# Freezing the VAT registration threshold

## (Lecture B1055 – 12.47 mintes)

*Introduction*

There was great excitement before Budget day that the Chancellor intended to slash the VAT registration threshold from £85,000 to £26,000. This speculation followed the publication of the OTS VAT report which identified that a large quantity of businesses were trading just below the threshold and that the £85,000 limit was a disincentive to trading growth. However, the speculation was unjustified, and the final announcement was that the £85,000 VAT registration threshold will be frozen until at least April 2020. You might think that this policy is not very exciting but I personally think the issues are very significant to many entities and advisers.

*Case study – guest house*

Jack and Jill Vera run The Hill Guest House in Blackpool as a partnership. Their annual turnover figure is £83,000 ie just below the VAT registration threshold – their gross profit is 80% of sales and net profit after expenses is £11,000. Expenditure that is standard rated for VAT purposes is only £6,000.

Jack and Jill close the hotel for three months a year (January to March) but think they could generate an extra £20,000 of sales if they opened in February and March as well.

Solution – if Jack and Vera progress with this strategy, then their gross profit will increase by £16,000 ie £20,000 x 80%. But the increased takings mean they will need to register for VAT at some stage and their annual VAT payment to HMRC will probably exceed this figure:

Output tax - takings £103,000 x 1/6 = £17,166

Input tax – standard rated expenses of £6,000 x 1/6 = £1,000

VAT payable = £16,166.

*Price increases with a frozen registration threshold*

We are hopefully all agreed that Jack and Vera will not be extending their opening hours because of the potential VAT problem but what will happen in March when they want to increase their prices for the new summer season? An inflationary increase of 3% would lead to anticipated turnover of £85,490 in the following 12 months, which is now above the VAT threshold because of the Budget announcement that it would remain at £85,000. So they might decide to freeze their prices for the year or restrict the increase to 1% or 2% but they will then have the same issue in April 2019 – and possibly April 2020.

Many experts predict that the threshold will probably be frozen at £85,000 for many years to come – 2020, 2021, 2022 etc. There are numerous examples of thresholds being frozen in the VAT world eg the annual joining threshold of £150,000 for the flat rate scheme has not been increased since April 2003! It is very hard to reduce the threshold by a significant amount because this would capture thousands of businesses and potentially convert them into a loss making position.

*Alternative strategies – income splitting?*

This is where I think the VAT issues will become very interesting: Jack and Jill will be faced with increases in their costs each year but we have identified how difficult it will be for them to increase prices on their sales when the VAT threshold is frozen for two or three years. And there are many thousands of businesses in the same position as Jack and Vera. I used to act for an architect who deliberately controlled his work level to avoid exceeding the VAT threshold in any rolling 12-month period. So I suspect that clients will start thinking about how they can have their cake and eat it ie increase their selling prices but still avoid a VAT problem.

Think about the following situation: Jack and Jill ask if they can avoid a VAT problem by asking their self-employed cleaner to invoice each guest for her services. So they would charge a guest £30 a night for the room and breakfast and the cleaner would separately charge the guest £5. The annual total of the £30 fees will be less than the VAT threshold, which might not be the case if the relevant figure was £35. As VAT enthusiasts will know, this strategy would be challenged by HMRC (almost certainly with success) because the reality is that the guest house is making all supplies to the guests, and the cleaner is working for the guest house. This outcome was reaffirmed in the case of Wendy Lane T/A Spot On (TC2909) a number of years ago.

Here are a few other suggestions that Jack and Jill might propose:

- There is a small bar in the guest house. Would it be possible for the bar activity to be organised by Jack or Jill as a sole trader ie a separate legal entity to the partnership guest house? This deflects taxable sales from the partnership to another business.

- How about if guests pay a 'room only' fee to the partnership – and then a separate payment of, say, £6 if they wanted breakfast? The breakfast service would be organised as a separate business to the partnership – say Jill as a sole trader.

- What would be the position if Jack and Jill ask their son Martin to organise either the bar or breakfast activity as a separate business ie separate characters are being introduced to part of the operation?

*Business splitting*

The powers of HMRC to treat separated businesses as one legal entity (a partnership) are given by paras 1A(1) and 2, Schedule 1(A), VATA1994. The key challenge is for HMRC to be able to prove that the two businesses have "financial, economic and organisational links." The key word is "and" ie all three links have to be proved rather than one or two of them.

The main outcome of a direction from HMRC is that the combined businesses will need to register for VAT as a single entity moving forward ie not retrospectively. But if HMRC decide there never was two separate businesses (such as in the example of the split between the room charge and the cleaning fee I gave), this will become a late registration issue. And don't forget that HMRC have the power to go back up to 20 years to correct a late registration. For guidance about business splitting issues, see HMRC VAT Manual: VAT Single Entity and Disaggregation.

As a general tip, there is no doubt that the most precarious business splits are those that involve family members. There is not the same incentive to do things on an arms-length basis as there is with non-family structures eg for shared overheads that are recharged or goods that move from one entity to another. However, a First-tier Tribunal case I enjoyed reading recently involved separate trading operations in one building in Swanage. The case was MG and ND Stoner (TC6193) and there did not seem to be any HMRC concern about the business splitting issue and the case was all about input tax claims.

*Revised trading structure for some supplies*

To share an example of a commercial arrangement that would work, see Example – mobile caterer. A plus point with this scenario is that the second caterer is not related to the first caterer, so there is a commercial incentive to do things correctly. And there is no doubt that the second caterer is clearly selling food and drink to the punters at the shows ie he is responsible for any VAT issues on the takings.

*Example – Mobile caterer*

Hot Dogs Ltd operates a mobile catering unit and has annual sales of £83,000. The company is not VAT registered. The director Steve would like to increase prices by 3% on 1 April 2018 but this will cause a VAT problem (£83,000 plus 3% = £85,490). The company provides catering services at three dog shows each year, achieving total sales of £4,500 and a net profit of £1,500.

As a change in trading strategy, he has decided to hire out his unit to a second caterer for these three events at a cost of £250 per event. The second caterer will be responsible for buying his own stock, arranging his own staff and selling the goods to customers. The taxable sales of Hot Dogs Ltd will be reduced by £3,750, but the company is still earning profit from the events (without any hassle) and has scope to increase its prices without creating a VAT registration problem.

*Contributed by Neil Warren*