Meaningful VAT reform: the patchwork quilt of tax

Indirect Tax

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If VAT is a simple tax, then why isn’t it easier to fix?

Key Points

What is the issue?
UK VAT has evolved into a highly complex, outdated system that no longer aligns well with the modern economy or policy objectives.

What does it mean to me?
Businesses face growing uncertainty, compliance costs and inconsistent outcomes as VAT struggles to keep pace with innovation, digitalisation and inflation.

What can I take away?
Meaningful VAT reform is needed, but it must balance simplification, revenue

protection and wider economic policy to avoid harmful unintended consequences.

When VAT replaced purchase tax in 1973, following the UK's entry into what was then known as the European Economic Community (the forerunner of the European Union), we were assured that it would be a 'simple' tax. Since then, VAT has grown steadily in importance and now represents a large slice of government revenue. In 2024-25, VAT raised over £171 billion and is forecast to exceed £180 billion in 2025–26. Increased VAT receipts, driven in part by higher inflation, were identified as one of the factors reducing the fiscal deficit and enabling the government to avoid raising income taxes at the Budget.

In addition to raising revenue, VAT also functions as a tool of government social policy. This has always been the case, with exemptions for health and various other services set out in both EU and UK law. This role has, however, been brought into sharp focus by the current Labour government and its decision to tax private education.

Was VAT ever really 'simple'?

Whether VAT can ever truly have been considered a simple tax is debatable. From the outset, it contained a complex web of exemptions and carve outs. Before the UK left the European Union, the implementation of VAT was required to comply with EU principles and interpretations to ensure uniform application across the member states. This framework was further complicated by a series of derogations negotiated historically to 'grandfather' existing UK tax treatments, including zero rating for children's clothing, many food items, house building, books and newspapers.

Although the social policy rationale for many of these reliefs is clear, the UK legal provisions underpinning them were subject to EU 'stand still' provisions, meaning that neither the legislation nor its interpretation could be updated or expanded while the UK remained a member state.

Brexit and the illusion of simplicity

You would be forgiven for assuming that the picture must now be far simpler. However, following the Brexit vote and subsequent legislation – including the EU Withdrawal Act, the Retained EU Law (Revocation and Reform) Act and the Finance Act 2024 s 28 – EU principles of interpretation continue to apply, even though UK VAT law can no longer be quashed or overridden by EU law.

The resulting framework of legislation, case law and legal principles for UK VAT is arguably akin to a piece of software that has been repeatedly patched over time, but which now requires a major upgrade rather than further incremental fixes.

Straining to keep pace with the modern economy

Given this complicated history and legal framework, it is perhaps easier to understand why VAT law has not yet been subject to major reform or simplification. However, the growing disconnect that exists under the status quo between VAT law and many of the goods and services supplied in the modern economy means that change must come – and soon – if the system is to continue to function effectively and to align with broader government policy objectives.

The fractures inherent in the current legal framework are all too often on display:

- Recent disputes have arisen over whether products should be standard-rated or zero-rated for VAT purposes, including chocolate-filled or chocolate-covered biscuits, and whether turmeric shots constitute a food item – a product perhaps not anticipated when the derogation for zero rating of food was formalised in the late 1970s!
- The rise of remote working and digital nomads makes it harder than ever to determine where a business is established or most closely associated with a supply, and therefore the country in which VAT should be charged and accounted for.
- Innovation in combining financial services and the digital world have led to challenges in determining the VAT treatment and place of supply for crypto-currencies, non-fungible tokens and in-game purchases.
- VAT conundrums also arise in relation to the green economy and the drive towards net-zero. Questions raised in recent years include whether voluntary carbon and biodiversity net gain credits should be subject to VAT at the standard rate, as well as the extent to which input VAT is deductible on costs

relating to long-term land preservation or remediation commitments.

Any assessment of the current VAT system must also acknowledge the impact of fiscal drag. Although the VAT registration threshold rose to £90,000 in 2024, had it risen in line with inflation it would now exceed £110,000. Many other VAT thresholds have not risen at all. The partial exemption de minimis remains frozen at £625 per calendar month and, while the planned increase to £600,000 is welcome, the £250,000 capital goods scheme threshold – above which input VAT on assets such as property must be adjusted – means that today's taxpayers become subject to greater complexity within the VAT regime much more quickly than in the past.

The case for reform – and the risks

The case for reform and simplification is therefore compelling. However, given how essential VAT is to funding government spending, the challenge lies in reforming the system without unintended consequences or adverse impacts on tax revenues.

Many think tanks and policy specialists favour a radical overhaul of the current UK VAT system, with proposals often centred on:

- significantly reducing the VAT registration threshold; and
- removing most VAT exemptions and zero- or reduced-rating reliefs.

A key argument in favour of reducing the VAT registration threshold – for example, to £40,000 (a level far closer to those seen in many EU member states) – is that it would reduce incentives for small businesses to keep turnover below the current £90,000 threshold. This 'bunching' of businesses is widely viewed as a brake on growth.

While removing barriers to growth is a laudable aim, the reality is far from straightforward. A sharp reduction in the VAT registration threshold would bring many small and micro-businesses within the scope of the VAT system, imposing additional administrative burdens and costs on taxpayers who may lack the knowledge or resources to manage them. The additional VAT revenue raised from these businesses – estimated by the Office of Tax Simplification in 2017 at around £1 billion to £1.5 billion – would be relatively modest given their low levels of turnover. This may not represent good value for money once the additional costs to HMRC of administering the tax for an estimated 400,000 to 600,000 additional

taxpayers are taken into account.

Moreover, the VAT charged on goods and services supplied by these businesses would likely be passed on to consumers, creating an initial inflationary impact. The wider economic impacts must also be considered, including the effect on the ability of small businesses to compete with larger businesses already within the VAT system, and potential knock-on effects for hiring and employment. All of these factors must be carefully weighed and potential mitigations introduced before such a bold step could be taken.

Broadening the base: a delicate balancing act

Broadening the VAT base is the second commonly proposed form for modernising the UK VAT system and one which many professionals support in principle. The challenge, however, is that such a complex landscape of exemptions and other reliefs makes this a delicate exercise – akin to a metaphorical game of Jenga, where removing one block risks destabilising others.

The political challenges are equally significant. Removing reliefs will inevitably be an unpopular move with those losing out, requiring the government to navigate the resulting negative publicity. It will also need careful consideration of how VAT reliefs interact with wider government policy, such as zero-rating for construction services to support government housebuilding targets.

Ironically, however, in the current post-Brexit environment – where the UK government is now able to fundamentally change VAT law – the noisiest and most extensive lobbying has often been for new and additional reliefs, as seen recently in relation to domestic fuel and power, renovation works for existing properties and sunscreen.

Principles for a future VAT system

If future VAT policy design is to be successful, several key considerations should guide its design.

Competitiveness: VAT policy should help to create an attractive environment in which businesses choose to locate and grow. A key consideration would include

lowering the standard rate of VAT if the tax base is significantly broadened. Alternatively, this could involve more targeted measures, such as introducing options to tax financial services where VAT would generally be recoverable by business customers.

Simplification: The existing system and legal framework must be simplified to reduce the complexity in determining the VAT treatment of goods or services. This will be essential if the VAT registration threshold is significantly reduced. Competing and overlapping provisions should also be reviewed and rationalised. The motive driven anti-avoidance *Halifax* principles were safeguarded as part the post-Brexit measures in Finance Act 2024 s 28; however, this sits alongside the 2018 DASVOIT disclosure rules (Disapplication of Anti-avoidance on the Grounds that it is Inconsistent with EU VAT Law), the 2004 and 2005 Regulations dealing with listed and hallmarked schemes, and specific anti-avoidance measures built into the legislation for which no motive test applies.

Cohesive policy making: Existing and future VAT policy must be considered in the context of broader policy objectives and what the government is trying to achieve. If current or proposed VAT legislation or policy positions do not support wider policy intentions, the rationale should be questioned.Recent examples include the welcome announcement that the VAT treatment of land transfers for the construction of social housing will be explored with a view to removing VAT as a potential obstacle to housing policy. Opportunities also exist to reduce friction where tax policy intersects with growth initiatives in in the digital, technology and financial services sectors.

Technology as an enabler: Greater adoption of technology should support more efficient administration of the VAT system for both taxpayers and HMRC, while making better quality data available to HMRC and HMT to underpin future policy decisions. Recent announcements of HMRC’s plans to introduce e-invoicing are a sensible step forward and could act as a catalyst for wider policy change and simplification, including reform of the special VAT accounting schemes or obscure invoicing rules.

Long-term planning and certainty: The UK VAT system is in need of significant modernisation, and this will not be a quick or easy task. Investment in detailed research, consultation and planning is necessary to develop a VAT system that is fit for the future. Taxpayers need certainty to manage their businesses and plan for the future. HMRC’s recent ‘Transformation Roadmap’ provides a useful model – perhaps

VAT policy reform and modernisation would benefit from a dedicated roadmap of its own.

In conclusion

Until this work can be done, the UK will continue to have a patchwork quilt of a VAT system – one that yields many anomalies and the occasional humorous food-related stories but offers precious few (chocolate-covered biscuit) crumbs of certainty for taxpayers. Achieving a modernised framework will require clarity of purpose and a long-term commitment to reform.

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