Think Ahead ACCA

Simplifying tax for unincorporated businesses

A public consultation issued by HM Revenue and Customs

Comments from ACCA to HMRC
November 2016
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ACCA has 188,000 members and 480,000 students in 178 countries, with approximately 75,000 members and over 70,000 students in the UK, and works to help them to develop successful careers in accounting and business, with the skills required by employers. We work through a network of 100 offices and centres and more than 7,400 Approved Employers worldwide, who provide high standards of employee learning and development. Through our public interest remit, we promote appropriate regulation of accounting and conduct relevant research to ensure accountancy continues to grow in reputation and influence.

The expertise of our senior members and in-house technical experts allows ACCA to provide informed opinion on a range of financial, regulatory, public sector and business areas, including: taxation (business and personal); small business; pensions; education; and corporate governance and corporate social responsibility. www.accaglobal.com

Further information about ACCA's comments on the matters discussed here can be requested from:

Jason Piper
Senior Manager, Tax and Business Law
jason.piper@accaglobal.com
+ 44 (0) 207 059 5826

ACCA
+44 (0)20 7059 5000
info@accaglobal.com
www.accaglobal.com
The Adelphi 1/11 John Adam Street London WC2N 6AU United Kingdom

ACCA welcomes the opportunity to comment on the proposals issued by HMRC. The ACCA Global Forum for Taxation and UK Tax Committee have considered the matters raised and a large number of ACCA Members and businesses have contacted us with their comments. Their views are represented in the following. This response should be read in conjunction with the comments made on the HMRC MTD consultation suite.

GENERAL COMMENTS

The proposals for Making Tax Digital ("MTD") and the associated £1.3bn investment in HMRC systems changes are the most significant tax project of recent years, and probably the single government project with the widest and deepest short to medium term impact on the population in general. There are three principle aspects to the tax system – the legislation that imposes the charge, the forms and mechanisms that enable assessment and communication of the charge, and finally the payment processes that facilitate collection of the charge – and MTD for business will affect all three.

ACCA has engaged with HM Treasury and HMRC from an early stage on the Making Tax Digital proposals, and we have significant concerns that the transition to quarterly reporting, and potentially payment, of taxes will create difficulties for many sectors, transactions and tax rules.

While this consultation is not directly a part of the MTD programme, and the measures contained in it could be implemented entirely independently of MTD, there will be an inevitable interaction between them. Where specific benefits can accrue from such interaction we have attempted to identify them, and likewise to warn of potential risks which may arise from imposing upon individuals who have little or no technological literacy a requirement to maintain fundamental accounting records using unfamiliar equipment and processes.

We welcome HMRC's commitment to explore mechanisms for simplifying tax compliance, and the recognition that in some cases simplification may have a small negative impact on cash flow of tax receipts which may nevertheless be outweighed by the wider benefits to society. We would urge HMRC to consider all the tax measures they are proposing in the context of the wider societal impacts. Tax systems exist for the benefit of society, not the other way around, and should be designed on that basis.

ACCA
+44 (0)20 7059 5000
info@accaglobal.com
www.accaglobal.com
The Adelphi 1/11 John Adam Street London WC2N 6AU United Kingdom

AREAS FOR SPECIFIC COMMENT:

Chapter 2: Increasing the trading cash basis entry threshold
Question 1a: What level do you consider to be an appropriate turnover entry threshold?
Question 1b: For a threshold not linked to the VAT threshold, should it be reviewed annually in the light of inflation or less frequently (please state recommended interval)?

The entry threshold for cash basis accounting will need to be considered in the light of any final decision on the entry threshold for MTD reporting itself. If, as has been proposed by most commentators, MTD is introduced only for businesses operating above the VAT threshold then of course cash basis would only be available in conjunction with MTD for those adopting it voluntarily. Ultimately of course it is to be hoped that MTD will be so simple and intuitive that all small businesses would opt in to it; for the time being however it seems clear that a combination of factors are likely to mitigate against that for most.

The risk of applying too high a threshold for any cash basis is that it might open the door for abuses of the rules. The higher the income levels in respect of which it can be operated, the greater the potential arbitrage between tax regimes. Given also the potential offset in taxes between incorporated and unincorporated business, the higher the level at which the choice is available, the higher the stakes for the taxpayer and the greater the risk of tax factors distorting business choice as to form.

However, for a significant number of businesses, evidence from our members indicates that the cash basis is often unsuitable anyway for other, non-tax reasons. The cash basis does not give a sufficiently accurate picture of how the business is performing to assist in meaningful planning. External sources of finance will not accept cash basis accounts, and will typically require three years' worth of properly prepared accounting records before offering credit; a well advised business, aware of the future likelihood of needing to provide such records, will operate on GAAP basis accounting from the outset. There is also evidence that clients who do operate on the cash basis may inadvertently incorporate personal expenditure into their records. Although this can of

ACCA
+44 (0)20 7059 5000
info@accaglobal.com
www.accaglobal.com
The Adelphi 1/11 John Adam Street London WC2N 6AU United Kingdom

course be avoided by maintenance of a separate business account, that in itself incurs costs and requires discipline on the part of the business owner.

Question 2a: If the entry threshold were to be increased, do you agree that the exit threshold should continue to be set at twice the entry threshold?
Question 2b: If the entry threshold were to be increased, do you agree that the UC threshold should continue to be set at twice the entry threshold?

There clearly needs to be some band above the initial entry threshold into which a business can grow without requiring it to leave cash basis accounting. However, if the initial threshold were to be significantly increased then there might be a case to limit that expansion band to a set figure (say £80,000 of additional income beyond the initial threshold). It is unlikely that a business would grow so rapidly as to unexpectedly exceed that limit, while still providing a reasonable buffer for growth. While UC profit accounting differs from tax cash basis accounting there is less of an imperative to link tax accounting thresholds to UC status.

Chapter 3: Reforming basis periods

Question 3: Do you agree with the proposed approach of following accounting periods? If not, what alternative approach would you support?

Moving to a non-annual period for tax accounting would require businesses to apportion those fixed amount allowances and limits which are set by fiscal year. Unless one period also aligned with the change of fiscal year, then the existing requirement to apportion figures for rate changes across fiscal years would remain.

However, as with the comments above regarding the use of cash basis for businesses requiring external finance, lenders will typically require annual accounts on which to base their decision. This might change with time, but that cannot be guaranteed.

ACCA
+44 (0)20 7059 5000
info@accaglobal.com
www.accaglobal.com
The Adelphi 1/11 John Adam Street London WC2N 6AU United Kingdom

As the consultation rightly recognises, individual self-assessment tax payers will need to aggregate all sources of income for a fiscal year before being able to finalise their position. This is likely to complicate the interaction with non-annual periods when assessing the ultimate liability and allocation of items such as the annual allowance or annual exempt amount. While it will be possible to calculate the taxable profit for a shorter period, it will not be possible to confirm the related liability arising until the aggregate of the individual's tax attributes for the year.

Question 4a: Are there any other events or situations which would require additional rules?

Any opportunity for taxpayers to exercise choice over the arrangement of their affairs may offer scope for some advantage to be gained. In many cases there are complex anti-avoidance provisions in place to prevent unfair or unintended advantages from being accessed.

In the case of a shift to non-annual accounting periods, there is scope for a business to artificially manipulate the timing of period ends so as to effectively defer the tax charge arising on up to one year of profits by one year. However, such a mechanism could be deployed only once in its lifetime in respect of any given business, and would constitute no more than a cash flow advantage which would reverse on cessation. In practice the taxpayer would be faced with a liability for tax on a year's worth of profits falling into a tax year in which the trade in practice ceased after as little as one day. We understand the Treasury to be aware of this potential, and that it will be factored into any final decision on design, set against the wider beneficial effects for all businesses of being able to align their tax accounting with whatever commercial drivers apply. The introduction of any avoidance rule to attempt to deal with that potential timing impact on tax payments is in itself likely to increase costs and complexity, to the detriment of the proposals overall goals.

ACCA would also welcome a mechanism to allow the relief of existing overlap profits on a move to the new basis. Such a move would tidy and simplify tax affairs for many

ACCA
+44 (0)20 7059 5000
info@accaglobal.com
www.accaglobal.com
The Adelphi 1/11 John Adam Street London WC2N 6AU United Kingdom

businesses, while also injecting much needed cash into the wider economy directly to those profitable businesses best able to make use of it.

Question 4b: Would it be helpful to make any changes to tax accounting periods for any other types of income?

Property owners should have the option to adopt the same basis where they have other trading income arising. Aligning all major sources of income around a single accounting date for tax, which may or may not align with the UK fiscal year end for individuals, would give them greater transparency over their tax affairs. The process of finalising their tax position for the year would be simplified, since all material information would be required for filing to a common deadline.

Chapter 4: Simplified reporting

Question 5: Are there other end of year adjustments not listed in paragraph 4.12 which could be simplified within a reduced reporting framework?
Question 6: Would you welcome the four relaxations proposed?
Question 7: Do you think that the restrictions proposed are appropriate? If not, what restrictions would you suggest?

In practical terms, relatively little time is actually spent on the adjustments identified for potential relaxation. The main burden of adjustment for tax filing relates to the permanent disallowances, such as subsistence and entertaining, rather than accounting timing differences. Detailed stock takes and accurate provisioning for it are uncommon outside larger audited businesses, so the time recovered by relaxing the requirement to estimate year end stock (which is in practice what typically happens) will be minimal. Relatively few unincorporated businesses operate long term contracts, and most accounting issues arise around those over 12 months, for which no relaxation is in any event proposed. As with detailed stock takes, general bad debts provisions are so uncommon as to merit little attention, while the 12 month condition for accruals and

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+44 (0)20 7059 5000
info@accaglobal.com
www.accaglobal.com
The Adelphi 1/11 John Adam Street London WC2N 6AU United Kingdom

prepayments would still require businesses to identify and analyse all such entries in order to establish which the relaxation might apply to. Strictly speaking, most prepayments for commercial insurance contracts will be in respect of a period of more than 12 months, since insurers require payment of the premium for a year's cover before that cover can commence.

While we welcome the intention to try to simplify tax compliance for smaller businesses, in practice it is likely that comparatively few will fall outside either the category of "qualifies for cash basis" or "requires full accruals accounting for other commercial reasons". Given the comparatively small pool of business for which the relaxations would represent any reduction in administrative burden at all (and as indicated above, the benefits may not be that great) it seems likely that these proposals would on balance create additional complexity for a relatively small benefit.

Chapter 5: Reforming the capital/revenue divide within cash basis

Question 8: Do you believe that simplifying the capital/revenue distinction as suggested in paragraphs 5.7 to 5.13 would simplify reporting for businesses within the cash basis?

To the extent that the new definition is shorter than the existing capital allowance rules it would represent a degree of simplification. However, it would still require businesses to undertake an analysis of their expenditure in order to identify items falling into the excluded list. While the draft clauses at annex C are comparatively clear and simple in tax law terms, they still run to three pages of legalese that a typical small business owner would struggle with unless presented entirely in the form of prose guidance with worked examples.

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Question 9: Can you identify any specific caveats which might be needed to ensure that the new rule operates as intended? Are there any potential tax planning opportunities which the current rules would not prevent?

We have been alerted to the potential for start-up businesses to potentially access both loss relief in respect of start up expenses where those are allocated to specific short period, and potentially set the personal allowance for the year against a subsequent profitable trading period within the same fiscal year. While the availability of such a benefit would depend upon the specific design of the allocation and aggregation rules for periods within a single fiscal year it nevertheless illustrates the detail and complexity which will attend any revision to basis periods such as that proposed.

Chapter 6: Assessment of impacts

Question 10a: If the cash basis entry threshold is raised would you consider using the cash basis, or advising your clients or members to use it? If so please provide details of anticipated impacts, including both one-off and ongoing benefits and costs.

Very few businesses of the size or temperament to engage the services of a professional account either qualify for or would derive any benefit from the use of the current cash basis accounting provisions. However, if the threshold were significantly raised then the obligation would arise upon professional advisers to alert their affected clients to its availability, and if necessary provide advice on whether adoption of the alternative basis might be commercially advisable.

Taxpayers will typically when faced with a choice ask for an explanation and calculation on which choice will be beneficial. As with the various VAT simplification schemes, this would place a burden upon the adviser to effectively operate two systems in parallel in order to be able to give properly informed advice on the subject. Every introduction of choice in the system adds complexity and adds cost, even where one of the options might itself be a simplification.

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Question 10b: If the proposed basis period reform is taken forward, how do you think this would impact on business admin burdens? If possible, please provide details of anticipated impacts, including both one-off and ongoing benefits and costs.

It is not practicable to estimate specific impacts of the proposed changes given the breadth and scope of interactions of the other changes to the UK tax system currently under consideration across the whole MTD programme. However, regardless of any changes to tax accounting for individual streams of trading income it seems that the individual taxpayers within self-assessment will still need to undertake a whole-year reckoning of their tax position after the end of the fiscal year. In addition, other commercial users of business information will not change their preference for annual calculations of GAAP profit and loss figures, so for many businesses the availability of alternative tax treatments will be of little relevance.

The abolition of overlap relief would however be a welcome step in simplifying that tax regime and ongoing record keeping requirements.

Question 10c: If the reduced reporting framework is introduced, please provide details of how this will affect your business or your clients or members, including details of both the expected one-off and ongoing benefits and costs for:
- Familiarisation with the new scheme and updating software or systems
- Having to make fewer adjustments than would be required under UK GAAP
Question 10d: If the revenue / capital divide is simplified as suggested do you believe that this would simplify reporting for businesses within the cash basis? If so please provide details of anticipated impacts, including both one-off and ongoing benefits and costs.

As with any change to ta law there will be an initial familiarisation cost upon all advisers. However, in the long term there is unlikely to be a significant saving, since Members will still be required to consider all options for their clients, and even where the limited exemptions around long term accounting or capital/revenue divide have been implemented, analysis will still be required to establish whether the exemption applies.

ACCA
+44 (0)20 7059 5000
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Members have estimated typical annual costs of around two hours per client to explain/monitor the additional choices available. Time is the one resource that no small business can replace, and the cost will be taken directly out of profit generating trading activity. Aggregated up across the entire affected business community it will represent millions of hours per year of diverted resource. HMRC should be sure that they can demonstrate the additional benefit to the wider economy of that allocation of resource.

Question 10e: Please tell us if you think there are any other impacts, benefits or costs not covered above.

The retention of the £500 finance cost restriction effectively limits the use of the cash basis to smaller enterprises with no need of any external finance. The interaction of the finance restriction with other commercial pressures can easily generate an affective tax rate considerably in excess of 100% of actual profits in any capital intensive business.

Care will be needed to ensure that the design of interactions between pre-population of SA tax accounts from CIS and RTI submissions to avoid confusion and possible double counting.

ACCA
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