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(ICAEWREP 84/12)

ICAEW TAX REPRESENTATION

SIMPLER INCOME TAX FOR THE SIMPLEST SMALL BUSINESSES

Comments submitted in June 2012 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales (ICAEW) to HMRC in response to the consultation on simplifying income tax for small businesses issued in March 2012

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A SIMPLER INCOME TAX FOR THE SIMPLEST SMALL BUSINESSES

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper, A simpler income tax for the simplest small businesses, published by HMRC in March 2012 at http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageExcise_RatesCodesTools&propertyType=document&id=HMCE_PROD1_031991

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 are pleased that HMRC is consulting on this issue at an early stage and welcome the opportunity to contribute to discussions. However we are concerned that some policy decisions may have already been taken, particularly since the release of the draft Universal Credit Regulations on 15 June 2012.

8. These regulations clearly reflect some of the detail contained in the paper, A simpler income tax for the simplest small businesses. This rather implies that the decision to implement large parts of this consultation, at least for Universal Credit purposes, have already been taken.

9. We are disappointed that while we have been considering in detail the implications of this consultation paper, the Department for Work and Pensions (DWP) has made proposals to implement similar changes to those proposed in this document in respect of the new Universal Credit. We are particularly disappointed that these proposals, to be made through draft regulations which are not subject to proper scrutiny by Parliament, have received little publicity and their implications will have been missed by many respondents to this consultation.

10. The income tax proposals are aimed at reducing the burdens on small unincorporated businesses. It is essential that all Government departments accept the same basis for drawing

up accounts for small businesses, otherwise there is little point in continuing with this simplification exercise.

11. In judging the proposals of the consultation on a simpler income tax for small businesses, we have measured them against our Ten Tenets for a better tax system – see Appendix. This leaves us in no doubt that while the system has merits for very small, largely cash based businesses, we do not support its use by larger businesses with higher levels of income, as suggested.

12. In relation to this consultation, our key points are as follows:

- We support tax simplification and the work of the Office of Tax Simplification (OTS) and the Administrative Burdens Advisory Board (ABAB).
- We have had a wide variety of member views on this, in particular on the cash basis proposals and the suggested limits.
- We are concerned that cash accounting has the potential to cut across one of the fundamental tenets of taxation, namely horizontal equity across taxpayers; all taxpayers in similar circumstances should be treated the same.
- We were broadly supportive of the proposals originally made by the OTS which suggested a turnover limit for the cash basis of £30,000. The Government's proposed higher turnover limit changes significantly the nature of the OTS's proposal which was to allow very small (usually unrepresented) businesses to adopt the cash basis. We therefore think that the turnover limits for any cash basis proposal should be in line with the recommendations made by the OTS.
- The underlying policy behind this consultation is to identify a worthwhile simplification of the tax system for the smallest businesses, not merely a different option for small business income tax that the sector will need to consider.
- We do not support the use of the cash basis by a business of any size where that business has other than minimal levels of fixed assets, stock, debtors or creditors, nor for growing businesses.
- We consider that those using the cash basis will still need to prepare proper accounts to support mortgage or loan applications.
- We do not support the proposal to force businesses which use the cash basis to prepare accounts to 5 April, nor should any date be made compulsory.
- We do not support the proposal to force businesses which use the cash basis to use fixed rate expense deductions. This should be a choice.
- Sideways loss relief should be allowed.
- The cash basis for barristers arises due to specific problems in that profession and should be the subject of a separate consultation.

13. We are broadly supportive of the proposals to allow a system of fixed rate deductions, but consider that:

- The amounts specified are too low.
- There should be only one rate for using a private car for business, being 45 pence a mile.
- The requirement to keep a record of hours spent using a home for business purposes represents an additional administrative burden, which cuts across the purpose of this proposal.
- The range of activities which qualify as being related to using a home for business is incomplete.
- Overdraft interest incurred wholly and exclusively for business purposes should be an allowable business expense.

UNIVERSAL CREDIT

14. The draft Universal Credit Regulations 2012 (UCR 2012) were published by the DWP on 15 June 2012 and can be found at http://www.dwp.gov.uk/policy/welfare-reform/legislation-and-key-documents/welfare-reform-act-2012/welfare-reform-draft-regulations/. Although these regulations are not specifically being consulted on, the Social Security Advisory Committee has published a call for evidence asking for comments, to which the ICAEW will be responding separately in due course.

15. It appears that the decision to implement the cash basis, at least for Universal Credit (UC) purposes, has already been taken with little, if any publicity, consultation or discussion either with those businesses which will be affected, or with the accounting and tax professions.

16. We support a unified tax system, where common definitions and systems are used as far as possible. This reduces the administrative burden placed on business and is simpler to understand and implement. While we are responding to the proposals for a cash based system for income tax in good faith, it would appear that for UC a cash based system has in effect already been adopted, but with little publicity and little or no consultation.

17. This is very disappointing. This places us in an extremely difficult position in relation to the income tax proposals.

18. UC will be payable to self employed people on a low income as well as to employees.

19. We note that the DWP proposals for UC are similar to, but not the same as, those proposed by HMRC for income tax. Most notably, a self employed person who makes a claim for UC **must** use the cash basis as the basis for the claim: the accruals basis is not an option.

20. We cannot emphasise strongly enough just how surprised and disappointed we are that the UC proposals appear to have been developed separately during the same period that the OTS was consulting and developing proposals for a simpler income tax system for small businesses and, latterly, while HMRC was developing its ideas, without taking care to ensure that the systems would be the same.

21. We note that the Explanatory Memorandum for the SSAC says at para 175:

    HMRC is currently consulting on its proposal to give people who run small businesses (i.e. turnover up to £77,000 a year) the option of reporting their income for income tax purposes on a cash income basis. The proposals below are intended to work effectively as a standalone system, but the book-keeping a Universal Credit claimant who also reports his/her income for income tax has to maintain will be streamlined if the tax system is changed in line with this consultation.

22. We sincerely hope that the measures of income used for income tax and to pay UC will themselves be brought into line, not just the book-keeping.

23. Reg 53, UCR 2012 requires gross profits for each month to be declared by the claimant, and this is required within 7 working days of the end of that month. Gross profits are actual receipts less expenses paid in that period, including amounts spent on utilities, phone and travel costs, including VAT. However, a scale of flat rate deductions must be used instead of the actual costs incurred of using a home for a business or the actual costs of using a car for the business.

24. We note that the flat rate deductions for use of home are at the same rates as those set out in para 9.9. of the simpler income tax consultation. These are based on the number of hours spent on various activities undertaken for the business while at home. There is no mention of

the alternative basis set out in para 9.10. We have commented later in this response on our views of this proposal.

25. The flat rate deduction for using a car or motor cycle is based on the mileage in that assessment period, ie that month. The deduction for mileage covered in the month for a car used for the business would be 45 pence per mile for the first 800 miles and 25 pence per mile thereafter. This will give a different result to the annualised deduction required for income tax, which is 45 pence for the first 10,000 miles and 25 pence thereafter.

26. The regulations, as presently drafted, do not allow any deduction for interest paid. While we have commented on the non deductibility of overdraft interest in the cash basis proposals, we note that other interest will be allowed for income tax but not as a deduction for UC.

27. The UC reporting structure requires a declaration by the claimant within 7 working days of the end of that month. This will be an assessment period, which according to draft Reg 17, will be.

    1. *(1) An assessment period is a period of one calendar month beginning with the first date of entitlement and each subsequent period of one calendar month during which entitlement subsists.*

28. This will be one calendar month from when the claim starts. This means that the small business will be making a return for UC each month, to whatever date within that month they first made their UC claim, using figures that are similar to, but not the same as those used for income tax. If the business uses the cash basis for income tax there will be a similarity, but it won’t be the same, and if accounts are being prepared using accruals accounting, they are even less likely to be the same.

29. Far from offering worthwhile simplification, the UC proposals and their interaction with the proposals in this consultation have the potential to increase considerably the administrative burdens on very small businesses. We are now very concerned that, taken together, these proposals have all the hallmarks of a policy disaster in the making. Both these and the UC proposals need to be reviewed as a matter of urgency.

GENERAL POINTS

30. We continue to advocate tax simplification and to support the work of the Office of Tax Simplification (OTS) and the Administrative Burdens Advisory Board (ABAB). The current consultation is the latest in a series of attempts to simplify tax for the smallest businesses.

31. The proposals are aimed at reducing the burdens on small unincorporated businesses. We support that aim in principle. However, we are concerned that the Government has taken some key aspects of the work of the OTS, in particular the proposed turnover limits for cash accounting, and made further proposals which we believe are fundamentally flawed.

32. The OTS report was published after considerable discussion with the profession and after some detailed research which included interviews with unrepresented small businesses themselves. We believe that most commentators were prepared to accept cash accounting within the turnover limits proposed by the OTS, not least because for many small businesses cash and accruals accounting would produce similar results and any differences would not be material. We believe that was a reasonable position, which for many small businesses probably reflects what already happens in practice, so the proposals would put it on a proper footing.

33. However, the current proposals in effect completely change the basis of the OTS’s proposals and no longer reflect what we believe was the underlying policy aim of the original proposals. This was to make life easier and cheaper for the very smallest businesses and, in particular, to help those businesses that do not have an adviser.

34. Given that the policy purpose appears to have become 'lost in translation', we believe that the proposals as now drafted suffer from fundamental flaws that make them unlikely to achieve worthwhile simplification. Nor are they likely to be attractive to those businesses they are aimed at. In particular, the proposal that businesses opting for the cash basis will have to use fixed rates of deductions for expenses potentially makes this an unattractive proposal.

35. Nevertheless the opportunity to reconsider taxation for small businesses is welcome. However, the consultation document has highlighted that there is a need to rethink the proposals in the light of what we believe is the underlying policy purpose and, in particular, how these proposals fit within the wider growth agenda. We would like to see further drafts, with subsequent consultation and refinement, before any changes are implemented. This is too important to rush and should not be implemented until there is broad consensus for the proposals.

36. There is a view that tax simplification should move towards a unified simpler tax regime for all business, not different sets of rules for businesses of different sizes. We are concerned that tackling one subset of unincorporated business increases complexity in the tax system as a whole. The associated company rules and marginal rates of corporation tax have long caused problems in the corporate regime and we fear that if not properly thought through, these changes will merely add to the existing complications in the UK business tax system. Offering a further optional tax system to small businesses, a system which in itself retains a considerable amount of complication, could conceivably mirror the problems faced by small companies.

37. We are also concerned that failing to produce accounts will leave sole traders and partners running very small businesses with even more difficulties obtaining finance and mortgages than they do already.

Views of our members on cash accounting

38. These proposals are controversial and we would be interested to see the research, other than that recently undertaken by the OTS, indicating that small businesses themselves are asking for change. A significant proportion, around one third, of our members who have sent comments to us, did not agree that the cash basis as described in this consultation should be permitted at all. Most of our members who have expressed views are against the scheme, certainly at the level of turnover suggested in this consultation document. The general view of our members was that if these proposals were to proceed, the turnover limits proposed by the OTS were at about the right level.

39. We contributed to the work of the OTS during the period when it was undertaking the research which informed its proposal that the turnover limit for entering the scheme should be £30,000 and £40,000 for leaving the scheme. We were therefore surprised that in this latest consultation document it is proposed to adopt much higher limits without the backing of similar research.

40. However, although overall our response must recommend a return to the lower limits proposed by the OTS, a number of our members told us that they would actually like the limits increased or even removed altogether, leaving them to prepare accounts for tax purposes that were least burdensome and most suitable for their clients' businesses. One also pointed to the French system for taxing small businesses, which allows tax to be charged on receipts less a fixed deduction to cover all costs. There, small one person businesses such as taxi drivers, stall holders, hairdressers, IT specialists, consultants report their turnover and have a fixed deduction for costs – in France this is 34% of turnover for service businesses and 71% for retail. This is broadly similar to the turnover based tax which was considered, but not taken further, by the OTS.

41. The general view of almost all of our members who commented is that they would welcome having the ability to choose what is best for their clients. One might assume that 'best for

clients' means that which attracts least tax, but this is not the only consideration. Simplicity and reduced paperwork where appropriate, are also significant decision making factors.

42. Cash accounting will reduce the incentive and make it more difficult for business owners to manage their business in Profit and Loss Account terms - turnover, gross margin, overheads and net profit. This means they will be less financially literate when talking with the bank, suppliers and customers. But most importantly they will be less equipped to manage their business. It may also make it more difficult to get credit and win new customers. For businesses with a turnover of up to £30,000, this may be manageable but above this level it will have an impact, particularly if the business aspires to grow significantly.

43. Cash accounting is not a suitable method for generating the accounting information management need to run their business and in many cases proper accounts will also be required by external stakeholders, for example lenders. Nevertheless, many simple businesses only prepare accounts for tax purposes. In these cases cash accounting may be seen by some to be a simpler method of discharging regulatory responsibilities. There are risks to doing so – both in the form of inappropriate business decisions that could be taken on the basis of this information and in the cost of preparing additional information part-way through a year when required by, for example, a lender, but those risks may be less for smaller businesses. However, even in a small business the existence of fixed assets, stock, debtors and creditors is also very important. Size may be an indicator, but size alone is not the only relevant factor.

44. A qualified accountant is well placed to advise a client on whether full accruals based accounts are better for a particular business.

45. Even if the choice of cash or accruals accounting was available for businesses of all sizes, if simplicity alone was the decision tool, our members considered that it would be unusual for the cash basis to be better for their larger business clients.

46. However, for a small business which deals largely in cash and requires little asset management, the difference between taxable profits calculated using accruals and cash accounting methods is unlikely to be material. There are obvious timing differences which could be exploited, but it seems likely that the only businesses which should be using the cash basis are those for which it will make very little difference to the taxable profit. However, this begs the question as to whether there is really much point in pursuing the proposals.

47. In summary, we believe that in extending the recommendation of the OTS, the underlying policy behind these proposals has been lost. The policy aim is for a simpler tax system for the simplest small businesses, in particular those that may not have an adviser. The proposal to increase the turnover limits extends the policy target far beyond this group of businesses, resulting in a fundamental policy conflict.

Property income

48. The consultation has specifically excluded property income which we understand will be subject to a separate consultation in due course. We are surprised at this given that cash accounting is already allowed by HMRC for businesses which have income and expenditure which are received and paid at regular, short intervals and have income below £15,000, see PIM1101 - Use of trading income rules. In our view an extension of this practice to cover all businesses would have formed a reasonable basis for testing the proposals against the wider business population, and could have been implemented at minimal cost to HMRC and businesses.

49. In any event, to have one limit for property income and another for all other businesses makes no policy sense, and small property businesses have an additional problem in accounting under GAAP in that they not only have to adjust for their debtors and creditors, but they must then make a second adjustment for rent accrued. For example, someone whose rent runs from

the usual quarter day of 25th March might issue an invoice on that day which is unpaid by the year end. Not only must the invoice be put into the accounts as a debtor, but then most of the income has to be taken out again as rent in advance. Given this, we see no reason to exclude property businesses from the proposals.

Equity across taxpayers

50. We are concerned that cash accounting has the potential to cut across one of the fundamental tenets of taxation, namely horizontal equity across taxpayers. Put another way, all taxpayers in similar circumstances should be treated the same. The current tax treatment achieves this by taxing the profit of a business in accordance with established accounting principles that reflect the underlying economic performance of a business. The cash basis cuts across this principle and can result in taxpayers being treated unequally. For example, where a proprietor of a small business has cash, it could be used to pay expenses in advance, thereby reducing the immediate tax bill as against a similar business that does not have cash. The precise behavioural effects would be difficult to determine but it does not seem right in principle that a proprietor who has spare cash (perhaps through an inheritance) can gain a tax advantage over a similar business that does not have such a luxury and may be under severe financial pressure.

VAT

51. We note that where a business is using the cash basis and is also registered for VAT, it will be required to also use the VAT cash basis. We consider that it would therefore be reasonable to also add that a business using the cash basis for VAT should be required also to use the cash basis for direct tax purposes. This would have to be subject to the direct tax limit.

RESPONSES TO SPECIFIC QUESTIONS

52. As noted above a significant proportion of our members did not agree with the cash basis as described in this consultation being permitted at all. The rest could see a role for it in simple businesses with few fixed assets, stock, debtors or creditors, which would usually be very small and would often not have an adviser. These are essentially cash based anyway and the taxable income would be similar using either the cash or accruals bases, with little saving in administrative costs. We have explained this in more detail above. Our responses to questions 1 to 11 should therefore be read in the light of this view.

Q1 The Government is considering that to qualify to use the cash basis, a small business' receipts would be less than £77,000 in 2012-13 and would be required to leave the cash basis when their receipts are more than £150,000. Do you think these entry and exit limits are appropriate?

53. No, we do not consider the entry and exit limits of £77,000 and £150,000 respectively to be appropriate.

54. Our members held a wide range of views on what limits should be used. Overall the view was that if these proposals are to be taken forward at all, the appropriate limits should be those proposed by the OTS, namely no greater than £30,000 for entry and £40,000 for exit.

Q2 If you don't think the entry and exit limits above are appropriate, why not?

Complexity of business

55. We do not believe that the cash basis is likely to be appropriate for a business which has more than a negligible amount of stock, debtors, creditors or fixed assets. We are also concerned

that as a business grows it is more likely to have employees, which further complicates its business records.

56. While the level of income is not the only indication of the degree of complexity, it is probable that a business with higher income will have more working capital and / or fixed assets. There is usually a considerable difference between a business which has income of £20,000 or £30,000 and one which has income of £77,000. This is one reason why many banks have a ceiling of £25,000 for personal loans.

57. We note that many small businesses may have a high volume of low value transactions. If these are cash transactions, it may mean a receipts book or till roll is all that is needed to keep track of income. However, even these businesses need financial information if they want to prosper and grow.

58. Shop rental costs mean that businesses need to earn considerable revenue before they make a profit as they expand. At income levels up to around £20,000 they can often operate without premises, but after that they may sign a rental lease. They may then need to consider additional income streams. A women's hairdresser may decide to start cutting men's hair as well or alternatively offer different colouring services. The ratio of time taken to the amount which can be charged may advise this business decision. Many high streets have recently seen the return of barbers shops. Some of these begin by just cutting hair, but others also offer wet shaves. Competition is key to the success of these ventures and profit margins are tight. Good financial record keeping becomes increasingly important to support decision making, even by small businesses.

59. The figures quoted by the OTS in its report, indicate that at the start of 2011, there were around 3.5 million unincorporated businesses in the UK, of which around 2 million had turnover below £20,000 and 2.5 million had turnover below £30,000. This compares with just over 3 million which have turnover below £77,000. With these estimates in mind, it would seem sensible to direct any new scheme to those who genuinely are likely to have the simplest businesses and assess those results before extending the scheme.

Fixed asset purchases

60. Larger businesses with turnover nearing £150,000, are more likely to have significant capital expenditure in excess of the £25,000 annual investment allowance limit. The cash basis proposals will allow an immediate deduction for the full cost of equipment whatever it costs. We wonder if this was considered when this very high limit for being able to remain within the scheme was set. This could be a significant benefit compared to a business using the normal accruals basis.

VAT registration

61. Schedule 1 Value Added Tax Act 1994 requires a business to register for VAT

    'at the end of any month, if the value of his taxable supplies in the period of one year then ending has exceeded £77,000. *Para(1) (a)'*

    Using the cash basis means it is less likely that the business will be keeping financial records to enable it to monitor this, which must be reviewed on a rolling 12 month basis. The cash basis requires cash accounts to be prepared to 5 April. Allowing a business to use the cash basis until its annual income is in excess of the VAT threshold will add complexity to the VAT position.

62. It is well known that for many small businesses, VAT registration is a particularly difficult time for a growing business. Many businesses, unable to pass on the cost of charging VAT to their

clients, may decide to reduce or stop trading for a few weeks. Others may not report some of their income, thereby sliding into tax evasion.

63. If the cash basis does indeed result in a simpler system with a reduced administrative burden, we are concerned that imposing an additional problem at this time will make even more businesses take action to avoid crossing the VAT threshold.

64. The VAT registration limit will presumably continue to change each year. If these rules are tied to the VAT threshold, the cash accounting limit for entry, and presumably for exit, will also need annual review and change. This will add to complexity and administration costs as business owners will not have an opportunity to 'learn' a fixed limit and HMRC publications and software require annual update.

65. Changing the threshold annually will also create more costs for the software industry as it has to make changes to products, including the record keeping applications (Apps) which it is currently being encouraged to develop.

Tax loss/leakage

66. We are very concerned that adoption of the cash basis will increase opportunities for tax planning and the potential for tax loss on Government revenues will be significant. There will be a temptation to defer receipts and accelerate payments around the end of the tax year in order to stay below the VAT registration limit. As noted earlier, the scope for tax planning will depend on the cash resources of a proprietor, but those with considerable cash resources will look to see how tax charges can be minimised by prepaying expenses. It is harder to do where income and associated cash resources are lower.

67. We also note that the terms cash received and paid will need to be defined. Cheque and, credit card receipts and payments will need to be part of this definition. We suggest using the same definition as for the VAT cash accounting scheme.

68. In the first year of the scheme, it is likely that many businesses will aim to defer taxable income by on average one month, or possibly more. As most small businesses eventually cease through winding down to insolvency or retirement, the amount deferred will represent a permanent loss of tax receipts to the exchequer. This will be a considerably smaller sum if the limit for the scheme is lower.

69. We note also that as income increases, it is likely that higher rate taxpayers (40% income tax and also 9% Class 4 NIC) will be affected. At income of £50,000 and above, child benefit begins to be withdrawn. Also higher education grants may be relevant. These all make it considerably worthwhile to keep taxable income lower, more easily achievable using the cash basis through judicious timing of receipts and payments. All in all the scope for tax planning at these income levels will be increased considerably, representing a considerable revenue risk to the exchequer.

Need for accounts for other purposes

70. Accounts are needed for many purposes in addition to tax. For example:

- To assess a business' past performance.
- To plan for the future sustainability and growth of a business.
- To provide assurance that a business has adequate working capital.
- To support bank overdraft and business loan applications.
- To support mortgage applications.

71. When seeking finance above the personal loan limit, usually £25,000, a business will be asked for financial statements to support its credit application. For those using cash accounting, this

will represent an added expense and they may not even know what these statements are, nor where to go to get them prepared. Keeping the limit for using the scheme low, will make this less of a problem.

72. It is notoriously difficult for a self employed person to obtain a mortgage. To do so, they will almost certainly need to produce financial statements, often with an accountants' report.

73. The average house price in the UK is currently around £160,000. Assuming a single purchaser has a 10% deposit, they will need to borrow £144,000. If we assume that this size of mortgage is beyond the reach of a person whose turnover, never mind profit, is £30,000, keeping the limit low, will mean that fewer small businesses need to produce financial statements just to support a mortgage application since at that level they would be less likely to be buying a house.

Harmful to growth

74. The scheme as set out in the current consultation has flaws which could be harmful to businesses as they grow. Encouraging larger businesses to use the scheme as described could actually increase their administrative burden.

75. Although higher limits would give greater flexibility and choice, this is only helpful to a business which understands its own finances. In such cases, producing accounts which follow GAAP principles is not an additional burden since it would anyway need detailed analyses of its stock, debtors, creditors and fixed assets for everyday decision making.

76. Having considered carefully the scheme which is being proposed, we consider that there are a significant number of issues which still need to be resolved. Because of this, we think that at this stage it is inadvisable to proceed with the proposals other than for the very smallest, simplest businesses.

77. Cash accounting is likely to result in poor control and understanding of a business' profitability, and may reduce a business' viability.

78. Potentially, allowing cash accounting increases complexity for growing businesses. Those small businesses that grow beyond the threshold for cash accounting will have to become familiar with a whole new financial accounting discipline and record keeping. As noted above, coinciding with VAT registration will make this worse.

Q3 If you don't think the proposed entry and exit limits above are appropriate, what figures would you suggest instead?

79. Overall, we could support an amended version of the cash basis proposals which had an entry limit of £30,000 and an exit limit of £40,000, in line with the proposals of the OTS.

80. We should record, however, that a number of our members did suggest that the limits might be considerably higher. Some even suggested that it was unnecessary to have any limits at all. We discussed the reasoning for these views further with the groups which had made these suggestions.

81. In their opinion, flexibility for their clients was key to their view on higher limits being acceptable. These members believed that it was unlikely that they would use the cash basis for any client which held much stock, debtors, creditors or fixed assets. However, they might use it for a single person, service business, which had higher income, but few expenses and which could easily have income in excess of £150,000 generated by only a few invoices. This could also apply to those motor traders who operate through such platforms as Ebay, maybe selling one car per week.

82. A business which uses an accountant will be advised to use the basis which is most suitable for its needs. In such cases, flexibility is more important than having a rigid and simple system, but only where the user already has a sound understanding of the business.

83. Unfortunately, flexibility usually means added complexity and will inevitably lead to more businesses doing ‘better off’ calculations. This adds to the administrative burden and does not seem advisable at this time. In short, we do not think that business flexibility, although desirable, is actually reconcilable with the underlying policy purpose of this proposal.

Q4 Should new small businesses be required to make an active choice between the cash basis and the normal rules? Alternatively should the cash basis apply to a new small business by default, unless they indicate otherwise?

84. Para 3.17. We can only support a third option, not suggested by the paper, which is to allow choice, but with normal accounting rules to be the default. We consider that years of development in accounting theory and practice has produced the accounting concepts which are considered best practice today. It would be an ill-considered choice to move away from this, adopting a supposedly simpler solution as the default, which is unproven.

85. We also consider that there should be a choice just as there is with VAT cash accounting. We do not think cash basis for income tax should be automatic when cash accounting for VAT is not (below £77,000).

86. The ‘opt in’ would need to be through, we suggest, a tick box on the tax return. We note that this makes validating use of the scheme retrospective although we do not see a problem with retrospection in this matter.

87. We support the proposal that existing businesses would continue to use the normal tax rules unless they make an active choice to switch to the cash basis.

Q5 Are there any issues or transactions relevant to small businesses eligible to use the cash basis that have not been considered or addressed adequately?

Businesses joining/leaving the scheme

88. We consider that the accounting and tax issues for a business entering the scheme and more importantly perhaps leaving the scheme, have been dealt with too lightly. For example, there could be a significant tax catch up for a business coming out of the simplified scheme which has significant levels of debtors or stock. This needs further consideration and may require some form of spreading provision.

89. We also consider that more consideration is needed regarding the effects of the proposals on business financing.

Sharkey v Wernher 36TC275

90. Para 3.26. In small business cases, the easiest and most pragmatic solution would be to disapply the ‘Sharkey v Wernher’ legislation, s 172B, ITTOIA 2005. The practical problem will be to identify whether business funds or private funds were used to fund the acquisition. If Sharkey v Wernher is ignored, then the cost is simply excluded as private expenditure which is simple and understandable, and avoids having to make estimates of market values. The tax affect will be minimal and we doubt whether unrepresented small businesses adjust for this at all under the current rules.

Interest

91. Para 3.40. One of the most controversial proposals of these proposals is that interest on borrowings would not be an allowable deduction.

92. All businesses need working capital, irrespective of whether or not their stock, debtors and creditors are recorded in the accounts. This working capital has to be funded.

93. Taxing income on a cash basis rather than an accruals basis may lead to profits being taxed later, in which case there is a cost for the exchequer. However, in some cases it could lead to earlier recognition, for example where customers pay cash but stock is bought from suppliers on credit. Depending on the credit terms allowed and the levels of debtors and creditors, not giving any recognition in the tax computation for the cost of funding working capital may be some compensation. However, the two are not connected and we do not consider that using the cash basis should result in the deduction for interest being disallowed. A bank overdraft is often the only source of finance available to a small business.

94. Illustration

In practical terms, consider a builder who needs to buy bricks costing £1,000 on 1 September. He will be paid when the wall is built, say on 1 December. His options are:

- Pay cash now. Cost and taxable deduction £1,000. He will use money in his personal deposit account and so with interest rates at 3% will lose interest income of around £8. Overall cost £1,008.

- Buy from the supplier on extended credit terms. Supplier will charge £1,200 in total. All allowable for tax.

- Borrow from the bank. Bank will charge 20% interest for 3 months on his overdraft, an interest cost of £75, £1,075 in total. However, only £1,000 is allowable for tax.

We do not see any reason to single out overdraft interest as being not allowed for tax.

95. We note also that for most builders, extended credit from building suppliers is increasingly hard to come by and rarely exceeds 30 days. An overdraft or credit card is their only alternative.

96. We have discussed the proposal to disallow overdraft interest with HMRC on a number of occasions. We are told that on the basis of evidence held by HMRC that 85% of sole traders and partnerships, with income below £73,000, claim no interest. This rises to 90% for those with income below £30,000.

97. We believe that these figures are unreliable as most businesses of this size will use the three line accounts option on their tax returns which makes it difficult to access any detail. Nevertheless, if these figures are correct, the cost of allowing interest on bank overdrafts would be negligible compared with the administrative cost of having to make the adjustment and for HMRC to have to check.

98. Accepting that the cost of allowing interest would be negligible, we suggest that the Government should consider whether the proposals are fair. These proposals need not only to be fair, but also be seen to be fair. We do not think it is fair to disallow interest because interest is a legitimate business expense. HMRC's reasoning is flawed as it assumes that interest is always spent on working capital loans, which are self-liquidating in a very short time. We think it is more likely in a micro-business climate to be used in the purchase of fixed assets, where HMRC's rationale does not hold.

99. It will not be seen to be fair because people will expect a genuine business expense to be deductible, and because interest received will always be taxable.

Sideways loss relief

100. Loss of sideways loss relief, particularly in opening years will affect many small businesses.

101. Non availability of sideways loss relief will put many small businesses off using the cash basis.

102. Many good new businesses start off making a loss in the first few years. Third party finance is rarely available and it seems an unnecessary complication to disallow sideways relief. Carrying back a loss suffered in the early years of a new business is a means of obtaining the finance necessary to see a business through its early loss making years.

103. If the income limit for joining the cash basis scheme is restricted as we have suggested above, the risk to the exchequer is minimised, although we accept that avoidance legislation may be required.

Mandatory 5 April year end

104. 31 March or 31 December are much simpler dates for a small business to use to prepare its cash accounts. Perpetuating 5 April is an historical anachronism and is, we feel, unnecessary. We note also that month end is used for bank statements, which ties in with the cash basis principle.

105. Forcing a 5 April year end on seasonal businesses, particularly those dependent on summer trade which buy their stock in April and May, would be particularly onerous.

106. On the requirement for an existing business to change, although it is not mentioned we presume that relief will be given for brought forward overlap profits. Changing a business' accounting date is a complicated calculation for the lay person to understand. Those businesses who do not have a professional adviser will struggle to understand what they have to do and why, resulting in additional calls to HMRC helplines.

Requirement to use fixed rate expense deductions

107. We do not agree with the proposal that businesses should have to adopt 'simplified expenses' just because they are using the cash basis.

108. The cash basis and fixed rate deductions are two quite separate methods of dealing with different items of income and expenditure. The decisions to use either or both schemes should be capable of being made independently.

109. We note that the levels of fixed rate deductions proposed, particularly for use of home, are so low that businesses are unlikely to want to use them. If their use is compulsory with the cash basis, few will choose to use it, thus negating the potential benefits of the proposals.

Q6 Are there any significant tax avoidance risks, which would not be adequately controlled by the proposed design?

110. At the limits proposed, the burden of moving from the cash to the accruals basis of accounting would coincide with needing to register for VAT. This is already a difficult time for a growing business. Many businesses unable to pass on the cost of charging VAT to their clients will choose to either stop trading for a few weeks or possibly not record some of their income, thus sliding into evasion and the black economy.

111. If the cash basis does indeed result in a simpler system with a reduced administrative burden, we are concerned that imposing an additional problem at this time will make even more businesses take action to avoid crossing the threshold.

112. See also our earlier comments concerning:

- Loss of tax revenue in the year the scheme first begins (para 66).
- Allowances in excess of the £25,000 annual investment allowance (para 60)

Q7 Do you agree that the same rules should apply to barristers or advocates, and the current special rules for barristers or advocates should be withdrawn?

113. No.

114. The rules for barristers were introduced many years ago due to the particular circumstances and business practices of their profession. The cash basis in this consultation document is part of tax simplification. These are two quite separate issues and should be treated separately. If HMRC wishes to look at the rules for barristers, or any other business, then this should be done as part of a separate consultation.

115. The early years of a new barrister's business is almost always beset with cash flow difficulties as debts are notoriously slow to be paid. This extends to income levels considerably in excess of the limits for small business proposed by either the OTS or the current consultation. Barristers with legal aid clients would be particularly badly affected.

116. We note also that banks have traditionally allowed their barrister clients access to large overdrafts, often the main source of finance available, although charged at higher rates than personal loans. The cash basis proposals would disallow overdraft interest.

Q8 Is a statutory restriction on switching between the ordinary and cash basis needed? If so, how should the restriction operate?

117. We do not support any restriction on switching between the cash and accruals basis. In our view, businesses in practice will not make frequent switches. Most business owners, and certainly their advisers, will recognise that to switch between the cash and accruals basis is more complicated than to use the accruals basis or cash basis continuously. There is no advantage in introducing rules which make the cash basis more complex for situations, which will in practice probably not arise.

118. Any switching would be mainly to avoid onerous issues in the cash basis, such as large losses. The restriction would be better dealt with by fixing the flaws of the proposed cash scheme.

Q9 Do you have any other comments on the details of the proposed design of the cash basis?

Partnerships and more than one business

119. We do not consider that there will be many partnerships where the cash basis is an adequate method for attributing profit shares to the partners. There will be some simple cash based businesses for which this would work, such as husband and wife businesses where work and income are shared equally, but this seems likely to be the exception.

120. If the limit for using the scheme is lowered to £30,000 as we have suggested, the relevance of the scheme to more complex business structures is any event reduced.

121. We note the reference to possible anti fragmentation rules. We can see that this may be necessary, but consider that the costs of setting up several partnerships to take advantage of the rules are likely to exceed the benefits, particularly if the threshold is reduced to £30,000. We also consider that using two different regimes simultaneously would be complicated and burdensome if the only purpose was to avoid tax.

122. Also, where the partnerships' businesses warranted using different bases, we consider that any such decision should be for the individual partners. The same applies where an individual has interests in more than one business. As stated above, if the limit for using the scheme is kept low, there will be less scope for avoidance.

123. The VAT system contains proven anti-fragmentation rules and the cash accounting system should be aligned with these.

Businesses joining or leaving the scheme

124. We see a practical problem with a business entering the scheme. Although the consultation suggests adjustments which sound simple, they will be anything but to the small businesses required to make them. In addition to defining cash received and paid in for a business continuing in the scheme, deciding which creditors have been paid by the cheque written out and posted/not posted/lost in the post/paid by credit card/ bank overdraft etc, will be most challenging. There will be a similar problem for debtors.

125. Calculating and valuing stock on hand when a business leaves the scheme will be very difficult, particularly as the decision to change is likely to be retrospective and only when the tax return is being prepared some months after the year end.

126. Fixed assets on hand when the business starts, other than cars, have not been dealt with adequately. See our comments at para 153.

Assets purchased on hire purchase

127. We presume that relief for these purchases will be given through an expense deduction as each payment is made.

Farmers and authors

128. We note that farmers and authors using the special averaging rules will not be permitted to use the cash basis. This seems an unnecessary restriction, particularly if the threshold is reduced the £30,000, since few of them would be able to benefit in any case.

Q10 What are the pros and cons, as well as any other implications, of the cash basis? Please list these.

129. Although we welcome the idea of the cash basis for some small, simple, businesses, we are unsure about its impact in practice. For those small businesses which prepare their own accounts and do not seek professional help, we suspect that in practice they already use a form of cash accounting and that any differences with the accruals basis are not likely to be material. This consultation document will not perhaps have a great impact on this group, other than to put what they do onto a proper statutory footing.

130. Those firms who seek professional help may well be advised to use the accruals basis, unless they are very small and are already using the cash basis because they do not operate on credit terms and carry no stock.

Advantages of cash accounting

131. Where a business transacts predominately in cash anyway and has few assets, cash accounting is simple to understand and requires little more than a list of cash received and paid out to operate.

132. Many small businesses are unrepresented and use this basis unwittingly in any case. It is merely legitimising what many do anyway although in practice any differences may not be material.

133. If only available to the smallest businesses, it will usually produce the same or very similar results as accruals accounting.

Disadvantages of cash accounting

134. Cash accounting is likely to result in poor control and understanding of a business' profitability, and may reduce a business's viability.

135. Proper accounts will still be needed to support business loans.

136. Lists of debtors, creditors, stocks and fixed assets will still need to be maintained, but with none of the cross checks afforded by traditional accounting.

137. There will be little reduction in record keeping needed since the records required for income will be the same and businesses incurring expenses other than those covered by fixed rate deductions, will still need to keep receipts, as they do now.

138. The proposal increases the scope for abuse as cash receipts and payments are moved easily from one year to the next. The tax take in the first year of the scheme is likely to be reduced by at least one month's tax receipts for the businesses which choose to use it, possibly more. Most of this will be a permanent loss to the exchequer as businesses eventually cease trading through a wind down to levels which are below the personal allowance.

139. Potentially, allowing cash accounting increases complexity for growing businesses. Those small businesses that grow beyond the threshold for cash accounting will have to become familiar with a whole new financial accounting discipline and record keeping. Coinciding with VAT registration will make this worse.

140. Complex transitional provisions will be needed.

141. 'Better off' calculations will be necessary to see whether adopting cash accounting is more beneficial. This is particularly important for businesses with low income levels since their owners are more likely to also be claiming tax credits, university grants and other income related benefits. Those who also claim, or whose partner claims, child benefit will also find that better off calculations are extremely important for incomes which marginally exceed £50,000.

142. New businesses usually seek professional advice only when they encounter a problem or need to file a return. If a business has chosen to use the cash basis in its first period of trading and submitted a tax return on that basis, it may already be too late to revise their figures to an accruals basis which may have been preferable for their circumstances.

143. We do not consider that there will be many partnerships where the cash basis is an adequate method for reflecting profit shares of the partners. There will be some simple cash based businesses for which this would work, such as husband and wife businesses where work and income are shared equally, but this seems likely to be the exception.

144. Allowing cash accounting for unincorporated businesses introduces a further difference between incorporated and unincorporated businesses further complicating the decision on

whether or not to incorporate. For some businesses, incorporation needs to be seriously considered, and evaluated, whilst the business is still very small and tax advantages can conflict with what is better for the business.

145. Cash needs to be defined. Is cash paid when a cheque is written out, banked, or cleared? What if a business pays its debt using a credit card or bank overdraft or loan? At what point will it be able to claim a deductible expense using the cash basis?

146. Many small businesses run their business through a personal bank account. Cash accounting increases the likelihood that they will get personal items mixed up with business items, and capital and revenue expenditure mixed up.

147. When seeking finance above the personal loan limited (usually £25,000) business will be asked for Financial Statements to support their credit application Cash accounting makes this an added expense and they may not even know where to go to get Financial Statements prepared

148. Paragraph 1.8 and the ‘Impact on individuals and households’ in Chapter 5 make reference to Universal Credits. Alignment of the income tax and UC rules may be difficult to achieve.

149. We are concerned that if the cash basis leads to more widely fluctuating income than the accruals basis, there will be more situations where benefits are under or over paid with consequent adverse effects on households. This will particularly be the case if the disregard for ignoring differences between actual and estimated ‘income’ is reduced.

150. The loss of sideways loss relief, particularly in opening years will affect many small businesses. Carrying back a loss suffered in the early years of a new business is a means of obtaining the finance necessary to see a business through its early loss making years.

151. The proposal to deny relief for interest paid (other than HP or trade credit related) is unnecessarily harsh. It makes little sense in policy and practical terms to disallow a cost which is totally related to financing the business’ working capital, which has little apparent cost to the exchequer.

152. Fixed rate deductions would be compulsory for businesses using the cash basis, but optional for businesses calculating profits using GAAP. Current amounts proposed for fixed rate deductions are so low that businesses are unlikely to use the cash basis at all. This is particularly so where the business is run from private rented accommodation.

153. No consideration has been given to assets owned at the commencement of a cash business. If these are to be grouped with purchases at the start, this could disadvantage the small business. Consider a photographer who has £9,000 of assets when he starts to trade. Under cash accounting, if he makes a first year profit of £12,000, this is reduced to £3,000, resulting in an unused personal allowance and a higher than necessary tax liability in year two. Although the business could use normal rules and claim a reduced capital allowance, it seems regrettable that this isn’t accommodated in the proposed cash scheme.

154. There will be particular difficulties where the scheme is used by a person with a foreign trade who will also have non-taxable foreign exchange differences to identify.

Q11 Do you have any comments on the tax impact assessment for the cash basis in Chapter 5?

155. We are not convinced that the cash basis will result in significant time and cost savings. We note that the net reduction in tax receipts is estimated at £300m in the two years following implementation. On this basis, we question whether this simplification represents value for money.

156. A consequence of disallowing non-specific interest in the cash basis will be that businesses will opt for hire purchase rather than bank loans to finance capital expenditure. It is not certain if these two sources of capital have the same financial costs. This issue has not appeared in the impact statement.

157. Further discussions with panels of practitioners dealing with small businesses might be very useful if not already planned for the next stage of the consultation process. We would be happy to help to arrange such sessions around the country.

Q12 Would a 3-tier banded rate or single fixed rate for business use of home strike the most appropriate balance between simplification and fairness?

158. Fairness is only achievable if a business is given the choice of whether it wants to use fixed rate expense deductions or whether it wants to use actual costs. Using the cash or accruals basis for its other income and expenses, should be irrelevant.

159. We consider that a three tier band is over complicating what is meant to be a simple system and again emphasise that we believe this system is of most use to very small businesses, many of which will pay very little tax anyway.

160. Requiring a business to keep detailed records of the hours spent working from home and the activity then being undertaken is a further administrative task.

161. We would favour a single rate, but think that £16 per month is too low and needs to be higher.

162. The experience of our members suggests that the normal minimum deduction used for this in practice tends to be around £10 per week. Indeed, £20 per week is not unusual. If the cash basis is to be used, rates which are in line with ordinary commercial experience should be proposed. This should help to encourage take up.

163. Many small businesses are run by people who live in rented accommodation. The rent paid is likely to be very disproportionate to the fixed rates being suggested.

164. We suggest that to reduce administration and detailed record keeping requirements, the single rate would preferably be one which is either claimed or not as the case may be. Alternatively, if HMRC feels that it is essential for the business owner to record time spent to substantiate a claim, an hourly rate applicable to all hours spent would be simplest.

165. We cannot see any reason for imposing a minimum number of hours – these are small businesses.

166. There is also an argument for considering regional variations in any fixed scale of rates.

167. It is not clear from paragraph 9.7 that administration time is allowable. This should certainly be the case and this should be stated explicitly. Time spent dealing with customers, suppliers, fixed asset purchases, financing matters or employee issues (although these are less likely to be relevant for a very small business).

Q13 Are there any issues or transactions relevant to businesses eligible to use simplified expenses that have not been considered or addressed adequately?

168. While a business might be able to record how many business letters it sends out, this seems a burdensome task for what is supposed to be a simplified scheme and in any event does not reflect the take-up of email in even very small businesses. It is therefore not a suitable method for apportioning stationery expenses. Stationery is used for many aspects of running a business, not just letter writing. Reports, plans, diagrams, pictures, posters, flyers, vouchers etc are also produced using stationery. We would support either a fixed amount, or fixed percentage of actual expenditure, as this would be simpler.

169. We consider the issue of apportioning or otherwise splitting expenses for business/private is a difficult one and more thought needs to be given to it. Clear guidance will be needed to enable this matter to be dealt with in a way that achieves the intended simplification.

170. Many small businesses use their home for storage. An allowance should be available for this.

Flat rate adjustment for personal use of business premises

171. There are indeed a variety of regional agreements in place for adjustments made by bed and breakfast and guest house businesses. These vary not only by the geographical location, but also by the size of property and the number of the members of the proprietor's family who live there.

172. A nationally agreed fixed scale of add backs for such businesses was discussed with HMRC a few years ago. This was resisted strongly by the industry on the basis that the variations were too great and, after discussion, HMRC agreed with this.

173. The current proposals allow for three scales, but this is unlikely to cater for the range of sizes of business and geographical variety with associated range of costs. If these businesses which use the cash basis are forced to use these rates, they will not use the cash basis.

Q14 Do you have any other comments on the details of the proposals for simplified expenses?

174. We disagree with the reduced mileage rate for the business use of a car in excess of 10,000 miles, which is presumably per year. Mini cab drivers and driving instructors and others whose businesses require extensive use of a car would be unfairly disadvantaged.

175. We are also concerned that as fuel prices increase rapidly on occasion, the fixed rates will not change quickly enough to keep pace.

176. When the initial mileage rate was increased from 40p to 45p for the first 10,000 miles a couple of years ago, no adjustment was made to the 25p rate. As a minimum, this should have been increased to 30p in recognition that the fuel element has increased and will continue to do so.

Q15 What are the pros and cons, as well as any other implications, of simplified expenses? Please list these.

177. We have noted the pros and cons in the preceding paragraphs, however, in summary:

Pros:

- Provided that detailed record keeping of time spent, letters written etc is reduced, then the scheme will be simpler and less paper work will need to be retained.
- It validates a practice already used by many small businesses.

- Recording only business use is easier than total and having to apportion the result.

Cons:

- Compulsory use for any business using the cash basis. It should be optional.
- The rates proposed are too low.
- Allowable use of home does not extend to enough activities or purposes.
- Rates will need to be reviewed annually.

Q16 Do you have any comments on the tax impact assessment in Chapter 5?

178. We assume that the one off cost in 2014/15 reflects the likelihood of businesses deferring income and accelerating expenses in year one. Depending on the take up of the scheme, this could be heavily under estimated, especially if the limits are set at £77,000 and £150,000.

179. If 500,000 small business tax payers paying higher rate tax were to defer for example £10,000 of income by using the cash basis, the tax cost may be as high as £2 billion.

180. We do not see that costs to the software industry have been reflected in these figures, particularly as the industry is currently developing Apps for record keeping using accruals accounting.

181. As the scheme is intended to be cost neutral in each year of operation thereafter, we are surprised to see that receipts are expected to increase each year thereafter by £20m annually.

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APPENDIX

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

In 1999, the Tax Faculty published The Ten Tenets for a better tax system. We have tested the proposals in this consultation document against our ten tenets and our conclusions are set out below.

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

We find it difficult to see how these proposals can be dealt with adequately by legislation. While we believe that a choice between the cash basis and accruals is essential, it will lead to a considerable volume of additional legislation. The definition of 'cash' received or paid, the rules and occasions for joining and leaving the cash basis scheme at all, moving in and out through the lifetime of a business, and anti avoidance for example, will all add to the length and complexity of the tax code.

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.

In most cases, it should be certain whether the rules apply and if so how. There could, however, be major difficulties defining 'cash' paid/received. Although rules already exist for the VAT cash basis, it is usual to find that only larger businesses are VAT registered. The smallest businesses may consider cash to be something different to that used for the VAT rules.

As most differences in the definition of cash will affect the timing of taxable profits rather than overall taxability, it is arguable that this is not of critical importance. However, as it leads to uncertainty from year to year, this is unwelcome. We note also that taxable income is relevant for benefits such as tax credits and the proposed child benefit clawback rules. A marginal change in income from one year to the next could make a large difference to an individual's retained after tax income.

There may also be problems at the cross over as a business grows and in particular where it needs to account for fixed assets, stock, debtors and creditors brought forward in the year of change. There could also be uncertainty where the structure of a business changes, perhaps through incorporation, or sale as a going concern.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

For a small, simple business with no fixed assets, stock, debtors or creditors, the rules will be simple. Indeed, the accruals and cash bases rules are likely to give almost the same results. This then begs the question of why we need an alternative basis at all.

For other businesses which will usually do 'better off' calculations, having to consider an alternative basis is unlikely to be simpler.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

Having decided which basis, cash or accruals, is most appropriate, the collection and calculation of tax due should be similar in process and administrative cost.

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.

Defining cash and the capacity to bring forward expenditure or defer receipt of income are all areas for likely avoidance. Targeting anti-avoidance legislation at the smallest business to prevent this is likely to be extremely difficult to either draft or for HMRC to police. There will be a temptation to use general legislation, although quite what this will achieve is debatable.

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.

We recommend that if these changes are taken forward, they are allowed to operate unchanged for a period of at least five years so that enough time can elapse to see whether and how much simplification they actually achieve.

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.

In June 2010, the new Government undertook to observe a five step process before implementing new policy changes. These rules have already been launched at stage two, using as step one, policy suggestions, the OTS work and report. This would be acceptable if the OTS was adopted 'en bloc' but not where the OTS proposals are subject to a fundamental change. This is a serious step backwards and risks undermining the credibility of the OTS work. The profession responds to the OTS proposals in the spirit that they are made; that is as ideas which the Government may decide to take forward through its own consultation process.

It seems that the current ideas are being rushed through for implementation in 2013. This will not allow adequate time for both the drafting of tax legislation and full consultation on it, nor for implementation by HMRC and DWP. We anticipate a botch.

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.

It is too early to comment further on this tenet.

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.

We anticipate this being reflected in the legislation and process in due course.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

We think it unlikely that the proposals will have any impact on whether a business decides to invest in or base itself in the UK.

Summary

We do not think that as they stand at the moment these proposals pass our 'ten tenets test'.

Note

The Ten Tenets 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-4-99-towards-a-better-tax-system.ashx).