Submission from
The Institute of Chartered Accountants of Scotland to
The Office of Tax Simplification

Small Business Tax Simplification Review, including IR35

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Introduction

Tax simplification differs according to the viewpoint of the beholder. Before the Government presses ahead with changes to simplify small business taxes, a clear attempt should be made to define the aims and objectives to the satisfaction of key interested parties, including The Institute of Chartered Accountants of Scotland (ICAS) and the other main tax agent representative bodies.

We would like to see a tax regime in which small businesses understand more clearly the rules by which they and their proprietors are taxed. This is likely to involve a shorter tax code, with fewer reliefs and therefore a need for fewer anti avoidance measures. It should also involve a significant cut in compliance costs and related administrative burdens, with a lessening of the dependence of small businesses on professional tax advisers.

Previous efforts to reduce tax compliance burdens, such as those spearheaded by the Administrative Burdens Advisory Board, were fundamentally flawed because they considered only the costs incurred by businesses in complying with particular tax provisions that applied to them. They ignored the additional and often substantial costs incurred by businesses in identifying which measures applied and confirming that a wide range of other tax provisions did not apply to them.

Careful attention will need to be paid to the transition to any new regime under which small businesses are taxed on a simpler basis. For businesses of all sizes, change is the most expensive and worrying aspect of tax. The threat of change can make the UK an uncompetitive location for business, and can discourage entrepreneurs from establishing and nurturing small businesses here.

In this paper we do not address in detail the possibility of a GAAR. If this replaced the plethora of specific anti-avoidance provisions that exist throughout the tax system, the removal of these many provisions could simplify tax compliance for small businesses. However, we would strongly oppose a GAAR unless it came with an advance clearance process and was accompanied by the repeal of all or most pre-existing anti-avoidance measures.

Also in this paper we do not address Calman. The drivers for the Calman proposals on a new Scottish income tax rate are essentially political, and it is not appropriate that we comment on these from a political perspective. We are aware of a Scotland Office estimate that annual tax compliance costs for Scottish business could double to more than £1bn if a separate Scottish tax system was introduced, as would be necessary under fiscal autonomy or separation. Whatever lesser changes may be made under Calman, we recommend that special consideration should be given to the impact they would have on small businesses and how any adverse compliance impact might be minimised.
1. National Insurance contributions

1.1. As the single most important recommendation contained in our representations, substantial simplification could be achieved by merging income tax with the National Insurance contributions paid by employees and the self employed. There would be large savings in administrative costs for HMRC and businesses from merging the broadly similar but distinctly different rules for these two levies.

1.2. Currently NICs are not payable by those working beyond State Pension age. It would be possible to adopt a merged system, while preserving existing differentials in tax rates by levying an income tax ‘earned income surcharge’ on taxable earned income (excluding pensions) received by all those under State Pension age.

1.3. Employees’ NIC rates are high compared with those paid by the self-employed, with this differential arguably accounted for by differences in rights to State benefits. The differential in contribution levels creates complexity by encouraging contrived self employment rather than employment, and thereby necessitating additional enforcement efforts by HMRC.

1.4. Given the need for greater austerity in Government, there are arguments in favour of reducing the levels of certain State benefits and making them available to all those in genuine need – regardless of employment status.

1.5. Advantages would flow from moving towards a level playing field in which the new levy derived from merging income tax and NICs is charged at the same rates and in accordance with a single set of rules on all earned income of those of working age, regardless of their employment status, and entitlement to state benefits is also uniform across that population.
1.6. The CIS regime (addressed at section 8 below) is a complex administrative layer of anti-avoidance measures, introduced partly as a result of the differential in NIC rates between employees and the self employed. CIS imposes heavy administrative burdens. Even the slightest infraction in tax compliance can lead to loss of gross payment status, with devastating impact on cash flow often leading to redundancies or business failure. The disproportionately high penalties being sought in many cases of inadvertent failure to observe all the detailed rules of CIS can have similarly dire effects. We recommend that CIS be reviewed in the light of a possible income tax/NICs merger and other simplification measures being considered, with the aim of making it easier for small businesses to comply. Any continuing requirements of CIS should then be applied with a greater understanding of the financial pressures which many small businesses face.

1.7. The IR35 legislation (addressed at section 3 below) was introduced to counter those who attempted to present employment under the guise of self employment, partly as a result of the differential in NIC rates between employees and the self employed. The degree of risk to the Exchequer should become virtually negligible if income tax and NICs were merged. Accordingly, we think the whole question of the need for any replacement of IR35 should be re-visited in the light of a possible income tax/NICs merger and other simplification measures being considered.

1.8. Employers’ NICs comprise a separate form of tax that can be a deterrent to the creation of new jobs – especially for small businesses. The Government has recognised this to a modest extent by introducing a temporary regional NICs holiday for employment by new start-up businesses, but the rules for this are complex. We see the future of employers’ NICs as a political matter, and as such it is inappropriate for us to comment further on the rate at which they are set.

1.9. For small businesses, we see the administrative hassle of operating PAYE as an even greater factor in discouraging the creation of new jobs. Many businesses choose to remain very small rather than take the huge step involved in taking on their first employee. Our suggestion of merging income tax and employees’ NICs into a single levy would go a long way towards simplifying the calculation of PAYE and making payroll administration less of a deterrent to business growth.

1.10. The bringing together of NICs with income tax and the removal of the difference in rates between self employed and employed would not only introduce a huge simplification but also negate much of the concerns of tax loss due to employment status, which have led to measures such as CIS and IR35 cases.

1.11. The merger of income tax and employees’ NICs would require enormous political will as people would finally become aware of their real marginal rates of tax. However, it would bring substantial benefits by simplifying the tax regime.
2. Determination of employment status

2.1. The rules for determining employment status are too complicated and produce arbitrary results, creating particular difficulties in the operation of the self assessment regime – especially (but not exclusively) for those involved with CIS.

2.2. The relevance of employment status could largely disappear if income tax and NICs were merged and the tax rates for employed and self employed became more closely aligned. Accordingly, we think the whole question of distinctions between employed and self employed for tax and NIC purposes should be revisited in the light of a possible income tax/NICs merger and other simplification measures being considered.

2.3. At present the burden of proof of an individual worker’s status falls unfairly on the engager. Should the distinction between employed and self-employed remain significant for tax and NIC purposes, we would suggest that this responsibility needs to be shared to reduce small business tax compliance burdens and minimise tax evasion.

2.4. Attempts to date to build deeming provisions on to the existing rules (such as those contained in the IR35 legislation) or introduce a clearer rules-based approach (such as that which was proposed in ‘False self employment in construction: taxation of workers’) have ridden or threatened to ride roughshod over the established legal definitions of employment and self-employment, thereby making the determination of employment status even more obscure.

2.5. There are many indicators which need to be considered when ascertaining whether the arrangements under which a worker has been engaged comprise employment or self employment. These have been demonstrated by the many decisions of the Courts, Commissioners and Tribunals. Some indicators that can be conclusive in one case may be only persuasive or even of little relevance in another. The law on this subject has become too complex.

2.6. We would welcome changes that would simplify this process. Nonetheless, it would be wrong to over-simplify the tax law or extend it by applying fiscal fictions in such a way that the results were clearly inequitable – as they were in the ‘False self-employment’ proposals. It would also be unfair and unreasonable to apply differing status rules within different business sectors, as was put forward in those proposals.

2.7. It is tempting to consider simplifying the decision-making process by introducing a short set of rules that might remove doubt from the vast majority (perhaps 80% to 90%) of status situations and thus free HMRC resources to provide a clearance procedure that would allow taxpayers and agents to obtain an advance ruling on those where doubt remained. However, a rules-based approach has already been tried by HMRC in their online Employment Status Indicator – and discredited by both HMRC personnel and tax agents.
2.8. On balance we prefer the more radical solution of making the determination of status irrelevant for tax and NIC purposes, by allowing small businesses in all business sectors to elect for either basis regardless of their actual legal structure. This would introduce greater equity by allowing questions relating to such matters as limited liability and employment rights to be addressed independently of tax considerations.

3. IR35

3.1. The IR35 legislation is not working well, and requires HMRC to incur high enforcement costs which are disproportionate to the modest resultant tax revenues. The operation of IR35 relies on deemed employment status. It therefore involves all the difficulties encountered in determining status, plus the added confusion of applying the rules in hypothetical situations.

3.2. IR 35 was introduced to counter those who attempted to present employment under the guise of self employment. Since then the majority of such contrived arrangements have been outlawed by the managed service companies legislation. This has left HMRC with a much reduced risk of tax loss through contrived self employment, but nonetheless a measure of risk remains.

3.3. As explained above, the degree of risk should be much reduced if income tax and NICs were merged. Accordingly, we think the whole question of the need for any replacement of IR35 should be re-visited.

3.4. The merging of NICs and income tax and the application of the merged levy to all income including dividends would remove the need for any IR35 replacement provisions. However, it would be particularly harsh to tax dividends at the full combined rate – hence the need for the income tax earned income surcharge which we have suggested above.

4. Tax impact of business structure

4.1. The choice of business structure can have a disproportionately high impact on exposure to tax. For example, a sole trader or partnership is subject to personal income tax and NICs on all profits earned, regardless of whether those profits are drawn out by the proprietors or re-invested in the business. By contrast, the proprietors of a company are subject to personal tax and NICs on remuneration, and to personal tax only on dividends, while profits re-invested in the business are subject only to corporation tax.

4.2. Small businesses are frequently under pressure to incorporate, and this is rarely to obtain limited liability or to meet their own tax requirements. Typically it may arise from the expectations of prospective customers – often brought on by the customer’s fear of becoming treated as an employer for PAYE and NIC purposes. At the smallest level, proprietors pressured into incorporating may fail to understand the distinction between company and personal funds, and may face difficulties in meeting their responsibilities under the Companies Acts. In these circumstances they may have little chance of understanding the machinations of the tax system.
4.3. We would welcome consultation on the possibility of introducing a ‘see through’ option that would allow small UK business entities to elect whether they should be taxed as incorporated or unincorporated, regardless of their actual legal form. Such a system would allow some businesses to respond to third party pressures to incorporate while retaining the simplicity of a see-through tax regime which they could more readily understand. It would allow others to keep their simpler unincorporated form while having the ability to grow by retaining profits subject only to corporation tax.

5. Income shifting

5.1. Small businesses operated by married couples or civil partners, or some other connected parties, have been placed at a disadvantage by the varying political attitudes to the settlement provisions of ICTA 1988 s 660 because of the uncertainties these have caused in determining their exposure to tax.

5.2. Recent HMRC attitudes, and even more so the proposals brought forward by the previous administration in 2008 to impose new restrictions on income shifting, have disregarded the commercial realities facing couples who run businesses jointly. Responsibility for a family business differs significantly from a nine-to-five employment by a third party, and few spouses or civil partners of business proprietors can avoid being drawn heavily into the affairs of the business.

5.3. It is acceptable for couples to transfer their property or other capital into the hands of the lower earning partner, thereby saving tax without any possibility of this being challenged. We suggest that the legislation should be amended to allow couples the same flexibility to transfer any other assets such as interests in their family business. In this way it could become much easier for the proprietors of small family-run businesses to self assess their tax liabilities, and their exposure to tax would become much more equitable.

6. Associated companies rules for CT small profits rate

6.1. The rules relating to associated companies for small profits rate purposes were subject to welcome relaxation in FA 2008. Nonetheless, the treatment of associated companies remains a problem for many small companies wishing to expand.

6.2. For a company with one or more associated companies, the lower and upper limits are divided by one plus the number of associated companies. This divides the £300,000 lower limit equally among the companies that are associated. Thus if Company A makes profits of £250,000 it is taxed at 21%. If it wishes to expand and forms associated Company B, very possibly for non-tax reasons such as limiting its exposure to risk in a new venture, and if Company B makes negligible profits, the lower limit applied to Company A becomes £150,000 and it is taxed at 28%. This can act as a powerful deterrent against expansion.
6.3. A further problem is that companies which would not otherwise be associated can become so if one lends money to another so that it would be the major creditor in a winding up. This too appears designed to inhibit the growth of new businesses.

6.4. We suggest that a first step towards simplification would be to allow the lower and upper limits to be split among associated companies either in proportion to their respective profits or as elected by the companies.

7. Capital allowances and depreciation

7.1. The rates of depreciation allowed for tax purposes and the extent of any incentives offered to businesses of any or all sizes to invest in capital assets are essentially political questions, and it would be inappropriate for us to comment on these.

7.2. The provision of incentives such as capital allowances through the tax system adds complications, and changes to the structure or rates of allowances impose further unwelcome compliance costs on businesses. Frequent alterations to the capital allowances rules cause cost and confusion and often prevent such changes from providing the intended incentives in an effective manner.

7.3. An alternative might be to provide small businesses with investment incentives such as direct grants, wholly outside the tax system. These might reflect the fact that cash flow limitations, aggravated by a shortage of bank finance, are often the most crucial constrains on a small businesses facing the cost of acquiring new equipment.

7.4. While capital allowance rates are a political issue, there seems little justification for granting allowances that fall behind commercial depreciation – even where there is only a timing difference. Cars are a particular bone of contention – they are often essential for small businesses and substantial disallowances or timing differences are seen by business proprietors as unfair.

7.5. We recommend that the Government should revisit the whole scheme under which capital allowances are made available, in the hope of finding a way that small businesses can be offered effective incentives to invest in new equipment and fair tax relief on subsequent depreciation. For small businesses who can understand the existing regime, the annual investment allowance offers useful relief and we would like to see this retained. However, for other small businesses (or perhaps micro businesses) a solution might be to allow them (optionally) to deduct their commercial depreciation charges instead of the statutory capital allowances rates currently available – thus providing simplicity and greater stability.

8. Construction Industry Scheme

8.1. The rules governing CIS are exceedingly complicated. They place unfair burdens on those who, on engaging other workers, are obliged to determine the employment status of those workers.
8.2. Even the slightest infraction in tax compliance, often unrelated to CIS, can lead to loss of gross payment status under CIS and this can have a devastating impact of the cash flow of a small business, often leading to redundancies or business collapse.

8.3. The CIS penalty provisions are proving very unforgiving to small businesses who transgress them even as a result of innocent error. For example, in one case recently brought to our attention, a business undertaking some work within CIS, both in receipt of and making payments involving tax of only £4,000 or £5,000 in each direction, had failed to register under CIS and submit monthly returns and now faces penalties of £56,000, which threatens to make the proprietor bankrupt.

8.4. We recommend that CIS be reviewed in the light of other simplification measures being considered, with a view to making it easier for small businesses to comply. We recommend also that it be applied with a greater understanding of the financial pressures which many small businesses face. We also suggest that it be linked to real time reporting measures, perhaps through the Real Time Information proposed under PAYE Reform, so that compliance irregularities can be identified swiftly before unacceptable penalties accumulate.

8.5. We also call urgently for the CIS penalty regime to be modified and applied so that the level of penalties sought are no greater than would be proportionate to the taxpayer's transgression, the reasons giving rise to it, and the net loss of tax suffered by HMRC.

9. Expenses and benefits

9.1. The task of completing Forms P11D is seen by most employers as burdensome. Automatic dispensations should operate to allow all businesses to reimburse expenses incurred wholly, exclusively and necessarily for business purposes – unless a business prefers to opt out and submit Forms P11D instead.

9.2. Mandatory payrolling of all benefits and expenses could be particularly burdensome for small businesses. However, we recommend that payrolling of benefits and expenses should be encouraged on a voluntary basis to assist those businesses that would find it helpful.

9.3. While it is understandable that the use of public transport is encouraged, cars remain an essential tool for many businesses and it is regrettable that political bias against their use should have been allowed to introduce inequity. The AA reports that average running costs for a family saloon are 63p per mile on annual mileage of 5,000, yet only 40p per mile is allowed for tax purposes. It is unfair that employees, especially those who keep their car usage to a minimum, should be disadvantaged when using their cars on mileage incurred wholly, exclusively and necessarily on their employer's business.
9.4. For many businesses, entertainment is a legitimate expense incurred wholly and exclusively for business purposes. We suggest that the automatic disallowance of all entertainment expenditure is a matter which should be re-visited with a view to introducing fairer and simpler treatment that recognises the heavy dependence of modern business on networking activities.

10. Entrepreneurs’ Relief

10.1. The rules for Entrepreneurs’ Relief have been structured differently from those which previously applied for taper relief purposes, and this has introduced unnecessary complexity for those wishing to claim the relief. For example, it is unclear why Entrepreneurs’ Relief does not extend to QCBs, EMI options and other forms of debt. These restrictions deny relief on earn-outs and thus discourage economic activity by frustrating attempts to buy and sell businesses. Removing them would be a welcome simplification.

10.2. Entrepreneurs’ Relief can also be denied where a shareholding that would otherwise qualify has fallen below the 5% threshold as a result of dilution – often as a result of bringing in the next generation to a family company. This catches many taxpayers unaware, and discourages others from passing on ownership to younger individuals who might be able to inject new vigour into the business. We see scope for simplifying the rules in this respect.

11. Share schemes

11.1. The rules governing Share Incentive Plans (SIP), Save As You Earn (SAYE or Sharesave), Enterprise Management Incentives (EMI) and Company Share Option Plan (CSOP) are complex, and we would recommend that they be reviewed generally to see if they can be simplified.

11.2. Of these schemes, EMI is the only one that really works for small businesses, since it has particular relevance in helping small, higher risk companies to recruit and retain skilled employees. In the interests of simplicity, it is arguable that most share schemes could be closed to future contributions or rationalised into one common format – based, for example, on EMI.

11.3. The qualifying requirements for EMI are too stringent and the limits and the 3 year gap need reviewing. The aims and objectives of and constraints on EMI options should be reviewed to identify simplification possibilities.

11.4. Legal fees to establish an EMI scheme tend to be at least £3,000 to £5,000, putting it out of the reach of many small companies. We suggest that the Government should investigate the possibility of making available online a standard or skeleton scheme which could be implemented more easily by small companies – perhaps by means of an online form-filling process. This could help the Government realise the objectives of EMI while helping companies reduce their dependence on costly professional advice.
12. Enterprise Investment Scheme

12.1. The Enterprise Investment Scheme aims to help smaller, higher-risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies.

12.2. Some adjustments should be made to the EIS rules, simplifying them and making the scheme more attractive to investors – thus making it easier for companies to raise additional funds at a time when bank funding is still in short supply. For example, we see no logic for the time limits on applications for this scheme – either a transaction meets the rules or it does not, and the time of application should not be a factor determining availability of the relief.

12.3. As with EMI, we suggest that for EIS the Government should investigate the possibility of making available online a standard or skeleton scheme which could be implemented more easily by small companies and their investors – perhaps by means of an online form-filling process. This could help the Government realise the objectives of EIS while helping companies and investors reduce their reliance on costly professional advice.

13. Online services

13.1. We accept that mandatory online filing will become the norm, and in principle we welcome the Government’s plans to improve the range of online services available from HMRC. However, if tax is to be relatively simple for small businesses, then it is important that the demands placed on them to do business online are not unrealistic.

13.2. As an example, we note that the Government has pledged that every home in the UK will have access to a minimum broadband speed of 2Mbps by 2015 – but this is after the date on which many new online filing obligations are to become mandatory. Given that many small businesses operate from home, this demonstrates a lack of joined-up thinking by Government. To keep tax compliance simple, mandation of online filing should be deferred until after the planned broadband rollout has been achieved.

13.3. We also believe that, in administering the tax system, HMRC needs to improve its appreciation of the range of situations in which the use of technology can fail, and the limitations on the IT literacy of those who are obliged to file online. For example, computers can break down, often at the most inopportune of moments; Internet connections can fail, frequently for reasons not understood by the user; and data backups can become corrupted. In such situations, HMRC should be obliged to live in the real world and accept that hard copy forms may have to be used from time to time, and this should not be seen as an automatic excuse to penalise the taxpayer. The indiscriminate application of penalties by HMRC is a real concern to small businesses and can be very harmful to them.