Regulatory Impact Assessment: VAT: Changes to the Annual Accounting Scheme (AAS)

1. Purpose and intended effect

(a) The policy objective

The purpose of this measure is to increase the number of small businesses that are eligible to use the AAS. It will take effect from 1 April 2006.

The measure increases the number of small businesses that can take advantage of the scheme. It forms part of the Government's wider strategy for administrative simplification, encouraging enterprise and productivity for the UK by removing administrative burdens and barriers to small business growth.

(b) Background

The AAS is a voluntary simplification scheme administered by HM Revenue and Customs (HMRC), which is available to over 1,000,000 small businesses. The scheme allows small businesses to spread their VAT payments more evenly over the year, making it easier to manage their cash flow. Businesses that use the scheme also benefit from a reduction in the costs of complying with their VAT obligations. They have to submit only one return each year, instead of the usual four, and get an extra month to submit the return and balancing payment. The rules for the scheme are contained in the VAT Regulations 1995.

2. Consultation

(a) Within Government

Specialist small business units in Treasury and in HMRC have advised on the taxpayer perspective. Those units have regular contact on small business issues with small businesses and with the Department for Trade and Industry.

(b) Public consultation

This measure has taken into account results from the Budget 2005 consultation *Working towards a new relationship*, and research into the impact of tax on small business cash flow commissioned by HMRC.

The consultation and research have highlighted the importance of cash flow to small businesses and the desire of many to even out their tax payments over the year. In response, the Government made a commitment in the Pre Budget report (5 December 2005), to introduce a measure that would increase the numbers of businesses that can join the AAS. The scheme helps relieve cash flow difficulties by allowing users the facility to make interim payments towards their annual VAT bill. The current measure will increase the number of businesses that can join the AAS.

3. Options

1. **Do nothing**. Leave the turnover threshold for entry to, and exit from, the scheme unchanged.

2. **Increase the higher turnover threshold for the scheme and remove the lower ceiling for immediate entry to the scheme**. This is the option recommended and comprises the following changes:

- removal of the lower turnover limit of £150,000, above which a business cannot join the scheme until it has been registered for one year.

- an increase, from £660,000 to £1,350,000, to the higher turnover limit below which businesses can join the scheme.

- an increase, from £825,000 to £1,600,000, to the turnover limit above which businesses must leave the scheme.

3. **Make larger increases to the turnover threshold for the scheme.** This has been ruled out for the reasons set out in the Benefits section below.

4. Costs and benefits

(a) Sectors and groups affected

This measure involves changes to the turnover thresholds for entry to the scheme and creates no fresh impact on different sectors or groups. There are no gender, regional, DPA or human rights issues arising from the measure.

(b) Benefits

Option 1: Do nothing. There would be no increase in the number of businesses eligible for the scheme and its associated benefits. And this option would provide no response to business concerns about cash flow or compliance costs.

Option 2: Increase the higher turnover threshold and remove the lower ceiling for immediate entry to the scheme. This is the option recommended. It will increase the number of businesses that are eligible to join by around 80,000. As well as obtaining the benefits of easier cash flow management, those who join the AAS will benefit from some compliance cost reductions, as do existing users. We currently estimate that benefit of making one return instead of four at £110 per business per year.

Removing the lower limit of £150,000 will simplify the rules for joining the scheme to the benefit of all potential users. We also estimate that about 12,000 new VAT businesses each year will be able to join the scheme when they register for VAT, rather than having to make a transition to the scheme after one year. When the AAS was introduced in 1988, no business could join until it had been registered for one year. This rule was relaxed in Budget 2002, and since then smaller businesses with an annual taxable turnover up to £150,000 have been allowed to join from registration. The rule was initially put in place to prevent any non-compliant business joining the scheme and then going missing with VAT owed to HMRC. HMRC have re-evaluated this risk and concluded that it is low.

Option 3. Make larger increases to the scheme threshold. In principle this would be possible but has been rejected because:
- Larger increases to the turnover threshold for the AAS would not proportionately increase the eligible population
- Customer research shows concern about managing payment to be greatest at the businesses which are the target of this measure
- The threshold minimises the cost of any unforeseen avoidance or abuse of the scheme

- It is intended to align the thresholds with those for the cash accounting scheme. As announced in the Pre Budget Report on 5 December 2005, the UK has applied for a derogation which will allow the turnover threshold for that scheme to be increased to £1.35m.

(c) Costs

Option 1: Do nothing. This option would present no additional costs or savings for businesses or Government.

Option 2: Increase the higher turnover threshold and remove the lower ceiling for immediate entry to the scheme. This is the option recommended. It will impose no new compliance costs on existing users. Any business that wants to apply for the scheme will have to fill in the current one-page form. Any cost associated with applying for the scheme will be outweighed by the administrative benefit of filling in just one VAT return each year, instead of the four required under standard VAT accounting. The estimated impacts of the compliance cost saving are noted in the Benefits section above

The AAS spreads the cost of VAT by making the estimated liability payable in instalments. This does not affect the total VAT payable and has negligible impacts on cash flow to Government.

Option 3. **Make larger increases to the scheme threshold.** As this option was ruled out for the reasons in the Benefits section above, no detailed costing has been performed.

5. Small firms impact test

This measure is an extension of an existing optional scheme that has a limited, but positive, impact on those small firms who use it. The AAS is available to all small firms across all sectors and the measure imposes no additional compliance costs.

6. Competition assessment

HMRC have carried out the competition filter. The AAS is available to businesses across all sectors and the change will not have any detrimental effect on competition.

7. Enforcement, sanctions and monitoring

HMRC will assure correct use of the scheme through their risk and assurance programmes. As the scheme simply offers an alternative way of accounting for VAT, there are no special sanctions, other than withdrawal of the scheme, for AAS users. Any sanctions for non-compliance will be those that apply to standard VAT accounting under the VAT Act 1994.

8. Implementation and delivery plan

The measure will be introduced by an amendment to the VAT Regulations 1995, coming into effect on 1 April 2006, subject to completion of the parliamentary processes. Guidance on the changes to the scheme will be published in a new version of Notice 732 *VAT: Annual Accounting Scheme*. Amendments to HMRC's website content, forms and computer changes required for the measure, are targeted for 1 April 2006.

The extent to which the scheme is used depends on awareness of the scheme and its benefits. In the months after Budget 2006, HMRC will attempt to raise awareness of AAS by improvements in their printed publicity and website and by direct mailing to eligible businesses.

In due course HMRC will also undertake a review of the figures in this RIA in Standard Cost Methodology terms.

9. Post implementation review

HMRC will deliver a post implementation review of this measure, including-

- Alterations to usage of the AAS will be monitored by interrogation of the VAT mainframe. This is already done monthly and figures will continue to be collated. Analysis of AAS users based on turnover and joining time since registration, will help evaluate the removal of the lower level for joining the scheme.

- Perceptions and attitudes to the changes will be evaluated by surveying the business population. Sampling of the VAT business population is done regularly and will be repeated as part of the Post Implementation Review of this change. Combined with information on usage, this will provide evidence as to the qualitative value of the changes to businesses and the quantitative role they play in assisting businesses to manage cash-flow and compliance costs.

10. Summary and recommendation

Option 2 is recommended as a well-targeted and proportionate measure for making the AAS more attractive to UK small businesses. This would increase the number of businesses that are eligible to join the AAS by around 80,000, enable existing members below the new exit ceiling to continue using the scheme and allow all those under the new entry threshold to use the scheme from the date of their VAT registration. This would mean that the benefits of easier payments, cash flow management and reduced administrative costs would be available to more small businesses.

Options 1 is not recommended, as it would not boost the number of businesses that are eligible for the scheme. Option 3 is not recommended for the combination of reasons about targeting the measure as described in the benefits section of paragraph 4 above.

11. Contact point

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Declaration

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

JOHN HEALEY MP:
Financial Secretary to the Treasury
Date: 28/02/06