

TAXREP 9/01

A REVIEW OF SMALL BUSINESS TAXATION

Response submitted in May 2001 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales to the Revenue in relation to a Technical Note issued in March 2001.

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Introduction and summary of our key comments

1. We welcome the opportunity to participate in the consultation relating to small business taxation.
2. The Technical Note appears to be intended to be an initial ‘sounding’ on a number of ideas. We welcome in principle any measure which simplifies tax compliance overall. However, we have strong reservations whether creating different corporation tax systems for small and large businesses is an appropriate way to achieve this. We hope that the discussion arising from the Technical Note will provide a chance to consider a wide range of ideas and potential solutions, not just those referred to in the Technical Note. We look forward to taking part in discussions to determine whether and, if so, how the issues raised in this Technical Note should be taken forward.
3. We applaud the Government’s desire to reduce regulatory and compliance costs. However, we do not believe that the cost of adjusting accounts profits to taxable profits is significant for most small businesses, particularly very small ones. Our members’ experience is that the largest computational problems arise in businesses with a turnover in the region of £2 million to £4 million.
4. We believe that there are far bigger burdens on small businesses that ought to be addressed in priority to what seems, on the face of it, to be a relatively modest tinkering with the tax system. In particular the areas that we believe could be simplified with a far greater benefit to small businesses than the proposals in the consultation document include:
 - a) The onerous burden of payroll compliance work including PAYE administration and P11D preparation. Many small businesses have no employees other than their proprietors and in most cases the proprietors rarely draw regular remuneration. We doubt whether the PAYE system is an effective method of accounting for tax in such cases. It may be that the introduction of the Limited Liability Partnership (LLP) will result in a shift away from limited companies as the normal form of business organisation, as an LLP will avoid such difficulties. Where a company has a handful of employees in addition to its directors, a simplified PAYE system ought to be possible.
 - b) The burden of dealing with National Insurance Contributions (NIC) both where earnings fluctuate and on benefits in kind. The latter is particularly burdensome because the legislation expects tax on many benefits to be collected through the payroll. We doubt that most small businesses have the ability to cope with the distinction between the company incurring a liability (which gives rise to a benefit on which employer’s NIC has to be paid on an

annual basis) and the company paying a bill incurred by the employee (where both employer's and employee's NI have to be dealt with as a payroll item). Most small businesses have difficulty identifying that a benefit exists, let alone drawing this to the attention of the person who does the monthly payroll.

- c) The compliance burden of VAT, particularly the difficulties in recognising when the registration threshold is exceeded and in identifying the correct VAT treatment of many supplies.
 - d) The pressures of complying with red tape such as the operation of the Working Families' Tax Credit, continuous pension changes and alterations to official forms which add to complexities in their completion. Indeed the burden of completing the corporation tax return form is probably a far bigger compliance burden than that of adjusting the accounting profits to taxable profits.
 - e) The burden of dealing with Inland Revenue enquiries into accounts. This can lead to considerable extra work for small businesses where little real tax is at stake. For example, there has been a significant increase in challenges in recent years to items in accounts such as provisions and stock valuations where the Inland Revenue seeks to substitute its own professional judgement for the judgement of the qualified accountant who prepared the accounts. Even if the interpretation of an accounting standard that the Inland Revenue seeks to impose is more appropriate than that taken by the accountant, such changes merely shift profits from one year to the next and have no long-term impact on the tax burden. In addition, for a small business there is normally very little short-term benefit to the Revenue as the amount of profit brought forward into the previous accounting period rarely produces a significant cash flow benefit for the Revenue.
 - f) The burden caused by challenges to accounts by Revenue officers where the officer does not really understand how the business operates and jumps to conclusions based on inappropriate assumptions. The cost of resolving such misunderstandings can be very high.
5. We believe that there is a need to achieve a balance between simplicity and fairness. A different regime for small and large businesses is bound to lead to unfairness, not only at the margin but because the tax treatment of an identical transaction becomes dependent on the identity of the taxpayer rather than the nature of the transaction. If coping with the adjustment between tax and accounting profits is felt to be onerous for the small business – an assumption with which we would not ourselves wholeheartedly agree as outlined above – then it is surely equally onerous for the larger business, even though the latter may be able to employ the staff to cope with the burden. It would be far better to remove the burdens generally than to simply seek

to relieve some businesses from them. If an adjustment is desirable it is surely desirable for all businesses, not merely for some.

6. The main cost saving will obviously be from the adoption of commercial depreciation in place of separately computed capital allowances. However, the Technical Note confirms, rightly in our view, that it is intended that the effect of tax incentives should be maintained. As many, if not most, of such incentives take the form of enhanced capital allowances the maintenance of such incentives will mean that it is not possible to simply adopt the commercial depreciation figures shown in the accounts. If there is a need to adjust that figure to reflect tax incentives we suspect that the overall time taken to prepare the computation will not be greatly different from the time taken to start again and calculate capital allowances.
7. A fundamental part of the review is centred upon whether there should be a move towards accounts-based taxation. Of course, the starting point for the tax computation at present is the business accounts. The discussion is, therefore, about how to better align the tax computation with the accounts. As we have stated on many previous occasions, we are in favour of the tax treatment moving closer to the treatment in the accounts providing that the accounting treatment is in accordance with generally accepted accounting principles.
8. Our detailed comments on the chapters of the Technical Note follow.

Moving towards accounts profits for tax

9. The Technical Note is not entirely clear exactly what is intended under this heading. We have assumed that it is intending different rules for different businesses e.g. a tax deduction for business entertaining for small businesses. Whilst we would not necessarily object to such a proposal it does have to be weighed up against the principle of fairness for all businesses.
10. There would appear to be two possible routes that could be followed. Either small businesses could be taxed on the profits in the accounts or there can continue to be an allowance for various adjustments. We believe there is some merit in removing some of the anomalies and bringing elements of the tax treatment into line with accounting. As mentioned above, any changes in this area need to be weighed against the compliance costs which may result.
11. We believe that any suggestion of taxing capital gains on an accounts basis would be particularly unwelcome. Indeed the current system where the tax on gains by the entrepreneur are alleviated by a generous taper relief, whereas those realised by the company itself are still heavily taxed, ought to be revisited. It is right that the burden of tax on capital gains should be alleviated. The various existing reliefs, including indexation relief and rollover relief, achieve this to some extent. We think it important that such reliefs are preserved. We would certainly welcome a relaxation of the current strict rules on what is deductible in calculating a capital gain if that is what

is proposed, and would not be averse to capital gains being calculated on Case 1 principles provided that the current reliefs are preserved.

12. Paragraph 4.3 of the Technical Note questions whether it is desirable to remove the special tax rules for rental income and other investment income and instead use a commercial accounts basis. We assume that the question relates mainly to losses, as rental income is of course calculated on the same basis as trading profits. We believe that if any new system is introduced rental income and interest received of a trading company should be included as part of its trading profits. Some adjustment would still be required to preserve the exemption for UK dividends. Presumably the double taxation relief rules would also need to be simplified, as it would cease to be possible to apply these on the existing source basis. The suggested change would create a significant saving of time in calculating the profits of pure investment companies where at present the tax computations are drawn up on a source-by-source basis rather than starting from the profit per accounts.
13. The Technical Note also asks at paragraph 4.3 whether commercial depreciation should be used instead of tax capital allowances for the majority of business assets. The depreciation/capital allowances debate has arguments on both sides. There is no doubt that any change would produce winners and losers and this needs to be weighed against the regulatory savings. We would welcome sight of figures so that an informed conclusion can be arrived at. We suggest that the Revenue is best placed to provide figures on this as it has access to the computations of all businesses.
14. If both accounts and tax computations are prepared on a true and fair basis then depreciation rates will be those appropriate to the nature of the asset, its expected life, etc and therefore a separate capital allowances code is not necessary.
15. We are unclear what is meant by the reference to using commercial depreciation for 'the majority of business assets'. Any departure from the accounts figure reintroduces much of the burden that the Government is seeking to remove. A major simplification in adopting commercial depreciation would be the removal of the need for separate calculations for 'expensive' cars. However, if this is no longer felt necessary for small companies, which is where we suspect most of the past abuse occurred, we would question whether this rule is needed at all. We are also unclear whether the intention is to allow small companies to deduct depreciation for commercial buildings. That certainly seems a logical consequence of the proposals.
16. We are concerned about the suggestion in paragraph 4.4 of the Technical Note that the proposed change raises issues about the standards of company accounts. The current adjustments to computation rarely affect items where there is scope for differing interpretations of accounting standards. In particular the boundary between business expenditure and directors' private expenditure does not normally arise in a corporation tax context, as the provision of benefits by way of payment for private expenditure is as much deductible for corporation purposes as is the payment of a salary to that director. The Revenue's control over private expenditure is in practice

applied at a P11D level. Unless the idea is to eliminate directors P11D's, which does not appear to be proposed by the Technical Note, we are unclear why this should suggest a need to improve accounting standards.

17. Accounts are formed on a 'true and fair' basis which allows for materiality to play a vital part in arriving at a sensible result. The Revenue has accepted for a long time that accounts are prepared using the concept of materiality and it is obliged to accept them as the starting point for the tax computation. However, the Revenue is less accepting of the materiality concept in relation to the adjustments in the tax computation and to non-accounts based calculations such as chargeable gains. We would hope that any move to a new system would not lead to any difficulties in this area which could give rise to higher costs for businesses.

Unincorporated businesses

18. We are pleased to see a mention of unincorporated businesses within the review as clearly these account for a substantial number of 'small businesses' and do have some different issues to companies. However, we are concerned that by drawing dividing lines between the tax treatment of businesses of different legal construction could lead to yet more complications.
19. We are, however, surprised to see no mention of Limited Liability Partnerships, as these may well become one of the key entities of choice for small businesses in the future. The introduction of LLPs re-emphasises the need for a tax friendly method to allow a small company to disincorporate. Our recollection is that the Department of Trade and Industry (DTI) were sympathetic to this the last time that we discussed it with them but that the Inland Revenue felt that there was little demand for it. The LLP is an attractive form of business organisation for the smaller business. It is likely that in the future it will displace the limited company. In these circumstances it is irrational that existing limited companies should be discouraged from adopting this new vehicle solely because of the adverse tax consequences of disincorporation as a prelude to becoming an LLP.
20. We would also like to see some consideration given to the United States idea that a small company could elect to be taxed as a partnership, which would bring with it simplification issues.

Working with small businesses, accountants and representative bodies

21. We welcome the opportunity to participate in further discussions in the area of reviewing possible changes to the current system but we do not underestimate the practical issues which will need to be confronted. We would, therefore, trust that sufficient time will be given for a review of all the key issues and that genuine consultation can take place in exploring the options before any policy commitments are made. As a starting point it would be useful if the Revenue could make available a

summary of its prior research which led to the outline ideas in the Technical Note.

22. As we have indicated in other discussions, we welcome the help that the Revenue's Business Support Teams (BSTs) are giving to new businesses, but with the proviso that this is on a voluntary basis. A business is not set up to pay tax; it is set up to generate wealth. We believe that Chartered Accountants are the most appropriate advisers to nurture a new business and that its systems need to be designed to reflect the needs of the business whilst enabling it to comply with its tax obligations, rather than directed towards compliance with tax and other regulations. Accordingly where a new business initially consults an accountant we believe that our members are better placed than BSTs to provide the appropriate help. Nevertheless we realise that many new businesses do not consult an accountant until they perceive a need for accounts. In such cases it is far better for BSTs to offer help than for our members to have to try and unravel what has gone wrong at a latter date. We would hope that your BSTs recognise that, whilst complying with tax obligations is important, a business needs help over a far wider range of commercial issues and that they will recommend the engagement of a qualified accountant to provide such help.
23. We are unclear what is meant in paragraph 6.5 of the Technical Note about the improvement of standards and practices. We would not accept that the Revenue should have any greater role than anyone else in the setting of accounting standards. The Revenue is as welcome as everyone else to comment on Exposure Drafts issued by the Accounting Standards Board (ASB). Indeed we believe that the Revenue currently discuss with the ASB matters of particular concern. We believe that this is the right approach. However, the Revenue is only one of a range of users of accounts, even for small businesses. We would strongly oppose any suggestion that accounts should be prepared with tax compliance in mind and then adjusted to provide a more balanced picture for, say, banks or new suppliers. That would not reduce compliance costs; it would increase them. Accounts should be prepared on commercial lines for commercial reasons and the tax system should work within the confines of such accounts.
24. As we have made clear elsewhere, we would welcome Revenue help in improving tax practice. Indeed we are disappointed that the Revenue delayed for a year the introduction of the 'common errors' procedure, which we and the other professional bodies thought we had agreed would start from April 2000. We have also previously made clear, and would emphasise here that we would like to see this procedure extended as quickly as possible to all work by accountants that, after internal review by the Revenue to eliminate any risk of victimisation, gives the Revenue cause for concern.
25. Paragraph 6.7 of the Technical Note refers to the 'kite marking' process for software. There are inherent problems with kite-marking as it can become akin to 'recommendation' with all the associated difficulties that brings, for example, on what basis was the software tested, to exactly what standards, agreed by whom? The paragraph in the Note also appears to suggest that anyone using a kite-marked

package would have a lower chance of being selected for enquiry. We are puzzled by this. Enquiry decisions ought to be based on concerns about the accounts, not on the method used to create them. The computer industry has a catch phrase, 'GIGO' (meaning 'garbage in, garbage out'), to emphasise that the result produced by a computer is only as good as the information that is keyed into it. We also doubt that it is possible to develop software capable of making many of the decisions that are required to ensure that accounts give a true and fair view as is required by the Companies Act.

Further consultation

- 26.** We are happy to expand on any of the points raised above and we would welcome any future meetings to discuss detailed issues arising out of this review process. We also look forward to hearing the feedback arising from responses to this Technical Note.

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