



# ICAEW REPRESENTATION 172/16

## TAX REPRESENTATION

### SIMPLIFYING TAX FOR UNINCORPORATED BUSINESSES

ICAEW welcomes the opportunity to comment on the consultation document [simplifying tax for unincorporated businesses](#) published by HM Revenue and Customs on 15 August 2016.

This response of 7 November 2016 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

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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.

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## MAJOR POINTS

### Key point summary

1. ICAEW welcomes the opportunity to comment on HM Revenue and Customs consultation [simplifying tax for unincorporated businesses](#) dated 15 August 2016, which considers changes to four areas of the tax system for unincorporated businesses.
2. While this paper was published as part of the Making Tax Digital (MTD) consultations it is clear that the proposals contained within this simplification paper are not dependent on the introduction and implementation of MTD. We understand the government is looking to simplify the taxation of unincorporated businesses however in our view it is not essential that these proposals are implemented alongside MTD.
3. In principle we support simplification of the UK tax system and moving to digital provides an opportunity to consider this aspect. However, too much change at the same time is not recommended. We strongly believe that these proposals should not be a priority for the government and the focus of attention should be a successful transition to a digital tax system. Moving towards a digital tax system by April 2018 will be a huge transition for many businesses and time should be given for businesses to ease into the new regime without additional unnecessary changes. In any event, we think that tax simplification measures should first be reviewed in the light of the proposals made by the Office for Tax Simplification.
4. While we support the move to digital, it will take 5 to 10 years to do this properly. The tax rules in scope for change must be separated from digitisation so that people have time to understand the changes without overloading the pace.
5. Decoupling the simplification proposals from MTD is recommended. The government should focus on the essential changes required for a digital system to work.
6. The concept of simplification is predicated on the presumption that small businesses do not need financial information in order to grow. While we accept that some small businesses will prepare accounts purely for tax purposes, in practice most businesses take some interest from the lessons that can be learnt from their accounts.
7. Our detailed responses to specific questions can be found below, but in summary:
  - 7.1. When the cash basis was introduced we recommended an entry level of no more than £30,000 income in line with the recommendation of the Office of Tax Simplification. The government chose to legislate for the VAT registration threshold instead. While this may be appropriate for some larger businesses, it is unlikely to be suitable for any business with significant levels of stock debtors creditors or which has fixed assets. While we would not oppose an increase to the cash basis entry level we would not advocate it as an appropriate method for calculating taxable profits for businesses with any degree of complexity
  - 7.2. We do not believe a reform of the basis period rules is critical at present. The current system is well understood and the creation of overlap profits can be avoided by choosing an appropriate year end date or changing the accounting date in the future. We do not understand why the proposals do not apply to partnerships. If the basis period rules are reformed the rules must apply to both sole traders and partners trading in a partnership
  - 7.3. In our view there is no appetite for a reduced version of UK GAAP. FRS 105 can be adopted by micro-entities, and small businesses with straightforward affairs may choose to adopt the cash basis. We do not support the introduction of more rules or further alternatives which will only lead to confusion and complexity
  - 7.4. Legislating items of capital expenditure which are specifically disallowable within the cash basis rules is welcomed.

## RESPONSES TO SPECIFIC QUESTIONS

### INCREASING THE ENTRY THRESHOLD FOR THE CASH BASIS

#### Q1a: What level do you consider to be an appropriate turnover entry threshold?

8. The Tax Faculty was heavily involved in the cash basis proposal back in 2011 and welcomes the opportunity to revisit this area of policy as part of the MTD consultations. As commented in our [TAX REP 64/11](#), many businesses were already adopting, in effect, a cash basis. Legislating the cash basis for preparing accounts was generally supported by the profession to allow those businesses with the most straight forward affairs to spend less time preparing accounts and more time pursuing their business endeavours.
9. Feedback from our members suggests that many agents do not believe there is an appetite or need to increase the entry level threshold as they do not generally advise their clients to use the cash basis. When asked why, agents responded that their clients did not prepare accounts purely for tax purposes and accounts prepared under the accruals basis were more meaningful and often required by providers of finance.
10. When the cash basis was introduced we recommended an entry level of no more than £30,000 income in line with the recommendation of the Office of Tax Simplification. The government chose to legislate for the VAT registration threshold instead. While this may be appropriate for some larger businesses, it is unlikely to be suitable for any business with significant levels of stock, debtors, creditors or which has fixed assets. While we would not oppose an increase to the cash basis entry threshold, we would not advocate to businesses with any degree of complexity that it is appropriate and nor would our members.
11. However if the cash basis is available to assist taxpayers and preparers of accounts/tax returns then there is an argument that there should be no restriction on the size of the business that can opt to use the cash basis (although we do agree with HMRC's comment that the larger a business becomes, typically the more complex its affairs will be and it would not be appropriate for all businesses to adopt the cash basis).
12. We would encourage the government to review some of the restrictions currently in place under the cash basis rules such as tax relief on interest costs and the inflexible loss relief rules. Changes to these rules would make the cash basis more attractive to small businesses who could benefit, but do not because they need flexible use of their losses.

#### Q1b: For a threshold not linked to the VAT threshold, should it be reviewed annually in light of inflation or less frequently?

13. We do not believe the entry threshold should be increased (other than to in line with the VAT registration threshold).

#### Q2a: If the entry threshold were to be increased, do you agree that the exit threshold should continue to be set at twice the entry threshold?

14. We feel strongly that the entry threshold should not be increased other than in line with the relevant VAT threshold each year.
15. We agree that the larger the business, generally the more complicated its affairs will be and so the cash basis would not be an appropriate method to calculate the taxable profits of the business.
16. If the entry threshold were to increase to £300,000 for example, the exit threshold would rise to £600,000. Not only would this mean large and possibly complex businesses were using the scheme, but there would be significant cash flow implications on exit in relation to opening stock and debtors that would now be taxable under the accruals basis.

17. We believe that there would be need to be some form of spreading provision to ensure any tax charge on exit did not damage the earning capacity of the business.

**Q2b: If the entry threshold were to be increased, do you agree that the UC threshold should continue to be set at twice the entry threshold?**

18. We believe that Universal Credit (UC) claimants should be able to use the cash basis regardless of the level of turnover.
19. Under the current system, where an individual's turnover exceeds the cash basis entry threshold they are required to prepare two sets of accounts (cash basis accounts on a monthly basis for UC purposes and UK GAAP accounts for tax). This imposes an unnecessary administrative burden to a number of individuals.

## REFORMING BASIS PERIODS

**Q3: Do you agree with the proposed approach of following accounting periods? If not, what alternative approach would you support?**

20. We do not see the need for change at present. Too much change at the same time will not be welcomed by those businesses affected by the introduction of MTD in April 2018.
21. We would welcome clarification as to why the current system is in need of reform. The consultation document states at paragraph 3.13 that the "policy aim is to simplify the rules around basis periods with a view to eliminating the "overlap" period." We are aware that, in the past, overlap profits were an issue for a large number of businesses, however it is not uncommon for agents to suggest 31 March or 5 April year end dates to new businesses to avoid this problem.
22. It is possible that MTD may create an incentive for the self-employed who also have rental income to choose a 5 April period end date as otherwise the quarterly reporting deadlines will not fall at the same time.
23. We do accept that some businesses prefer to run their accounts to the anniversary date of when they started so they have a good understanding of their annual income in the first year. If this creates overlap profits, relief can be given by a future change of accounting date.
24. For those businesses where a change of accounting date is not possible, perhaps for commercial reasons, we recommend that the government provides relief now. This could be spread over five years to lessen the burden to the exchequer.
25. We also question why the proposed changes will not apply to partnerships. This will create issues for individuals operating as self-employed but also as a partner in a partnership, and in our view will create additional and unnecessary complexity. Changing the rules for sole traders only could lead to distortionary behaviour and tax driven decisions, such as individuals deciding not to form a partnership, because they could still be affected by overlap profits, whereas if they traded separately they wouldn't. This seems inconsistent and not part of the policy intention.
26. Option one would allow a business to choose its accounting period end date as per the current system. The taxable profit would be apportioned to give the businesses results for the tax year. This system would be unworkable as businesses would have to allocate the results for a period which ends long after the end of the tax year. For example, a business with a December year end, would need to estimate and apportion profits for an accounting period ending nine months after the end of the tax year.
27. This appears to contradict one of the main advantages of MTD according to HMRC which is to allow businesses "a better understanding of their tax position and their cash flow" (paragraph 3.1). While this option does allow flexibility to choose an appropriate period end date, we do

not welcome the need to apportion into tax years.

28. Option two is to mandate the tax year which will remove all flexibility to choose an appropriate period end date to suit the businesses' needs. This will be impractical for businesses which are busy in spring time and many will be affected by moveable Easter holidays, for example. Businesses need flexibility to choose a date that best suits them, for example, a business providing tuition might prefer to choose a 31 July year end date to fall in line with the academic year. Adopting a 5 April year end date will make accounts meaningless if they do not accurately reflect a typical 12 month cycle for a particular trade. There was much discussion of this option in the late 1980s/early 1990s when 'simplified assessing', later renamed 'self assessment', was being designed, and the government finally concluded, rightly, that businesses should continue to be able to select the year end that best suits commercial needs.
29. It will also be highly impractical for agents who would not be able to spread client work throughout the year.
30. This option would be impractical for businesses wishing to make pension contributions, as final profits would not be known until after the end of the tax year and contributions cannot be carried back.
31. This option would however remove the need to apportion profits into the tax year, which would be simpler to operate compared to option one.
32. Option three is based on the concept adopted by companies. As with option one, businesses are able to choose an appropriate period end date that suits. Rather than apportioning profits into tax years the business would pay tax on the accounting period ending in the tax year, i.e. the current year basis that is currently in place.
33. This approach offers a lot of flexibility to businesses who may choose to adopt short periods of account. The total profits for periods ending in the tax year would be aggregated to give the total taxable profit to be taxed. Our concern with adopting short periods of account is how this interacts with quarterly reporting obligations and the end of year activity report.
34. Under this option there is also the possibility of creating a scenario where more than 12 months of profits could be taxed. For example, a sole trader could acquire the business of another sole trader. It would be likely that the individual would want to align the accounting periods for both businesses, and in doing so might need to prepare accounts for a short period. If this short period of accounts ends in same tax year as the normal year end date, more than 12 months of profits would be taxed.
35. We are not aware of any relief available in this particular scenario.
36. By adopting a 30 April year end date businesses will be able to delay the payment of tax considerably. We question whether the government is aware of this opportunity and the impact it would have on the exchequer.
37. If 30 April year ends are adopted to maximise the benefit of delaying the payment of tax this would lead to higher profits being taxed on cessation, in addition to the loss of personal allowance in the first tax year. While those who are represented by agents will have been advised on the pitfalls of such planning, it is the unrepresented who will suffer. This seems to go against the principle of MTD which is being more certain of your tax liability.
38. Under the proposed changes, overlap profits will be eliminated for new businesses starting to trade. If the business adopts a 30 April year end, for example, it could have a larger tax bill on cessation of trade but would have no overlap profit relief to utilise. The consultation document does not consider the implications of eliminating overlap profits for new businesses.

**Q4a: Are there any other events or situations which would require additional rules?**

39. We question how Class 4 National Insurance will interact with the proposed reform to the basis period rules, in particular if option three is adopted and there is the option of flexible accounting periods.

**Q4b: Would it be helpful to make any changes to tax accounting periods for any other types of income?**

40. The proposals to change the basis period rules cannot be looked at in isolation. We have an annual tax system in the UK and therefore would expect this consultation to have considered how the new basis period rules would interact with all of the annual adjustments, reliefs and allowances that are typically considered in the annual tax return. To name a few, loss relief, personal allowance adjustments/withdrawals, charitable donations and pension contributions, and the high income child benefit charge.
41. Paragraph 3.29 states that “the new rules would also provide flexibility where traders were reporting on a quarterly basis and wanted to set four accounting dates each year so that they can finalise each quarter without having to revisit and adjust it based on subsequent events.” It is not clear how these four quarters can be finalised without considering the adjustments we raise above.
42. It is unclear from the consultation document just how these changes would work in the real world. If an individual chose to adopt four short periods of account, the timing of their income and any related expenditure would determine what rate of income tax needed paying. This could open up the system to abuse, with individuals spreading income over the tax year.
43. The consultation document does not provide sufficient information regarding the End of Year declaration for businesses

**SIMPLER BUSINESS REPORTING**

**Q5: Are there other end of year adjustments not listed in paragraph 4.13 which could be simplified within a reduced reporting framework?**

44. We do not support an alternative to the current system at present and therefore do not wish to comment on any other year end adjustments which could be simplified. We strongly believe that the government should be focussing on implementing essential changes only at this time.

**Q6: Would you welcome the four relaxations proposed?**

45. No. As above, we do not support the simpler business reporting concept. Not only is it not the right time to be making unnecessary changes to the system, there are already options available for businesses. FRS 105 was introduced to ease reporting requirements for micro-entities while still giving a “true and fair view” of the business’ performance and position. We do not see the need for further simplifications at this stage.
46. Through various engagement with our members and colleagues in the Financial Reporting Faculty it is evident that there is no appetite for a reduced version of UK GAAP including the four relaxations proposed in the consultation document.
47. If the changes were introduced we would suggest the restriction on bad debts at paragraph 4.29 should include bad debts written off in the books as well as those where recovery action has failed, as some debts are not pursued as it is not cost effective.
48. We do not think a reduced version of UK GAAP is appropriate. Businesses already have the option to adopt the cash basis which eliminates the need to account for accruals and prepayments. Those businesses which exceed the entry threshold are likely to be more complex, in which case, accounting adjustments are beneficial to ensure the accounts show a true and fair view and are accepted by banks and other lenders.

49. On a recent HMRC webinar it was said that the simplified reporting is aimed at businesses who are either excluded from the cash basis (because they are too large) or choose not to adopt the cash basis. Therefore they only produce GAAP accounts for tax purposes and have no other need for accruals based accounts. We query whether a simplified version of GAAP is appropriate for these businesses or if the relaxations to the cash basis were made (as mentioned above in paragraph 9) this would encourage these businesses to adopt the cash basis, and obviate the need for GAAP accounts for HMRC only.

**Q7: Do you think that the restrictions proposed are appropriate? If not, what restrictions would you suggest?**

50. We do not agree with the proposed changes and have no comment on the restrictions imposed.

## **REFORMING THE CAPITAL/REVENUE DIVIDE WITHIN THE CASH BASIS**

**Q8: Do you believe that simplifying the capital/revenue distinction as suggested in paragraphs 5.7 to 5.13 would simplify reporting for businesses within the cash basis?**

51. We do not agree that this measure provides simplification, although we do support the intention to clarify the rules and provide legislation which explicitly states which items of capital expenditure are disallowable under the cash basis.
52. However this does increase the length of the tax code and we would question if this is necessary, as we are unaware of any significant cases where relief has been incorrectly claimed, or the current rules have led to uncertainty.
53. We understand that under the proposed draft legislation, initial training costs would be deductible, and we request clarification on this matter.

**Q9: Can you identify any specific caveats which might be needed to ensure that the new rule operates as intended? Are there any potential tax planning opportunities which the current draft rules would not prevent?**

54. No comment.

## **ASSESSMENT OF IMPACTS**

**Q10a: If the cash basis entry threshold is raised would you consider using the cash basis, or advising your clients or members to use it? If so please provide details of anticipated impacts, including both one-off and ongoing benefits and costs.**

55. Feedback from our members suggests that the cash basis is not a suitable alternative for most businesses. Even the smallest of businesses need to know how much they are owed and how much they owe at a given point in time to enable them to make sensible business decisions. We understand that the cash basis legitimises the approach taken by some small unrepresented businesses.
56. As with the VAT flat rate scheme, for example, businesses are likely to want to see their profit under the accruals basis and the cash basis to identify which is more beneficial. Accordingly there will be extra work for businesses themselves or their agents (albeit the extra cost will not be a burden if the cash basis appears a more attractive basis for calculating taxable profit).

**Q10b: If the proposed basis period reform is taken forward, how do you think this would impact on business admin burdens? If possible, please provide the details of anticipated impacts, including both one-off and ongoing benefits and costs?**

57. No comment.



**Q10c: If the reduced reporting framework is introduced, please provide details of how this will affect your business or your clients or members, including details of both the expected one-off and ongoing benefits and costs for:**

- Familiarisation with the new scheme and updating software or systems
- Having to make fewer adjustments than would be required under UK GAAP

**58.** We strongly believe that choice equals complexity. If these proposals go ahead agents could find themselves with three variations of client files; one prepared under the cash basis, one adopting full UK GAAP and one which is a halfway house under the simplified reporting rules. This will put undue pressure on agents who will already be coping with the move to MTD itself.

**Q10d: If the revenue/capital divide is simplified as suggested do you believe that this would simplify reporting for businesses within the cash basis? If so please provide details of anticipated impacts, including both one-off and ongoing benefits and costs?**

**59.** The proposal does not simplify reporting because it will still be necessary to identify capital items in order to consider whether any of the exclusions built into the legislation will apply.

**Q10e: Please tell us if you think there are any other impacts, benefits or costs not covered above.**

**60.** The introduction of Making Tax Digital will change the ways in which businesses operate, maintain records and report information to HMRC. There is a lot of information and change to digest and implement. We believe that while some of the proposals within this consultation document could simplify tax for unincorporated businesses, they should not be considered further until MTD has been firmly established and businesses have had time to adapt.

**61.** The pace, scale and nature of the changes are significant and it would seem appropriate to leave the tax system alone until MTD has been successfully rolled out.

## APPENDIX 1

### ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

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

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via <http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax>).