

**TREASURY COMMITTEE: VAT INQUIRY  
RESPONSE FROM THE NATIONAL HAIRDRESSERS FEDERATION**

**BACKGROUND INFORMATION**

The National Hairdressers' Federation (NHF) is the UK's biggest trade association, representing the owners of over 5000 hair salons, barbershops and beauty salons. The hair and beauty industry generates turnover of more than £7bn per year and across 40,000 salons the sector employs around 270,000 people.

**Micro-businesses**

NHF members are mostly micro-businesses, often family-owned salons, which are typical of the sector where 69% of businesses employ fewer than 5 people and 93% employ fewer than 10 people. Some of the smallest hair and beauty businesses are deliberately operating just under the VAT threshold because they cannot afford a VAT bill of £17,000 as soon as they go over the VAT threshold.

**Labour-intensive service industry**

As a service industry, the highest cost of running a hair or beauty salon or a barbershop is wages. The scope for reclaiming VAT on products is very limited. Any VAT charges therefore have to be passed onto clients. Businesses which do not have to charge VAT therefore have a strong commercial advantage.

**High street**

Hair salons, barbershops and beauty salons are the backbone of the high street, with a strong community presence in all areas of the UK. High street retailers are struggling at present with high business rates and rents, on-line competition, reduced footfall and empty shops. If the high street is to thrive, it is important that high street service industries such as hair and beauty (which cannot be provided online) are supported by government policies. Without that support, the high street risks further decline with salons and barbershops closing in favour of informal 'pop up' locations, or working from home or on a mobile, freelance basis - which can only further decrease VAT revenue.

**Self-employment trend**

There is a trend towards self-employment which is growing year on year. In 2017, 57% of people working in hairdressing and barbering and 54% of people working in beauty were classified as self-employed. There are two main kinds of self-employment:

- a) **Chair renting or room renting:** Many salons rent out chairs (chair renting) to self-employed hairdressers or barbers who work in the owner's salon or they rent out rooms or a defined space to beauty therapists. These individuals work in the same salon, often for years at a time, under the salon owner's brand.
- b) **Mobile or freelance:** There are also self-employed mobile and freelance hairdressers and beauty therapists who work from their own homes or travel to a client's home.

The NHF has produced a guide to chair renting, pointing out the pros and cons of employment versus self-employment. We have also produced chair renting / room (or space) renting agreements so salon and barbershop owners and the people they rent chairs or space to are clear on who is responsible for what and how self-employment within the salon works.

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Nevertheless, in our survey 72% of respondents consider that there is unfair competition between salons/barbershops with self-employed workers compared to salons with employees. Similarly, 72% considered that the rules on what counts as 'self-employment' need to be tightened.

*'There is a grey area where rent a chair is concerned, where people are self-employed but not self-employed.'*

We are responding separately to the government consultations on employment status, calling for clarity on which of these should be classified as employees, workers (or 'dependent contractors' as recommended by the Taylor Review) or self-employed.

### **Loss of VAT revenue through self-employment**

The vast majority of self-employed hairdressers, barbers and beauty therapists will be individuals who do not earn enough to reach the VAT threshold. This also applies to self-employed chair/room renters working in a salon rather than freelancing.

Businesses who employ their staff are far more likely to pay VAT as their turnover is for one business. Those having self-employed individuals in their salon are less likely to pay VAT because there are several micro-businesses operating within their salon, each trading under the VAT registration threshold.

This is a continuing source of frustration for businesses using the traditional employment model who see their competitors getting an unfair advantage, not only on VAT but not having to pay minimum wage, holiday pay, sick pay, maternity/paternity leave, pensions means they can charge their clients less.

### **Summary of our view on VAT**

Our preferred solutions, in order of preference, are:

- Reducing the rate of VAT for labour-intensive service industries, as already allowed for within existing EU rules;
- Raising the VAT threshold significantly, for example to £250,000 or £500,000 so all small businesses (including the self-employed) are exempt;
- Introducing tiered rates of VAT once a business crosses the threshold e.g. 10% for turnover of £85,000 to £100,000; 13% for £100,000 to £150,000;
- Change the existing flat rate scheme of VAT;
- Allow labour-intensive service industries to pay VAT at 20% once they reach £85,000 in turnover but only on the portion **above** £85,000, not the full amount;
- Remove the VAT threshold altogether, so everyone pays it (removing the competition between self-employed and employed), but at a significantly reduced rate of VAT eg 5% until they reach an agreed threshold.

### **Survey data**

The data informing our response to this call for evidence is drawn from responses from 379 people, predominantly NHF members, to a survey carried out during April 2018. Text in italics is verbatim responses from survey respondents.

**QUESTION 1: VAT AND THE TAX GAP**

**i. What are the root causes of the UK VAT gap and how might they be addressed?**

Due to the current VAT threshold design, we have identified a trend of self-employment as a way of avoiding VAT registration. In our survey, 70% of salon owners who employ their staff regard those who use self-employed workers as unfair competition because of the significant financial advantages they gain from not employing anyone.

NHF surveys suggest that self-employed workers also prefer not to be employed because they can earn more as deductions such as National Insurance Contributions and pension contributions are not being made from their pay.

Salon owners who employ their staff also suggest, anecdotally, that there is far more scope for self-employed individuals to work 'cash in hand' especially in an environment where there are a lot of low-value, frequent transactions often paid for in cash by clients.

*'Some are dodging paying anything - being paid in cash and not wanting to work more hours because they would lose benefits and avoiding paying VAT.'*

*'Clamp down on cash only businesses like nail bars.'*

In a high-end salon, the average bill is likely to be £100+ which clients will therefore pay for using a card rather than in cash. But cut-price barbershops present a particular challenge because transaction costs are usually low, often under £10.

*'We have had 6 new barbers opening up in the last 12 months. None are VAT registered yet all have taken trade from us because they can charge lower prices so HMRC has lost out. All have signs in the window reading 'cash only'.'*

*'The current loopholes allow for self-employed to escape VAT and salon owners to escape employment responsibilities. The government must be losing millions in lost NICs, PAYE and VAT and the rules are inadvertently encouraging a black market.'*

**ii. Is government policy-making sufficiently responsive when a weakness in the UK VAT regime is identified?**

In our view, recent government policy has been insufficient in addressing weakness in the VAT regime. A key example of this are the changes to the Flat Rate VAT scheme which took effect in April 2017. The changes which increase the flat rate from 13% to 16.5% for limited cost traders have proved counter-productive for NHF members who are running labour-intensive businesses where only a small proportion of expenditure is on products, tools or equipment.

*'I have opted to take up the flat rate system, purely because of the time it takes and it stops me worrying about making a mistake with claiming on invoices in the wrong quarter.'*

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The flat-rate scheme still has the potential to deliver benefits which could help smooth the cliff-edge of VAT registration. However, this would require a partial reversal of the 'limited cost trader' rules. We understand that this category was introduced to prevent an abuse of the flat-rate scheme where VAT-registered businesses were able to charge and collect 20% VAT from customers, but were then only liable to account for a much lower rate to HMRC via the flat-rate scheme.

We understand that this incentivised a large number of businesses to register voluntarily for VAT in order to profit from the scheme. We believe that HMRC's response could be more nuanced and should recognise that VAT is a pure cost for labour-intensive service industries, including salons and barbershops. If the rules were altered to exclude labour-intensive service industries from the definition of 'limited cost traders' the benefits of the scheme could be restored to our members without undermining HMRC's legitimate concerns about the abuse of the scheme by business-to-business suppliers of services.

The flat-rate scheme has the additional benefit of a 1% reduction in the first year of VAT registration which also helps smooth a salon's introduction into VAT.

### **iii. Are there ways in which HMRC's compliance strategy for VAT could be better targeted to close the VAT gap? Could its resources be deployed more effectively?**

We would like to see HMRC having a much stronger local presence for several reasons:

- to provide accessible support for the businesses who are genuinely trying to do the right thing but who need some technical advice from people who understand the complexities of VAT;
- to more accurately target the businesses who are flouting the rules, for example the barbershops referred to earlier (Q1i) which are blatantly displaying 'cash only' signs;
- a more coordinated response with other agencies, for example, immigration to target cut-price barbershops and nail bars as these are also the businesses most likely to be flouting other rules such as illegal workers.

At present, HMRC appear to target the more reputable businesses, penalising employers who have made genuine mistakes, rather than targeting those businesses which are operating outside many legal boundaries. Employers who are at least trying to do the right thing find this very disheartening, and it also leads to a perception that HMRC targets only those businesses which could actually pay fines, leaving the disreputable businesses 'getting away with it'.

The added worry of non-compliance and consequences such as 'naming and shaming' as well as fines is another red tape burden which many salons and barbershop see as yet another reason for abandoning the concept of employing their staff in favour of switching to only having self-employed people working in their businesses.

Measures which would help to rebuild the trust and confidence employers have in HMRC would be welcome. A more personal, localised approach would help, but at present, technological

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solutions such as Making Tax Digital appear to be going in the opposite direction, making HMRC ever more remote and impersonal.

HMRC could also work more effectively with trade associations, such as the NHF, making use of the well-established communication channels which already exist. The NHF has worked collaboratively with HMRC on an awareness-raising campaign to improve compliance with the National Minimum Wage/National Living Wage by identifying the common reasons why employers make mistakes when calculating the right rates.

**iv. Do developments such as the growth of on-line trading or changes in the labour market reflecting modern working practices require a new approach to VAT compliance?**

Please see our detailed response to Q1v below, in particular the growing trend towards self-employment and the competitive disadvantage faced by salons who employ their staff.

**v. Is HMRC's approach to large, medium-sized and small businesses appropriate for the nature of the risk to the VAT element of the tax base that each sector poses?**

It is our view that HMRC has not appreciated the trend towards self-employment as means of circumventing the VAT threshold, in its approach to small businesses.

Hair salons, beauty salons and barbershops are mostly micro-businesses, often family-owned. 69% of businesses employ fewer than 5 people and 93% employ fewer than 10 people. As there are so many micro-businesses in the sector, it is not surprising that many have turnover where the financial consequences of crossing the VAT threshold is a real concern.

The table below is taken from the Office for National Statistics and shows turnover for 41,450 hair and beauty businesses which were registered for VAT or PAYE in 2017:

Turnover	Number	%
Up to £49,000	12,775	31%
£50,000 to £99,000	15,000	36%
£100,000 to £249,000	11,105	27%
£250,000 to £499,000	1,790	4%
£500,000 to £999,000	540	1%
£1m to £2m	150	0.3%
£2m to £5m	60	Negligible
£5m to £10m	15	Negligible
£10m to £50m	10	Negligible
£50m+	0	Negligible
<b>TOTAL BUSINESSES</b>	<b>41,450</b>	

While the ONS statistics do not allow us to look at the number of businesses below £85,000, they clearly show that over a third of hair and beauty businesses are close to the VAT threshold.

In addition, hairdressing, barbering and beauty are service industries where wages make up by far the highest proportion of their costs. The scope for reclaiming VAT on products is very

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limited. Any VAT charges therefore have to be passed onto clients. Businesses which do not have to charge VAT therefore have a strong commercial advantage.

Businesses with employed staff are more likely to reach the threshold because they are counted as one business. Businesses who have self-employed individuals working within their salon or barbershop are much less likely to reach the VAT threshold because each self-employed person is running their own business and their individual earnings are therefore unlikely to reach the VAT threshold (but if viewed collectively the salon or barbershop's turnover would easily cross the VAT registration threshold).

The VAT threshold is considerably higher than the UK average earnings for all sectors (around £30,000) and significantly higher than average earnings within the hairdressing, barbering and beauty industries (which have the highest proportion of workers on minimum wages, according to the Low Pay Commission).

- vi. **In what ways is the tax base in the UK vulnerable to exploitation by those determined to circumvent VAT rules, push boundaries or develop aggressive VAT planning arrangements? How might either the law or HMRC's processes and procedures be improved to reduce that vulnerability?**

Please see our detailed response to the previous question, in particular the growing trend towards self-employment and the competitive disadvantage faced by salons who employ their staff.

In order to tackle the vulnerability of the VAT regime, we believe that only by raising the VAT threshold significantly for all businesses (eg to £250,000 to £500,000) or reducing it significantly for all businesses would resolve the 'level playing field' issues. 'Bunching' just under the VAT threshold could be relieved by having tiered rates of VAT once a business reaches the threshold, or by charging VAT only on the portion of income above £85,000, thereby removing the immediate and powerful disincentive of a £17,000 VAT bill.

### **QUESTION 2: VAT AND BREXIT**

We welcome the flexibility which already exists within the EU to charge VAT at different rates for certain sectors. Hairdressing is one of those sectors and several EU member states already have lower rates of VAT (the Republic of Ireland (9%), the Netherlands (6%), Poland (8%), Finland (10%), Luxembourg (8%).

A move to follow suit in the UK by having a lower VAT rate for labour-intensive service industries such as hairdressing, barbering and beauty is the NHF's preferred option. 78% of our survey respondents said this 'would help a lot'.

This would also incentivise salons to employ people directly as VAT would be less of a burden and would therefore be in a better position to provide the whole raft of rights that employees have under UK and European law.

As hairdressing, barbering and beauty businesses are based in the UK and trade only within the UK, other measures contained within the EU's proposal on the administration of VAT for SMEs

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would not be of great benefit, for example, a cross-EU threshold for businesses which trade with other European countries.

### QUESTION 3: VAT AND BUSINESS

- i. **What aspects of VAT (either process or design) cause the biggest problems for businesses? How might they be improved?**

In our view, the administration process has proved far less challenging than the current design of the VAT registration threshold. The main challenge is that as soon as a business crosses the VAT threshold by even £1, they then face a VAT bill of £17,000. A business needs to grow very rapidly to build up turnover to the point where they can afford to pay a bill of this size.

*'I was previously VAT registered. It's a headache and seriously affects cashflow. You have to fly over the threshold so your business succeeds. You're in trouble if you stumble over it.'*

*'When you make the horrendous mistake of being over the threshold and don't realise until you have to pay that back and start charging VAT it's crippling to a small business.'*

While staying under the VAT threshold has an immediate advantage of saving £17,000, in the longer term a salon operating on this level of turnover is unlikely to be profitable.

From our survey responses, there was clear consensus that the 'cliff edge' nature of the VAT threshold was the most important issue to address, far more so than the administration involved.

Our preferred solutions, in order of preference, are:

- Reducing the rate of VAT for labour-intensive service industries, as already allowed for within existing EU rules
- Raising the VAT threshold significantly, for example to £250,000 or £500,000 so all small businesses (including the self-employed) are exempt;
- Introducing tiered rates of VAT once a business crosses the threshold, for example 10% for turnover of £85,000 to £100,000; 15% for £100,000 to £150,000;
- Change the existing flat rate scheme of VAT;
- Allow labour-intensive service industries to pay VAT at 20% once they reach £85,000 in turnover but only on the portion above £85,000, not the full amount;
- Remove the VAT threshold altogether, so everyone pays it (removing the competition between self-employed and employed), but at a significantly reduced rate of VAT e.g 5% until they reach an agreed threshold.

Some salons and barbershops are keen for the threshold to be scrapped altogether, to ensure that all businesses register and charge VAT regardless of size. This is seen as a realistic solution to the problem of unfair competition between salons who employ their staff and salons using self-employed people. However, if the VAT threshold was scrapped, the rate of VAT should be reduced significantly for everyone, for example to 5%, at least until they reach an agreed threshold.

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Other suggestions included increasing the threshold significantly, for example to £500,000 (a proposal which was included in the OTS review). Again, as the median turnover for salons is £100k to £250k this would have the effect of removing the competitive advantage currently enjoyed by salons using self-employed workers compared to salons who employ their staff.

- ii. **In 2015-16 over £3.5 billion was lost due to mistakes in VAT returns according to HMRC figures? Will Making Tax Digital be sufficient on its own to reduce error and significantly improve the collection of VAT? What other action would help businesses to get their VAT returns right?**

NHF believes that the significant disincentive to register for VAT when they should, due to the current threshold design is a major contributor to the loss in VAT revenues, rather than errors made on VAT returns.

The most time-consuming aspects of the process are:

- Sorting out VAT paid on costs and purchases in the last quarter (28%)
- Checking figures (19%)
- Having to do it so often (17%)
- Comparing VAT charged on sales and VAT paid on costs and purchases to reach the final VAT due figure (17%)

*‘The high volume of small value receipts is time-consuming.’*

*‘Making sure correct VAT input and output, also what is claimable and not.’*

29% of our survey respondents use an accountant or book-keeper to do their VAT returns. Although this means the business owner does not have to be as worried about administration, they still have to provide information and there is still a significant cost to passing this task onto someone else.

*‘It costs me time and money even though my accountant does it.’*

While many salons have salon software to manage appointments, to take payments and provide a range of business reports, around half of all salons are still not computerised. Those with software systems and using accounting packages such as Sage are less likely to struggle with VAT administration. It also helps if the business owner has a good understanding of finance, which is not necessarily common in micro-businesses.

Of the salons and barbershops which don't have an accountant or book-keeper, 23% said 'VAT administration takes up a lot of time and money' while 22% said 'it is manageable but still takes up a significant amount of time and money'

Many salons use HMRC Basic Tools, which we understand are to be withdrawn when Making Tax Digital comes in. Access to MTD-compliant software is likely to increase costs for salon owners who do not have these tools at present. It is therefore difficult to estimate whether new technology and MTD will simplify VAT administration at this point.



- iii. Can disagreements between HMRC and a business about how much VAT is due be resolved quickly and fairly? If not, what are the obstacles and how might they be overcome?

We understand that HMRC has an Alternative Dispute Resolution scheme, but there is a widespread lack of awareness of this option. If ADR is an accessible and efficient way of resolving VAT disputes, then the NHF would like to see the scheme more widely publicised and promoted to small businesses. Currently, the scheme only seems to favour large businesses and organisations in the terms of settlement offered.

It would also be useful to be clear on the circumstances in which ADR can be used. For example, can it be used for any tax dispute including VAT? Can it be used to resolve disputes such as potential underpayments on the National Minimum Wage / National Living Wage?

#### **QUESTION 4: VAT AND GOOD TAX POLICY**

As set out in our responses above the current cliff edge is that greatest inhibitor to growing businesses and encouraging competition.

We call on the Government to reduce the VAT rate for labour-intensive industries as we believe it would make a real difference. Alternatively, raising the VAT threshold to £250,000 or £500,000 thus removing small businesses from VAT altogether, including the self-employed, would level the playing field which is currently skewed in favour of businesses who have reduced their cost base by having self-employed people working in their salons or barbershops. Any graduated tiers or reliefs for businesses once they do cross the threshold would also make a difference.

#### **National Hairdressers Federation**

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