Simpler Income Tax for the Simplest Small Businesses

22 June 2012
Introduction

We are pleased to have this opportunity to respond to the HM Revenue & Customs consultation document entitled ‘Simpler Income Tax for the Simplest Small Businesses’ published on 27 March 2012.

UK GAAP has been developed over a long period as a means of measuring and reporting objectively on the state of affairs of businesses. The rules and principles within GAAP are designed to ensure that a wide range of situations and transactions are reported in a consistent and comparable manner. Specific aspects of GAAP that are of most relevance to small businesses are generally simple to understand and straightforward to apply, and to disregard them would lead to inconsistencies in approach and opportunities to manipulate reported business results. Furthermore, ideas such as debtors, creditors and stock, where cut-off can have a significant impact on reported results, are already well understood by proprietors of almost all but the very smallest of businesses.

We can understand that, superficially, allowing very small businesses to self-assess their tax on a cash basis and to claim simplified expenses as an alternative to allowable costs may seem to have some attractions. The proposals were based on sound preliminary thinking undertaken by the Office of Tax Simplification. However the extent to which the developed proposals now deviate from the initial principles set out by the OTS has resulted in a situation that could amount to significant additional tax and tax compliance burdens being placed on proprietors of small businesses, misguided by the apparent simplicity of the changes.

The proposed changes would add complexity and cost to the accounting and tax compliance obligations of all businesses with turnover below or close to the chosen upper threshold. Businesses close to the margin would be forced to monitor their position to ensure that they complied with the tax law. Smaller businesses would be reckless if they did not take reasonable steps to ensure that their tax liabilities were kept to a legal minimum. Such behaviour should be nurtured so that small businesses, the future lifeblood of the economy, would be encouraged to grow. If the proposals were introduced, then in the course of acceptable planning many business proprietors would probably wish to undertake the following:

(a) they would need to determine whether or not they were eligible for the new regime;

(b) depending on (a) they would need to evaluate whether they would benefit from claiming relief for expenses on the proposed simplified basis;

(c) depending on (b) they would need to decide whether or not to opt for the cash basis;

(d) many businesses opting for simplified expenses, or for the cash basis including simplified expenses, would need to repeat the process at (a) annually to avoid the risk of finding themselves over the upper threshold and therefore potentially exposed to extra tax, interest and penalties;

(e) if the new regime was optional, businesses would need to repeat the processes at (b) and (c) annually or at least periodically to decide whether to opt in or opt out; and

(f) if the new regime was mandatory or the ability to opt in or out was restricted, businesses might need to consider annually or at least periodically whether it would be prudent to incorporate as a means of reverting to being taxed on their business results calculated in accordance with GAAP.

For businesses wishing to do no more than take acceptable steps to minimise their exposure to tax, complying with their tax obligations would become considerably more cumbersome and expensive if the proposals were adopted. Business proprietors able to handle their own tax compliance would spend more of their time doing so and less time on the essential running of their businesses. Those who employ tax agents and advisers would almost certainly rely on them more and pay more for doing so. Many others would feel it necessary to employ professional advice for the first time – as has happened with small companies faced with the onerous obligations involved in trying to comply with iXBRL.
There are, of course, businesses that would be prepared to go to extra lengths – though within the bounds of what is legal and acceptable – in planning to minimise their exposure to tax. For them we think the proposed cash basis would be a godsend. It would be relatively simple, for example, to manipulate the timing of certain receipts and payments so that (say) every other year showed poor business results, entitling the proprietor to maximise their state benefits. This might involve more time and effort in planning, but we have sounded out the views of ICAS members in public practice who provide accounting and tax services to a wide range of clients including small businesses, and it is clear that many of those clients would prefer to pay extra fees to their adviser rather than extra tax to the Exchequer.

Accountants, tax agents and advisers should all have much to gain from the introduction of the proposed new regime, because it would bring more work to them. However, under our Royal Charter ICAS has public interest responsibilities and these are strongly reflected in the views of our membership. Although professional advisers would have much to gain from the introduction of the complex proposals contained in the consultation document, a substantial majority of the ICAS members we have sounded out are opposed to both the cash basis and simplified expenses. They believe that the current system, based on GAAP, serves Government and businesses well. We are convinced that retaining the current system, at least for all but the very smallest businesses, would be in the public interest.

We think that the proposals put forward by the Office of Tax Simplification in its July 2011 discussion paper ‘A simpler income tax for the smallest businesses’ were balanced and constructive. The OTS questioned whether the exit level for the cash basis should be at £20,000, £30,000 or the VAT registration threshold and we responded saying that £30,000 seemed reasonable.

It seems that the OTS had the very smallest of businesses in mind. For example, we would quote the following from para 1.5 of their paper, as follows:

A view that has been put forward to the OTS is that very small businesses should be able to deal with their tax obligations and compute their tax liability without needing to apply detailed and complex tax and accounting rules and without needing to use an accountant or agent unless they choose to do so. One example would be individuals starting up a part-time business to supplement employment income. A major simplification of the rules could improve the extent to which such businesses engage with the tax system.

The example immediately following that paragraph used, for illustrative purposes, an employed teacher earning an extra £2,700 per annum from giving private lessons. For micro businesses such as that, an optional cash basis and simplified expenses would recognise and regularise the status quo, in that many taxpayers in that position may be unaware of GAAP or simply feel that it is unnecessary to pay any attention to it, and many of them already claim de facto simplified expenses. We agree therefore that there may be a place for the cash basis and simplified expenses, for the very smallest of businesses and on an entirely voluntary basis. However, HMRC’s proposals as they stand are ill-judged, poorly targeted, and would impose additional complexity at a time when simplification of the tax system is desperately needed.

At a late stage in preparing this response, we have become aware of the publication in draft on 15 June by the Department of Work and Pensions of The Universal Credit Regulations 2012, together with their call for evidence by 27 July. We note that the related Explanatory Memorandum sets out (at paragraphs 171 to 188) the DWP’s proposals for Income from Self Employment and Income Reporting. We are very concerned to discover that the DWP’s proposals for cash accounting and the basis on which business expenses should be claimed for the purposes of the Universal Credit are different from those being proposed by HMRC. We are relieved to note (from paragraph 184) that the DWP aims to do further work to develop the regulations to achieve alignment where possible with tax concepts. However, we think there should be much greater emphasis on the need for uniformity across the board. For HMRC and the DWP to have gone public separately with proposals that are incompatible with one another indicates a very regrettable absence of joined up Government.
Views from a range of ICAS members

On a poll of members to gauge their reactions to HMRC’s proposals, we obtained the following opinions:

**Cash basis**

- Over two-thirds of the ICAS members we consulted were opposed to the introduction of an optional cash basis of accounting for small unincorporated businesses. Only about one-third favoured its introduction.

- When asked whether they felt that an option to move away from GAAP on to a cash basis would bring worthwhile benefits for a small business that was likely to remain small and therefore within the scope of these new rules on an ongoing basis, two-thirds felt that the option would bring no worthwhile benefits. Only one-third thought that it would.

- For a small but expanding business that was likely to grow through the £150,000 turnover threshold within (say) 3 years (i.e. businesses that offer real hope of generating growth and creating expanding employment) and would therefore have to change to preparing accounts in accordance with GAAP at that point, an overwhelming 85% of those we consulted felt that the option of using the cash basis would bring no benefits. Only 10% thought that it would.

**Simplified expenses**

- Opinions were more evenly divided on simplified expenses. Just under half of the members we consulted generally welcomed the proposed introduction of the optional simplified expenses rules, while just over half were against them.

- The same even balance was reflected in our members’ responses when we asked whether they believed that an option to claim simplified expenses would bring worthwhile benefits for a small business that was likely to remain small and therefore within the scope of these new rules on an ongoing basis.

- However, as with the cash basis, a large majority thought it unlikely that the simplified expenses proposal would benefit a small but expanding business that was likely to grow through the £150,000 turnover threshold within (say) 3 years and would therefore have to change to claiming expenses in accordance with GAAP at that point. 75% believed that the option to claim simplified expenses would bring no worthwhile benefits for such a business, while only 20% thought that it would.

Extrapolating from these views expressed by a sample of ICAS members, we conclude that a strong majority of our members are opposed to the proposals, while nonetheless a significant minority are in favour of them. However, under our Royal Charter we have an over-riding responsibility to act in the public interest and on this basis the remainder of this response concentrates on technical and practical issues which we believe HMRC needs to take into account in deciding on a way forward.

**Our responses to HMRC’s consultation questions**

**Question 1**

The Government is considering that to qualify to use the cash basis, a small business’ receipts would be less than £77,000 in 2012-13 and would be required to leave the cash basis when their receipts are more than £150,000. Do you think these entry and exit limits are appropriate?

No. There is a strong view among our members that, if the optional cash basis is to be introduced at all, it should be aimed at only the smallest businesses. It was at this level of business that the OTS directed its original recommendations, and we think that HMRC should pay greater heed to those recommendations.
Question 2

If you don’t think the entry and exit limits above are appropriate, why not?

It would be fundamentally wrong to allow a business of any significant size to move away from preparing its accounts in accordance with GAAP. GAAP is intended to show a true and fair view of the results of a business, and this cannot be achieved without having appropriate regard to accruals and prepayments, other debtors and creditors, stocks and work in progress, capital employed and financing costs.

Using GAAP to measure business results is important in helping business proprietors understand and monitor their results and financial position. Accurate GAAP accounts are likely to be needed by any potential lender, and this could be important – not only for raising new business finance to fund expansion, but also for raising personal mortgage finance. Accurate GAAP accounts might also be demanded by any potential investor in or purchaser of the business. It would also need to be established whether GAAP accounts would be required to support applications for Government grants and any subsequent monitoring in relation to these. The absence of a balance sheet would mean that accounts prepared on a cash basis would be seriously deficient for any of these purposes.

Businesses that hope to grow, and have the potential to do so, should be encouraged from the outset to prepare their accounts in accordance with GAAP. If any businesses are to be allowed to stop short of this and use the cash basis instead, in the interests of simplification, then this should be restricted to very small and very simple businesses – ideally those unlikely to grow – where the cash basis is already the de facto practice in many cases and where the above requirements for GAAP accounts are unlikely to arise.

Businesses operated by individuals in partnership would need to continue preparing their accounts in accordance with GAAP in order to determine the interests of the various parties.

Question 3

If you don’t think the proposed entry and exit limits above are appropriate, what figures would you suggest instead?

When our Small Business Tax Sub-Committee considered these proposals, it was their unanimous view that an entry ceiling of around £20,000 to £30,000 would be appropriate, with the exit limit set no higher than the level of the VAT registration threshold (currently £77,000). Previously, in our response to the OTS discussion paper, we had suggested that the exit limit for the proposals they were then exploring should be set at no higher than £30,000.

In practice, it might be easier to adopt limits that would broadly keep pace with inflation, and this might be achieved (for example) by setting the entry level at one half of the VAT registration threshold, and the exit limit at the VAT threshold.

We also suggested to the OTS that it would be helpful if a business should not be required to cease using the scheme until the second consecutive year in which the threshold was breached, since one of the objectives should be to limit the necessary change in treatment to those businesses that have reached the threshold and appear to be staying above it.

We would expand on this by recommending that, when a business ceases to be eligible for the cash basis and simplified expenses, the onus should be on HMRC to notify the business of their obligation to adopt GAAP and stop claiming simplified expenses, and the business in question should then be required to comply from the next fiscal year that begins after receipt of that notice – unless turnover in the intervening year has fallen back below the exit limit. This should be relatively easy for HMRC, based on self assessment tax returns received, and would avoid exposing small businesses to additional risks of extra tax, interest and penalties as a result of a ‘tax compliance trap’ created by a purported simplification measure.
**Question 4**

*Should new small businesses be required to make an active choice between the cash basis and the normal rules? Alternatively should the cash basis apply to a new small business by default, unless they indicate otherwise?*

HMRC claim that the Government is trying to encourage growth in the economy by helping small businesses. Few of our members believe that the cash basis would bring worthwhile benefits for a small but expanding business that was likely to grow through the exit limit. It would certainly be fundamentally wrong to impose the cash basis on such a business since this might place it at a disadvantage. This would create a situation where a new small business going for growth would need to prepare its accounts in accordance with GAAP for sound business reasons, while also having to adjust these to an artificially imposed cash basis accounts in order to comply with a misguided ‘simplification’ requirement imposed by tax law.

If HMRC were determined to adopt the proposals in spite of our reservations, we think that every eligible business should be required to make an active choice for GAAP or the cash basis, rather than either of these applying by default. We think this would be important to avoid relatively unsophisticated small business proprietors from falling into one or other treatment without having an opportunity to decide, supported by clear and concise guidance from HMRC.

**Question 5**

*Are there any issues or transactions relevant to small businesses eligible to use the cash basis that have not been considered or addressed adequately?*

The cash basis is not a valid way to measure business results, except in the case of a business where purchases and sales are all in cash and no fixed assets, stock or work in progress of any significance are held.

It is fundamentally wrong to suggest that interest paid on business borrowings should not be allowed in computing taxable profits, and that a cash basis deficit should not be allowable for the purposes of sideways loss relief. We think there have been flaws in HMRC’s thinking in putting forward these suggestions, and it would be wrong to introduce the cash basis with these restrictions.

For example, suppose that a business borrowed £1,000 to spend on stock. This stock would be sold, the loan and interest on the loan paid, and the proceeds taxed. If the stock was sold for (say) £1,500 and the loan interest was £100, then the profit made on the stock would be £1,500 minus the business costs (cost of goods and interest) of £1,100, i.e. a profit of £400. The cash flow from the sale of £1,500 would be applied in repaying the loan of £1,000 and paying the interest of £100. HMRC wish to disallow the loan interest and tax the business on a deemed profit of £500, but there can be no justification for this on either a cash or an accruals basis. We think the additional tax charge for the business would be entirely inappropriate. The disallowance of borrowing costs would place heavy additional burdens on small businesses, making it difficult for them to survive, let alone grow and create employment. Thus the disallowance would ensure that the new basis would achieve exactly the opposite of the original OTS proposals.

Similarly, the availability of sideways loss relief can be a crucial factor in helping a new business to get off the ground. For example, in present economic circumstances, self employment is an attractive option for many individuals leaving employment, and it is vital for the economy that these new businesses should be encouraged so that they can continue to pay taxes and create employment. Sideways loss relief against the proprietor’s other income, including their employment income in the year they start, can be vital in ensuring their survival, and we think that it would be wrong to encourage or impose use of a cash basis that would deny such relief.
**Question 6**

*Are there any significant tax avoidance risks, which would not be adequately controlled by the proposed design?*

The proposed cash basis would provide huge opportunities for taxpayers to defer tax liabilities, and to manipulate profit levels to maximise state benefits. It would create a raft of new opportunities to avoid tax and maximise benefits.

There could be particular opportunities for tax avoidance towards the end of every tax year, when the rendering of sales invoices might be delayed in order to postpone the receipt of monies due to be brought in as income on the cash basis. Likewise, there could be opportunities for avoidance whenever a business changed its basis of accounting from GAAP to cash or vice versa. The risk that such opportunities might be exploited could be reduced by imposing a requirement that any business using cash accounting must render all its sales invoices promptly.

The majority of our members could gain from the proposals, because the introduction of greater complexity would lead to a higher demand for tax advice; nonetheless they are predominantly opposed to the proposals.

**Question 7**

*Do you agree that the same rules should apply to barristers or advocates, and the current special rules for barristers or advocates should be withdrawn?*

We have no strong views on whether the current special rules for barristers and advocates should be retained or withdrawn, and we think that they should be well able to make their own representations on this matter.

**Question 8**

*Is a statutory restriction on switching between the ordinary and cash basis needed? If so, how should the restriction operate?*

If (as we suggest) the cash basis should be available only to very small businesses, the proprietors of which are likely to be generally unsophisticated from a financial and tax perspective, any restriction on the ability to switch between GAAP and the cash basis would merely impose additional complexity and this would run counter to the Government’s simplification objective.

If HMRC felt that such a restriction should be imposed in spite of our reservations, then this would only be appropriate if the business had been required to make an active choice for GAAP or the cash basis (as suggested in Question 4). In these circumstances it would be reasonable to require the business to stay with that choice for a minimum period of (say) three or (at most) five years. If this was imposed we suggest that it should be accompanied by a let-out in cases where there had been a major change in the nature or scale of the business.

Again because users are likely to be relatively unsophisticated, the proposed regime could operate very harshly at the margin, where proprietors of growing businesses might find themselves facing extra tax, interest and penalties because they had failed to spot that their turnover had reached the crucial point at which they had to adopt GAAP. This risk does not exist at present, because all businesses are required to comply with GAAP, so it would be a new pitfall introduced by the proposals. To prevent this from placing small businesses at a disadvantage, the onus should be on HMRC to notify the business (when appropriate) of their obligation to adopt GAAP and stop claiming simplified expenses.
Question 9

Do you have any other comments on the details of the proposed design of the cash basis?

While we have reservations about the introduction of the cash basis, we have particular concerns about the use of the cash basis by partnerships – where moving away from GAAP would bring fundamental distortions into the relationships among the partners and their respective interests in the business. Businesses operated by individuals in partnership would need to continue preparing their accounts in accordance with GAAP in order to determine the interests of the various parties.

Question 10

What are the pros and cons, as well as any other implications, of the cash basis? Please list these.

Already covered in our introduction and our answers to Questions 1 to 9.

Question 11

Do you have any comments on the tax impact assessment for the cash basis in Chapter 5?

Chapter 5 contains a single tax impact assessment covering both the cash basis and simplified expenses, so we have responded to this question at Question 16.

Question 12

Would a 3-tier banded rate or single fixed rate for business use of home strike the most appropriate balance between simplification and fairness?

We see nothing fair about the proposed simplified expenses regime. We think that simplified expenses are likely to be relevant only to the very smallest businesses, and in very many cases the suggested rates of allowances for business use of home would be insufficient to take account of the true levels of expenses incurred by most home-based businesses.

We are also concerned that the proposals for business use of home appear to be based on the pre-existing levels of allowance for home-based employees, where the costs must be incurred wholly, exclusively and necessarily for the purposes of their employment. This seems to ignore that fact that self-employed business are taxed in accordance with a wholly different set of rules, and that they are entitled to relief for costs incurred wholly and exclusively for business purposes. It is disingenuous of HMRC to overlook this important distinction in putting forward these proposals.

Question 13

Are there any issues or transactions relevant to businesses eligible to use simplified expenses that have not been considered or addressed adequately?

We see a real danger that those least able to understand their tax affairs will lose out because they may accept, without question, suggestions by HMRC that the proposed levels of simplified expense allowances represent a fair measure of relief for business expenses incurred. In very many cases the simplified expenses will be far from adequate.

For example, a home-based business involving long hours of evening work might well involve significant costs incurred on extra heating and lighting that would not otherwise have been required by the household, and in such a situation the standard allowances for business use of home could fall a long way short of the extra expenditure incurred. Likewise, the 45p per mile allowance for business use of a modest family car could easily cover only (say) half the real economic cost of business miles actually driven in cases where total mileage is low.

Even from among our members who thought that the cash basis and simplified expenses might bring some measure of simplification, strong views have been expressed that the suggested levels of simplified expenses would prove inadequate in many cases and that
businesses opting to use them would be likely to lose out financially. For this reason we think
that very few represented businesses would opt for the cash basis or simplified expenses;
instead, these options would generally be chosen only by the ill-advised and those without
advisers.

**Question 14**

Do you have any other comments on the details of the proposals for simplified expenses?

We see HMRC’s description of the proposals as a ‘simplification’ as dangerous, and likely to
mislead many businesses into thinking that they would automatically benefit by opting for
simplified expenses. We think that most small businesses would pay additional tax by
claiming simplified expenses.

If simplified expenses were available piecemeal, they could offer genuine simplification for
small businesses without unnecessarily penalising them. Therefore we suggest that they
should be available on a ‘pick and choose’ basis. In these circumstances a business could
decide (for example) to claim simplified expenses for use of home but actual costs for motor
vehicles. This would ensure that tax compliance could be simplified without depriving
unsophisticated business proprietors of reasonable tax relief for genuine business costs
incurred.

While there might be some very small businesses that could benefit from the suggested
simplification that the cash basis or simplified expenses might bring, we see no reason why
the two options should be tied together. For example, there might be a very small business
for which the cash basis could offer genuine simplification, but where the patterns of home
use or motoring were such that the simplified expenses would be a significant disadvantage.
In such circumstances, if the option of the cash basis was introduced, it should be possible to
opt for the cash basis while still claiming expenses on the statutory basis.

**Question 15**

What are the pros and cons, as well as any other implications, of simplified expenses? Please
list these.

Already covered in our introduction and our answers to Questions 12 to 14.

**Question 16**

Do you have any comments on the tax impact assessment for simplified expenses in Chapter
5?

We note that simplified expenses are expected to increase tax receipts by approximately £20
million per annum. While we accept that this figure is scarcely material in terms of UK-wide
tax revenues, it does confirm our belief (stated at Question 12) that the suggested levels of
simplified expenses are unduly low rather than being revenue neutral and that business would
therefore tend to pay more tax by opting for them. Indeed, we would question the accuracy of
HMRC’s figure of extra tax of only £20 million, and we would expect the real figure to be
significantly higher than this.

We generally disagree with the assertions that the proposals would be a substantial
simplification for small unincorporated businesses, making it easier and cheaper for them to
calculate their tax liabilities. These statements might be true (in theory) for the very smallest
micro-businesses, but many of those businesses are probably already using a de facto cash
basis in any event. The proposals would mean that very many other small businesses would
need to seek professional help, or extra professional help, to assist them in coping with the
additional complexities that these so-called ‘simplification’ measures would impose. A large
majority of our members have pointed this out and have said that they oppose the proposals,
in spite of the fact that this goes against their obvious self-interest.
Conclusion

We believe that the proposals as they stand would be against the public interest. If the options for a cash basis and simplified expenses were to be introduced, they should be restricted to very small businesses – e.g. those with annual turnover of less than half the VAT registration threshold, with an exit limit equal to that threshold. Decisions to opt for the cash basis or simplified expenses should be independent of one another; in other words, a very small business should be able to opt for the cash basis, without being forced to claim simplified expenses.

If simplified expenses were to be introduced, they should be increased to levels which reflect more accurately the true levels of expenditure which very small businesses incur. They should also be available on a ‘pick and choose’ basis to ensure that they offered small businesses an element of simplification without depriving them of reasonable tax relief for genuine business costs incurred.

We are concerned by misleading protestations from HMRC that the proposals would bring about ‘simplification’. We think they would not – the more so because at the same time the DWP are bringing forward similar but different simplification proposals in relation to Universal Credit. The current messages from HMRC, reflected in the consultation document, might encourage some business proprietors to continue preparing their accounts and self-assessing their tax without professional advice (as echoed in paragraph 174 of the DWP’s Explanatory Memorandum), while the very introduction of the HMRC and DWP proposals would bring new complexities and might make professional advice even more necessary than hitherto. As the regime changes and businesses have to become accustomed to two (or very possibly three) alternatives ways of preparing accounts and tax computations, confusion will arise and there will be increased scope for inadvertent or deliberate misstatements of profits, often resulting in loss of tax revenues by the Exchequer.

It would be unacceptable to expose small businesses to additional risks of extra tax, interest and penalties as a result of a purported simplification measure. To ensure simplicity for the small businesses concerned, there should be a period of grace for any business whose turnover rises through the exit limit. In that situation the onus should be on HMRC to notify the business of their obligation to adopt GAAP and stop claiming simplified expenses, and the business in question should then be required to comply from the next fiscal year that begins after receipt of that notice – unless turnover for the intervening year has fallen back below the exit limit.

HMRC and the DWP should reconsider their respective proposals for cash accounting as they relate to the Universal Credit, and should come forward with a new shared proposal for simplification which will meet the needs of the Universal Credit while also securing the simplification for very small businesses which was the focus of the OTS recommendations.

About ICAS

ICAS is the world’s oldest professional body of accountants, having received its Royal Charter in 1854. Since then ICAS has played a leading role in the accountancy profession. The Institute’s main objective is to uphold the integrity and standing of the profession of chartered accountancy in the interests of society and the membership. We have approximately 19,000 members spread throughout the world and many chartered accountants hold key positions in commerce, industry, the public sector and private practice.