



A SIMPLER INCOME TAX FOR THE SMALLEST BUSINESSES: A DISCUSSION PAPER

Comments submitted in October 2011 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales (ICAEW) to HMRC in response to the consultation on a simpler income tax issued by the OTS in July 2011

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper, A simpler income tax for the smallest businesses: a discussion paper, published by the Office of Tax Simplification (OTS) in July 2011 at http://www.hm-treasury.gov.uk/d/ots_tax_for_small_business_discussion_paper.pdf
2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.
3. Information about the Tax Faculty and ICAEW is given below. We have also set out, in the Appendix, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

4. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
5. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
6. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

MAJOR POINTS

7. We support the work of the OTS in their efforts to simplify the income tax system for the smallest businesses. It is important that, whatever proposals are taken forward for further research, apply equally to National Insurance and to tax credits.
8. Even the smallest businesses don't just prepare accounts in order to file their tax returns. They also need to know how much profit they are making and accounts information will enable them to make commercial judgements.
9. We are aware, however, that some very small businesses already use what is in effect a cash basis for their accounts and these are usually accepted by HMRC. It would be better in such cases for a cash basis to become a statutory option so that such businesses do not have difficulties with their tax in future if HMRC later seeks penalties. Accounting for income this way with a few standardised deductions for use of home, telephone, broadband and travel, may indeed save some time.
10. Any special scheme should be voluntary. If the proprietor is willing to keep the necessary records and do some simple calculations, it would be unfair and unreasonable to deny tax relief

for actual business expenses just because the business is small, if its expenses exceed the norm for similar businesses.

11. We note that HMRC has recently been placing considerable emphasis on the need for good record keeping and any proposals made by the OTS should support this.
12. We do not support using non-profit measures as the basis for taxation.
13. Allowing a greater use of flat rate deductions for expenses and private use of assets should be given further consideration.

RESPONSES TO SPECIFIC QUESTIONS

Q1 Do you think that businesses would want to take advantage of a simplified system? If you run a small business, would you be interested, and if so, why? Would you still be interested if you pay more tax as a result?

14. We quite understand the comment made frequently by people running small businesses who have no background in finance that all they really want to do is work at their business and make money. They do not want to waste their time with distractions such as book keeping and paperwork. Clearly in such cases any accounting required should be kept to a minimum, and we support the OTS in its ambition to make this task as simple as possible.
15. The starting point for the current OTS consultation seems to be that 'preparation of accounts is time consuming and complicated'. While this may be true for some businesses, the vast majority of small businesses operate to a simple model and prepare simple accounts. They buy or make things and then sell them, or they sell their own services. Many of the more complicated accounting principles are irrelevant when preparing these accounts.
16. However, businesses don't just prepare accounts in order to file their tax return. They do it so they can know how much profit they are making and to enable them to make commercial judgements. All small businesses operating commercially intend to make a profit.
17. Overall, we suspect that for most businesses, there would be little benefit from the proposals for deregulation. There would be small cost savings at the margins, but a meaningful tool for industry analysis would be lost. HMRC would still need to understand the figures being filed, however they are presented. The consultation document suggests that owners don't need accounts prepared using generally accepted accounting practice (GAAP). This will be true for many, but other users will still need to see figures which conform to a common standard, for example their customers, creditors and other providers of finance.

Cash basis rather than accruals basis

18. In practice some small businesses do indeed use a cash basis and, unofficially, we believe that HMRC accepts such treatment although it looks to be contrary to the law although there may be little practical difference between the two approaches. We agree that it would be better for a cash basis to become a statutory option so that such businesses do not have difficulties with their tax in future if HMRC later seeks penalties.
19. Many freelance workers will also be taxed as small businesses. Those who prepare accounts and pay income tax and NIC as self employed earners, may do so using the cash basis. Accounting for income this way and taxing it on the receipts basis with a few standardised deductions for use of home, telephone, broadband and travel, may indeed save some time, although possibly many of these taxpayers who do not take professional tax advice, do something like this anyway.

20. For businesses which buy and sell or make goods, receipts and invoices will need to be assembled, listed and added up whether the cash or accruals basis is used. Little time will be saved either way.
21. We think that allowing businesses to change the basis on which they are taxed at frequent intervals would be counter productive. Using the cash basis rather than the accruals basis, consistently, will result in approximately the same amount of tax being paid over time.

Standardised deductions

22. If flat rate deductions are permitted, most taxpayers will only choose them if they pay less tax as a result. For very small businesses, small amounts of cash are important so they will want to adopt any method that results in less tax to be paid.
23. Any special scheme should be voluntary. If the proprietor is willing to keep the necessary records and do some simple calculations, it would be unfair and unreasonable to deny tax relief for actual business expenses just because the business is small, if its expenses exceed the norm for similar businesses.
24. We note that HMRC has recently been placing considerable emphasis on the need for good record keeping and any proposals made by the OTS should be consistent with, and support, the need for proper record keeping.
25. We think that allowing businesses to change the basis on which they are taxed, at frequent intervals, would be counter productive.

Q2 Are there any other, better options that have not been set out?

26. One possible alternative would be to offer to micro businesses a non-reversible election to be taxed on accounts profit. The threshold for micro businesses could be the EU threshold or the VAT registration threshold.
27. We would not support using non-profit measures as the basis for taxation and have the following comments on some of the ideas in the consultation.

Using non-profit measures as the basis for the tax charge.

28. A flat rate charge to tax, comparable to the TV licence fee, will mean that highly profitable businesses pay less tax which does not sound right in principle. Loss making businesses would pay the same amount as the highly profitable ones which would lead to accusations that the system is unfair.
29. Turnover is often a very poor indicator of profit. This may not matter if it is an optional method, as those worst hit by the 'simplification' can revert to the normal basis.
30. Indicator based methods for example by reference to the number of tables in restaurants, would be incredibly complicated because you would need a measure for every different type of business. Under such a method, there are many restaurants that would end up paying considerable amounts of tax despite having few customers. Further, there is a considerable difference in income and expenses between a restaurant serving Michelin starred quality food and, say, a café in a disadvantaged area.
31. Depending on what percentage is adopted, using turnover is likely to penalise those with high expenses, such as perhaps good employers who pay their staff more generously. If a single rate is used it also penalises dealers (including retailers) as their running costs are paid out of their gross profit, not their turnover, whereas for service businesses they are paid out of

turnover. If there are a lot of different percentages for different types of business there will be problems classifying businesses, as experienced with the VAT flat rate scheme.

32. Our conclusion is that indicator based methods of taxing profit are likely to be wrong in principle and result in tax charges that bear little or no relation to the underlying economic reality.

Q3 What aspects of preparing accounts and adjusting them for tax purposes take the longest? To what extent would any of the options mentioned in this document make matters simpler and quicker?

33. Analysing bank and cash and agreeing these to the underlying records, primarily relating to income, takes most time.
34. Clearly, if a business didn't need to keep and analyse details of its expenses, then preparing accounts and tax computations would be quicker. However, we have serious concerns about the message this gives to a small business about the need for it to keep control over its costs.
35. Perhaps one of the consultation questions should be to ask how difficult unrepresented taxpayers find it to complete the self employment pages of the tax return and which particular parts.

Q4 When preparing tax returns do you prepare the business income figures in accordance with the rules outlined in paragraph 1.15 i.e. GAAP, tax adjusted? If not, why not?

36. Yes.

Q5 Do you use the following and why (if you are an agent please indicate what proportion of your clients use the following)?

i. Fixed rate (40p up to 2010/11 or 45p for 2011/12) per mile for mileage expenses in a self-employed business.

37. Most businesses below the VAT registration threshold use the fixed rate per mile. The only drawback is that it relies on businesses keeping accurate mileage logs, which some find difficult.

ii. Estimates for certain expenses (it would be helpful to know in which categories of expenses and why, and also how you arrive at the estimated amount claimed).

38. Almost all businesses use some estimates.
39. Use of a standard amount for 'use of home as office' is common. This deduction is estimated based on the standard cost of running the home, apportioned based on square footage or time spent working.

iii. The VAT Flat Rate Scheme.

40. Use of the VAT flat rate scheme is more variable and not helped by potential pitfalls inherent in the scheme. Categorising business activities can be problematic.
41. The VAT Flat Rate Scheme is generally only used where less tax is paid overall.
42. The scheme is used almost exclusively following advice from an accountant as it is unlikely that an inexperienced small business owner would be comfortable operating the rules.

Q6 Would you prefer to use a flat rate deduction (i.e a stated amount e.g. £100) for certain expenses or an amount which is a percentage of turnover? Which categories of expenses

(e.g. travel, subsistence, postage and stationery, goods for resale, telephone) would this work best for? What advantages and disadvantages can you see?

43. If flat rate deductions are permitted, most taxpayers will only choose them if they pay less tax as a result.
44. For very small businesses, even very small amounts of cash saved are important and many will be prepared to do the 'better off' calculations needed to achieve this.
45. Less tax will be collected by the Government in consequence.
46. Any special scheme should be voluntary. If the proprietor is willing to keep the necessary records and do some simple calculations, it would be unfair and unreasonable to deny tax relief for actual business expenses just because the business is small, if its expenses exceed the norm for similar businesses.
47. Flat rate deductions will save record keeping time only if the business owner is happy to risk paying more tax.
48. We note that HMRC has recently been placing considerable emphasis on the need for good record keeping and as noted above any proposals made by the OTS should support this.
49. We think that allowing businesses to change the basis on which they are taxed, at frequent intervals, would be counter productive.
50. It is important that flat rate deductions are adjusted for inflation.
51. Travel, subsistence, home use of telephone and broadband, would all lend themselves to flat rate deductions.

Q7 Where there is private use of an asset (e.g. cars, equipment, home), businesses currently have to prepare detailed calculations to find the business element of an expense. What is your, or your client's, view of the advantages and disadvantages of using a specified flat rate amount and would you, or your client, prefer to use such a rate?

52. A flat rate deduction for private use of many assets would be simpler.
53. However, see above for our comments on using flat rate deductions for revenue expenses. In particular;
 - The business should be able to use actual costs, based on actual usage if it is prepared to keep the necessary records. No business would spend £10,000 on advertising for example, where the tax system will give them deduction for a fixed amount of only £5,000. These should be commercial decisions and not driven by tax.
 - The method adopted for tax deductions should be used consistently.
 - It is important that flat rate deductions are adjusted for inflation.
54. We agree that allowing small expenditure on capital items should be allowed to be written off as an expense. In practice, the annual investment allowance (AIA) allows full tax relief, but strictly, records still need to be kept in case the asset is sold.

Q8 In your view, would the simplifications delivered outweigh the cost of transition and other complexities?

55. Yes

Q9 For the purposes of using a simplified scheme for taxation, at what level do you think it is appropriate to set the threshold for being able to use it and why? And at what level should the business cease to use a scheme? Should this apply the first year after the threshold is reached or the year after that?

56. We suggest that allowing simplification for the smallest businesses which generate turnover below £30,000, and which are already allowed to make a tax return on the '3 line accounts' basis, should be looked at further.

57. The next threshold which could be looked at is the point when a business registers for VAT, either voluntarily or because it has reached the compulsory threshold. This is the point when other business changes need to be made and it would be a suitable time to move from a simplified accounting regime to one which uses GAAP principles.

Q10 When should businesses be permitted to change from the simplified scheme, for example after a period of years and/or on stated events? How many years and which events?

58. We favour using events, such as on VAT registration, rather than a simple time basis.

Q11 If the VAT registration threshold is used to determine whether the simplified scheme can be used, should a rolling 12 month total be used in the same way as for VAT?

59. We suggest that the change should align with the accounts preparation date or the end of the tax year. A rolling basis would be too onerous for a business to operate.

60. Consistency with the VAT threshold would be sensible, but the turnover recognition period needs to be the same for both VAT and this purpose. On that basis, an accounts based rule needs to apply for VAT.

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APPENDIX

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see http://www.icaew.com/~media/Files/Technical/Tax/Tax%20news/TaxGuides/taxguide_towards-a-better-tax-system.ashx)