VAT focus

Making tax digital for VAT: practical issues

Speed read

The digital revolution is coming to the UK's tax system. Making tax digital for VAT is the first step and is to be introduced with effect from April 2019, with other taxes following in 2020. Entities (including businesses, charities and public bodies) that have taxable turnover in excess of £85,000 will be required to keep their VAT accounting records in a digital format and must submit their VAT returns digitally using functionally compatible software and an application program interface (API). With only 11 months to go, the big question, as ever, is whether UK entities will be ready for this fundamental change.

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A fundamental change is on the horizon, which will bring the UK tax system kicking and screaming into the 21st 'digital' century. In July 2017, HMRC introduced the concept in a policy paper, *Making tax digital*, which set out how it would provide businesses with a modern, streamlined system to keep their tax records and pass information to HMRC.

Making tax digital (MTD) is to be introduced in a number of phases: the first relates to VAT reporting, and is scheduled to be introduced from April 2019. The new system will mean that entities (including businesses, charities and public bodies) with a turnover above the VAT registration threshold (there are few exemptions) will, to a greater or lesser extent, be required to upgrade their accounting systems in order to report their VAT return information using a particular form of digital interface.

The UK is not the first country to contemplate such a change. Brazil, Portugal and Spain have already implemented a number of tax reporting requirements and developed digital solutions to assist tax collection. Many other countries are following suit. For example, from July 2018 B2B transactions in Hungary will have to be reported in real time.

Later phases of MTD will be introduced for all other taxes, with an end goal of 2020. This promises a massive revolution for both tax administration and taxpayer alike and, undoubtedly, there will be teething troubles on the way. HMRC's goal is to be able to access individual taxpayer information at the push of a button, whilst allowing taxpayers to report tax obligations without any manual intervention. MTD is a first step along the long road to full automation and, according to HMRC, there are many benefits. For example, digital links should eliminate commonplace 'cut and paste' errors; taxpayers should have much greater confidence that the reported figures are correct; it should be easier to stay on top of record keeping; and taxpayers and advisors should be able to work together more collaboratively.

The first VAT period affected by MTD will commence on 1 April 2019. At the time of writing, this gives businesses only 11 months to consider and implement any necessary system and accounting changes. No doubt that time will pass very quickly, and businesses must prepare now for these fundamental changes.

Overview

Essentially, two main changes must be introduced: businesses must keep digital VAT accounting records (including a VAT account); and they must be able to submit VAT returns to HMRC through application program interface (API) compatible software.

The Value Added Tax (Amendment) Regulations, SI 2018/261, confirm that, subject to a number of exemptions, digital records must be maintained by taxable persons. In particular, reg 32A requires each taxable person to maintain the information in an electronic format (the electronic account). The information required to be kept includes such things as the taxable person's name and address, the VAT registration number and details of any VAT accounting schemes. In addition, the taxable person must also keep the following information in electronic form:

- for each supply of goods and services made in the VAT period, the time and value of supply and the rate of VAT charged;
- for each supply of goods or services received in the period, the time and value of supply and the total amount of input tax for which credit is allowed;
- for each VAT period, the details currently required to be kept (under reg 32 of the VAT Regulations, SI 1995/2518, to maintain a valid VAT account (i.e. details of adjustments to both the VAT payable and VAT allowable;
- a record of any other adjustments or corrections required under VATA 1994 or the VAT regulations; and
- a breakdown of outputs made in each period to reflect the proportion relating to standard rate, reduced rate, zero-rate, exempt and outside the scope outputs.

This 'electronic' VAT account must be kept and maintained using 'functional compatible software', which must take a form that is approved by HMRC either in a specific or a general direction. The term 'functional compatible software' is defined in reg 3 of the regulations. In simple terms, this means a software program (or set of compatible programs) that includes functions to record and preserve the 'electronic' account and to provide information and VAT returns to HMRC using an API platform. An API platform is the electronic conduit that enables the taxpayer's system to communicate with HMRC's system.

Practical issues

From a practical perspective, creating and maintaining the electronic VAT account should not really be too difficult. Many choices are available for taxpayers looking to 'bolt on' appropriate software solutions to existing accounting packages. Even if VAT return workings are kept in a spreadsheet format, API enabled 'apps', bolt-ons and software solutions are being developed to collate the information and transmit it to HMRC.

Experience so far suggests that the 'electronic' VAT account could be a cause of concern for some organisations, particularly where complex VAT adjustments are being made and many journals are raised. Other issues of concern are the quality of the data contained within the taxpayer's system(s); and how adjustments to the raw data on both the inputs and outputs of the VAT account will be made.

For organisation that only make taxable supplies and are, thus, entitled to recover all input VAT in full, the preparation of the VAT return is a relatively straightforward exercise. In principle, this should continue in a 'digital' environment. However, there exists a huge spectrum of complexity when it comes to adjustments to the basic data. Even the 'simplest' of taxpayers are required to make some adjustments to their VAT account; for example, fuel scale charge calculations, claims for bad debt relief, the correction of errors in previous returns, and the restriction of VAT on particular types of expenditure.

Levels of complexity

Other organisations need to make more complex adjustments, including partial exemption calculations and capital goods scheme adjustments. In a digital reporting environment, they face the difficulties of ascertaining whether the required adjustments to the VAT account are correct. What degree of confidence do they have that the existing accounting system:

- identifies all of the required adjustments; and
- pulls the correct numbers through to the VAT account?

To answer those questions, organisations will need a deep analysis of their VAT accounting systems, the VAT codes used and the accuracy of their VAT adjustments. If not all relevant figures are being picked up by the reporting systems or if there are inconsistencies in how the VAT codes are used, work will be needed to put it right.

The VAT account

The VAT account has been a statutory requirement ever since VAT was introduced in the UK in 1973. In practice, it ought not to be an issue in either a manual or a digital environment. However, in our experience, this is a part of the VAT records that is often either overlooked or, to some extent, 'fudged'. Many organisations have multiple spreadsheets with different adjustments made on different tabs and workbooks.

The VAT account should be a detailed summary showing all of the key input and output adjustments for each VAT return, including the statutory adjustments. Sadly, for organisations with complex VAT return workings, the adjustments are often buried deep inside the working papers and it is not easy to establish an audit trail or the provenance of the numbers. In the new 'digital' era, all adjustments will need to go through the digital VAT account, so it is important for all organisations to identify any existing weaknesses and put them right before going 'live' with MTD.

System security

When the eventual digital link is established between the taxpayer's records and HMRC's platform, what exactly will HMRC be able to see? How secure is your system and is there any risk that data other than that required by the law is transmitted to HMRC (or anywhere else for that matter)? System security checks are advisable and entities should work with IT departments and their software providers to ensure that no more is reported and transmitted than is required.

Consideration should also be given to whether your organisation will choose to submit the VAT account to HMRC on a voluntary basis. HMRC would be entitled to request this information. However, if you choose to submit the VAT account, HMRC will have greater visibility over the adjustments made and may raise fewer enquiries. It may also be helpful for the purposes of maintaining a low risk rating with HMRC.

Once the accuracy of the VAT account and the integrity of the accounting data have been verified, the next step is to consider the API connection. Again, organisations must liaise with their IT departments and software providers. Time will be required to develop the necessary software solutions and to test the systems.

Final thoughts

For the simplest organisations, the transition to MTD should, to all intents and purposes, be relatively straightforward. For more complex organisations with multiple adjustments, systems or registrations, the transition is likely to be a challenge. However, no matter the size or the complexity, all organisations that have to meet the MTD requirements should be looking to implement a MTD readiness plan.

This plan will, undoubtedly, involve additional costs for putting in place and maintaining the software, processes and controls. There will be a hard cost of purchasing functional compatible software or having your existing system upgraded so that it meets all of the MTD requirements, including API. The more complex the organisation, the greater the potential cost and so the higher the budget that will be required. There will be soft costs, too, as staff (both within the finance and IT teams) will need training to understand the new MTD digital environment.

Assuming that there is no slippage in the implementation timetable, MTD will arrive with a bang in little under a year, with the first VAT returns due in 13 months. Whilst HMRC has said it will adopt a soft approach to compliance failures (e.g. not having all digital links in place), it may be best to prepare for the worst and hope for the best.

Organisations should seek to go live in April 2019. Those leaving MTD to the last minute will find themselves in a situation where it is virtually impossible to comply with the legal obligations and that is likely, in the end, to lead to potential compliance problems. As ever, we would urge all businesses to consider their MTD strategy now and not leave it until it is too late.

Organisations can, if they wish, volunteer to take part in a test pilot programme. At the moment the pilot is open to those with fairly simple VAT returns, with the expectation being that the pilot will be widened to more complex organisations during the year.

A new digital era is definitely upon us and MTD for VAT is only the beginning. MTD is to be introduced for all other taxes from 2020 and HMRC has already issued a consultation document on the possible introduction of a VAT 'split payment' system of collecting VAT revenues (a system which collects VAT on transactions in real time by splitting the payment at the point of sale). As technology, artificial intelligence and robotics develop, we are likely to see more use of technology in the world of tax reporting and tax collection. ■

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