Corporation tax compliance for medium sized companies

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Executive Summary

ICAS believe that it is time to take a fresh look at corporation tax compliance for medium-sized audited companies. The Autumn Statement 2014 covered a proposal to support mid-sized businesses through a specialist business unit to act as a gateway for businesses transitioning through a key business change with significant tax implications. ICAS welcomes this change but consider that a more fundamental review of the way in which HMRC approach corporation tax compliance for medium-sized companies is required. This would allow Government, taxpayers and their advisers to take the time to consider how to address the issues and arrive at a compliance process that is fit for purpose.

We believe it is time to review the current corporation tax compliance regime for medium sized companies to address the following issues:

- The interaction of accounting and materiality – the extent to which HMRC will rely on the audited accounts of a company as the basis for the tax returns and computations
- The level of detailed analysis required as part of a corporation tax computation – the analysis of tax sensitive items to prepare the tax computations where the detail is not required for audit purposes. Medium-sized companies and their tax agents can devote significant resources to doing this work whilst larger businesses who are dealt with by the LBO are able to agree their processes and minimise the work they do in this area
- The level of resources that are available to HMRC – the proposed change in methodology will help HMRC target its resources at companies who are most at risk of non-compliance
- Recognising the value of an audit and the use of tax agents – An audit of a company’s accounts should give HMRC comfort on the numbers used in the tax return. The additional work done by agents in preparing and checking corporation tax returns should also be recognised by a different approach to computations and returns which have been prepared or reviewed by an agent.

The Government has recently concluded a consultation on R&D tax credits for the medium-sized company sector. The need for this consultation acknowledges that this sector face issues in identifying their eligibility and claiming the tax reliefs to which they are entitled and recognises that the “one size fits all” approach for corporation tax does not suit medium-sized companies.

Large businesses have greater resources to comply with the requirements of UK legislation and to influence policy. As a result, many of the provisions in the UK corporation tax system take the concerns of large businesses into account. Medium-sized businesses are under-represented in these efforts and their voices are rarely heard on the complexity of UK legislation. As a result, there are piecemeal revisions made to the system to make it work more effectively for these companies but no consideration given to how to give these businesses the support they need to succeed as businesses and compliant taxpayers.

The proposed new approach would focus on evaluating the risk categories for medium-sized companies and taking self-assessment one step further. It would give companies the opportunity to demonstrate that they have robust and effective controls in place to prepare, submit and calculate their corporation tax liabilities and allow HMRC to review the returns in the light of this additional information.
Background

There are two significant issues for companies when they are preparing their tax returns and computations. These are:

- Accounting and materiality – the extent to which HMRC will rely on the audited accounts of a company as a basis for the tax return and computations
- Detailed analysis for the tax return – the detailed analysis required of tax sensitive items to prepare the tax computation and return where the information is not required for audit purposes

Accounting and materiality – current practice

There has always been a disconnect between the requirement of the UK tax legislation for a company to deliver a tax return that is “correct and complete” and the obligation to prepare “true and fair” accounts on which those computations are based. The underlying disconnect between these two different approaches has been treated historically by the statutory requirement for a taxpayer to keep such records as may be required for it to file correct and complete returns.

The disconnect arises because of the “materiality” adopted for audit purposes. “Materiality” defines the threshold or cutoff point after which financial information becomes relevant to the decision making needs of the users of financial statements. Information contained in the financial statements must therefore be complete in all material respects in order for them to present a true and fair view of the affairs of the entity.

The level of materiality adopted when preparing the financial statements will determine whether errors are adjusted in the financial statements or not – and obviously this will have an impact on the tax returns and computations. For example, if there is an error identified in the valuation of stock by a company this will affect the level of profits reported and the tax return. It is only where this adjustment is considered to be “material” in terms of the audit that it must be adjusted in the financial statements and this is dependent on a number of factors relating to the size and complexity of the business and its activities. This is often a timing issue as the adjustment will be made in the financial statements for future periods.

There is guidance from HMRC on materiality in the Business Income Manual (BIM31047) that:

“Some entries in accounts depend on the estimates and judgement made by the preparers of the accounts and will lie within a range of values. The requirement that information should be free from deliberate or systematic error should prevent materiality judgements being skewed in a particular direction. But ultimately the factual accuracy of any item in the accounts is a matter for the Commissioners to decide”

This statement confirms the possibility of HMRC challenging the approach adopted in the financial statements. In practice, this is unlikely to happen, but the option is available to HMRC. There is no acceptance in HMRC guidance that the accounting profits as stated under accounting standards should not be challenged. The profits recorded in financial statements form the first line of the tax computations for most companies and they would place reliance on this number being acceptable to HMRC as it has been subject to review and independent audit. The Greene King judgement [2012 UK FTT 385(TC) TC 020069] covers this area and the Tribunal indicated that the accounting method adopted by the taxpayer for measuring the accounting impact of loan relationships was not appropriate and could not be accepted as the basis for the corporation tax returns. The decision covers the interpretation of the judges of the relevant accounting standards and how the taxpayer should have accounted for the loan relationships.

HMRC have comments in the Inspectors’ Manuals on this area (BIM31001 onwards). The process for the Inspector to go through is to:

- Ascertain the profits of the trade computed in accordance with the correct principles of commercial accountancy
• Adjust the accountancy profits in accordance with any tax rules or principles which differ from the accountancy principles

The Inspector is required to make sure that the method arrives at the full amount of profits or gains to be subject to tax and is encouraged to challenge positions adopted where it is felt that the accountancy approach is not correct.

**Detailed analysis required for the tax computation – current practice**

A company is required to make a tax return if HMRC issues a notice 603 to it and a company must notify HMRC if it is within the charge to corporation tax within the UK. The filing of the tax return will require the filing of supporting accounts, statements and reports and if a company files a return without these supporting documents then it has not satisfied the filing requirement. Companies are required to file accounts and supporting tax computations in iXBRL for periods from 1 April 2010.

HMRC have issued some guidance on the preparation of the corporation tax computations. There is a requirement for the records to be correct and complete and this presents some very practical problems for companies as much of the detail is not required for audit purposes.

The work that is needed to arrive at a “correct and complete” for corporation tax computations is extensive – reviewing every expense claim in detail, checking all receipts etc. – and most finance departments in companies are resource constrained; the detailed work required to arrive at this information is often carried out by junior staff. The analysis may well be reviewed by a more senior member of the team and/or the tax advisor to the company but there are risks that the work done and the figures that are arrived at would not satisfy HMRC’s interpretation of “complete and correct”.

The risks for most companies are that a particular nominal ledger account code is not identified as tax sensitive and is therefore not analysed as part of the tax computation process, and that tax sensitive items are unspotted innocent errors. This can mean that non-deductible expenditure is not identified and adjusted in the tax computations or that mispostings are not corrected on review. These types of errors can result in adjustments on enquiries and potentially discovery assessments and penalties for businesses.

Another risk area arises from journal entries; for example the provisions made by a company and whether these can be treated as specific provisions in accordance with case law – and tax deductible – or are general in nature and have to be adjusted in the tax computations. This can be a very complex area and the individual preparing the data on provisions may well not be aware of all the complex tax issues to consider or form a judgment that HMRC may later decide to challenge.

For larger companies, these complexities can be addressed through discussion with the Customer Relationship Manager (CRM) to identify areas of risk and review the systems adopted by the company so that both parties are satisfied with the numbers reported for corporation tax purposes. HMRC has updated its corporation tax compliance approach to focus on risks and assign a risk category to each company. The CRM relationship allows HMRC to more accurately undertake this risk rating exercise and the contact between a taxpayer and the CRM gives the taxpayer more awareness of their risk rating and the actions they can take to improve this.

There are also agreements between a company and the CRM about the approach that can be adopted when preparing the tax computations – such as de minimus levels for analysis. It should be stressed that this type of agreement between a taxpayer and HMRC is informal and would be revoked if any issues arose regarding the tax processes adopted by the company. This is a way for taxpayers to manage their compliance processes and most larger groups of companies prepare their corporation tax computations on this basis.

There is no such process available for companies which do not qualify to be dealt with under the Large Business Office (LBO) system and who do not have a CRM. They can find themselves in a very difficult position when completing tax computations. Do they devote a significant proportion of their resources to ensuring that they comply with the “complete and correct” requirement or should they take a pragmatic view and only analyse items over a
certain value – i.e. fixed asset additions over £2,500 per item or costs within legal and professional advice over £500?

Many companies use professional advisers to review and submit their tax returns and advisers will require the company to confirm that the information that is provided to HMRC is complete and correct in line with their obligations to provide advice to their clients. This usually takes the form of the company confirming this to its advisers rather than the adviser undertaking an audit of the information provided. This means that a company will have to justify its approach to both HMRC and its advisers.

**ICAS suggested approach to addressing these issues**

There are issues for both taxpayers and HMRC as a result of both of these factors. Each party has to take a pragmatic approach in practice to allow the tax system to work effectively. At the moment, neither side is open and transparent about the detailed behind the scenes approach that it follows. This could lead to anomalies in the treatment of different taxpayers in the same situation and types of differences can undermine confidence in the operation of the corporation tax system.

HMRC acknowledge the issues in dealing with SMEs in their comments on the ‘Tax Gap’ and this has been followed up with the announcement in the Autumn Statement 2014 (paragraph 2.170) of support for mid-sized businesses. This comprises a new mid-sized business unit to act as a gateway to specialist tax help needed by mid-sized businesses, including temporary access to a named individual for mid-sized businesses transitioning through key business changes. While this is a welcome development, it does not address the underlying issues for medium sized businesses.

The approach ICAS would like to see implemented is a more radical change to the current methodology and would create a new compliance framework for the medium-sized company sector based on risks. We believe that making this change would enable HMRC to risk assess companies and allocate its resources more effectively. The experience with the LBO has shown that increasing interaction and availability of HMRC staff to businesses can result in an increase in taxpayer satisfaction and the amount of tax collected from a particular sector.

This new approach would mean that a company would prepare a short document of its tax systems, processes and approaches and be specific about the approach that it takes in preparing its tax returns such as the level of capital expenditure it analyses for capital allowance purposes and limits on the level of expenditure it reviews when preparing its tax return. This document would be agreed by the directors and shared with HMRC.

This approach would be an “opt in” process and would allow HMRC to review this and determine if they were happy with the internal controls and processes. Where this is the case HMRC would notify the company and its directors who would then have responsibility for maintaining the controls and processes. We propose that businesses that opt in to this approach are dealt with a single team within the business tax division to give them a team to contact on tax issues.

This new approach would demonstrate HMRC’s commitment to compliant taxpayers in this category and provide useful experience to HMRC staff as these businesses tend to cover the full range of taxes. The team should be contactable by email and for live chats over the internet to give businesses the advice that they need to comply with the relevant tax law. It is important to recognise that businesses of this size do not tend to have any internal tax resource and use HMRC published guidance extensively. Access to tax specialists within HMRC is likely to increase both understanding and compliance.

There would be a need for HMRC to have the resources to undertake risk assessments. The experience of the LBO approach will be invaluable in introducing this methodology for medium-sized businesses.

ICAS suggest that this approach should be limited to companies who are required to have an audit only. The current limits on a company which requires an audit are set out in section 477 of Companies Act 2006 and require that a company must have two of the following:
• An annual turnover in excess of £6.5 million
• Assets over £3.26 million
• 51 or more employees

Linking the limits to the requirement for an audit will mean that only the larger companies are eligible to opt in to the new system and that smaller companies are not able to benefit from any relaxation in the requirement to prepare tax computations that are “correct and complete”. However, it does give HMRC some comfort that the accounts have been subject to independent review and that the system and processes adopted by the company have been tested by the auditors.

ICAS believes would like to look at options for smaller companies in due course but our initial focus is on larger companies as we believe that the audit requirement gives an additional comfort. The experience of introducing this approach to medium-sized business could be used to inform changes for smaller companies.

The certificate to be provided to HMRC would effectively be a self-assessment of the risk profile of the business. The proposal is for a document that covers the following details:

• The structure of the business – a chart of any group relationships detailed the company names and place of residence for tax
• The accounting systems used by the business and how these are maintained and updated
• The accounting procedures used by the business – details of accounting policies adopted by the business and the instructions to staff, the frequency of reconciliations of accounts etc.
• The processes adopted by the business to record data onto its accounting systems and the qualifications and experience of the staff who perform these roles
• The processes and systems adopted by the business to calculate its corporation tax payments
• The processes and systems adopted by the business to prepare its corporation tax returns and supporting computations including details of how the business captures the level of disallowable expenditure included in its accounts and how it calculates tax reliefs such as writing down allowance and research and development allowances
• The processes and systems adopted by the business in respect of any reporting requirement for participators/directors loans under section 455 CTA 2010

This is a significant volume of information and we are conscious that collating the detail will impose a burden on companies. We would make the following observations:

• Sharing this level of detail with HMRC will demonstrate that the business has effective controls on its financial systems and will allow HMRC to risk assess the business effectively. If this approach were adopted HMRC would be required to adopt a light touch to the review of businesses that opt into this system. We would anticipate that a business would have to reconfirm its procedures in an annual statement and that there would be a stringent penalty regime for an inaccurate statement
• Giving HMRC this detail will allow risk assessment across a range of taxes and give HMRC a clearer picture of the operations of the business. This should help HMRC target its resources effectively.
• The detail required is equivalent to that required under the Companies Act for a director to fulfil his/her duties under the requirement of that Act. It is not adding additional requirements – but it does require that the process and policies are documented. This process will require time and management input and it is incumbent on HMRC to make sure that companies are able to see advantages in opting in to the approach.
• The detail is equivalent to that required under the Senior Accounting Officer regulations that apply to “large” companies so there is a precedent for requiring companies to keep these records
• The information could be expanded to cover processes for other taxes - VAT, PAYE, NIC, CIS and Customs Declarations.

ICAS would also like to see the input of tax agents into the compliance process acknowledged. There have been some moves towards this, and HMRC have designed a
series of toolkits for agents to use when preparing tax computations to check that they have taken all the issues into consideration. These completed toolkits could be shared with HMRC to show that the basic checks – information is consistent with accounts, signatures are includes – along with more detailed technical checks have been made. As with the systems documentation, this process would allow an initial risk assessment to be made.

Conclusion and calls to action

This paper has examined the issues for medium-sized businesses in preparing and submitting corporation tax returns. ICAS believe that it is time to take a fresh look at corporation tax compliance for medium-sized businesses to design a compliance framework for the sector that is effective and deliverable. Under the proposed approach, the work that is required of companies and their agents – to document systems and complete toolkits – will help HMRC target its resources more effectively. Companies that can participate should expect a light touch – and targeted support from HMRC. It is the companies outside the system where there are likely to be problems, either because the company is not aware of its tax obligations or is deliberately non-compliant.