Not in the long grass

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There were almost audible sighs of relief when the Financial Secretary to the Treasury announced in July a deferral of the MTD timetable for income tax. However, the timetable for VAT did not change, and this has a greater impact than many think. *Richard Wild* provides an update

Key Points

What is the issue?

VAT is now at the forefront of the Making Tax Digital proposals. In practice, this means for many businesses that the majority of the MTD requirements will still apply, even though mandation for income tax has been deferred.

What does it mean to me?

Unless specifically exempted, from April 2019 all businesses with a UK VAT registration, whose taxable turnover is above the VAT registration threshold (currently £85,000 per annum), will need to both maintain digital records, and submit VAT returns directly from those records.

What can I take away?

Although mandation may (at the moment) just be for VAT, for many businesses the practical impact will be much wider than this, requiring a significant change in behaviour, record keeping, and reporting – within a period of less than eighteen months. This is no mean feat and if not started already, planning should begin now.

On 13 July 2017, after representations from many professional bodies and stakeholders (including CIOT, ATT and LITRG), the Financial Secretary to the Treasury, Mel Stride, announced a relaxation in the timetable for implementing the Making Tax Digital (MTD) proposals. It is worth taking a closer look at specific elements of that announcement, in particular:

- only businesses with a turnover above the VAT threshold (currently £85,000) will have to keep digital records and only for VAT purposes
- they will only need to do so from 2019
- businesses will not be asked to keep digital records, or to update HMRC quarterly, for other taxes until at least 2020

Superficially, you could be forgiven for thinking that MTD had been kicked into the 'long grass'. No digital record keeping or quarterly reporting is required for income tax (which, as we will see below, was the main driver for MTD), and businesses submit VAT returns online anyway, so all in all a great relief – isn't it?

Well, let's just think about this. The requirement is to maintain digital records in order to prepare the VAT return (see further detail below), but how many of your clients keep different sets of records for different taxes (very few I hope!)?

Therefore, all your clients who are VAT registered because their taxable turnover is above £85,000 (sole traders, partnerships, companies, overseas businesses etc) will need to be keeping digital records, as stipulated by HMRC, from April 2019. Secondly, even if your clients already use digital records such as a software package, how many of them submit their VAT returns directly from that software? Very few I suspect. In fact, only around 12% of VAT returns are submitted directly from software. Reasons for this vary, but it does mean that vast majority of affected businesses will need to change how they submit their VAT returns.

If MTD hadn't got your attention before, I hope it has now.

Context

Before I turn to the specific requirements of MTD for VAT, it is interesting to consider what is driving this move to increased digitalisation. Whilst it is of course important to move with the times and recognise the increased demand for, and functionality of, software – and of course there is constant pressure on HMRC to reduce costs – the main driver is to reduce the tax gap.

For fear of stating the obvious, the tax gap is the difference between the amount of tax HMRC think is due to the Exchequer and the amount actually collected in any given year. The latest tax gap figures have recently been released, and are for the tax year 2015/16. They show an overall tax gap of some £34bn. Looking beneath that figure reveals some interesting analysis:

- The tax gap attributable to failure to take reasonable care is £6.1bn
- The tax gap attributable to error is £3.3bn
- The tax gap attributable to SMEs (those businesses not managed by HMRC's Large Business Service or Large and Complex division) is £15.5bn

So, around £9.4bn of tax is lost through 'mistakes'. And the major single 'culprit' for the tax gap is the SME sector, representing 46% of the tax gap. Indeed, we further understand that around 80% of the 'mistakes' element arises in businesses who operate below the VAT registration threshold.

Now, MTD wasn't expected by HMRC to remove mistakes entirely, nor was there any real expectation that it would reduce avoidance or illegal behaviour. In fact, the proposals were predicted to reduce mistakes by about 10%, although as you can see from the above numbers even a relatively modest reduction would have a significant impact on tax receipts. It also explains why, unlike most IT / large projects (which start with the largest businesses first) HMRC intended to start with small businesses – if they didn’t it would take much longer for the savings effect to kick in.

Whether you agree with HMRC’s expectations, it is difficult to criticise the logic – target the measure first at the greatest risk area, and expand to other areas once the system is fully embedded. Deferring the timetable on income tax was, of course, the right decision. Software is not adequately tested and widespread, and there needs to be a far greater understanding of MTD across the business population. But it does beg the question; why are we sticking to the original timetable with VAT? It will still require a shift to full digital record keeping, in the same timescale as before the 13 July announcement, for those VAT registered businesses affected, yet HMRC recognise that there will be a much reduced revenue benefit from MTD for VAT (because the vast majority of errors is from businesses below the VAT registration threshold). Whilst HMRC say that they can de-risk businesses, through the provision of additional, voluntary information (which will be an element of MTD for VAT), it is not clear why this functionality could not be developed outside MTD. For me, this is a strong indicator that MTD for income tax and corporation tax will ultimately be mandated, too.

In the meantime, for many VAT registered businesses, the same challenges will arise as under the original MTD timetable. And we haven’t even mentioned the ‘B’ word, which will occur around the same time as VAT is mandated.

MTD for VAT requirements

Let’s look at some of the main MTD for VAT requirements. At the outset, it’s worth pointing out three things:

1. Not everything is set in stone, and at the moment we are yet to see the draft Regulations that will implement MTD for VAT, which makes preparation difficult for some businesses.
2. HMRC recently published a ‘Making Tax Digital for VAT: legislation overview’ and provides a useful outline of the expected requirements.
3. The CIOT has prepared a blog which digs a little deeper into the requirements and the main challenges which businesses will face.

Digital records

The first main requirement is for businesses to maintain digital records – in what HMRC refer to as ‘functional compatible software’. This means a software program or set of compatible software programs which can connect to HMRC systems via an Application Programming Interface (API). Its functions must include (amongst others) the ability to keep and preserve records in a digital form (as required by Regulations), create a VAT return from those digital records, and provide HMRC with the return digitally.

Spreadsheets will be considered to be a digital record, but on their own will not comprise ‘functional compatible software’, so API-enabled software will be needed in order to extract figures from that spreadsheet and transmit the information to HMRC.

HMRC set out what information should be recorded within the digital records. This includes:

- Designatory data – the business name, principle place of business, VAT registration number, and information about which VAT accounting schemes are used.
- The VAT account – totals of output tax and input tax, and any adjustments (although only the total figure for the adjustment needs to be recorded digitally, not the calculations underlying the adjustment).
- Transactional data – the line by line entry of income and expenditure, so the date, invoice totals, and the VAT charged. HMRC state that for both inputs and outputs the values should be split between standard rate, reduced rate, zero rate, exempt and outside the scope elements. This level of detail is greater than many businesses currently record, and we have fed back to HMRC the difficulties that may arise if this analysis is mandated, particularly as such an analysis is not required on a VAT invoice. Retailers and those on special schemes will have some easements from these requirements.

VAT returns

The second main requirement is for businesses to submit their VAT returns, not through the HMRC portal, but from their functional compatible software. HMRC would like to see a seamless, digital link, from the recording of the transactional data in the digital records, through to the submission of the VAT return from software.

The level of digital interaction is one of the elements that might be described as work in progress, and is perhaps illustrated by way of an example. Let's say a business records its day to day transactions in software, which is capable of submitting the VAT return, but the business is partially exempt and so needs to undertake a restriction of its input tax. There are two main ways this could be achieved:

1. The business undertakes the partial exemption calculation outside of software (e.g. on a spreadsheet), and journals the effect of the calculation back into the software (say, credit input VAT reclaimable, debit Irrecoverable VAT expense). The VAT return can then be submitted directly from the software.
2. The business exports data from the software into a spreadsheet (link 1), which undertakes the partial exemption calculation. The business then uses separate software to extract the VAT return figures from the spreadsheet and submit to HMRC (link 2).

In the latter example, we are exploring with HMRC what data must be exported digitally, and what can be transferred manually, and this may be subject to change. At the time of writing, we understand that whilst desirable, it will not be mandated for link 1 to be undertaken digitally. However, link 2 must be undertaken digitally.

Other aspects of MTD for VAT

Many of the other detailed elements of the MTD for VAT requirements are set out in the legislation overview, or our blog, but let me focus on a couple of areas here.

Exemptions

The key point here is that the exemptions for MTD for VAT are not the same as the exemptions for MTD for Income Tax. The exemptions for MTD for VAT are limited to:

- Those businesses exempt from the requirement to file their VAT returns electronically – they will similarly be exempt from the MTD for VAT requirements, both in terms of keeping digital records, and submitting their

VAT return from software. Broadly speaking, this includes those who do not use electronic communications due to religious beliefs, businesses in an insolvency procedure, or where HMRC are satisfied that it is not reasonably practicable for reasons of disability, age, remoteness of location etc.

- If the value of the business' taxable supplies is below the VAT registration threshold; so, voluntary registrations, and overseas businesses who, whilst being compulsorily VAT registered (there being no VAT registration threshold for overseas businesses), have taxable turnover below £85,000, are not mandated into MTD for VAT. However, once the VAT threshold is reached, and the business is obliged to comply with MTD for VAT, mandation continues, even if turnover subsequently falls below the VAT registration threshold.

Eagle eyed readers will see that there is no mention of charities in the above, nor the other types of business expected to be exempt from MTD for income tax such as local authorities. This is correct, and these organisations will be within the scope of MTD for VAT if their taxable turnover is above £85,000 per annum. Charities are only likely to have exemptions for income and corporation tax.

Supplementary data

The existing VAT return contains just nine boxes, and no easy facility upon submission of the return to provide additional information. Such a facility would be extremely useful where a return discloses figures which are out of the 'norm', such as a payment trader submitting a repayment return, when the ability to provide an explanation or additional documentation could head-off an unnecessary enquiry, or speed up the repayment.

The MTD for VAT proposals provide for the voluntary submission of supplementary VAT data as part of a VAT return (or a voluntary update, which might be provided alongside an MTD for Income Tax submission). HMRC envisage that this supplementary data will represent the totals of certain transactional level data maintained in the digital records (as set out above), and that businesses would commit to providing this information with each VAT return, to enable HMRC to 'de-risk' the business. We have suggested to HMRC that different supplementary data, such as 'white space' type explanations and a document upload facility, would help drive down unnecessary enquiries and delays, and we will see how this develops.

Special schemes

There are many special schemes in VAT, such as the Flat Rate Scheme, Annual Accounting, margin schemes etc. These schemes will continue, with the requirements of MTD adapted to facilitate the scheme. For example, businesses operating the Flat Rate Scheme will only be required to keep digitally the same records that they are currently required to maintain, i.e. records of sales and records of capital purchases with a VAT-inclusive value of £2,000 or more.

MTD for income tax/corporation tax

No article on MTD would be complete without mention of MTD for Income Tax and Corporation Tax. Ironically, the system that has been deferred is actually most advanced in the process of implementation. The Finance Bill contains lengthy clauses on MTD for Income Tax, and draft Regulations have been published (although we understand that they won't be laid before Parliament any time soon). Software is also being trialled and you might wish to have conversations with your software providers, and clients, with a view to considering the transition of some clients over to software or spreadsheets. You may wish to warn your clients that if MTD for Income Tax is mandated from April 2020, HMRC could be unsympathetic to cries of 'we're not ready'.

The position in relation to corporation tax is less clear, with no legislation as yet, nor any dates for software trials. In fact, looking at direct taxes, you can see some of the difficulties being faced by HMRC. Many small companies are very similar in nature and operation to small unincorporated businesses. Equally, many large unincorporated businesses, such as professional partnerships, are not dissimilar to large corporates. We have already seen exemptions from MTD for income tax for large partnerships (turnover above £10m) and non-resident companies. Would a further deferral/exemption for companies lead to the incorporation of more small businesses? But what is the case for mandating large businesses, who are likely to have complex digital systems already, and may be subject to external audit/Senior Accounting Officer rules etc. Only time will tell.

Conclusions

The above only scratches the surface around MTD for VAT, and I would recommend that you read the legislation overview and CIOT blog referenced earlier, to get a greater understanding of what it means for your business and / or your clients. Then start planning ahead, such as identifying which of your clients will be mandated into MTD for VAT; who out of those clients do not currently keep digital records and will therefore need the greatest behavioural shift; which clients operate in a sector with VAT complexities such as partial exemption, business : non-business, special schemes etc; which of all these clients is going to need the most help; will your practice have to adapt in order to meet these clients' needs; and can you get involved in the trial of MTD for VAT software. Creating a plan of action now will ensure that you and your clients are ahead of the game, come April 2019.

As we are in regular contact with HMRC, we would be pleased to hear your suggestions and feedback on the MTD for VAT proposals, our blog, and also what we might usefully suggest to HMRC to make the proposals workable for businesses.

And by the way, the 'B' word is Brexit, not that you hadn't already guessed.