
VAT/GST Thresholds and Small Businesses: Where To Draw the Line?

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PRÉCIS

N'importe quelle taxe d'affaires comporte nécessairement pour les petites entreprises des frais d'observation plus élevés tandis que les administrations fiscales doivent engager des frais administratifs plus élevés pour ces petites entreprises, tout en tirant d'elles de faibles recettes fiscales nettes. En réaction à cette situation, de nombreux pays qui lèvent une taxe à valeur ajoutée (TVA) adoptent un seuil d'enregistrement pour soustraire du régime de TVA les petites entreprises pour lesquelles le fardeau de l'observation serait le plus onéreux, et fixe ce seuil à un niveau qui ne nuit pas beaucoup aux recettes de TVA. Cependant, la distinction créée par le seuil entre les entreprises exclues du régime de TVA et celles qui y sont entièrement intégrées donne lieu à des distorsions de concurrence; ces distorsions diminuent pour certaines entreprises lorsqu'elles choisissent volontairement de s'enregistrer, tandis qu'elles incitent certaines autres entreprises à adopter un comportement qui leur permettra de rester sous le seuil d'enregistrement. Qu'il soit sous la forme de contraintes commerciales, de division d'entreprise ou de sous-déclaration des revenus, ce comportement entraîne de plus amples distorsions et menace le recouvrement des recettes. Cet article examine les principaux défis et considérations dans l'établissement d'un seuil d'enregistrement de la TVA et les conséquences de l'adoption de ce seuil.

Deux questions liées au choix du seuil se rapportent à l'utilisation par certains pays de régimes transitoires de subvention pour réduire la discontinuité fiscale pendant que les entreprises passent au plein régime de TVA, et à l'utilisation par d'autres pays de régimes spéciaux de concession pour réduire le fardeau de l'observation des petites entreprises lorsqu'elles sont assujetties à la TVA. D'autres pays choisissent d'utiliser une frontière entre deux régimes différents, mais voisins, plutôt qu'un seuil d'enregistrement. Dans ce genre de régime, les entreprises qui sont au-dessus de la frontière sont assujetties au plein montant de TVA, et les petites entreprises qui sont sous la frontière paient une taxe sur le chiffre d'affaires. La taxe sur le chiffre d'affaires est parfois présentée comme un régime visant la simplification, parfois l'accroissement des recettes. Il se peut que les avantages des régimes de simplification et de transition soient exagérés, et que l'on ne reconnaisse pas suffisamment les coûts et les distorsions

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qui en découlent. Un examen de ces régimes sera utile aux décideurs politiques qui envisagent de réformer leur régime ou d'en adopter un nouveau.

ABSTRACT

Inherent features of any business tax are the imposition of relatively higher compliance costs on small businesses and higher administrative costs faced by tax authorities in respect of these firms, allied with low net tax revenue collected from the sector. A common response in jurisdictions levying a value-added tax (VAT) is the adoption of a registration threshold to remove from the formal VAT system small businesses for which the compliance burden would be most onerous, with the threshold being set at a level that does not seriously undermine VAT revenue. However, the distinction caused by the threshold between enterprises excluded from the VAT and others fully incorporated into the tax system gives rise to competitive distortions; these distortions are ameliorated for some businesses through a voluntary registration option, while other businesses are induced to adopt behaviour that will allow them to remain below the registration threshold. Taking the form of commercial restraint, enterprise splitting, or underreporting of sales, this behaviour leads to further distortions and threatens revenue collection. This article reviews the key considerations and challenges in setting a VAT registration threshold and the consequences of adopting that boundary.

Two issues related to the choice of threshold concern the use of “transitioning” subsidy regimes adopted in some jurisdictions to reduce the tax discontinuity as enterprises move into the full VAT system and the special concessional regimes used in some countries to reduce the compliance burden that small businesses face once they are subject to VAT. Another approach found in some jurisdictions is the use of a tax regime border instead of a registration threshold, with a full VAT being levied on enterprises above the border and a substitute turnover (revenue) tax being imposed on small businesses below the border. The turnover tax alternative has been variously explained as a system intended to achieve simplification or revenue-raising objectives. The benefits of the transitioning and simplification schemes may be exaggerated, while their unintended costs and distortions may be insufficiently recognized. A review of these systems can provide guidance to policy makers contemplating reform or the adoption of new regimes.

KEYWORDS: VAT ■ GST ■ VOLUNTARY ■ REGISTRATION ■ SMALL BUSINESS ■ TAX SIMPLIFICATION

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INTRODUCTION

Two features common to most value-added tax (VAT) and goods and services tax (GST)¹ systems are the use of a registration threshold, usually based on annual turnover (business revenue),² to determine when businesses are subject to the tax, and one or more small business regimes that provide specific tax rules for small businesses that have crossed the registration threshold or that sit below the threshold. The common (but not universal) support for adoption of a registration threshold does not extend to the level at which it should be set. Among members of the Organisation for Economic Co-operation and Development (OECD), in 2016 registration threshold levels ranged from £83,000 (approximately Cdn\$148,708) in the United Kingdom to zero in Spain, Turkey, Chile, and Mexico.³ Other countries are widely scattered between the two extremes, with most of them having a registration threshold far lower than that of the United Kingdom. The threshold for Canada's GST/HST (harmonized sales tax) system, for example, is an intermediate amount of Cdn\$30,000.⁴ As is the case with the registration threshold, there is no unanimity on the rules for small businesses.

The primary purpose of a registration threshold is to reduce administrative and compliance costs; study after study shows that the administrative costs incurred by tax authorities to apply the VAT to small businesses and the compliance costs incurred by small businesses are disproportionate to the revenue that these enterprises generate. The registration threshold has the effect of omitting the smallest businesses from the formal VAT system. Generally, a bright-line test is used to determine when an enterprise has reached the registration threshold, though in some cases evidence of sustained turnover above the threshold is required.⁵ Businesses with turnovers below the registration threshold are not, however, fully outside the scope of the VAT. Although they are not required to register for or remit

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- 1 In this article, the term "VAT" is used to describe the tax broadly labelled the value added tax and the goods and services tax, as it is known in Canada and a few other anglophone jurisdictions, as well as India and Malaysia.
 - 2 In some instances, however, there are alternative measurements of the threshold. For example, in the Netherlands, the thresholds are calculated by reference to net annual VAT due. While "turnover" is commonly used in GST and VAT laws, Canadian law prescribes a somewhat circuitous path to registration. All persons making taxable supplies in Canada are required to register, unless the person is a "small supplier." The definition of small supplier refers to consideration received for supplies.
 - 3 See Organisation for Economic Co-operation and Development, *Consumption Tax Trends 2016: VAT/GST and Excise Rates, Trends and Policy Issues* (Paris: OECD, 2016), at 89.
 - 4 The general rule is subject to exceptions with separate thresholds for public service bodies, at \$50,000, and charities or public institutions, at \$250,000. In addition, taxi drivers, including Uber drivers, are required to register for and remit GST/HST regardless of their turnover.
 - 5 For example, an exemption threshold in the French VAT allows businesses that cross the threshold to retain the exemption for up to two years provided that their turnover does not exceed €90,300 (for sales) or €34,900 (for services) for more than a year during this period.

VAT, unregistered firms bear VAT on their inputs, and this cost becomes incorporated into their selling prices.

Thresholds raise two concerns. The first is competitive distortion. A threshold that creates differences in terms of tax payments and compliance costs for businesses above and below the registration borderline appears to affect the relative competitive positions of the firms.⁶ Many countries allow businesses with turnovers below the threshold to voluntarily register for the VAT in order to mitigate this problem where unregistered businesses would be prejudiced by their exclusion from the VAT system.

A second and more significant concern is the possible economic and revenue cost of business behaviour aimed at keeping the enterprise below the registration threshold. The observed bunching of small businesses below the registration threshold may be the result of three types of business behaviour: dishonesty and failure to report some sales, artificial separation of a business into multiple unregistered parts, and reduction of activity to reduce sales. Underreporting of sales and business splitting lead to revenue losses, while business restraint causes economic harm of particular concern to policy makers. One way of mitigating these problems is to reduce the double shock of compliance costs and higher tax faced by businesses entering the VAT system. Some jurisdictions have adopted “transitioning” rules that provide subsidies to offset the costs and tax for businesses crossing the registration threshold.

While adoption of a threshold can mitigate the burden of comparatively high compliance costs faced by small businesses, it cannot eliminate the problem if some small businesses remain above the threshold. The adoption of simplified VAT procedural rules for small businesses to address the disproportionate compliance costs borne by these enterprises is not uncommon. Measures incorporated into simplified regimes include less frequent filing (and, often, less frequent payments) and cash basis accounting. A variation allows eligible small businesses with turnovers exceeding the threshold to use a single presumptive input tax entitlement calculation in lieu of tracking all acquisitions to determine total entitlements.

Separately, instead of using a registration threshold that excludes the smallest businesses entirely from the indirect tax system, some jurisdictions adopt a turnover border that distinguishes businesses subject to the full VAT and those subject to an alternative lower-rate turnover tax.

Registration thresholds and small business regimes work in tandem, and the absence or presence of a simplified regime will have an impact on the full VAT registration point and vice versa. However, the interaction is complex. As explained further below, regimes that reduce compliance costs for small businesses in the formal VAT system may make lower thresholds feasible, but the reduced threshold will lead to higher administrative costs with little offsetting revenue. Also affecting the threshold level is the choice of treatment of small businesses outside the formal

6 Liam P. Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria J. Perry, *The Modern VAT* (Washington, DC: International Monetary Fund, 2001), at 119-21.

VAT. As a general rule, higher-income jurisdictions favour input taxation (that is, no recovery of input tax, leaving businesses to bear the burden of the tax in the first instance) for smaller businesses below a registration threshold. The approach taken by medium- and lower-income jurisdictions is less consistent. Some subject small businesses with turnovers below the registration threshold to input taxation, while others have substituted alternative tax borders for registration thresholds and impose a lower-rate turnover tax on businesses below this boundary.

The lack of agreement on registration threshold levels does not reflect the absence of any theoretical framework for policy development in this area. Rather, it reflects the dearth of clear practical guidance in current theoretical analysis of the issue and the impact of exogenous factors on VAT design. Country-specific factors and domestic political considerations play crucial roles in tax design, and there is thus no one-size solution that can address all these issues. In the case of small business regimes, policy makers must address the design issues, for the most part, without the benefit of any theoretical discussion to provide guidance or a conceptual framework on the subject.

It is nevertheless possible to identify the issues that should be taken into account when policy makers consider where the registration threshold should be set, whether simplified and phasing-in regimes should be available for small businesses that have crossed the registration threshold, and whether alternative small business regimes should be adopted for businesses below the threshold at which they are required to register for the full VAT. An analysis of these issues can set the stage for the development of sorely needed practical guidance.

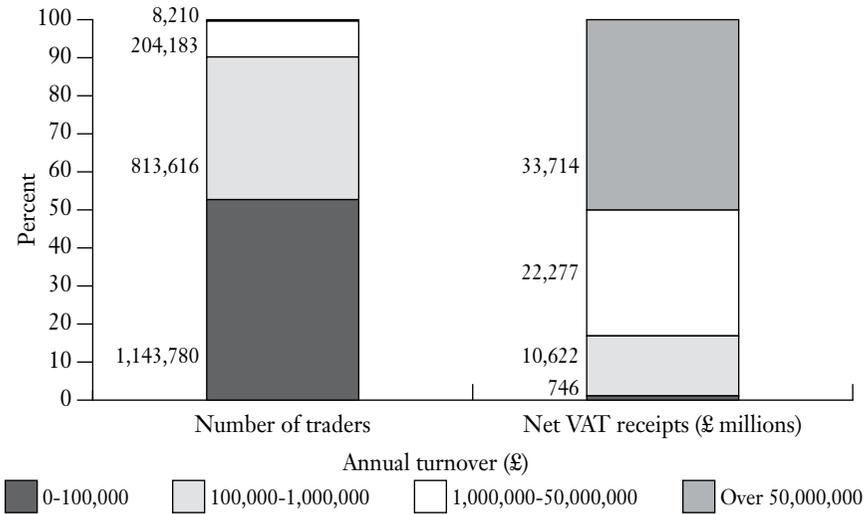
BALANCING REVENUE NEEDS AGAINST ADMINISTRATIVE AND COMPLIANCE COSTS

In principle, a neutral VAT will apply to all types of supplies made by all categories of suppliers. The general principle, however, neglects the uneven distribution of administrative and compliance costs and tax revenue across different sizes of businesses. Small businesses constitute a large proportion of registered persons but contribute only a small proportion of VAT revenue. The sheer number of small enterprises in the VAT system means that administrative resources devoted to the group are necessarily high even as the revenue collected from them is low. At the same time, compliance costs borne by the group are disproportionately high as a percentage of turnover compared to the relative cost of compliance for larger firms.

In most countries, a large share of VAT revenue is collected from an exceptionally small number of registrants with the highest turnovers. In the United Kingdom, for example, in 2010-11 half of the total VAT revenue was paid by only 0.4 percent of VAT-registered businesses, and 10 percent of the VAT registrants contributed 83 percent of the total VAT revenue (see figure 1).⁷

7 United Kingdom, HM Revenue & Customs, "Value Added Tax Factsheet," November 22, 2011, at section 2.2.

FIGURE 1 Distribution of Net Value-Added Tax (VAT) Revenue by Turnover Groups in the United Kingdom, 2010-11



Source: United Kingdom, HM Revenue & Customs, “Value Added Tax Factsheet,” November 22, 2011.

Administrative efforts, however, are primarily devoted to the large group of small businesses that generate little net tax revenue. While overall VAT administrative costs are sensitive to two main factors—the complexity of the tax (the use of reduced or zero rates and exemptions) and the number of VAT registrants⁸—those costs do not fall proportionately on small and large businesses. In the United Kingdom, more than half of the cost of administering the VAT can be attributed to the administration of the smallest businesses that account for the bulk of taxable persons and a tiny fraction of VAT revenue collected.⁹ A US study considering the implications of adopting a VAT in that country estimated that removal of smaller businesses from the VAT to reduce the number of registrants by more than half

8 Sijbren Cnossen, “Administrative and Compliance Costs of the VAT: A Review of the Evidence” (1994) 63:12 *Tax Notes* 1609-26.

9 In a study looking at the 1977-78 fiscal year in the United Kingdom, Sandford estimated that 55 percent of administrative resources were allocated to 69 percent of registered businesses (under £50,000 turnover) from which less than 5 percent of revenue was collected; see Cedric Sandford, Michael Godwin, Peter Hardwick, and Michael Butterworth, *Costs and Benefits of VAT* (London: Heinemann, 1981), and Cedric Sandford, “The Administrative and Compliance Costs of Taxation: Lessons from the United Kingdom” (1985) 15:3 *Victoria University of Wellington Law Review* 199-205.

could reduce administrative costs by one-third while reducing revenue collection by only 3 percent.¹⁰

Compliance costs borne by registered persons may be of even greater concern than administrative costs borne by the tax authority, given that compliance costs appear to be much higher.¹¹ There is, to be sure, a risk that measurements of compliance costs are vulnerable to overestimation and might be subject to a wider margin of error than estimates of administrative costs.¹² For example, it is difficult for businesses, in particular small businesses, to separate VAT compliance costs from the cost of basic record-keeping and accounting activities that would be incurred in any case in the process of running the business or meeting income tax obligations.¹³ Also, empirical studies on compliance costs conducted in previous decades must now be read with caution, taking into account the impact that technological advances in accounting and record keeping have had on compliance costs.¹⁴

Notwithstanding these caveats, it is clear that compliance costs fall disproportionately on small businesses.¹⁵ In one study, compliance costs as a percentage of turnover were estimated to be more than 30 times greater for small businesses than for large firms.¹⁶ These heavy and disproportionate compliance burdens on small businesses raise equity concerns,¹⁷ in particular in countries where policies tend to favour small and medium-sized enterprises (SMEs).

In terms of both administrative and compliance costs, small businesses thus present a special case in the VAT. From an efficient tax design perspective, even more important than the absolute cost of small business administration and compliance is its magnitude relative to the revenue collected from these enterprises.¹⁸ As discussed

10 United States, General Accounting Office, *Value-Added Tax: Administrative Costs Vary with Complexity and Number of Businesses*, GAO/GGD-93-78 (Washington, DC: General Accounting Office, May 1993).

11 Sandford, "Administrative and Compliance Costs," supra note 9, at 201.

12 Cnossen, supra note 8, at 1610.

13 Ibid.; and United Kingdom, House of Commons Treasury Committee, *The Administrative Costs of Tax Compliance*, Seventh Report of Session 2003-04 (London: Stationery Office, June 2004).

14 Cnossen, supra note 8, at 1610. As early as 1993, a Canadian study showed that GST compliance costs for businesses that used computerized accounting systems were 20 percent to 40 percent lower than the costs for businesses that used manual accounting systems; see Plamondon & Associates, *GST Compliance Costs for Small Business in Canada: A Study for the Department of Finance, Tax Policy* (Ottawa: Department of Finance, December 1993).

15 Cedric Sandford, Michael Godwin, and Peter Hardwick, *Administrative and Compliance Costs of Taxation* (Bath: Fiscal Publications, 1989); Cedric Sandford and John Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (Wellington: Victoria University of Wellington, Institute of Policy Studies, 1992); and Plamondon & Associates, supra note 14.

16 The study looked at the 1977-78 fiscal year: see Sandford, "Administrative and Compliance Costs," supra note 9, at 201.

17 Cnossen, supra note 8, at 1619.

18 Michelle Salvail, *The Goods and Services Tax: The Government's Administration Costs* (Ottawa: Library of Parliament, Parliamentary Research Branch, Economics Division, February 1994).

above, revenue authorities devote significant resources to apply the VAT to small businesses, and these businesses in turn incur relatively high costs to comply with the law, with little net tax revenue to show for all these outgoings. In fact, the total administrative costs incurred to collect tax from small businesses and compliance costs incurred by small businesses in respect of calculating and paying the tax may well outweigh the VAT revenue generated by this group of enterprises.¹⁹

The response in most countries to the high costs and limited revenue associated with the application of the VAT to small businesses has been the adoption of a registration threshold to exclude a portion of small businesses from the VAT system. This approach allows revenue authorities to concentrate scarce administrative resources on larger taxpayers and relieves small businesses outside the system from the burden of VAT compliance. While the outcome seems not to be fully appreciated by jurisdictions with relatively low thresholds, the revenue loss resulting from even high thresholds is unlikely to be significant. With no entitlements to input tax credits, firms below the threshold are still taxed on inputs; only their final value added escapes additional taxation.

Focusing on the tradeoff between revenue and administrative and compliance costs, Keen and Mintz developed a simple theoretical rule that the optimal threshold should be set at the level where the marginal revenue gains from bringing more taxpayers into the VAT equals the additional administrative and compliance costs.²⁰ The application of the rule has proved to be more complex in practice since a host of other factors also affect the choice of threshold, leading to thresholds either above or very often below the optimal threshold to which the Keen and Mintz approach would point.²¹

A strict balance between revenue and collection costs also provides a case for a lower threshold for sectors with higher value-added-to-sales ratios.²² A few countries (for example, Ireland and France) apply differentiated thresholds for goods and services.²³ They are, however, unlikely to be models for other countries because of the practical difficulties of distinguishing between goods and services, in particular for registered persons that provide mixed supplies.²⁴ Differentiated thresholds increase administrative and compliance costs, compromising some of the benefit of adopting a threshold in the first place.

19 Sandford and Hasseldine, *supra* note 15, at 120; and Ebrill et al., *supra* note 6, at 117.

20 Michael Keen and Jack Mintz, "The Optimal Threshold for a Value-Added Tax" (2004) 88:3-4 *Journal of Public Economics* 559-76.

21 For example, most of the member states in the European Union have a threshold that is lower than the theoretically optimal threshold: see Institute for Fiscal Studies, *A Retrospective Evaluation of Elements of the EU VAT System: Final Report* (London: IFS, December 2011), at 83.

22 Ebrill et al., *supra* note 6, at 119; and Keen and Mintz, *supra* note 20, at 563.

23 Keen and Mintz, *supra* note 20, at 563.

24 Alan Carter, ed., *International Tax Dialogue: Key Issues and Debates in VAT, SME Taxation and the Tax Treatment of the Financial Sector* (Paris: OECD, International Tax Dialogue, 2013).

An optimal threshold that balances revenue against administrative and compliance costs is inherently transitory. In theory, the threshold should shift downward—for example, if administrative costs fall as capacity grows with experience, and compliance costs decrease with advances in technology. At the same time, inflation will cause the nominal turnovers of businesses to rise while their economic size and capacities remain constant, suggesting that a rising threshold is appropriate. The United Kingdom and Canada represent examples of opposing practice. The VAT threshold in the United Kingdom has typically been increased annually in line with inflation, leaving the current threshold level in nominal terms at 16.6 times that used when the VAT came into effect in 1973. In contrast, Canada has never changed its threshold since the GST was introduced in 1991. Between these extremes lie countries with ad hoc threshold lifts.²⁵

A system of continual adjustments such as that used in the United Kingdom appears to disregard the likelihood of reductions in administrative and compliance costs over time, while the effective reduction of the threshold in real terms experienced in Canada brings ever smaller businesses facing relatively higher compliance burdens into the system. A more sensible approach would be to periodically review and adjust the threshold to balance changes in the real value of money and changes in administrative and compliance costs.

THRESHOLD-RELATED DISTORTIONS AND INEFFICIENCIES

A registration threshold can mitigate the relatively high compliance costs that would be faced by small businesses and the disproportionate collection costs that would be borne by revenue authorities if all enterprises were subject to the VAT. Provided that the threshold is set at an appropriate level, these benefits can be achieved with a minimal cost to revenue. However, there might also be economic costs resulting from the adoption of a threshold. The omission of some small businesses from the formal VAT system creates a break in the VAT chain if small unregistered businesses buy from or sell to registered businesses. This break may deny revenue authorities a source of information that is useful for assessment and audit purposes. In addition, the inability of small businesses to issue tax invoices could lead to a cascading problem since unrecovered VAT will become another cost of acquisition for other businesses that buy from unregistered firms. Most importantly, the differential treatment of firms above and below the threshold in terms of tax payments and compliance burdens may give rise to costly distortions to the competitive positions of registered and unregistered businesses making otherwise comparable supplies, and may induce inefficient changes in business behaviour that cause further economic harm or lead to revenue losses. Policy responses to these problems could in turn yield new problems and distortions.

25 For example, the registration threshold in New Zealand was increased by 50 percent in 2009 in response to the global financial crisis.

Distortion of Competition

A registration threshold drives a wedge between businesses that are in the VAT system and businesses that are excluded from the formal VAT system and are instead subject to input taxation. It is a given that greatly different tax treatment of two groups of enterprises operating within the same market will result in competitive distortions, but identifying the precise types and levels of distortions and devising responses to mitigate the negative impact of the distortions have proved difficult. Some firms left outside the VAT by a registration threshold enjoy benefits from exclusion while others are prejudiced by it.

On the apparent plus side of the advantage-disadvantage scale are small businesses that sell to final consumers.²⁶ Firms that have lower inputs relative to outputs and sell primarily to final consumers are likely to enjoy competitive advantages from being input-taxed only, with their value added escaping tax. This competitive advantage will increase as the proportion of the final price attributable to a firm's value added rises.

The claimed competitive advantages in this respect may not, however, be a real-world problem, for two reasons. First, although small firms below the threshold may enjoy tax advantages, their prices at the retail stage may still be higher than those of larger firms that are able to reduce costs by exploiting proprietary information and enjoying economies of scale.²⁷ Second, to the extent that the economic positions of firms just above and below the threshold are largely similar, the advantages and disadvantages are only a temporary phenomenon, since business sizes are not static. On the one hand, some small businesses below the threshold may grow larger and cross the threshold. On the other hand, where firms just above the threshold are disadvantaged, their turnovers may fall below the threshold owing to a reduction in sales volumes or profit margins.

While the perceived benefits of escaping the full VAT may prove illusory for some enterprises, two types of small firms below the threshold may be disadvantaged relative to firms subject to the VAT. The first type comprises businesses that seek to make supplies to registered businesses. Small firms below the threshold are unable to issue invoices that entitle registered purchasers to input tax credits. Registered businesses will thus be reluctant to purchase from unregistered firms. The second group consists of enterprises from registered businesses with high input costs relative to taxable output sales. Examples include new businesses that incur startup costs that initially exceed turnover and businesses that make zero-rated export sales. These firms might be entitled to VAT refunds if they were within the VAT system.

To minimize the competitive disadvantage that these firms may face, many countries, including the United Kingdom, New Zealand, and Canada, allow voluntary registration by small firms with turnovers below the threshold. The option for

26 Ebrill et al., *supra* note 6, at 120.

27 A similar argument was made in Ebrill et al., *ibid.*

voluntary registration, which removes the compliance and administrative cost savings that flow from the registration threshold, has markedly different implications for enterprises choosing to enter the tax net and revenue agencies responsible for administering the tax. Since the former group is voluntarily incurring higher compliance costs, it must be assumed that these firms believe that they will enjoy an overall economic benefit from registration after incurring new compliance costs; otherwise, they would not have elected to enter the VAT regime. In contrast, from a tax collection perspective, the result may be reduced revenue and disproportionately high administrative costs.

Voluntary registrations may constitute a relatively high percentage of total registrations; in several OECD countries, well over one-third of total VAT registrants are voluntary registrants.²⁸ For example, in the United Kingdom in 2016-17, 46 percent of the businesses registered for the VAT operated below the threshold.²⁹ Tax statistics in New Zealand show even higher percentages of voluntary registration in most years, ranging from a low of 45 percent to a high of 52 percent of total registrants during the period 2009-2016.³⁰ As a consequence of the self-selection nature of voluntary registration, this group is likely to be disproportionately populated by persons claiming refunds from the revenue authority rather than those paying net tax to the government. In the United Kingdom and New Zealand, for example, a sizable proportion of voluntary registrants reported nil output sales (about 25 percent and 37 percent respectively), and in both jurisdictions, VAT receipts from firms at the bottom of the turnover scale are negative.³¹ In 2015-16, voluntary registrants in New Zealand collectively claimed a net VAT refund of NZ\$656.5 million (approximately Cdn\$573.72 million), a figure equal to 4 percent of the net VAT revenue collected.

The self-selection character of voluntary registration also has significant implications for VAT administrative costs. Voluntary registration exacerbates considerably the disproportionate cost of administration relative to revenue that is a feature of the imposition of VAT on low-turnover enterprises. Disproportionately high administrative costs follow two aspects of voluntary registration. First, there is the increased risk of refund-related avoidance schemes and outright fraudulent claims for refunds. Refund requests must be vetted carefully, drawing costly additional administrative

28 Organisation for Economic Co-operation and Development, *Taxation of SMEs: Key Issues and Policy Considerations* (Paris: OECD, 2009). In 2003-4, over 34 percent of all GST/HST registrants in Canada had registered voluntarily. See Canada Revenue Agency, *Compendium of GST/HST Statistics: 2004 Edition* (2002 tax year) (Ottawa: CRA, 2004), at table 6.

29 United Kingdom, HM Revenue & Customs, "Value Added Tax (VAT) Factsheet 2016-17," October 31, 2017, at section 2.7.

30 New Zealand Inland Revenue, "Number of GST Filers by Turnover Band 2007 to 2016," October 27, 2017.

31 HM Revenue & Customs, *supra* note 29, at section 2.7; and New Zealand Inland Revenue, "Net GST by Turnover Band 2007 to 2016," October 27, 2017.

resources.³² Second, voluntary registration opens the door to whipsaw behaviour by firms that register to claim input tax credits related to startup costs and then deregister if ongoing business activities yield turnovers below the registration threshold.³³ It is not uncommon for jurisdictions to require voluntary registrants to remain registered for a minimum period of time (commonly between one and five years)³⁴ in order to discourage whipsaw behaviour. However, the limited VAT that may be collected from these firms in the compulsory registration period does little to offset the high administrative costs incurred in respect of these registrants that are responsible for negative VAT remittances for much of that period. An alternative, such as that used in Canada and Australia to address the risk of whipsaw behaviour while avoiding ongoing administrative costs, is to adopt a relatively short minimum registration period but effectively recapture input tax credits on deregistration.³⁵

As noted, in theory the optimal registration threshold would be set at the level where the marginal revenue gains from bringing more taxpayers into the VAT equal the increased administrative and compliance costs resulting from the additional registrations. However, the theoretical model disregards the impact on revenue and collection costs of voluntary registration. These costs must affect the choice of threshold level. The revenue yield from voluntary registrants below the threshold is likely to be less, and quite probably substantially less, than if the registration threshold were simply lowered to bring the same number of businesses into the VAT system. At the same time, the increased administrative costs incurred in respect of voluntary registrants will increase revenue needs. The task of recomputing the tradeoff between revenue and collection costs to take into account the potential impact of voluntary registration becomes a multilayered undertaking.

There is, however, little evidence of careful consideration of the impact of voluntary registration on the optimal threshold level. While small businesses may seek to register voluntarily for a number of reasons, including trade with registered businesses and market benefits from appearing larger than is actually the case,³⁶ there are few comprehensive studies of the relative weighting of different factors inducing

32 Edith Brashares, Matthew Knittel, Gerald Silverstein, and Alexander Yuskavage, "Calculating the Optimal Small Business Exemption Threshold for a U.S. VAT" (2014) 67:2 *National Tax Journal* 283-320.

33 OECD, *supra* note 3, at 75.

34 For example, the minimum registration period is one year in Canada and Australia, two years in Denmark and France, and five years in Austria and Germany. There is no minimum registration period requirement in the United Kingdom and New Zealand. See OECD, *supra* note 3, at 75 and 89.

35 For the Canadian rule, see the Excise Tax Act, RSC 1985, c. E-15, as amended, subsection 171(3); for the Australian rule, see A New Tax System (Goods and Services Tax) Act 1999, as amended, section 138.5.

36 United Kingdom, Office of Tax Simplification, *Value Added Tax: Routes to Simplification* (London: Office of Tax Simplification, November 2017), at 18.

voluntary registration.³⁷ It is also unclear how voluntary registration rates would change if registration thresholds were raised or lowered. Cross-country comparisons reveal no discernible relationship between threshold levels and the rate of voluntary registration.³⁸ For example, although the threshold is significantly lower in New Zealand (in 2015-16, NZ\$60,000, equivalent to approximately Cdn\$52,425) than in the United Kingdom (£82,000 in 2015-16, or approximately Cdn\$146,056), the voluntary registration rate in New Zealand appears to be higher (see tables 1 and 2). At the same time, Japan, with a relatively high registration threshold (approximately Cdn\$113,987), has a voluntary registration rate that is less than $\frac{1}{10}$ of the UK rate.³⁹ The comparisons must be read with extreme caution, however, given the fact that the nominal monetary value of thresholds may differ substantially from the actual purchasing power parity value.

In-country comparisons also yield inconsistent results. In the United Kingdom, for example, the voluntary registration rate has remained largely static in the past 10 years, although the registration threshold has been raised annually (see table 1). At the same time, following invitations from the tax authority to deregister when registration thresholds were raised twice in each of 1977 and 1978, only $\frac{1}{5}$ of the taxpayers who were newly eligible for deregistration opted to move outside the VAT system.⁴⁰ In contrast, in New Zealand, where there were no changes in the threshold between 2009-10 and 2015-16, the voluntary registration rate declined by about 1 percent each year (see table 2).

Policy makers seeking to calibrate the registration threshold in light of the impact of voluntary registration on revenue and costs thus face a quandary. On the one hand, they may realize that voluntary registration will affect tax revenue and tax collection costs, but they have no means of ascertaining the actual effects of voluntary registration. On the other hand, they may appreciate that changes to the registration threshold can influence the rate of voluntary registration, without having any means of estimating the direction in which voluntary registrations may head or the degree to which the level might change.

These challenges may go some way toward explaining why VAT theorists most often ignore the question of voluntary registration when discussing an optimal registration threshold. Wherever the threshold is otherwise set, adoption of a voluntary registration option to assist businesses with turnovers below the threshold

37 A recent UK study sought to rank factors using subjective data gathered from interviews with a limited sample of small businesses, but the findings are difficult to reconcile with HMRC data based on all taxable persons. See Rebecca Klahr, Lucy Joyce, Rory Donaldson, Graham Keilloh, and Cheryl Salmon, *Behaviours and Experience in Relation to VAT Registration: Final Report*, HM Revenue and Customs Research Report no. 446 (London: HM Revenue and Customs, November 2017).

38 Brashares et al., *supra* note 32, at 287.

39 OECD, *supra* note 28, at 122.

40 United Kingdom, HM Customs and Excise, *Review of Value Added Tax*, Cmnd 7415 (London: HM Customs and Excise, 1978), at 12-13.

TABLE 1 Value-Added Tax Thresholds and Voluntary Registration in the United Kingdom, 2007-8 to 2016-17

	2007-8	2008-9	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Threshold (£).....	64,000	67,000	68,000	70,000	73,000	77,000	79,000	81,000	82,000	83,000
Voluntary registrants as a percentage of total registrants.....	43	43	44	43	42	43	44	44	44	46
Nil turnover registrants as a percentage of total voluntary registrants.....	30	30	30	28	24	23	25	25	25	25

Source: United Kingdom, HM Revenue & Customs, “Value Added Tax (VAT) Factsheet 2016-17,” October 31, 2017.

TABLE 2 Value-Added Tax Threshold and Voluntary Registration in New Zealand, 2009-10 to 2015-16

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Threshold (NZ \$)	60,000	60,000	60,000	60,000	60,000	60,000	60,000
Voluntary registrants as a percentage of total registrants	51.70	51.00	49.45	48.80	47.36	46.12	44.92
Net payment by voluntary registrants (thousands of NZ \$)	-647.5	-450.5	-228.1	-347.3	-437.3	-518.7	-656.5
Nil turnover registrants as a percentage of voluntary registrants	38.54	37.70	38.65	38.24	37.63	37.11	36.39

Sources: New Zealand Inland Revenue, "Number of GST Filers by Turnover Band 2007 to 2016," October 27, 2017 and "Net GST by Turnover Band 2007 to 2016," October 27, 2017.

removes the downside of a registration threshold for enterprises that must be in the VAT system for commercial reasons.⁴¹ However, as soon as voluntary registration is contemplated, its impact on revenue and administrative costs must be factored back into the equation used to identify the optimal threshold. While exact calculations may not be possible, an effective revenue service should be able to generate sufficient information for authorities to take the probable effects of voluntary registration into account when setting the registration threshold.

Behavioural Responses to a Threshold

Not surprisingly, the sharp rise in tax liability and compliance costs for firms that cross the registration turnover threshold prompts behavioural responses by firms enjoying the advantages of sitting outside the formal VAT system. Coexisting with the VAT registration threshold is the phenomenon of business bunching, with a large number of businesses reporting turnover just below the threshold level that would require VAT registration. A registration threshold thus creates a cliff-edge: a sharp increase in the number of businesses falling into the first turnover band below the threshold compared to the number in the second band below the threshold, matched by a drop to a much smaller number of businesses in the first turnover band above the threshold.⁴² Figure 2 illustrates this pattern based on UK data for 2014-15. Unlike the VAT, the income tax generally has no registration threshold, and income tax data in some countries provide unambiguous evidence of small businesses bunching below the VAT registration threshold.⁴³ Businesses that are registered for VAT purposes but that qualify for particularly generous small business concessions or beneficial regimes within the VAT are equally likely to adopt behaviours to ensure that turnovers stay below the threshold at which the concessions are withdrawn.⁴⁴

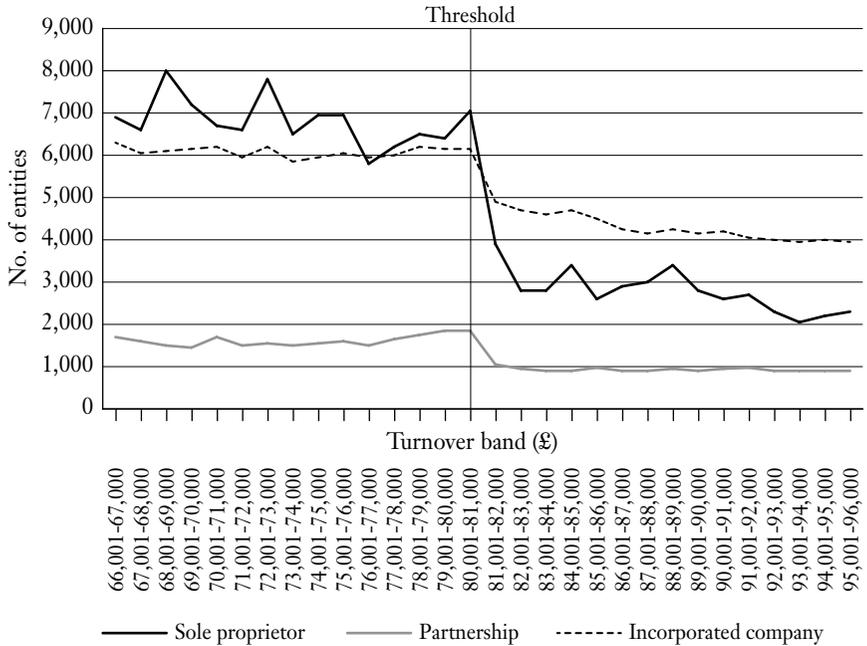
41 For those who do not believe that the removal of commercial disadvantage should be a priority, the case for allowing voluntary registration may be overwhelmed by the disproportionate value of administrative costs relative to tax revenue collected from small businesses; see William J. Turnier, "Designing an Efficient Value Added Tax" (1984) 39:4 *Tax Law Review* 435-72, at 458-60.

42 Office of Tax Simplification, *supra* note 36, at 6.

43 See Li Liu and Ben Lockwood, *VAT Notches, Voluntary Registration and Bunching: Theory and UK Evidence*, Oxford University Centre for Business Taxation Working Paper WP 16/10 (Oxford: Oxford University Centre for Business Taxation, July 2016); and Jarkko Harju, Tuomas Matikka, and Timo Rauhanen, *The Effects of Size-Based Regulation on Small Firms: Evidence from VAT Threshold*, VATIT Working Paper no. 75 (Helsinki: VATIT Institute for Economic Research, 2016).

44 A clear example of behaviour related to concessions for registered small businesses can be found in Japan, where concessions included generous tax credits; see Kazuki Onji, "The Response of Firms to Eligibility Thresholds: Evidence from the Japanese Value-Added Tax" (2009) 93:5-6 *Journal of Public Economics* 766-75. The Japanese concessional regime is described in Justin Dabner, "The Japanese Consumption Tax Experience: Lessons for Australia?" (2002) 5:2 *Journal of Australian Taxation* 185-212; and Vicki Beyer and Koji Ishimura, "The Progress

FIGURE 2 Number of Entities by Turnover Band in the United Kingdom, 2014-15



Source: United Kingdom, Office of Tax Simplification, *Value Added Tax: Routes to Simplification* (London: Office of Tax Simplification, November 2017), at 7.

Businesses seeking to stay below the registration threshold may adopt one or more of three tactics:

1. deliberately holding back expansion in order to remain input-taxed suppliers;
2. splitting enterprises with total turnover above the threshold into smaller separate entities, each of which has a turnover below the threshold; or
3. fraudulently underreporting sales where actual turnover is above the threshold.

These behaviours impose economic costs on the community or lead to lost revenue, though their impact varies. While the empirical studies successfully document the

of the Japanese National Consumption Tax” (1993) 3:2 *Revenue Law Journal* 115-24. More recently, the UK revenue authority uncovered a scheme to split a single enterprise into hundreds of mini-companies, each of which would be able to use a concessional presumptive input tax credit regime; see Simon Goodley, “Recruitment Advisers’ Tax Scheme Liquidated After HMRC Asks Questions,” *Guardian*, July 10, 2017 (<https://amp.theguardian.com/business/2017/jul/10/tax-scheme-anderson-group>).

existence of bunching,⁴⁵ findings are often ambiguous in terms of identifying the extent to which each tactic is used. A UK study attributes bunching largely to output restraint and underreporting,⁴⁶ while case-law evidence in the United Kingdom points to splitting as a factor as well. A Finnish study suggests that restraint is the main cause of bunching in that country,⁴⁷ but the methodology employed in the study to dismiss splitting as a tactic is problematic. A later UK study based on a telephone survey of a limited pool of businesses, not surprisingly, downplayed significantly the role of underreporting and artificial splitting.⁴⁸ The limited and completely subjective data set, however, makes reliance on the findings vulnerable to challenge.⁴⁹ In any case, uncertainty as to the prevalence of each tactic compounds the difficulty of devising effective responses.

Much of the emphasis in the academic literature and in policy discussions is on the first tactic, with concern that restrained production will result in “significant efficiency losses”⁵⁰ from underutilization of resources and reductions in potential outputs.⁵¹ Businesses may decide to restrain outputs and remain below the registration threshold in two circumstances. First, they may wish to stay out of the formal VAT if they make supplies to final consumers and much of the sale price is attributable to their value added. As long as these firms are subject to input taxation only, their value added remains untaxed, providing an important competitive advantage relative to businesses in the full VAT system. These enterprises may conclude that higher sales will not yield greater profits if they have to reduce markup in order to maintain attractive pricing. Second, businesses may decide that the higher compliance costs that they would incur in the VAT system would outweigh the increase in net profits from additional sales. The Finnish study that found output restraint to be the primary tactic used by enterprises to stay below the threshold suggests that concern over compliance costs, as opposed to increased tax liability, was the driving factor for this behavioural response.⁵² The conclusion is logical given that Finland has a relatively low registration threshold (approximately Cdn\$12,918) and that compliance costs relative to turnover fall disproportionately on small businesses.

Underlying the view that restraint is a primary cause of bunching is an assumption that small businesses have unlimited potential and desire for growth. However,

45 See, for example, Mesay M. Gebresilasie and Soule Sow, *Firm Response to VAT Policy: Evidence from Ethiopia* (New York: Columbia University, August 2016).

46 Liu and Lockwood, *supra* note 43, at 4.

47 Harju et al., *supra* note 43.

48 Klahr et al., *supra* note 37.

49 The UK government explained its reservations about the accuracy of the data based on telephone surveys in United Kingdom, HM Treasury, *VAT Registration Threshold: Call for Evidence* (London: HM Treasury, 2018), at 8.

50 Harju et al., *supra* note 43, at 32.

51 Office of Tax Simplification, *supra* note 36.

52 Harju et al., *supra* note 43.

the risk of economic harm may be exaggerated. Not all businesses that value the lower tax burden or reduced compliance costs associated with being outside the formal VAT will be tempted to reduce output to stay below the threshold. Businesses that genuinely lie below the threshold fall into three groups: (1) those that are not capable of further growth; (2) those that are capable of a little growth, enough to cross the threshold but not much more; and (3) those that are capable of ongoing growth. The threshold will be an inhibition only for the second group. Behaviour modification by the first group yields no benefits, while the temporary setback of tax on value added and the increase in compliance costs will not outweigh the additional profits from continuing expansion for firms in the third group. The focus, therefore, is on small firms that would have limited prospects for future growth in a no-threshold world and that are likely to enjoy market advantages by holding back expansion to stay below the threshold. The efficiency losses caused by restrained production by these firms are unlikely to be great.

An alternative to restraint for an enterprise that is concerned that increased taxation or compliance costs will offset the benefits of higher sales to final consumers is to continue to pursue a total turnover above the registration threshold but to artificially split the enterprise into smaller entities, each of which operates below the threshold. In some cases, splitting arrangements may extend to enterprises with turnovers well above the threshold. Concern over this tactic is not related to economic costs but rather to lost revenue from final consumption that should be in the VAT system. Theoretical discussions of the optimal registration threshold and empirical studies of bunching tend to disregard splitting as a factor contributing to bunching.⁵³ An exception to this observation is the Finnish study on bunching referred to earlier, which explicitly considered artificial splitting as a possible explanation for bunching behaviour but found no clear evidence that splitting was significant. However, as noted above, the methodology adopted in that study to dismiss this avoidance tactic appears to be problematic. The study examined the average number of firms owned by individuals below and above the threshold on the assumption that split entities are owned by the same person,⁵⁴ an assumption that appears to discount the probability of multiple-tier ownership structures or ownership structures between related individuals where enterprises are engaging in splitting arrangements.

The most convincing evidence of splitting is found in appeals documenting such behaviour uncovered by revenue authorities. UK cases reveal a number of techniques used by taxable persons who have attempted to split the output of service enterprises to yield multiple turnovers below the registration threshold. One technique is to treat individual service providers within a single operation as separate contracted businesses (for example, characterizing hairdressers in a hairdressing

53 Ravi Kanbur and Michael Keen, "Thresholds, Informality, and Partitions of Compliance" (2014) 21:4 *International Tax and Public Finance* 536-59; and Liu and Lockwood, *supra* note 43.

54 Harju et al., *supra* note 43, at 30.

salon as independent contractors).⁵⁵ Another is to attribute different elements of a service to different businesses and business owners (for example, treating a pub meal as separate supplies of food and drink from different related persons).⁵⁶ A third technique is to seek to file separate registrations for different businesses operated by the same person (for example, attempting to register a real estate agent business separately from a land developer business).⁵⁷ These types of avoidance arrangements prompted the UK government to add to its VAT legislation a specific anti-avoidance provision targeting the artificial separation of business activities.⁵⁸

The concern with the third tactic used to remain below the threshold, under-reporting of sales, is also lost revenue. This behaviour clearly constitutes illegal tax evasion and is most likely to take place in the case of small traders making cash sales to final consumers who do not request invoices.⁵⁹ False reporting is not limited to those seeking to avoid VAT registration. It may also be used by registered businesses (including voluntarily registered firms) seeking to mismatch full claims for inputs while reporting a fraction of outputs,⁶⁰ and by both unregistered and registered firms seeking to evade VAT on sales and income tax on profits.

The implications of each of the three types of behaviour for the setting of the threshold differ. One view holds that, to the extent that production restraint is a cause of bunching, a higher threshold might be desirable.⁶¹ As the threshold increases, the firms that limited their output to less than the optimal level could produce a little more.⁶² A contrary view holds that the preferable response to bunching attributable to restraint is a substantial reduction in the registration threshold.⁶³ The latter view assumes that businesses tempted to bunch below the current threshold would find it impractical to hold back production in order to operate at a significantly lower threshold.

The hypotheses underlying both views may fail to capture fully the implications of the proposed changes, particularly in respect of the group of businesses that find

55 *Customs and Excise Commissioners v. Jane Montgomery (Hair Stylists) Ltd.*, [1994] STC 256 (Scot. Ct. Ex.).

56 *Commissioners of Customs and Excise v. Marnier and Marnier*, [1977] 1 BVC 1060 (VATTR Manchester).

57 *Customs and Excise Commissioners v. Glassborow and Another*, [1974] QB 465 (QB).

58 Value Added Tax Act 1994, schedule 1, paragraph 1A (amended by Finance Act 1997, c. 16, section 31(1)). See also Alan Schenk, Victor Thuronyi, and Wei Cui, *Value Added Tax: A Comparative Approach*, 2d ed. (Cambridge: Cambridge University Press, 2015), at 69.

59 Dina Pomeranz, "No Taxation Without Information: Deterrence and Self-Enforcement in Value Added Tax" (2015) 105:8 *American Economic Review* 2539-69.

60 Liu and Lockwood, *supra* note 43, at 3.

61 Kanbur and Keen, *supra* note 53, at 551.

62 Ravi Kanbur and Michael Keen, "Reducing Informality" (2015) 52:1 *Finance & Development* 52-54.

63 Office of Tax Simplification, *supra* note 36, at 23.

themselves just below the new threshold. A change in the threshold level does not remove the temptation to bunch, but simply shifts it to a different group. If the threshold is raised to a level inhabited by fewer enterprises, there will be a much smaller pool of potential restrainers, *prima facie* translating to less bunching. Reinforcing this conclusion is the host of practical constraints that larger businesses contemplating restraint would face in terms of more substantial operating assets and a larger number of employees. Conversely, if the threshold is reduced substantially, the group of businesses that potentially might bunch grows exponentially, with the result that the absolute value of reduced output could be greater than that caused by restraint by far fewer firms at a much higher threshold. The sheer number of small firms and their dispersal through the economy may also mean that restraint could have a greater impact on the economy as a whole regardless of any output loss.

In respect of the restraint issue, in theory, the optimal choice of a new threshold will turn on a balance between potentially increased production by firms with turnovers just below the previous threshold and newly suppressed production by firms with turnovers just below the new higher or lower threshold.⁶⁴ In practice, however, policy makers are unable to compare actual behaviour at both points. Moreover, as noted, the efficiency losses caused by restrained production may not be large enough to warrant a specific policy response in any case.

Finding an optimal threshold to discourage splitting behaviour is similarly challenging. One possibility is that a lower threshold would reduce avoidance by artificial splitting.⁶⁵ The lower the threshold, the more a business would have to split to remain below the threshold. A lower threshold would raise the cost of avoidance by limiting the size of legitimate input-taxed businesses.⁶⁶ However, whether it is more difficult and costly for businesses to split into multiple parts will also depend on a host of non-VAT considerations, including the nature of the businesses, income tax consolidation rules, company and securities laws, and licensing rules. For example, large integrated firms with central financing and management functions would find it difficult to split finely to slip below a low threshold. Service providers that are able to characterize employees as independent contractors may be indifferent to the number of notional enterprises that they create. It is questionable how effective a lower threshold would be in reducing avoidance by artificial splitting if such activities are strongly concentrated among small service providers, as might be the case in practice in light of the UK cases noted earlier.

A preferable response to splitting may be the use of a dedicated specific anti-avoidance measure to consolidate the output of associated or closely bound enterprises. This approach has been adopted in Canada as well as the United Kingdom. There are, however, limits to the effectiveness of such rules since they operate

64 Kanbur and Keen, *supra* note 53, at 549.

65 Ebrill et al., *supra* note 6, at 121.

66 *Ibid.*

within the definition of associated or closely bound persons. The Canadian rule,⁶⁷ for example, applies broadly to entities, but unlike other anti-avoidance rules in Canadian tax legislation that are relevant to associated persons, the output consolidation rule appears not to apply to related individuals. The UK rule may suffer from a similar shortcoming. Nor will the Canadian rule apply to unrelated persons working in the same enterprise but presenting themselves as independent contractors who have elected to operate out of the same premises. These arrangements are more likely to fall within the scope of the UK rule, though its application in these situations is not certain. A better anti-avoidance rule would explicitly overcome the doubts raised by existing models.

As is the case with bunching attributable to business splitting, bunching resulting from turnover underreporting involves no constraints on business growth. Businesses expand or operate to capacity and simply fail to report some outputs. Thus, the concern with respect to this tactic to remain below the threshold is lost revenue. It has been suggested that responses to underreporting by businesses above the threshold can include raising the threshold so that evaders become legitimate input-taxed unregistered enterprises.⁶⁸ The argument assumes that the revenue lost to underreporters is lost in any case, so there is no revenue cost in terms of this group from raising the threshold to explicitly exclude these enterprises from the VAT. It must be recognized, however, that raising the threshold to change the status of underreporters will have ancillary impacts on revenue and administrative costs. While no revenue is lost in terms of enterprises that stayed below the lower threshold by underreporting, the higher threshold will have the effect of excluding a host of honest enterprises above the original lower threshold. Any revenue loss from excluding these persons from the VAT will be offset to some extent by the resulting administrative and compliance cost savings. Contemporaneously, raising the threshold will encourage a new group of enterprises above the new threshold to become underreporters. This observation may be tempered by the lower proclivity of larger enterprises to underreport.

An alternative view aimed at identifying and pursuing underreporters calls for reducing the threshold so that there will be a smaller number of businesses legitimately outside the VAT net, making it easier for authorities to detect those illegitimately below the threshold.⁶⁹ However, this view is problematic in respect of the impact that a lower threshold might have on administrative costs. While the total number of businesses outside the net would be smaller, the lower threshold would apply to that pool of businesses selling primarily to final consumers and hence more likely to underreport. Administrators' workload in terms of the number of businesses to be investigated may increase as a result. Also, there is a possibility that those who evaded in order to remain below the old threshold might still be

67 Excise Tax Act, *supra* note 35, subsection 148(1) and section 127.

68 Kanbur and Keen, *supra* note 53, at 551 and 556.

69 Office of Tax Simplification, *supra* note 36, at 23.

engaging in evasion after entering the VAT system. In that case, administrative resources might remain equally stretched, with responsibility for finding evaders below and above the threshold. Administrative savings may be realized, however, if authorities conclude that only limited resources should be allocated to chase the relatively small revenue lost to evasion by the larger group of low turnover enterprises. At the same time, the larger cohort of registered persons in the VAT would increase administrative costs, although these would be offset to some extent by the increased revenue.

The various revenue and administrative tradeoffs encountered at different turnover levels are factors that should be considered as elements of the initial threshold-setting exercise, not factors that lead to adjustments of the optimal threshold to address a problem of underreporting. Wherever the threshold is set, there will be underreporters with true turnovers above the threshold and consequent administrative costs incurred to protect the integrity of the VAT. Given the uncertainty over possible business responses to higher or lower thresholds, the best way to address underreporting may be to accept this as an inevitable phenomenon whatever the VAT registration threshold, and to direct resources to uncover underreporters and bring those exceeding the threshold into the VAT. Persons underreporting for VAT purposes are equally likely to underreport for income tax purposes. Since thresholds for income tax purposes are uncommon, enhanced enforcement of the income tax for small businesses can be used to reveal underreporters that should be registered for VAT. This route is admittedly more difficult in jurisdictions where VAT and income tax are administered by separate agencies, as is the case in China and Malaysia.

A registration threshold balancing revenue objectives and administrative and compliance costs is a desirable feature of an efficient and fair VAT. The bunching problem that it creates, and the restraint, splitting, and underreporting tactics adopted by enterprises to fall below the threshold, yield economic harm for wider society and revenue losses for the state. A number of techniques are needed to combat these behavioural responses. Adjustment of the registration threshold has been suggested as one means of responding to the behaviour of businesses nearing the threshold. There are, however, competing views on how a registration threshold should be adjusted to address the different ways in which businesses might reduce actual or apparent turnover to avoid crossing the threshold. The contradictory conclusions along with the absence of empirical evidence on the extent of each type of behaviour make consideration of threshold responses to these issues problematic. A preferable approach is probably to look beyond threshold adjustment when considering these issues.

Policy makers in jurisdictions such as the United Kingdom that have identified a bunching phenomenon but not pinpointed the behaviour that has led to bunching need to investigate further the means adopted to remain below the threshold before they can develop appropriate responses. Policy makers in jurisdictions such as Canada where the phenomenon itself has yet to be studied need first to conduct this preliminary research to ascertain the extent to which bunching is present.

TRANSITIONING REGIMES FOR SMALL BUSINESSES SHIFTING INTO THE FULL VAT

In the absence of any special rules, the consequences of crossing the registration threshold can be significant for small businesses. Compliance costs jump, and the burden of implicit tax built into the price of acquisitions is replaced by liability to remit a higher explicit tax. As noted, the increase in compliance costs and tax burden can lead to bunching behaviour by small businesses seeking to remain below, or to appear to remain below, the registration threshold. To mitigate this problem, a small number of VAT jurisdictions have adopted “transitioning” regimes that subsidize the costs incurred by small businesses shifting into the full VAT.⁷⁰

The measures are intended to remove the rationales for some of the behaviour that results in bunching. They will, of course, have no impact on unregistered firms that are nearing the registration turnover threshold and have limited prospects for or interest in further growth.⁷¹

The transitioning subsidies commonly take the form of a disappearing credit provided to businesses with turnovers that climb over the registration threshold, with the credit phasing out as turnover rises.⁷² Variations of the transitioning regime can be found in Finland and the Netherlands. Japan had a similar regime at the time its consumption tax (as the Japanese VAT is known) was introduced, but the regime was abolished after eight years. The subsidies provided in the Japanese transitioning regime were particularly generous. When it commenced, the consumption tax featured a high registration threshold of ¥30 million (approximately Cdn\$341,687) and a vanishing credit for businesses with turnovers between ¥30 million and ¥60 million, starting with a full offset for consumption tax otherwise payable by enterprises with turnovers immediately above the threshold.⁷³ As a consequence of

70 Institute for Fiscal Studies, *supra* note 21, at 91. Transitioning assistance is also found in some other sales tax regimes. For example, the retail sales tax (RST) in Manitoba includes a capped “commission” that businesses collecting the RST can retain. The cap has the effect of directing the commission primarily to small businesses; see Manitoba Finance, *Retail Sales Tax Act Information Bulletin* no. 004, “Information for Vendors,” June 2017.

71 Institute for Fiscal Studies, *supra* note 21, at 91.

72 *Ibid.* An alternative regime adopted in Mexico in 2014 provides generous offsets for compliance costs and increased tax burdens by way of a disappearing formula, which allows newly registered businesses to retain a portion of VAT collected from customers sliding from 100 percent of the tax collected in the 1st year of registration to 10 percent in the 10th year. An even more generous concession allowing very small businesses to retain all VAT collected for a decade after entering the VAT has allowed Mexico to remove the threshold entirely, although it remains to be seen whether other concessional measures for small businesses will be enough to offset the compliance costs and increased tax burden that will be incurred when small businesses emerge from the full subsidy period. See Organisation for Economic Co-operation and Development, *Taxation of SMEs in OECD and G20 Countries* (Paris: OECD, 2015), at 74.

73 The transition tax credit was calculated using the following formula: Transition tax credit = VAT otherwise payable × (¥60 million – annual sales)/(¥30 million).

a high threshold and a generous offset, tax savings could be significant, and not surprisingly, there was a high takeup rate, with 93.3 percent of eligible registrants signing up for the concession when the consumption tax was adopted.⁷⁴ While the concession may have had an impact on firms otherwise inclined to underreport sales,⁷⁵ its most obvious impact was a loss of 88 percent of the total revenue that would have been gained if all taxpayers within this turnover range had been subject to the normal consumption tax.⁷⁶ To limit the windfall gains by businesses with relatively larger turnovers and capabilities to comply with the consumption tax, Japan lowered the upper limit of the scheme from ¥60 million to ¥50 million two years after the introduction of the regime and finally abolished the concessional regime in 1997.

A less generous regime was adopted in Finland in 2004. Under the Finnish system, still in effect, the VAT registration threshold remains unchanged at €8,500 (approximately Cdn\$12,918), but a disappearing transition tax credit in addition to the ordinary input tax credit entitlement is provided to firms with turnovers between €8,500 and €22,500.⁷⁷ For businesses that have turnovers of less than €8,500 and that voluntarily register for the VAT, the transitioning regime tax credit equals the total VAT otherwise payable, with the result that their taxable supplies are essentially zero-rated. Because the credit is calculated by reference to the net VAT payable, the transitional credit relief does not apply to businesses that have a negative VAT liability.

The Finnish regime had very limited impact on bunching by businesses below the threshold.⁷⁸ It also attracted surprisingly little interest from registered firms that were eligible for the relief, with only 31 percent of the eligible firms applying for the transitioning credit when the concessional regime was introduced.⁷⁹ The unremarkable impact of the transitioning regime in Finland may be explained by the very limited benefit that the concession yields for eligible enterprises.⁸⁰ As a result of a relatively low registration threshold and the relatively low level at which transitioning relief disappears, the average relief for eligible businesses that did not apply would have been only €617, and 10 percent of these businesses would have received less than €100 had they applied.⁸¹ The value of incentives compared to the relatively high compliance costs faced by firms entering the VAT was insufficient to

74 Hiromitsu Ishi, *The Japanese Tax System*, 3d ed. (Oxford: Oxford University Press, 2004).

75 William J. Turnier, "Accommodating to the Small Business Problem Under a VAT" (1994) 47:4 *Tax Lawyer* 963-86.

76 Ishi, *supra* note 74, at 292.

77 The tax credit is calculated using the following formula: Transition tax credit = VAT paid - [(turnover - €8,500) × VAT paid]/(€22,500 - €8,500).

78 Institute for Fiscal Studies, *supra* note 21, at 88-89.

79 *Ibid.*, at 90.

80 *Ibid.*

81 *Ibid.*

encourage very small unregistered businesses with limited sales to expand operations and lift turnover above the registration threshold.⁸²

The Finnish and Japanese experiences illustrate the tradeoffs encountered at the margins of transitioning regimes. If the registration threshold is low, a transitioning regime is unlikely to have a significant impact on bunching, since the value of tax relief is low relative to the compliance cost burden faced by registered businesses. If the registration threshold is high, the corresponding higher value for tax relief may reduce bunching, but the high take-up rate by eligible registered businesses above the threshold may deliver windfall gains at a high cost to revenue. The risk of windfall benefits is particularly acute in the case of voluntary registrants. By definition, these enterprises were willing to be part of the full VAT system, but as a result of the transitioning regime, they will retain a portion of the output tax that they collect.

It remains to be seen if transitioning regimes to reduce bunching incentives could yield better results in VAT systems with thresholds that lie between the two examples described. The challenge faced by policy makers is to determine the level of relief and the withdrawal formula that will achieve an optimal balance between providing incentives that are high enough to encourage transition to a normal VAT system and avoiding excessively high windfall gains to businesses that would make no deliberate effort to remain below the registration threshold.

SIMPLIFICATION REGIMES FOR SMALL BUSINESSES IN THE VAT SYSTEM

Both small businesses facing VAT compliance costs and VAT designers recognize the unfairness of the disproportionate compliance costs faced by the sector compared to the burden borne by large businesses. The response has been the adoption of a number of “simplification” systems designed to reduce the cost of compliance for small businesses that have moved into the VAT system. These regimes can operate in conjunction with a VAT threshold, applying to businesses in a defined band above the threshold; or, in the absence of a threshold, they can apply to all businesses with turnovers below the level at which it is agreed the unfairness has largely dissipated. Simplified regimes may have an impact on the optimal registration level if they operate in conjunction with a registration threshold. The optimal threshold balances revenue against compliance and administrative costs. The reduction of compliance costs for businesses with turnovers at the lower end of the VAT system in theory makes it possible to use a lower threshold while still balancing compliance costs and revenue. However, any reduction would be limited, and perhaps negated, by the increased administrative costs that would follow if more enterprises entered the VAT system. Even if the goal of reduced costs from simplified rules is not achieved, the professed outcome may provide a rationale for a lower threshold if policy makers seek to tip the balance in favour of increased revenue.

Simplified regimes or methods that are commonly used to reduce compliance costs borne by small businesses fall into three groups:

82 *Ibid.*, at 91.

1. less frequent filing and payments;
2. optional cash- or payment-basis accounting (as opposed to accrual-basis accounting); and
3. presumptive regimes for small businesses that approximate the VAT that would otherwise be paid under the normal VAT system.

Many countries use more than one of these regimes. For example, the United Kingdom uses all three regimes, while Canada uses two of the three—less frequent filing and payments, and a presumptive regime (known as quick method GST/HST accounting). A cross-country comparison of the regimes adopted in OECD and Group of Twenty (G20) countries is presented in table 3. Each type of regime is described in more detail in the text that follows.

Less Frequent Filing and Payments

Many countries allow small businesses to file and remit less frequently than larger counterparts, often coupling the small business rules with a more frequent filing requirement for very large enterprises. The filing (and payment) periods available vary from jurisdiction to jurisdiction. The United Kingdom, Canada, and Australia use monthly, quarterly, and annual filing. The assumption that less frequent filing could significantly reduce compliance costs⁸³ may, however, be exaggerated. Return filing often accounts for a small proportion of compliance costs. A study of compliance costs in Canada shows that the actual completion of the return accounts for only 4 percent of the total labour effort on compliance, indicating that small businesses allocate very little time to return-filing activities.⁸⁴ The costs of filing returns may have been largely reduced, moreover, by the availability of online filing services. The larger costs are incurred in the process of identifying inputs and outputs to be inserted into the return, and this task requires a fixed amount of time and effort regardless of the frequency of return filing. It is likely that the total compliance costs remain relatively constant whether returns are filed once or four times a year.

In a worst-case scenario, less frequent filing may actually be counterproductive in terms of its simplification goals. In the United Kingdom, for example, quarterly filing is the standard option for small and medium-sized businesses (defined by turnover ranges), while small businesses below an annual filing turnover level can elect to file annually. Evidence suggests that in some cases annual return filing raised compliance costs because the single filing prompted poorer record keeping, leaving businesses struggling to assemble records required to complete one return covering a full year of transactions.⁸⁵ As a result, many small businesses that joined

83 OECD, *supra* note 28, at 124.

84 Plamondon & Associates, *supra* note 14, at 46-47.

85 United Kingdom, Office of Tax Simplification, *Review of Value Added Tax: Progress Report and Call for Evidence* (London: Office of Tax Simplification, February 2017), at 14.

TABLE 3 VAT Simplification Measures for Small and Medium-Sized Enterprises in OECD and G20 Countries, 2015

	Calculation of VAT/GST liability			Accounting, payment, filing		
	Exemption thresholds	Presumptive tax schemes	Simplified input tax credit calculation schemes	Cash accounting	Reduced frequency of filing	Other
Argentina		✓				✓
Australia	✓		✓	✓	✓	✓
Austria	✓		✓	✓	✓	✓
Belgium	✓	✓			✓	✓
Brazil		✓		✓	✓	✓
Canada	✓	✓	✓		✓	✓
Chile		✓			✓	
China					✓	✓
Czech Republic	✓				✓	
Denmark	✓				✓	
Estonia	✓			✓		
Finland	✓				✓	
France		✓			✓	✓
Germany	✓		✓	✓		
Greece	✓	✓		✓		✓
Hungary	✓			✓	✓	✓
Iceland	✓					
India						
Ireland	✓			✓	✓	
Italy	✓			✓	✓	✓
Japan	✓		✓			
Korea	✓	✓				✓
Luxembourg	✓			✓	✓	✓
Mexico		✓		✓	✓	✓
Netherlands	✓					✓
New Zealand	✓			✓	✓	
Norway	✓				✓	
Poland	✓			✓	✓	✓
Portugal	✓			✓	✓	✓
Slovak Republic	✓					
Slovenia	✓			✓		
South Africa	✓			✓	✓	✓
Spain		✓			✓	✓
Sweden	✓			✓	✓	
Switzerland	✓	✓			✓	✓
Turkey						✓
United Kingdom	✓	✓		✓	✓	✓
United States						

GST = goods and services tax; VAT = value-added tax.

Source: Based on data extracted from Organisation for Economic Co-operation and Development, *Taxation of SMEs in OECD and G20 Countries* (Paris: OECD, 2015) and updated and corrected by the author.

the annual accounting scheme later moved back to standard quarterly returns.⁸⁶ In fact, although over 90 percent of the total registrants in 2016-17 had turnovers eligible for annual accounting, less than 1 percent of all registered taxpayers had elected to join the scheme.⁸⁷

An alternative rationale for using less frequent filing is to reduce administrative costs. With a view to reducing the total number of returns handled by the tax authority,⁸⁸ the Canadian law was amended to provide a default annual reporting period for small businesses below a specified turnover level, effective beginning in 1994, with the option to elect to use other reporting periods. The assignment of annual reporting as the default option may have contributed to the relatively high takeup rate of this option. By 2003-4, 36 percent of small businesses below the annual filing threshold were annual filers.⁸⁹ The significant difference in the takeup rates of the annual accounting option in the United Kingdom and Canada may be attributable to the way in which the option is made available—that is, whether the default is a standard filing period with an opt-in to annual filing or the default is annual filing with an opt-out to other filing periods. Thus, the UK approach could be used by countries that are concerned about compliance costs, whereas the Canadian approach could be followed by countries that are concerned about administrative costs. However, the overall benefits of the less frequent filing option are uncertain given its potential to increase compliance costs and discourage good business management.

For small businesses that use less frequent filing, there may be a separate fiscal benefit if tax payments are tied to the filing of returns. Less frequent tax payments may provide a small cash flow benefit to qualifying taxpayers that could be seen as compensation for the relatively higher compliance costs faced by small businesses.⁹⁰ There has been concern, however, that small businesses tend to have difficulties in meeting deferred payment obligations associated with less frequent filing.⁹¹ A compromise solution is to allow optional less frequent filing but to require qualifying small businesses to make estimated advance payments with the same frequency as is required for other businesses.⁹² The annual accounting scheme in the United Kingdom is an example of this approach.⁹³

86 Ibid.

87 HM Revenue & Customs, *supra* note 29, at section 2.11.

88 Salvail, *supra* note 18.

89 Canada Revenue Agency, *supra* note 28, at table 2.

90 OECD, *supra* note 72, at 112; and Cedric Sandford, “The Administrative and Compliance Costs of the United Kingdom’s Value-Added Tax” (1990) 38:1 *Canadian Tax Journal* 1-20.

91 Alan A. Tait, *Value Added Tax: International Practice and Problems* (Washington, DC: International Monetary Fund, 1988), at 138-39.

92 Turnier, *supra* note 75, at 984.

93 For details, see United Kingdom, “VAT Annual Accounting Scheme” (www.gov.uk/vat-annual-accounting-scheme/overview).

Cash Accounting

VAT systems are generally accrual based, meaning that the VAT is paid (or deducted) when invoices are issued (or received). In many countries, small businesses have the option to use a cash accounting method, accounting for VAT on the basis of payments received or made. While cash accounting is often advocated as a means of reducing compliance costs,⁹⁴ the overriding purpose is more likely to provide cash flow benefits to eligible businesses. In particular, businesses that collect the payments from their customers long after the invoices are issued may benefit greatly, since the output tax is not due until payments are received. Cash accounting thus avoids VAT being paid on bad debts.

The common practice in most countries is to set a threshold based on turnover, with businesses below the threshold being eligible to use cash accounting. Businesses with turnovers above that threshold should account for VAT on an accrual basis. Concurrent cash and accrual accounting, however, creates a timing mismatch between input tax deduction and output tax liability when a cash-basis supplier makes a supply to an accrual-basis purchaser.⁹⁵ The accrual-basis purchaser claims an immediate input credit while the cash-basis seller may defer the payment for a significant period of time or even indefinitely. New Zealand and Australia had the experience that some related cash- and accrual-basis taxpayers aggressively exploited the timing mismatches to obtain what were effectively interest-free loans from the government.⁹⁶ The schemes were considered avoidance arrangements and were attacked by tax authorities using general anti-avoidance rules (GAARs). New Zealand also subsequently adopted a specific anti-avoidance rule (SAAR) to address the problem.⁹⁷ In the United Kingdom, where the GAAR does not apply to the VAT, a SAAR was used to target these schemes.⁹⁸ New Zealand's experience shows that inadequately designed SAARs may limit avoidance schemes but do not eliminate them.⁹⁹ It is quite possible that the cases uncovered by the Australian and NZ authorities

94 OECD, *supra* note 72, at 110.

95 New Zealand Inland Revenue and New Zealand Treasury, *Options for Strengthening GST Neutrality in Business-to-Business Transactions* (Wellington: New Zealand Inland Revenue, Policy Advice Division, June 2008), at 29.

96 See, for example, *Cb'elle Properties (NZ) Limited v. Commissioner of Inland Revenue*, [2007] NZSC 73; *Education Administration Ltd. v. Commissioner of Inland Revenue*, [2010] NZHC 663; and *VCE and Commissioner of Taxation*, [2006] AATA 821.

97 New Zealand, Goods and Services Tax Act 1985, section 19D.

98 Value Added Tax Regulations 1995, regulations 58(e) and (f). For an analysis of the Australian, New Zealand, and UK approaches, see Yige Zu and Richard Krever, "GST Cash and Accrual Mismatches: Avoiding the Avoidance" (2017) 46:4 *Australian Tax Review* 271-83.

99 In *Case X25*, [2006] 22 NZTC 12,303 (TRA), the parties avoided a SAAR by structuring the transaction to fall just below the trigger threshold for the SAAR. The tax authority ultimately prevailed applying the GAAR.

represent only the tip of a cash-accrual mismatch abuse iceberg. The problem is avoided in the first place in countries such as Canada where the GST law does not provide the cash accounting option.

Presumptive Input Tax Entitlement Regimes

Presumptive input tax entitlement regimes seek to simplify the calculation of VAT liability by removing the need to record and total input tax on all acquisitions and instead allowing qualifying persons to substitute a single presumptive input tax entitlement. Under presumptive regimes, small businesses charge VAT at regular rates on all taxable supplies of goods and services. A single flat rate is then applied to the total (VAT-inclusive) turnover to determine the amount of tax to be remitted to the tax authority. This amount is a proxy for the amount of net VAT that the enterprise would have remitted after deducting actual input tax credits from output tax in the ordinary VAT system. Importantly, registered customers of persons using the presumptive input tax entitlement system are entitled to full input tax credits, since they have been charged full VAT on their acquisitions. The presumptive input tax calculation regimes do not affect the amount of VAT imposed on supplies and charged to customers. Their only role is to determine the amount of net VAT remitted by qualifying small businesses while obviating the requirements that the businesses track and then total the VAT included in the price of every acquisition.

The presumptive input tax entitlement may vary across industries or sectors, and may reflect both the average costs incurred by enterprises in a sector and the extent to which acquisitions within the sector are likely to be exempt, zero-rated, or reduced-rate supplies.¹⁰⁰ In addition to the presumptive input tax credit entitlement provided through retention of a proportion of output tax collected, further explicit input tax credits are allowed for acquisitions of capital assets. Notable examples of such presumptive schemes include the flat rate scheme (FRS) in the United Kingdom and the quick method of GST/HST accounting in Canada. Both are optional for registered businesses below a specified turnover.

An inherent problem in any presumptive regime that determines net VAT to be remitted by the use of a single flat rate applied to turnover is inaccuracy in specific cases. The input tax credits notionally incorporated into the flat rate are based on averages that are by definition not accurate for most individual traders. The finer the group used to determine an average, the more accurate the calculation will be in theory. However, the finer the group, the greater the number of boundary problems that are created. For example, seeking to mitigate the presumed input tax inaccuracy problem, the United Kingdom has calculated different presumptive rates ranging from 4 percent to 14.5 percent for 54 categories of industries. The proliferation of categories creates a new level of complexity for businesses that must determine

100 OECD, *supra* note 72, at 107.

which type of business activity they conduct when registering¹⁰¹ and a new set of policing problems for the tax authority.¹⁰² Successful challenges to the UK tax authority's guidance and decisions illustrate the difficulty that revenue officials have in applying the law.¹⁰³

Enterprises with higher than average inputs that believe that they will be unable to recover fully all input taxes under the industry-by-industry flat rate scheme can simply not opt to join the scheme. In 2016-17, only 25 percent of the taxpayers eligible to join the UK scheme were actually in it.¹⁰⁴ Deciding whether or not to opt in is not a cost-free exercise. Eligible businesses will regularly incur internal and external costs to estimate VAT liabilities under both the FRS and the normal VAT regime before making the decision.¹⁰⁵ At the same time, the flat rate will provide a tax advantage to businesses in each group that have lower than average input purchases. The additional compliance costs incurred by businesses to determine whether the "simplified" scheme prejudices or enhances their recovery of input tax clearly offset some of the simplification benefits that the FRS is expected to achieve.

The FRS therefore functions in practice as a concessional scheme for some businesses rather than a simplification scheme as intended. The main purpose for many of these businesses to enter the scheme is actually to reduce their tax liabilities. Subsequent to the adoption of FRS, the UK government ascertained that about 30 percent of the businesses that used the scheme enjoyed substantial cash advantages relative to the position that they would have faced under the ordinary VAT regime.¹⁰⁶ The government viewed this outcome as an abuse of the FRS and consequently introduced a new remittance rate to remove the benefit from service providers with presumed limited input costs.¹⁰⁷ A new 16.5 percent rate then applies to "limited cost traders" whose expenditure on goods is less than 2 percent of their

101 KPMG LLP, *Administrative Burdens—HMRC Measurement Project: Report by Tax Area Part 27: Value Added Tax* (London: KPMG, March 2006).

102 James Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James M. Poterba, *Tax by Design: The Mirrlees Review* (Oxford: Oxford University Press, 2011).

103 See, for example, *Idess Ltd. v. Revenue & Customs*, [2014] UKFTT 511 (TC); *SLL Subsea Engineering Ltd. v. Revenue & Customs*, [2015] UKFTT 43 (TC); and *JJK Engineering Ltd. v. Revenue and Customs*, [2016] UKFTT 615 (TC).

104 HM Revenue & Customs, *supra* note 29, at section 2.10.

105 KPMG, *supra* note 101, at 24.

106 United Kingdom, HM Revenue & Customs, "Explanatory Memorandum to the Value Added Tax (Amendment) Regulations 2017," 2017 no. 295 (www.legislation.gov.uk/ukxi/2017/295/memorandum/contents).

107 United Kingdom, HM Revenue & Customs, "Tackling Aggressive Abuse of the VAT Flat Rate Scheme—Technical Note," December 5, 2016 (www.gov.uk/government/publications/tackling-aggressive-abuse-of-the-vat-flat-rate-scheme-technical-note/tackling-aggressive-abuse-of-the-vat-flat-rate-scheme-technical-note).

turnover. The limited cost trader test adds further complexity for businesses that genuinely use the scheme to save compliance costs, since it requires businesses to separate records of purchases of goods and services, a distinction that does not readily exist in a modern economy. Moreover, the test can be easily avoided by those that use the scheme “abusively” to achieve tax savings.¹⁰⁸ For example, a firm primarily supplying services may be able to enjoy a fiscal benefit if it engages in a subsidiary activity of buying goods and selling them at a loss.¹⁰⁹ The UK experience shows that specific anti-avoidance measures may have limited value in preventing businesses from benefiting from a system that is presumptive in essence. At worst, the measures may induce unproductive and inefficient business responses.

The initial design of the Canadian quick method may have avoided some of the problems experienced in the United Kingdom. Instead of calculating dozens of industry-specific rates, Canada has only two sets of rates, distinguishing between businesses that purchase goods for resale and businesses that provide services, with the former being allowed a higher notional input tax credit by way of a greater retention of output tax.¹¹⁰ The Canadian system thus avoids much of the complexity found in the UK system as a result of the need to identify each business’s specific industry category. However, a sharp distinction between businesses that primarily sell goods and those that primarily provide services may induce inefficient behaviour by enterprises operating near the margin, a risk noted in the United Kingdom. While the Canadian system may prevent excessive windfall benefits for pure service providers, with its broad sweep approach across all industries this system has much more scope for inaccuracy in respect of any given enterprise within each rate category.

The number of rates, to a degree, reflects a government’s perception of the balance between neutrality and simplicity. The quest for greater accuracy in, and less abuse of, the presumptive regime in the United Kingdom, for example, has had an impact on its effectiveness as a simplification system. Cost savings from the UK FRS were initially estimated to average £750 per business,¹¹¹ but a later evaluation estimated average compliance cost savings to be only £45.¹¹² Potential savings are

108 Office of Tax Simplification, *supra* note 85, at 11.

109 Neil Warren, “VAT: Limited Cost Trader Category for FRS Users,” December 20, 2016 (www.accountingweb.co.uk/tax/hmrc-policy/vat-limited-cost-trader-category-for-frs-users).

110 A further mandatory regime applies to charities that allows them to retain 40 percent of the GST/HST they collect in lieu of input tax credits.

111 United Kingdom, HM Customs and Excise, *Easing the Impact of VAT: Consultation on a Flat Rate Scheme for Small Firms: HM Customs and Excise Summary of the Responses to the Consultation Document Issued in June 2001*, Parliament Deposited Paper 02/956 (London: HM Customs and Excise, 2002).

112 United Kingdom, HM Revenue & Customs, “VAT Flat Rate Scheme (FRS): Impact Assessment of Changes to the Flat Rate percentages in January 2010,” December 7, 2009 (www.legislation.gov.uk/ukia/2009/327/pdfs/ukia_20090327_en.pdf).

likely to fall even further with increased computerization of cash registers and accounting systems, which, as noted earlier, have greatly reduced compliance costs.¹¹³ However, these technological changes cannot entirely eliminate the need for simplification schemes. Computerized systems are useful where they can automatically record tax attributes of sales or acquisitions—for example, whether supplies are taxable or exempt, and in the former case whether they are subject to standard, reduced, or zero rates—but they offer no savings where judgments are required, such as the apportionment of input tax credits by businesses that make both taxable and exempt supplies. Simplified regimes will continue to play a cost-reduction role in these cases.¹¹⁴ From a tax policy perspective, the need for simplification regimes in these circumstances arguably reinforces the need to address the underlying complexity of a concession-ridden VAT.

Of the three techniques that have been used—less frequent filing and payments, cash-basis accounting, and presumptive input tax calculations—the first appears to entail the least risk of abuse or inaccurate and inappropriate outcomes. However, the simplification benefits of all three techniques are uncertain. Leaving political considerations aside, it is difficult to pursue so-called simplification regimes as a reform priority. If measures are necessary, less frequent filing and payments seems to be the best candidate of the trio for adoption.

ALTERNATIVE REGIMES FOR SMALL BUSINESSES

As noted, the primary rationale for a threshold is to reduce compliance and administrative costs. Firms with turnovers below the threshold are input-taxed, meaning that they need not remit any tax on sales, but at the same time they are not entitled to claim input tax credits for their acquisitions. Subjecting small businesses to input taxation comes at a small revenue cost to the government but shields the firms almost entirely from compliance costs.

Highest-income countries have universally concluded that a registration threshold with input taxation of enterprises below the threshold is the preferable response to disproportionate compliance and administrative costs associated with very small businesses in a full VAT system, although there is a wide variation in their conclusion on the level of the optimal threshold. Commonly, these jurisdictions also adopt simplified rules for small businesses above the registration threshold. A handful of middle-income countries have instead opted to remove registration thresholds entirely in a bid to extend the revenue base. In some jurisdictions, particularly

113 See also Office of Tax Simplification, *supra* note 85, at 11. The adoption of a simplified regime has been seen as a direct outcome of the compliance challenges faced by small businesses in the period before widespread computerization; see L. Dana, “A Goods and Services Tax (GST) and the Small Business Sector: Some Canadian Reflections” (1993) 52:4 *Australian Journal of Public Administration* 457-64.

114 Office of Tax Simplification, *supra* note 85, at 11.

developing countries, another approach to simplification for small businesses is used, with the registration threshold being replaced by a turnover border that distinguishes larger businesses subject to full VAT and smaller businesses subject to an alternative turnover tax system. The latter is commonly described as a “simplified” VAT system.¹¹⁵

There is no doubt that compared to full VAT, a turnover tax imposed solely on sales without regard to input tax credits is easier from both a tax administration perspective and a taxpayer compliance viewpoint.¹¹⁶ It is equally clear, however, that subjecting small businesses to a turnover tax is not as simple as the alternative of removing the businesses from the VAT system entirely and leaving them subject to input taxation. Not surprisingly, other rationales are offered for the application of so-called simplified regimes to these firms.

A common explanation for the alternative turnover tax is to bring informal businesses into the “formal” economy, but advocates of this view offer no example of formality apart from formally paying higher taxes.¹¹⁷ In theory, tax authorities could pass on details of known enterprises to other authorities responsible for business licences or other attributes of the formal economy; in practice, however, particularly in developing economies, channels for the automatic exchange of data between ministries are limited. It is possible that if appropriate information channels were established, incorporation of small businesses into the formal (taxpaying) economy could provide the government with a better understanding of the overall economy, allowing it to make more informed macroeconomic decisions. Somewhat ironically, many of the jurisdictions that have embraced an alternative turnover tax as a means of reducing informality have a relatively lower administrative capacity than those jurisdictions that exclude enterprises with turnovers below the VAT threshold from tax with the goal of a smaller taxpayer base.

A second explanation for simplified turnover tax regimes for small businesses is to provide these businesses with basic fiscal skills as preparation for compliance should they grow sufficiently to cross the full VAT border.¹¹⁸ The theory is that an introduction to simple turnover accounts can mature into more sophisticated record-keeping skills at a later stage.

While small business turnover tax regimes appear to lack all the fundamental attributes of a VAT, particularly entitlement to input tax credits on acquisitions and the provision of tax invoices on sales, the description of these regimes as simplified quasi-VAT alternatives is not wholly misleading. A single low tax rate imposed on total turnover is notionally similar to the full rate applied to sales reduced by input

115 Examples of jurisdictions with a turnover tax for small businesses that is notionally incorporated into a VAT include China, Ethiopia, and West Bengal in India.

116 Richard M. Bird and Pierre-Pascal Gendron, *The VAT in Developing and Transitional Countries* (Cambridge, UK: Cambridge University Press, 2011), at 29.

117 The weakness of this explanation was noted in Kanbur and Keen, *supra* note 62, at 52.

118 Bird and Gendron, *supra* note 116, at 187.

tax credits on acquisitions. However, the analogy between a turnover tax and an actual VAT is limited. Without tax invoices in hand, registered taxpayers under the normal VAT system who purchase from suppliers in the turnover tax system cannot claim input tax credits, and the turnover tax becomes a cascading non-recognizable cost of acquisition for enterprises in the VAT system. The cascading effect is noticeably higher than that encountered when small businesses are simply left outside the VAT but incur input taxation on acquisitions.

In some ways, the turnover tax applied to small businesses below the registration threshold resembles the presumptive input tax system designed for small businesses above the threshold. Under both regimes, the amount of tax remitted to the tax authority is determined by applying a reduced rate, lower than the standard VAT rate, to gross receipts. In the case of the presumptive input tax, the net remittance is presumed to reflect the application of full tax to sales and full recovery of input tax credits, so that a registered customer will receive a tax invoice evidencing payment of the full VAT. The notional netting of input tax credits against output tax is manifested in a reduced remittance by the supplier to the tax authority, not in the tax paid by customers. In the case of the turnover tax, however, there is no presumption that the final price always includes a full VAT component, and the vendor is not able to issue a tax invoice.

In a revenue-neutral context, a lower-rate turnover tax on small businesses allows a government to raise the threshold at which a higher-rate VAT applies.¹¹⁹ This is because the tax collected by way of a lower-rate turnover tax applied to gross receipts with no recognition of input tax credits is likely to exceed the revenue that would be collected if these enterprises were excluded entirely from the VAT and consequently subject to input taxation. However, the tradeoff comes with an economic cost. To begin with, the non-recoverable turnover tax provides an incentive for self-supply that may result in less specialized and less efficient businesses.¹²⁰ Concern over this outcome was one of the factors prompting members of the predecessor to the European Union to replace their turnover taxes with VAT systems.¹²¹ Equally importantly, the non-creditable feature of the turnover tax and the tax cascading to which this leads put small suppliers subject to the tax at a significant competitive disadvantage relative to enterprises in the full VAT system when selling to registered businesses.

CONCLUSION

Registration thresholds and small business regimes are primarily designed to reduce administrative costs borne by tax authorities and compliance costs that fall on small businesses. Each of these features of VAT systems gives rise to concerns.

119 Ibid., at 120.

120 Richard Krever, "Designing and Drafting VAT Laws for Africa," in Richard Krever, ed., *VAT in Africa* (Pretoria: Pretoria University Law Press, 2008), 9-28, at 10.

121 For example, France, Italy, and the Netherlands. See Henry J. Aaron, ed., *The Value-Added Tax: Lessons from Europe* (Washington, DC: Brookings Institution, 1981).

The registration threshold raises concerns because of the distinction that it creates between small businesses bearing lower tax and compliance burdens and slightly larger firms with higher liabilities and compliance costs. Businesses left outside the full VAT that primarily sell to final consumers will generally enjoy a competitive advantage from the lower tax burden and compliance costs. Those selling to registered enterprises will be disadvantaged, a problem that can be addressed through voluntary registration, albeit with implications for both revenue and administrative costs. These factors will affect the optimal registration threshold, particularly in countries where the voluntary registration rate is high.

These reduced tax burden and compliance costs for unregistered enterprises create incentives for businesses selling primarily to final consumers to stay below the threshold through real output changes or avoidance or evasion activities. Empirical studies clearly reveal business behaviour to bunch below a registration threshold in the jurisdictions in which this research has been conducted. They do not reveal the extent to which the capped turnover that leads to business bunching is attributed to real output changes, avoidance, or evasion—causes that may vary in impact across different jurisdictions depending on the nature of incentives given to small businesses above the threshold, relative compliance costs, and administrative and enforcement capacities.

Views on a possible role for the registration threshold level to address unwanted behavioural responses are ambiguous, with different observers proposing higher or lower thresholds to address the same type of behaviour in some cases. Each recommendation is based on assumptions regarding probable changes to business behaviour, a risky basis for policy development. Balancing the recommendations may thus be impossible, in particular where empirical studies do not provide evidence on the extent of each behaviour. At the same time, it seems that concern over restraint as a cause of bunching may be exaggerated. In the face of uncertainty coupled with the availability of alternative direct policies that can be used to address splitting and underreporting, the best approach for policy makers appears to be to seek a threshold that balances revenue and compliance and administrative costs without regard to bunching behaviour but taking into consideration the impacts of voluntary registration.

A few countries have sought to minimize inefficiencies and distortions caused by a sharp increase in tax liability and compliance costs at the threshold by adopting a graduated phasing-in regime. Experience nevertheless suggests that it is difficult to set the correct incentives to make the regime work effectively while not providing excessive windfall benefits.

Wherever the VAT registration threshold is set, just above the threshold are enterprises relatively smaller than those further up the turnover scale. These smaller businesses face disproportionate compliance costs, prompting the adoption of simplified regimes to reduce those costs. If the simplified regimes truly led to reduced compliance costs, the optimal threshold level balancing costs and revenue might shift, subject to the constraint of greater administrative costs. Even if an actual reduction of costs does not materialize, as appears likely in many instances,

the nominal outcome of a simplified system may provide political cover for adoption of a lower threshold.

Further considerations that may affect the decision to adopt a simplified regime include the risks entailed in simplified systems and questions about their fairness and behavioural consequences. Simplified regimes that allow concurrent cash- and accrual-basis accounting for VAT purposes are vulnerable to avoidance schemes involving cash-basis sellers who may defer tax liability indefinitely while related accrual-basis buyers claim immediate input tax credits. Presumptive regimes intended to remove the need for small businesses to track input tax will approximate the impact of a VAT in respect of only a tiny number of businesses that mimic exactly the characteristics of the models used to calculate the notional input tax entitlement built into the retention formula. For all other eligible businesses, these regimes provide either windfalls or penalties. At the same time, separate presumptions for enterprises that provide different types of supplies may induce businesses to add particular types of supplies to or remove others from their business models.

While higher-income jurisdictions have concluded that input taxation only of smaller businesses below the threshold is the optimal solution to the compliance cost and administrative cost problems, there are some jurisdictions with no registration threshold, where the VAT is extended to all enterprises. A different approach adopted in some middle- and lower-income jurisdictions replaces the registration threshold with an alternative tax border, with a lower-rate turnover tax being imposed on businesses below the full VAT threshold. The turnover tax leads to cascading and consequent competitive disadvantages for many businesses, while encouraging others to adopt less efficient self-supply structures.

VAT thresholds and small business regimes are among the most difficult policy areas in a VAT, presumably because the evidence on the extent of problems associated with them and business responses to attempted solutions is so ambiguous. Subject to this caveat, however, a number of tentative conclusions can be reached. First, the adoption of a registration threshold is the most efficient measure to reduce administrative and compliance costs. A higher threshold with the option of voluntary registration is generally preferable to a lower threshold with concessional or simplified regimes for businesses above the threshold, and input taxation rather than alternative turnover taxation is preferable for enterprises with turnovers below the registration threshold. Second, where simplified rules for small businesses with turnovers above the registration threshold are necessary (for political reasons), the option for less frequent filing, possibly coupled with less frequent payments, is the least harmful concession available. Third, incentive schemes designed to facilitate the transition of small businesses into the VAT appear not to be successful. Distortions and inefficiencies caused by a threshold may have to be seen as a necessary price to be paid for achieving administrative and compliance cost savings, at least before more evidence on the negative effects of a threshold is available.

What are the implications of these conclusions for Canada? Prior to the adoption of the federal GST, most provinces levied retail sales taxes, often with lower thresholds. The shift to GST/HST in selected provinces allowed some small businesses to

reduce their compliance costs and lowered overall administrative costs. In the absence of any adjustments or indexation, the Canadian registration threshold, set in 1991, has fallen in real terms for 16 years, drawing an ever-higher proportion of businesses into the GST net.¹²² This may not be a problem. Over the same period, administrative capacity to collect and enforce the tax has grown, and technological developments have reduced compliance costs, likely softening the impact of more firms entering the formal GST regime. Study of the relative weighting of these issues will help to determine whether the enlargement of the GST net has been appropriate.

This balance must also be considered in light of current concessional regimes for small businesses. In particular, Canada's quick method GST/HST accounting for small businesses may yield more problems than solutions to the compliance cost issue. Winding up the system and at the same time raising the registration threshold to remove more enterprises from the GST could generate similar or greater compliance savings without the current risk of concession abuse.

In terms of the bunching issue, the implications for Canada will turn on empirical data that until now have not been collected. Before a full response can be developed, the distribution of businesses must be investigated to ascertain the extent of bunching and to identify the means used to remain below the registration threshold in Canada. In the absence of evidence of either the extent of or the means used to reduce turnover, simply continuing along the current path may do less harm than changes in response to unknown behaviour. A better approach, however, would be to commence the research required for more reasoned long-term reform.

122 If the real value of the threshold used in 1991 had been adjusted in line with inflation, registration in 2017 would have been required only for businesses with sales revenue of \$47,334 or more.

