Universal Credit and Related Regulations: Impact on the Self Employed

26 July 2012
Introduction

We are pleased to have this opportunity to respond to the call for evidence by the Social Security Advisory Committee in connection with the publication on 15 June 2012 of the draft Universal Credit and related Regulations.

We note that, as part of the Committee’s consideration of these Regulations, it has stated that views would be welcome from a broad range of organisations and individuals. In this response we restrict our observations on the draft Regulations to our grave concerns about the intolerable additional administrative burdens which they would place on potential Universal Credit claimants who are self employed. This reflects the seriousness of our concerns on this aspect, and should not be taken as implying that the remainder of the draft Regulations are satisfactory.

Both in relation to the impact on the self employed, and on a more general basis, we feel that there are serious risks that the draft Regulations would be unworkable to apply in practice. We would urge the Social Security Advisory Committee to learn from the mistakes of the original Tax Credits regime, where unsatisfactory and unworkable regulations were introduced with too little thought as to their practical impact. It would be far better on this occasion to ensure that due weight is given to all the concerns being raised in the current consultations, and thus ensure that Universal Credit is built on a strong foundation.

Monthly accounting by the self employed

The proposals for monthly reporting by the self employed, within 7 days after the end of each month, would have a devastating effect. In many cases they would prevent self employed taxpayers from claiming Universal Credit to which they would otherwise be properly entitled. In many more cases they would discourage the setting up of self employed businesses, or would encourage those already self employed to cease their business activities. There is also a very real risk that otherwise visible business activities would be driven underground into the black economy, resulting in a double loss to the Government – with tax being lost by the Exchequer and fraudulent claims to Universal Credit being made.

We are very concerned that those who have prepared these proposals appear to have no practical knowledge or experience of how small self employed businesses operate. Many small businesses rely heavily on their accountants or tax advisers to prepare their financial statements at the end of each year and agree their tax liabilities. To carry out such tasks monthly, even on a cobbled-together cash basis that bore no relation to actual business performance, would be so time consuming that either the time devoted to it by the business proprietor would seriously impair his ability to run the business, or the professional costs involved in getting the necessary accounting help would be unsustainable.

Many self employed businesses are sole traders. Such individuals would not always be available to carry out monthly accounting tasks. They might be occupied on pressing business commitments that are essential to their business survival. On other occasions they might be ill – perhaps a time when the support of Universal Credit would be particularly important to them. At other times they might be on holiday. Even when they were available, the banking information to enable them to prepare a monthly account would not always be available within 7 days. Bank statements typically take much longer than that to arrive. Internet banking is not favoured by some businesses, and is not always reliable – indeed, some businesses have limited or no Internet access.

Even where a business proprietor is in a position to prepare cash accounts within 7 days after each month end, there is a lack of clarity about the proposals. When is a receipt to be treated as received? Is a cheque received by the business to be taken as a business receipt, or should it not be taken into account until paid into the bank, or not until cleared funds become available? Similar doubts might arise regarding the payments to be taken into account. Is a cheque written by the business to be treated as ‘cash out’, or should it not be recognised until presented by the payee’s bank, or perhaps not until fully processed through the banking system. These are just a few of the questions that would arise, and we believe that they would cause huge uncertainty and confusion, leading to a lack of consistency throughout the Universal Credit regime.
We appreciate that the Government is trying to devise a system that correlates immediate self employed income with immediate needs. However, self employed businesses simply do not work this way, and accounting for them on a monthly basis would be impracticable. While the measure of income for Working Tax Credit has not been wholly satisfactory, it was adapted in a pragmatic way to recognise the real circumstances of the self employed. It uses the same annual profit and loss figures as for income tax self assessment, based on generally accepted accounting principles, thus avoiding unacceptable administrative burdens on claimants. It recognises how the business is actually performing in economic terms, and generally supports businesses through start-ups and difficult periods such as the loss of a key customer, the emergence of a bad debt, the taking on of a new employee, and so forth.

The approach used for income tax, which has applied in an adapted form for Working Tax Credit, recognises that small businesses need to prepare accounts annually, and that to expect them to do so more frequently would be unreasonably burdensome.

The primary purpose of accounts should be to serve businesses

The normal basis of accounting for businesses of all sizes is UK GAAP (generally accepted accounting principles), and typically a self employed business prepares accounts on this basis each year and uses these to self assess its tax liabilities.

The once-a-year process of preparing the accounts and tax computations can be time-consuming and difficult, and many businesses sub-contract this work to a professional accountant or tax agent. Accounts prepared in this way show a realistic view of the results of the business operations, and can therefore by relied upon by the business proprietors as an accurate indication of business performance. They can also be relied upon as such by third parties – not only HMRC, but also potential suppliers, customers, lenders and purchasers. Thus these accounts are already useful, and justify the cost and inconvenience involved in their preparation.

HM Revenue & Customs have recently published proposals for the simplest small businesses to be allowed to prepare their annual accounts on a cash basis and using simplified expenses. We have responded to HMRC’s consultation on those proposals, pointing out how introducing these as optional or mandatory alternatives for businesses with turnover below certain limits would add to the complexity of their tax compliance obligations. Many of our members are accountants and tax agents in public practice, offering services to large numbers of small businesses, and HMRC’s proposals could benefit those members by strengthening demand for their services. Nonetheless, a strong majority of our membership have insisted that the proposed cash basis and simplified expenses, at least for all but the very smallest businesses, would be against the public interest.

We are astonished to discover that the draft Universal Credit Regulations propose that self employed businesses should be required to adopt a ‘simplified cash income’ basis and simplified expenses for Universal Credit purposes, that these are different from the cash basis and simplified expenses proposed by HMRC, and that they would be imposed on a mandatory basis – unlike HMRC’s which are proposed as optional. Thus we have two major Government departments, encouraging small businesses to prepare accounts on two different ‘artificial’ bases, neither of which will reflect the true business results.

Accounting distortions being proposed by DWP

Even if it were practicable for small businesses to prepare accounts every month (and we think it is not), we see no value whatsoever in requiring them to prepare accounts that bear no relation to the actual business results.

Few businesses operate solely on a cash basis. Others typically have trade debtors and creditors and hold trading stock or work in progress, and the values of all these vary from month to month. Measuring the business results on a cash basis, as proposed by HMRC as a means of annual accounting by very small businesses, might produce a rough and ready approximation to annual accounts complying with GAAP. However, for the majority of small businesses, monthly cash accounts would be much too volatile to do this, and the figures produced would be meaningless. If the chosen ‘cash basis’ imposed arbitrary restriction on
what can and what cannot be recognised in such accounts, the results would move even
further away from the truth.

Paragraph 181 of your Memorandum states: ‘Claimants will not be permitted to carry forward
negative balances of income: if the net income for the assessment period is a negative
amount, this would be treated as zero for the purposes of the award calculation and the next
assessment period’s income would be based solely on the income for that period.’ This fails
to recognise that businesses (even small businesses) do not exist from hand to mouth each
month, but undertake transactions affecting much longer periods. For example, a business
may spend substantial sums in one month on trading stock or supplies, to be sold or used
over several subsequent months, but they would be denied relief for this proper business
expenditure if it created a negative cash position. This would be grossly unfair. Some self
employed businesses (e.g. farmers) could lose out very substantially compared with others
whose results were less affected by seasonal factors.

To take another example, we understand that under your proposals the interest paid on a
bank loan for business purposes would be a non-deductible expense, although hire purchase
payments would be fully deductible. This is a serious anomaly and it would undoubtedly
interfere with decisions as to how a business would finance its assets and equipment.
Interest paid on borrowings incurred for the purposes of the business should be deductible in
all cases.

A further problem we see relates to the months for which a self employed person would be
expected to prepare cash basis accounts for the DWP. Any existing business will already
prepare annual accounts to its chosen accounting date or, if the HMRC proposals on cash
basis accounting were to be imposed, to 5 April. However, your proposals would require
each self employed person to report their earnings over ‘assessment periods’ of one month
starting to run from the date the claimant first became entitled to Universal Credit. In most
cases this date would not fall into line with the natural months of their business period of
accounts, adding further complications.

The minimum income floor

We note that the minimum income floor would not apply where a claimant was subject to no
work-related requirements, or to work focused interview or work preparation requirement only,
and that there would also be a 12-month start-up period during which the floor would not
apply. These are to be welcomed.

We fail to understand why the minimum income floor is limited to one start-up period per
working life. This could discriminate harshly against younger claimants who have long
working lives ahead of them, and could discourage enterprise. We think the limitation would
discourage those who have been in business before from trying again. This would work
against the public interest, since those who have failed in business are often those best
experienced to make a success of a subsequent attempt.

We see it as a fundamental flaw in the proposals that there would be no relaxation of the
minimum income floor for periods when a business experienced a genuine dip in profits, or for
periods when a business was reinvesting in order to expand, or taking on a new employee.
Working Tax Credit has successfully supported growing businesses through such difficult
periods, and it would be short-sighted of the Government not to continue its supportive
stance.

Under the proposals, a loss would not be allowed even where a negative cash position for a
month had arisen as a result of an exceptional outlay – for example, a large purchase of
trading stock, or a half-yearly tax payment under self assessment. In those months the
minimum income floor would makes things even worse by creating an artificial profit, and this
could place the self employed person at a serious disadvantage compared with an employed
claimant earning the same amount.

Gainful self employment and work search

We note that a claimant would be required to work at his or her self employment for at least
half the expected number of working hours, or else accept work search and conditionality
requirements with no recognition of the hours worked in self employment. This would effectively prevent anyone from being employed part-time and building up their own business part-time if they were engaged in the latter activity for any less than (usually) 18 hours a week.

This would work against the public interest, by presenting a serious handicap to those trying to move from welfare into work using self employment as a stepping stone. The administrative burdens involved in preparing for and attending Gateway interviews, and proving gainful self employment, would seriously encroach upon the time available to the claimant for carrying on the self employed business, and many would-be entrepreneurs would be discouraged from started new businesses.

Conclusion

Far from offering worthwhile simplification compared with the pre-existing Tax Credits regime, the Universal Credit proposals have the potential to increase considerably the administrative burdens on small businesses.

For the reasons stated above, we believe the proposals for monthly cash accounting by self employed Universal Credit claimants would be unduly burdensome – indeed, completely unworkable. We think they would operate against the public interest by discouraging claims by those who need Universal Credit, and by driving others into the black economy and thus losing tax due to the Exchequer and facilitating fraudulent Universal Credit claims.

We recommend that the draft Universal Credit Regulations need to be reviewed urgently as they relate to self employed claimants, and the proposals materially altered to make them workable in practice.

About ICAS

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