Using a simplified VAT scheme could unexpectedly trigger Making Tax Digital for Income Tax compliance

OMB Indirect Tax



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LITRG explores how the way in which turnover is calculated for accounts purposes when a small business uses the VAT flat rate scheme may inadvertently create Making Tax Digital for Income Tax obligations.

The 2024/25 tax year is effectively the ‘base year’ for triggering Making Tax Digital (MTD) for Income Tax compliance from 6 April 2026. It might be helpful to consider how accounts are prepared for self-employed clients with turnover of under £50,000 who are voluntarily registered for VAT, to ensure that they are not unintentionally brought into the MTD for Income Tax net. These clients should of course already be submitting VAT returns in line with the MTD for VAT rules unless they have been granted exemption. There is more on exemptions from MTD below.

For a client who is voluntarily VAT registered and using the Flat Rate Scheme (FRS), their turnover would usually be shown in the accounts inclusive of the associated VAT; and then the FRS VAT due at the appropriate percentage rate would be charged as an expense in the accounts. For example, for someone with sales income from self-employment of £45,000 in 2024/25, using the limited cost trader rate of VAT of 16.5%, the relevant figures in the accounts would be:

Turnover: sales £45,000 + VAT £9,000 = £54,000

Expenses: FRS VAT due £54,0000 x 16.5% = £8,910

In this example, the turnover figure on the short self-employment pages of the 2024/25 self assessment tax return would be £54,000. This exceeds the MTD for Income Tax entry threshold of turnover of £50,000 or more, even though the net income position for this business is £45,090 (i.e. £54,000 - £8,910). HMRC have recently confirmed that this business would need to comply with the MTD for Income Tax rules from 6 April 2026, unless it was granted exemption by HMRC (see below).

It is worth noting that HMRC's Business Income Manual (at BIM31585) suggests that where a trader is using the FRS VAT scheme, their turnover should be shown as the net position, that is sales including VAT less FRS VAT due. This would be £45,090 in the above example and so would mean that the MTD for Income Tax threshold would not be breached.

For voluntarily VAT registered small businesses using the cash basis for accounting purposes (which is the default accounting basis for 2024/25 onwards), guidance on GOV.UK says they can record income and expenses either VAT inclusive or VAT exclusive (see tinyurl.com/2j9f62m7).

Therefore, if the trader chooses to record income as VAT inclusive in their business records, the turnover figure on the self-employment pages of the 2024/25 tax return will be a VAT inclusive amount. This will then give a similar problem as above in that the VAT element of the income itself could tip a self-employed trader over the MTD for Income Tax threshold.

If a business is filing VAT returns under the MTD for VAT rules, it should already be using software for record-keeping. Depending on the software used, it is perhaps unlikely that the accounting will lead to this issue arising. But for those currently using spreadsheets and bridging software, modifications may be needed to the

record-keeping, so the VAT is accounted for separately and the income and expenses are shown net of VAT in the accounts.

With regard to exemption from MTD obligations, if a trader has been granted exemption from MTD for VAT, they should also be automatically entitled to exemption from MTD for Income Tax without having to reapply. Even if a trader is not exempt from MTD for VAT, they might still consider that they meet the criteria to be exempt from MTD for Income Tax and so wish to submit an exemption application to HMRC. The exemption process is still being developed by HMRC but we expect exemption applications to be possible from April 2025, well in advance of the MTD for Income Tax start date of 6 April 2026. There is more information on exemption from MTD for Income Tax on GOV.UK at tinyurl.com/mre5yuk2.

We would be interested to hear from you if you think some of your clients might be brought into MTD for Income Tax as a direct consequence of their VAT accounting.

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