
- However, the business earns a turnover greater than the £120,000 threshold which rules it ineligible for a VAT rebate.
- **Total VAT paid is £23,000**

SIMPLIFICATION

Since its introduction, VAT has grown inherently complex as exemptions, varying rates, and administration requirements have all increased. FSB data supports the case for simplification: 18 per cent of small businesses state reducing the number of rules and rates would encourage them to grow (Figure 6). Changes to simplify the VAT system must only be done in tandem with increasing the threshold and applying the allowance to maximise the widespread advantage for businesses.

Broad-based VAT can be designed to be simple and efficient, and if applied to a larger portion of economic activity, can raise significant revenues with minimal economic harm. The OECD calculated the VAT Revenue Ratio (VRR), a measure of how much VAT is collected compared to the amount collected if standard rate VAT were to be collected on all consumer goods and services. The UK is 11 points lower than the OECD average, at a ratio of 0.45 points.²⁰ The UK's VAT exemptions and zero rates are an international outlier given the extensive range of goods and services they are applied to. The IMF has previously recommended that the UK remove preferential rates on some goods to improve efficiency, increase tax neutrality and reduce pressure on public spending.²¹ For a small business trying to figure out what is applicable, HMRC's website contains an extensive list of 12 different categories of exemptions, with a range of different products within each.

Complexity is costing small businesses time and revenue. HMRC closed the web portal to file VAT in November 2022 as MTD became mandatory, followed by a new VAT penalty regime coming into effect in January 2023. This disproportionately impacts small businesses, which are penalised for non-compliance as they grapple with new VAT systems and lack the resources of large businesses. HMRC data shows 99 per cent of businesses over the threshold were using MTD in 2022/23.²²

The Government sought to reduce the complexity of VAT with the introduction of the flat rate VAT option in 2002, where small businesses with a turnover under £150,000 can pay a fixed, constant amount. Whilst designed to reduce the time and compliance of VAT returns, the flat rate VAT does not allow small businesses to claim input tax on purchases as these are settled with flat rate payments. HMRC does not publish the uptake of the flat rate VAT versus regular VAT returns, and without this

20 OECD, Consumption Tax Trends 2022, Annex Table 2.A.7 VAT VRR 2020 https://www.oecd-ilibrary.org/sites/6525a942-en/1/3/2/index.html?itemId=/content/publication/6525a942-en&_csp_=9be05a02fe0e4dbe2c458d53fbfba33b&itemIGO=oecd&itemContentType=book#section-d1e17270

21 IMF, UK Article IV 2017 Release <https://www.imf.org/en/Publications/CR/Issues/2018/02/13/United-Kingdom-2017-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-45627>

22 HMRC, Annual Report and Accounts https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1179615/HMRC_annual_report_and_accounts_2022_to_2023.pdf

information, the proportion of businesses it applies to is unclear. The uptake and success of the scheme is unknown in terms of achieving its simplification objectives.

To assist in navigating their VAT obligation, 18 per cent of small businesses said a reduction and simplification of the VAT rules would be beneficial to their growth (Figure 6). A broader, more uniform structure would reduce complexity and allow for revenue to be raised to offset any changes from an increased threshold and the introduction of a smoothing mechanism, creating an overall more economically efficient system.

Recommendation

HMRC should review the number of VAT goods and services with a zero or lower exemption rate, to simplify the system and to reduce compliance and administrative burdens. A comprehensive review of the current zero or low-rate VAT products would ensure that the list is appropriate in an ever-changing market, and could help to reduce complexity and compliance time.

METHODOLOGY

This report is based on FSB members' views on VAT from FSB's Small Business Index, Quarter 2, 2023 survey, carried out by Verve. The survey was undertaken between 22 June and 7 July 2023. 5,461 panel members were invited to take part in an online survey as well as through an open link shared with FSB members. Reminders were sent to all non-respondents. We received 882 responses, with a response rate of 7 per cent for the panel. The data are weighted by regional gross value added to match the profile of small businesses across the UK.

FSB's Small Business Index (SBI) surveys used throughout are conducted with members across the UK on a quarterly basis, with the most recent being Q3 2023, which was in the field from 13 September to 28 September. Individuals were invited to participate in all surveys via email and social media channels. All SBI surveys were administered by the research agency Verve.

The report also includes references to and analysis of data from HM Revenue and Customs, the Office for National Statistics, the Office of Tax Simplification, the Department for Business and Trade, the International Monetary Fund, the Office for Budget Responsibility, and the Organisation for Economic Co-operation and Development.

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