Office of
Tax Simplification

Small business tax review: Final report

Simpler income tax for the smallest businesses

February 2012

Office of
Tax Simplification

Small business tax review: Final report

Simpler income tax for the smallest businesses

February 2012

Official versions of this document are printed on 100% recycled paper. When you have finished with it please recycle it again.

If using an electronic version of the document, please consider the environment and only print the pages which you need and recycle them when you have finished.

ISBN 978-1-84532-947-1
PU1274

Contents

Foreword

One of the results of the first stage of the Office of Tax Simplification's (OTS) work on small businesses was that we all realised just how many very small businesses there are in the UK. HM Revenue & Customs (HMRC) figures suggest there are about 2 million whose turnover does not exceed £20,000 a year.

We therefore set ourselves the task of devising a simpler tax framework for these businesses. In parallel with this work, we have looked at how HMRC interacts with small businesses and highlighted potential ways to make life easier for small businesses in their dealings with HMRC (HMRC administration). There has also been a separate study on a possible disincorporation relief. The result of all this work is three reports being published together.

Last summer we floated some of our ideas in a discussion paper on "A simpler income tax for the smallest businesses". It was stressed that we were looking at the very smallest businesses. We were pleased with the discussion this stimulated and the submissions we received. The term "small business" covers a huge range of sizes and activities and it would be helpful to use the term "nano-business" to differentiate these smallest businesses from other small businesses. This is an issue that is discussed in our report on HMRC administration.

This report concludes on the three main areas in the discussion paper:

- should a "cash basis" be allowed for tax purposes?
- would a wider range of flat rate allowances be useful?
- what about a real alternative system such as a turnover-based tax?

All three areas have aroused passionate debate, not least in our consultative committee: all three have merits and should, we think, be taken forward. Forms of "cash accounting" are widely used by small businesses and we think that these should be an acceptable basis on which "nano-businesses" calculate their profits for tax purposes – we do, though, prefer the term "receipts and payments" rather than cash accounting. In saying this we do not detract at all from the need for proper financial information for many business decisions – but many of the smallest businesses are of a size and outlook that only prepare accounts for tax purposes.

Flat rate allowances already exist, examples being the well-used mileage allowance for cars and wear and tear allowance for furnished lettings. We believe there is scope to offer more fixed rates to simplify tax for small businesses, particularly in the areas they have told us that they have the most difficulty and uncertainty. If more flat rates are introduced, the amounts chosen will need to be realistic and also have regard for possible effects on tax revenues. There is also the major issue of whether these alternatives should be compulsory, optional or, as we prefer, a default which can be opted away from. We want to make things easy for small businesses but we need to be fair as well.

This brings us to the idea of a genuinely alternative system. We found no enthusiasm for taxes that were based on indicators, such as numbers of tables or employees. But charging tax based on turnover, rather than profit, evoked more support than we expected and we think that there should be a formal study of such a system, examples of which are already in use in many other countries.

This report has been led by Angela Williams, one of the small team of tax specialists working with the OTS and great thanks are due to her. She has been ably supported by Andy Richens and Anish Mehta and all of the OTS team have contributed to the evolution of the ideas. We have benefitted from a great deal of input from outside the OTS, through surveys, meetings and responses to our discussion paper. Our consultative committee has both helped and challenged us throughout and I should make it clear that not all support all our proposals.

In the end, this is an OTS report which I hope will find favour and be taken forward by HMRC and HM Treasury, though the initial decision is with the Chancellor of the Exchequer. We think the ideas it contains have the potential to help our smallest businesses, leaving them with more time to focus on what they do best.

John Whiting

Tax Director, Office of Tax Simplification

Executive summary

As part of the second and final stage of the small business tax review, the Government asked the Office of Tax Simplification (OTS) to explore options that might deliver simplifications for the very smallest businesses. The final stage of this review also covers recommendations for simplifying tax administration for small businesses and the possible introduction of a disincorporation relief, which are dealt with in separate papers.

This paper builds on previous work undertaken and evidence from surveys and meetings with small businesses and their tax advisers[1] together with input from our Consultative Committee[2]. Arrangements in other countries which attempt to make calculation of tax liabilities easier for smaller businesses have been reviewed and suggestions put forward by those consulted and the reasons for resistance to, and support of, proposals have been appraised.

It should be emphasised that **in this work we have been concentrating on the very smallest unincorporated businesses.** These are businesses:

- with turnover of £30,000 or lower;
- with little or no significant capital investment;
- normally not registered for VAT; and
- probably with no employees.

These businesses are often simply a single person carrying on a trade or profession. **They will often not have the help of a tax or accounting specialist.**

Our research indicates that "cash accounts"[3] are already widely used, which demonstrates that businesses find this method easier and less time-consuming to use. We have also heard that claiming for certain business expenses, such as use of home, can be disproportionately burdensome for very small businesses, particularly given the small amounts that are often involved. It could be possible to go further, and achieve greater simplification, by moving to a completely different way of calculating the tax charge of the smallest businesses.

Such simplification could deliver benefits to HMRC in its management of the tax system, although we are conscious that the issue of set amounts for expenses may raise concerns over increased costs for the Exchequer. As well as delivering simplification, we think that an alternative system could make a contribution by helping some businesses move out of the informal economy and so help HMRC's work on the "tax gap".

For all of these recommended changes, there is the issue of whether the alternative system should be compulsory, an annual free choice or, as the OTS recommends, the default position. It may be seen as unfair to compel a business to use an alternative system or a fixed rate. However, permitting frequent change, or an annual choice of regime, leads to extra complexity for businesses. We believe that the solution is a simplified regime which is recommended for use by all, but to allow an opt-out into using precise expense claim calculations or full accounts, provided that this method is adhered to for a minimum period, say five years.

[1] We received approximately 3,500 responses to surveys from The Futures Company (TFC) (commissioned by the OTS and HMRC), members of the Federation of Small Businesses (FSB) and tax agents.

[2] Further information can be found at: www.hm-treasury.gov.uk/ots_smallbusinessreview_committee.htm and in Chapter 1 of the OTS Small Business Tax Review: Final report.

[3] "Cash accounts" is a phrase commonly used to refer to accounts prepared on the basis of money in and money out rather than those prepared using generally accepted accounting principles (GAAP).

Mindful of transitional issues as businesses grow, we think that there needs to be generous headroom – say a limit of £40,000, or a two year transition period – before a business is required to change.

Our recommendations for simplifying small business income tax are therefore:

1 **Receipts and payments accounting**[4]: Businesses which have turnover of up to £30,000 should calculate their profits using "receipts and payments" but have the option to continue to use profit figures calculated in accordance with generally accepted accounting principles (GAAP) should they prefer this (Chapter 5).

2 **Simplified expenses claims:** Simplified arrangements should be introduced for deductions of certain specified business expenses which should make expenses claims easier to calculate and give certainty to businesses. The following have been identified as expenses which businesses have difficulty with and our recommendations for each:

- Use of home – standard or higher flat rate amount per week (6.17–6.24);
- Mileage – Approved Mileage Allowance Payments (AMAPs) with no upper turnover limit, and new AMAPs for vans (6.25–6.29);
- Capital items – allowed as a deduction rather than capital allowances (6.30–6.35);
- Private use assets and services – disregard limited private and business use (6.36–6.41);
- Telephone, mobiles and internet – a standard allowance or "disallowance" (6.42–6.44);
- Subsistence – improve guidance and consider use of flat rates (6.45 – 6.47);
- Laundry – same rates as used by employees (6.48); and
- Postage and stationery – allow estimates for small amounts or flat rate amount (6.49 and 6.50).

3 **The OTS view is that receipts and payments accounting, flat rates and standard amounts should be the default basis for income and for claims for these expenses, with the option to use GAAP and a strict apportionment of expenses if desired.** Businesses would not be permitted to choose which regime was best for them each year: whichever method is chosen would need to be adopted consistently in subsequent years.

4 **Alternative tax systems:** turnover-based taxes should be investigated further because these have the capacity to simplify significantly tax for the smallest businesses.

5 **Definition of profit for non-tax purposes:** the definition of income for the new Universal Credit should have regard to changes that may be introduced to simplify tax for the smallest businesses. Furthermore, where income or profit is referred to in other legislation, for example national insurance contributions and repayment of student loans, it would be undesirable if the measure is different from that which is used for tax purposes.

Finally, it is important to stress that the OTS has been set up to advise Government, and cannot make policy decisions itself. We have presented these recommendations to the Chancellor of the Exchequer and anticipate a formal response as part of Budget 2012. It will be the Chancellor who decides on any changes, which would be subject to the normal Parliamentary process.

---

[4] We refer to "receipts and payments accounting" rather than "cash accounting" because cash accounting means different things to different people. "Receipts and payments" is the name given to the simplified accounting arrangements used by charities. See Chapter 5.

1 Introduction

1.1 In March 2011, the Office of Tax Simplification (OTS) published an interim report[5] on areas of complexity and uncertainty for small businesses and recommended priority areas for simplification. The Chancellor asked the OTS to undertake further work and report before Budget 2012 in three areas:

- improving HMRC's tax administration for small businesses;
- a new system for taxing the smallest unincorporated businesses; and
- a possible new tax relief for disincorporation.

1.2 This report covers options for simplifying income tax for the smallest unincorporated businesses. Disincorporation relief and HMRC administration are addressed in separate, self-contained reports published alongside this document. Where relevant, the links between the documents and the recommendations have been made clear.

1.3 The conclusions are based on feedback from the discussion paper published in July 2011[6], a research project carried out by The Futures Company (TFC)[7] on behalf of the OTS and survey evidence from members of the Federation of Small Businesses (FSB)[8] and tax agents for small businesses[9]. This information has been taken together with views obtained in a series of meetings around the country over the last 18 months and the input of the consultative committee[10]. Our work has also been informed by insights we have obtained from reviewing tax simplification in other countries.

1.4 The businesses under consideration here are below the VAT registration threshold[11]. The vast majority do not have any employees[12]; many are simply one person carrying on a trade or profession. It is envisaged that any simplified systems will be available only to the smallest unincorporated[13] businesses; the interim report suggested an upper limit of £20,000 for turnover. Since then we have sought views on different upper limits.

1.5 The aim of the OTS is to recommend changes that deliver genuine simplification. We are conscious that change brings complexity, particularly where transitional arrangements are required. Where taxpayers are given a choice over their tax arrangements, this also introduces complexity. Our consultative committee has emphasised these matters.

[5] *OTS Small Business Tax Review March 2011*: http://www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf

[6] *A simpler income tax for the smallest businesses*, http://www.hm-treasury.gov.uk/d/ots_tax_for_small_business_discussion_paper.pdf. A summary of responses is given in Annex B.

[7] The OTS and HMRC commissioned a joint piece of research from TFC that reported in December 2011. This work was primarily for the purpose of the tax administration strand of this review. A summary report is available via the OTS website http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm

[8] The OTS contributed a set of questions to the FSB's survey of members in September 2011. The survey received approximately 1,700 responses.

[9] The OTS launched a survey of tax agents in November 2011. This was circulated via a number of accountancy and related bodies and also available on the OTS website. The survey received over 700 responses.

[10] A full list of Consultative Committee members and minutes from meetings are available on the OTS website: http://www.hm-treasury.gov.uk/ots_smallbusinessreview_committee.htm

[11] The VAT registration threshold is £73,000 in 2011-12; some small businesses with turnover below the registration threshold will register voluntarily.

[12] OTS analysis of HMRC data shows that in 2009-10 over 90% of sole traders with turnover below the VAT registration threshold had no employment related costs. This analysis covers businesses that submitted detailed breakdown of expenses in the self employment pages of the self assessment return.

[13] We are mindful of initiatives from the European Commission and the Department of Business, Innovation and Skills looking at reporting requirements for "micro entities". This is mentioned in paragraph 5.50.

1.6 Based on the evidence collected, the recommendations in this report have the potential to bring long term benefits to the small business community. In our view, these benefits would outweigh the transitional costs and provide greater certainty and simplicity for between two to three million small businesses in the UK[14].

1.7 In making these recommendations, we emphasise that the OTS is not devaluing the management information provided to small businesses or the assistance they receive from the accounting profession. We are, however, mindful of the number of comments we have received which state that too much of the work that is undertaken for the smallest businesses is for the purposes of taxation alone.

1.8 Clearly many businesses will want to have accounting assistance for reasons other than tax; for example to help ascertain profit, to provide management information or to help with obtaining finance. However, where there is scope to remove the mandatory requirement for work that is not necessary for some businesses, we think that is a goal worth pursuing.

1.9 Furthermore, reducing the time and cost spent dealing with tax obligations will allow businesses and their advisers more time to devote to the success of the business.

[14] Based on OTS analysis of HMRC data from 2009-10, as published in Annex A of the OTS discussion paper "A simpler income tax for the smallest businesses" http://www.hm-treasury.gov.uk/d/ots_tax_for_small_business_discussion_paper.pdf

2 Anatomy of a small business

The definition of a small business

2.1 The label "small business" applies to approximately 99% of all UK businesses[15], and covers businesses that differ very significantly in terms of their size. To some, it is a business that is effectively a sole trader, while others see it as one with fewer than ten employees. To a quoted group, a "small business" can be anything that is unquoted although there are many well-established unquoted companies of a significant size.

2.2 This strand of the OTS small business tax review focuses on the very smallest businesses. Using existing EU definitions these businesses are "micro", but this definition covers businesses with up to nine employees and turnover or balance sheet total of no more than €2 million[16]. The needs of a sole trader who is not VAT registered and has no employees are very different from those of a substantial unquoted company with forty employees which may be looking for external investment.

2.3 We believe that there is a real need to adopt a differentiating nomenclature for the very smallest businesses. The OTS notes that the All Party Parliamentary Group on Micro Businesses has recognised the same problem in other areas of Government policy[17].

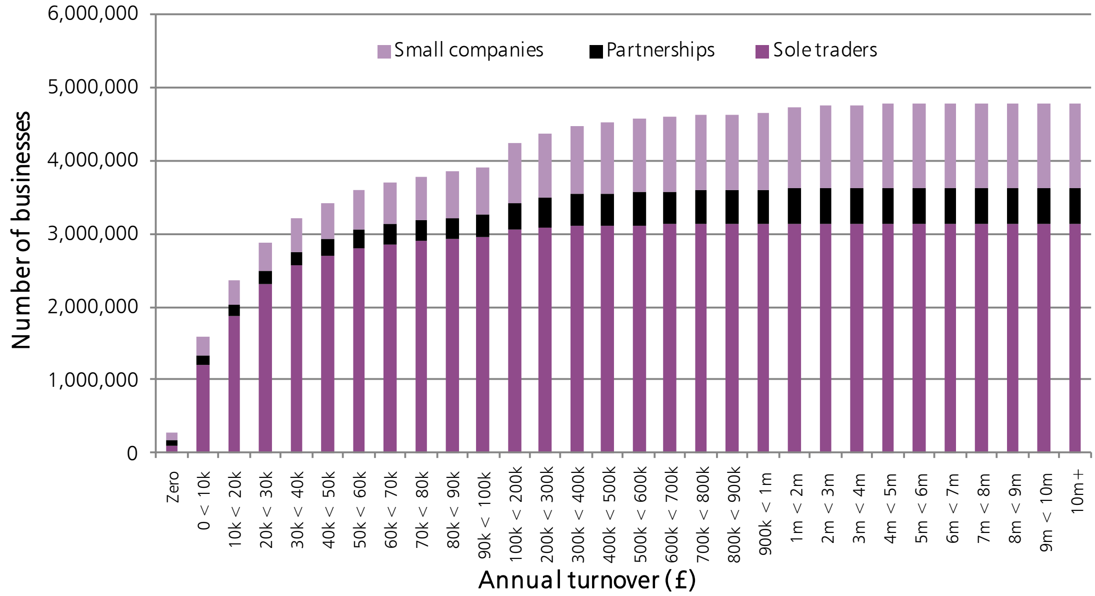
2.4 The OTS discussion paper on a simpler income tax, published in July 2011[18], sought views on three alternative turnover ceilings: £20,000; £30,000; and the VAT registration threshold (£73,000 in 2011-12). We like to use the term "nano-businesses" to describe these businesses. We have chosen to use turnover to define eligibility for our recommendations, as is already done in many other aspects of the tax system. However, as we recognise in this paper, low turnover is an imperfect proxy for a simple business.

Size of the population

2.5 At the start of 2011, there were over 4.5 million businesses in the UK. Of these, nearly 75% were unincorporated[19]. These unincorporated businesses are concentrated at low turnover levels: over 35% of all businesses with turnover below £20,000 are unincorporated and over 60% with turnover below £70,000 are unincorporated[20].

[15] Data available at http://www.bis.gov.uk/analysis/statistics/business-population-estimates
[16] http://europa.eu/legislation_summaries/enterprise/business_environment/n26026_en.htm
[17] See: Micro Businesses – The Importance of a Definition for Policy Making, First Report by the All Party Parliamentary Group for Micro Businesses, November 2011: http://www.annemariemorris.co.uk/pdf/APPG_Micro_Business_Report.pdf
[18] See: A simpler income tax for the smallest businesses: a discussion paper: http://www.hm-treasury.gov.uk/d/ots_tax_for_small_business_discussion_paper.pdf
[19] Data available at http://www.bis.gov.uk/analysis/statistics/business-population-estimates
[20] Based on OTS analysis of HMRC data from 2007-08 and excluding those with no turnover.

Chart 2.A: Number of businesses by turnover band and legal status



Source: OTS analysis of HMRC 2007-08 data

2.6 The very smallest businesses make a significant contribution to the Exchequer. In 2009-10, sole traders and partnerships with turnover below £30,000 contributed £5.4 billion in income tax and class 4 national insurance contributions (NICs)[21] while those with turnover below £70,000 contributed £9.0 billion[22]. At the same time, we note HMRC's concerns that small businesses contribute disproportionately to the "tax gap"[23].

2.7 The tax liability of individual business owners (and their business) varies significantly. Approximately 30% of sole traders or partnerships with turnover below £30,000 did not pay any income tax or class 4 NICs in 2009-10[24]. Less than 10% had a tax liability above £5,000. This partly reflects differences in the extent to which business profits contribute to the overall taxable income of the individual. As can be seen in Chart 2.B, approximately 50% of sole traders and partnerships with turnover under £30,000 received between 90-100% of their taxable income from business profits.

[21] To avoid double counting of individuals, the data has been analysed by reference to the total turnover of all businesses owned by the individual. Tax liability covers income tax and class 4 NICs due for the tax year before deducting PAYE, construction industry scheme payments, self assessment payments on account, tax credits on interest and dividends and other reductions in tax liability.

[22] The figures quoted exclude businesses with no turnover.

[23] www.hmrc.gov.uk/stats/mtg-2011.pdf

[24] These figures are an OTS estimate based on HMRC data on liability for income tax and class 4 NICs. Businesses with no turnover have been excluded from statistical analysis. Zero liability might be because the owner's income was less than their annual tax free personal allowance, the business was loss-making or because the individual has other allowances or claims which reduce their taxable income.

Chart 2.B: Distribution of business profit as a proportion of taxable income for unincorporated businesses in different turnover bands

Source: OTS analysis of HMRC 2009-10 data

The majority of small businesses do not grow

2.8 Government initiatives have often focused on the need to encourage all small businesses to grow by increasing turnover and taking on staff. Many businesses do grow considerably, and ought to be structured from the start in a way that accommodates future growth, for example in terms of financial management information. This is often true for start ups that operate with zero turnover while a product is being developed. However, it is clear that many businesses do not have staff or significant fixed assets or stock, remain relatively small and have no plans to expand to any significant extent.

2.9 Research commissioned from TFC by the OTS shows that almost 40% of those sampled with turnover below £70,000 plan to maintain their business at its current size. OTS analysis of HMRC data shows that only 2% of businesses with turnover below £70,000 in 2007-08 had turnover above £70,000 in 2008-09[25].

2.10 This data indicates that the vast majority of businesses are unlikely to be affected by issues arising from moving through an eligibility ceiling, so-called "transitional" issues. Clearly, some businesses will grow and we have given consideration to the transitional issues they may face. However, it is the stable small businesses which are most likely to benefit from a simplified income tax regime, particularly where they have used the simplified regime from the outset of their business. That said we accept that, for existing businesses, continuing with the existing regime could be considered to be the least complex outcome, provided they are familiar with it and managing comfortably with what is required of them.

[25] See Annex A of the OTS discussion paper "A simpler income tax for the smallest businesses" available at: http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm. For businesses with turnover between £1 and £30,000, approximately 8% had turnover in excess of £30,000 in the following year. Figures exclude businesses with turnover of zero.

What our research shows

2.11 Data highlights that business owners are trying to get their tax right but equally that a significant proportion worry that they may have made unintentional errors[26]; interestingly, there was not a statistically significant difference between represented and unrepresented businesses. The survey findings also show that for many this worry does not diminish significantly with experience.

Chart 2.C:

Source: Understanding small businesses’ experience of the tax system, The Futures Company

2.12 For businesses that are not represented by professional advisers[27], the same data shows that many are making errors in fundamental areas such as treatment of capital expenditure, recognition of income and expense claims[28]. It is the view of the OTS that **simplified and clearer rules for the taxation of business income would mean that more businesses would be able to get their taxes right and that HMRC would also find the regime easier to police**.

2.13 As it is not possible to quantify emotional and psychological costs in monetary terms, these can be overlooked when conducting a cost benefit analysis of policy. Our view, reinforced by survey findings, is that **fear and uncertainty have a clear effect on the perceived complexity of the tax system, and that reducing this cost by providing greater certainty and easier ways to deal with tax must be a worthwhile objective**. This theme is also highlighted in our report on tax administration.

Eligibility for the OTS recommendations

2.14 For the recommendations in this paper, there was support for aligning the ceiling for eligibility with the VAT registration threshold. There are similar alignments in other areas of tax policy[29] and there is an argument that it is simpler to use an existing threshold. However, we are conscious of the numerous representations received that businesses with higher turnovers are more likely to have significant fixed assets as well as employees. For such businesses, the recommendations in this report may be inappropriate.

2.15 The view of the OTS is that **to access the simplification measures in this report, the turnover of the business should initially be not higher than £30,000 per annum**. Particularly in the case of

[26] Almost 50% say that even though they keep good records and are careful filling in the form, they worry after it is submitted that they might have made a mistake. Based on TFC research.

[27] OTS analysis of HMRC data shows that in 2007-08 approximately 40% of unincorporated businesses with turnover below £30,000 per annum do not obtain professional tax advice.

[28] See the summary report of TFC research *Understanding small businesses’ experience of the tax system* available at http://www.hmrc.gov.uk/research/reports.htm

[29] In income tax self assessment “Three Line Accounts” (where less detailed accounting information is required on tax returns) may be submitted for businesses with turnover up to the VAT registration threshold.

turnover-based taxes, which represent a radical departure from the current regime, there are compelling arguments for starting the regime using a lower ceiling. Once successful and established, the eligibility levels could be increased and the VAT registration threshold could be an aspiration.

2.16 Where we indicate a ceiling, it is intended that businesses will assess eligibility by reference to receipts of income rather than turnover calculated using GAAP.

2.17 There are many businesses, often individuals providing professional services, which have turnover significantly in excess of £30,000 but do not have significant fixed assets or employees. These are essentially simple businesses which may not need detailed accounting information. Such businesses could also benefit from a simplified regime and we recommend that consideration be given to including these businesses in a simplified regime in the future.

2.18 The profits and losses of a rental business are computed on the same basis as other trades and professions, although some differences exist. Any changes made to simplify the taxation of small businesses could, in principle, apply equally to small rental businesses.

2.19 Consideration also has to be given to dealing with those businesses whose profits fluctuate around the ceiling. One way to deal with this is to have a higher exit limit than the maximum for entry into the regime. For example, businesses with turnover under £30,000 that access the regime could remain in it provided that their turnover does not exceed £40,000. Similarly, businesses could be given a two year period of grace so that they would not need to adopt the "normal" rules until the beginning of the second year after their profits exceeded a stated figure, allowing plenty of time for the transition.

2.20 Such rules are linked to the need for a way of preventing businesses from changing between regimes from year to year in order to minimise tax. One option would be to make the change irrevocable (unless the upper limit was exceeded) and another would be to require the business to remain in the regime for a minimum of, say, five years.

2.21 **The recommendations in this report are for unincorporated businesses.** There is a case for simplified regimes for small companies as well, but they are subject to separate and more formal reporting requirements. Accordingly, it is not possible to recommend at this stage that simplified arrangements such as receipts and payments accounting should be used for the smallest companies. We think that, once the simplified procedures recommended in this report are established for unincorporated businesses, work should be carried out to see how the advantages could be made available for the corporate sector.

3 Identifying the basis of the tax charge

3.1 Basing tax on the profits of a business is only one of a number of ways in which tax can be assessed. Our interim report in March 2011 included examples of a number of different bases on which tax could be charged, for example on turnover, on other indicators such as tables in restaurants, or a fixed lump sum for a business (like the television licence for using a television). To provide certainty, the measure chosen as the basis for tax calculations should be clearly defined, understood by its users and, ideally, readily accepted by them.

3.2 A simple tax system would be one where the base on which tax is charged is easy to identify and no further calculations are needed. This is not as straightforward as it might seem.

3.3 For example, if tables in your restaurant are the basis, what is a "table" for these purposes? Would the tax charge reduce if you push two tables together and does the charge apply if the table is used throughout the tax year, for only part of it or on any day in the year? If tax is a fixed sum for a business, how would "a business" be defined and how would partnerships and businesses with more than one trade be treated?

3.4 For income tax[30] purposes, the profits of a business[31] must be calculated using generally accepted accounting principles ("GAAP" and "GAAP accounts"), and then adjusted as required or authorised by law[32] to arrive at the profits liable to income tax[33] ("taxable profits").

3.5 The starting point for GAAP accounts will be the business's record of income received and amounts expended. These figures must then be adjusted in respect of items such as:

- work undertaken or stock sold for which invoices have not been issued or paid (work in progress and debtors);
- expenses incurred but not yet paid (creditors);
- fixed asset purchases, disposals and depreciation; and
- loans received and loan interest payments made.

3.6 After GAAP accounts have been prepared, certain adjustments have to be made to arrive at taxable profit. In the case of small businesses the adjustments most commonly seen are for:

- depreciation, and profits and losses on fixed asset disposals;
- private use of business assets;
- capital expenditure and capital allowances; and
- items which are not tax deductible e.g. entertaining.

3.7 The following chapters consider ways in which calculation of tax could be simplified for the smallest businesses, that is, unincorporated businesses with turnover up to £30,000.

[30] and class 4 NICs.
[31] Strictly a "trade" but this paper is about small businesses so the word "business" is used rather than "trade".
[32] Section 25, Income Tax (Trading and Other Income) Act 2005 (ITTOIA).
[33] and class 4 NICs.

4 Non profit measures

4.1 The OTS believes that the simplest tax system for small businesses would be one that is based on a single, easily identified measure. The UK income tax system currently uses profit as the basis of the income tax charge, and therefore requires both income and expenses to be calculated. Chapters 5 and 6 suggest some simplifications to the calculation of "income" and "expenses". However, there is scope for more fundamental simplification by changing the tax base for income tax for small businesses.

4.2 OTS discussions with small businesses suggest that a straightforward[34] and certain regime which does not involve calculating profits may be attractive to some of these businesses.

4.3 Non-profit measures for the tax charge fall into three main categories:

- standard lump sum payments;
- indicator-based measures; and
- turnover-based measures.

International examples

4.4 The OTS has researched the non-profit based systems which are used in other countries. Our high level conclusions follow below, and more detail is set out in Annex C.

4.5 The use of alternative systems around the world, together with our research on businesses in the UK, leads us to believe that an alternative tax calculation approach is worth a formal in-depth study. Our study of alternative systems highlights some issues:

- cash basis is widely used and seen as normal (e.g. by the OECD[35]);
- it is possible to have a limited range of set percentages (see for example France where services and trading are distinguished);
- an alternative system needs to set out, as part of its operation and qualification, clear rules on what (simple) records need to be kept (e.g. South Africa);
- interactions with benefits and other taxes need to be thought through (e.g. Australia);
- knowing and understanding the tax rate is seen as a benefit by taxpayers, and is linked to the benefits of greater transparency on tax;
- problems can arise if an alternative system is made compulsory for those that are eligible (e.g. Australia); and
- greater tax yield through more businesses entering the tax system is not proven but a possibility.

[34] 64% of businesses in the TFC survey agreed with the statement "Tax is too complicated: I don't have the skills and expertise required".

[35] Organisation for Economic Cooperation and Development

Standard lump sum payments

4.6 A standard lump sum tax payment, similar to the current class 2 NI charge or the television licence fee, would appear to be the most straightforward way of levying tax on a business. It would be simple to understand and, given the existing requirement to register as self-employed[36], should be easy to levy and collect on an annual basis.

4.7 However, such a charge would be a significant departure from the current system of progressive tax and NIC rates. Businesses of different sizes and profitability would pay the same amount of tax and such a charge may pose a barrier to those that are starting up in business. Changing to this system could understandably be perceived as unfair, as many businesses will be worse off, or better off, relative to their current tax position.

4.8 Furthermore, responses to the OTS discussion paper[37] indicate that despite the apparent simplicity and certainty of the arrangement, it might not be a popular choice for businesses.

4.9 Notwithstanding the simplicity of this approach, the OTS does not consider that measures of this type should be considered further, mainly because of their non-progressive nature.

Indicator-based measures

4.10 Responses to the OTS discussion paper indicated a lack of interest in using measures based on indicators such as restaurant tables, business premises footprint and number of employees. Such measures were not thought to be appropriate and it is the view of the OTS that such an approach, although adopted in other jurisdictions, would introduce complexity due to the difficulties associated with choice and definition of indicators. It also appears rather arbitrary in its impact and again may widely be seen as unfair.

4.11 The OTS does not recommend considering this approach further.

Turnover-based measures

4.12 Although a single rate of tax applied to turnover has the advantage of simplicity and certainty, in our discussions and meetings with small businesses and advisers, many argued that it could be unfair. For businesses with the same turnover, those with low expenses would pay proportionately less of their net income in tax than those with high expenses. However a significant minority made comments such as "A turnover-based tax – tell me about it".

4.13 In 2008, the Government concluded[38] that there was too much variation in the ratio of expenses to turnover for a flat rate scheme based on turnover to be successful for income tax. However, to achieve a radical simplification of tax, there would need to be acceptance that there would be winners and losers in terms of tax liability. Further research would be needed to quantify the extent of the impact on the affected population. The current OTS view is that the magnitude of the change in tax liability may be small given the sizes of the businesses under consideration.

4.14 One area of concern raised in discussions is business losses. The extent to which this is a problem is likely to depend on whether the regime is compulsory or not. In France those using the Auto-Entrepreneur system[39] must accept that if they choose to use the simplified regime with the benefits that brings, they will pay tax even if they make a loss. The limited feedback we have had indicates that this is accepted.

---

[36] Section 7,Taxes Management Act 1970 requires individuals to advise HMRC about self employment income.

[37] See Annex B for a summary of responses to the July discussion paper.

[38] http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/prebud_pbr08_simplificationreview.htm.

[39] See Annex C for details of the Auto-Entrepreneur regime in France.

4.15 In the Flat Rate VAT Scheme (FRVS)[40], the flat rate of VAT applied to turnover varies according to the type of business undertaken. Using a scheme with multiple tax rates may be fairer but this comes at the cost of being more complex[41]. Discussions with tax agents, businesses and HMRC staff suggests that, even with 55 business sectors for FRVS, it is not always easy to decide on the appropriate business sector, which creates uncertainty.

4.16 A reasonable compromise may be to follow the French Auto-Entrepreneur system and have only three rates of tax on turnover; one for businesses providing services, one for professional trades and one for sales-based and accommodation supply businesses. The key advantages for businesses are simplicity and certainty over their tax liability.

4.17 In our meetings with small business and tax advisers, the OTS has been told that businesses considering the FRVS tend to calculate whether adopting the FRVS would result in less VAT being paid and only use the arrangement if they would be better off as a consequence. Moreover, we have been told that businesses which do not need to be VAT registered voluntarily register because they calculate that they will be able to increase their profits by using the FRVS. In both these scenarios there is a loss of tax revenue to the Exchequer and extra administrative effort.

4.18 There is a risk that a similar approach would be taken with a turnover-based income tax, potentially with comparative calculations being undertaken each year with a consequent increase in the administrative burden, defeating the simplification aim.

4.19 The OTS view is that a business should adopt a turnover-based scheme on a consistent basis, perhaps for a minimum of five years, rather than being able to decide each year which basis it will use. This will ensure that businesses cannot take advantage of the most favourable outcome in each tax year and supports the aim of certainty and simplicity.

4.20 The rate(s) chosen would need to be set at an appropriate level to meet Government objectives. If there is any increase in tax liability between the current system and a simpler turnover-based system this might be offset by reduced professional fees if the business is able to deal with its own tax affairs as a result. Although some told us that the French rates are deliberately low to make the regime attractive, the evaluation of the regime indicates that this was not the intention[42].

4.21 Among small businesses surveyed for the OTS by TFC, 17% of those that currently hire an accountant would like to deal with their own tax affairs, and the proportion was even higher for businesses with turnover below £20,000 per annum. A further 20% of the sample would like greater control over their tax affairs. Reasons cited by small businesses for not dealing with tax matters themselves included complexity (both real and perceived), fear of getting it wrong (particularly as regards expenses claims) and fear of HMRC. As with the receipts and payments basis for accounts recommended in Chapter 5, a simpler, turnover-based tax charge would mean that more businesses would feel capable of dealing with their own tax affairs.

4.22 In order to help businesses which have turnover that fluctuates, the OTS recommends that the upper limit for exit from the scheme is set at a significantly higher level than the upper limit for entry to the scheme in the same way as for the FRVS.

4.23 The definition of turnover would need to be clearly set and, to make the arrangements as simple as possible, be based on income received rather than turnover calculated in accordance

---

[40] The FRVS is an optional simplified VAT scheme which is available to small businesses. See HMRC Leaflet 733: http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ShowContent&propertyType=document&id=HMCE_CL_000345

[41] It also introduces an element of uncertainty in cases where a business does not clearly fall within a category.

[42] http://www.senat.fr/rap/r09-365/r09-365.html

with GAAP. Research indicates that most small businesses incorrectly believe that their turnover is income received[43], so this appears to be the logical starting point for the smallest unincorporated businesses.

4.24 **The OTS recommends that further research and analysis is undertaken with a view to putting forward firm proposals with indicative tax rates. We also recommend perhaps piloting the scheme** to better gauge demand from the very smallest businesses, the fiscal effects and the size of business for which it would be appropriate. Our initial view is that it would be appropriate for businesses with turnover of no more than £20,000 or perhaps £30,000. However, a turnover-based tax arrangement may also be suitable for single- or two- person service-based businesses with higher levels of turnover, no significant capital assets and no employees.

4.25 Some of the members of our consultative committee were strongly opposed to a turnover-based tax. Others thought that although there were drawbacks, it met the objective of simplification. The main objections to a turnover-based tax were that:

- there is no proven need to change the existing profit-based system;
- it would be unfair because there is no regard for the varying cost bases of businesses; and
- businesses would not be aware of either their profit or their financial position.

4.26 If the arrangement was optional, this would introduce an element of choice thereby introducing complexity for those businesses that wished to compare the tax charge under the two options. This complexity could be reduced if the scheme was initially optional but once adopted had to be used consistently in future years, either until the business was required to leave the scheme because its turnover was too high, or until a minimum number of years had elapsed.

4.27 Allowing businesses a measure of choice does potentially mean the Exchequer will always lose out. While this poses a risk to the public finances, we believe that it can largely be designed out with a careful choice of rates and limits for eligibility that mean that the amounts involved will be small[44]. The significant administrative savings will attract many businesses: the aim is to provide a simpler system for businesses which in turn should allow them to spend more time achieving commercial success.

4.28 If a turnover-based tax is introduced, there would be the inevitable threshold issues. Businesses approaching the ceiling may try to suppress income in the same way as we are told businesses approaching the VAT registration threshold do now. The existence of a ceiling is likely to influence the behaviours of some businesses operating just under that ceiling, thereby distorting behaviour.

4.29 A further issue is that some businesses may seek to exploit the regime by setting up multiple small businesses, by manipulation of profits or by "phoenixism" (ceasing one business and starting another identical business). An alternative regime may also increase the risk of tax avoidance at the employment/self-employment boundary. All of these potential risks could be addressed by anti-avoidance legislation, but at the cost of additional complexity.

4.30 New businesses should be able to adopt the turnover-based regime easily when they start their business. Existing businesses wishing to move to the turnover-based regime will face

[43] Approximately 50% of businesses surveyed by TFC said that the sales or income that they included in their accounts was "Money received in the year, whether or not an invoice had been issued". Sole traders with turnover below £20,000 are more likely than average to do this.

[44] OTS analysis of HMRC data shows that in 2009-10 sole traders with turnover below £30,000 per annum paid an average of £2,300 in income tax and class 4 NICs. Over 90% had total tax liability of less than £5,000.

transitional issues, already noted as being a complication. These exist already for the FRVS and with many other changes in tax legislation. The choice and complexity of the transitional arrangements may well affect take up of the scheme.

4.31 In considering all these issues with non profit measures, it must be borne in mind that we are looking at the smallest businesses. While there are huge numbers of these, the great majority of these businesses do not intend to grow. This is not to understate the potential problems inherent in an alternative system, but they must be kept in context.

Interaction with welfare benefits

4.32 One area that will need careful investigation before introducing a change from a profits-based measure for tax is the interaction of income and tax with state welfare benefits. It is, after all, likely that a significant proportion of the smallest businesses in the ambit of an alternative system would also be involved in claiming such benefits.

4.33 The impact of a different tax system on the calculation of current welfare benefits such as tax credits will need addressing. Starting in 2013 the UK will be introducing a major change in welfare benefits, "Universal Credit". The interaction of the OTS's recommendations with the Universal Credit must also be considered, as it is likely that many small businesses would also be eligible for the Universal Credit[45].

4.34 If an alternative system for calculating tax (and NIC) liabilities is adopted, it is essential that the regime used for tax is also accepted for other purposes, such as claiming welfare benefits. It would not only negate any simplification if claimants needed to keep different records and calculate income in different ways for tax and for Universal Credit, it would add complexity.

4.35 If our recommendations are taken forward, the OTS view is that Universal Credit calculations of self employed income should be based on:

- the receipts and payments basis;
- set expense amounts for certain items; and
- if that route is pursued, any alternative basis.

4.36 Using turnover as a measure from which to calculate entitlement to Universal Credit may in fact make things easier for claimants because it is generally simpler to keep track of turnover (sales) than to calculate profits on a daily basis. It may well be that, in the interests of fairness, Universal Credit will need to be adjusted for those using a different profit measure, such as turnover, so that after-tax income reflects Government policy in this area. This needs to be factored into the design of Universal Credit, although we accept that this may be difficult to deliver in practice.

4.37 The alternative systems that we have recommended (see Chapters 5 and 6) also have the merit of giving taxpayers greater certainty over their taxable profits which in turn may help their Universal Credit income calculations.

Summary and recommendations

4.38 Calculation of tax for businesses would be very straightforward if a single measure such as the existence of the business (licence fee approach) or an indicator (such as number of tables in a restaurant) was used as the basis of the tax charge. However, our research suggests that there was little demand for these approaches, mainly on the grounds of fairness.

[45] Over 85% of small businesses have turnover below £30,000 (2007-08 data, excludes zero turnover businesses). OTS analysis of HMRC data shows that for approximately half of these business owners, taxable profit from the business makes up the vast majority of their total income.

4.39 **A turnover-based tax could represent a significant simplification over the current profits-based tax.** There is opposition to such an approach from some accountants[46], who believe that businesses need proper financial information and to understand their profitability, not simply their sales figures. Against that, many advisers have told us that the smallest businesses – which is what we have in mind for this alternative proposal – operate on a receipts and payments basis and only calculate profits after the year end, mainly for tax purposes. Businesses were uncertain about the fairness of a turnover-based tax but many thought the idea had merit: inevitably, views would be coloured by the question of how much tax would be due.

4.40 The OTS view is that **an alternative system could provide simplification**, particularly if a two- or three tier system is used with different rates for suppliers of goods, services and professional trades. **We therefore recommend that a full study is undertaken of the area** to ascertain whether such options could deliver the simplification anticipated without introducing unwanted consequences. In particular work would need to be undertaken on:

- identifying clearly the measure on which the tax charge is based, for example, should turnover be money received or invoices issued?
- determining eligibility criteria for the regime;
- whether the regime should be optional;
- the appropriate level of tax charge or rate;
- the effect on other issues such as NICs, raising finance and claiming state welfare benefits (see paragraphs 4.32 to 4.37); and
- transition into and out of the arrangement.

4.41 We do have an **overriding concern about the interaction of any new approach to tax with the proposed Universal Credit**. If this is not considered before the finalisation of the Universal Credit rules, and these are based on GAAP profits, any simplification from the use of a turnover-based system for tax will be wasted and worthless for claimants and potential claimants.

[46] 20% of agents in the OTS survey said accounts for small businesses should always be prepared using GAAP.

5 Receipts and payments accounting

Background

5.1 As noted in paragraph 3.4, profits on which income tax is charged must currently be calculated using GAAP (GAAP profits) but there is no requirement for a business to produce full accounts with a balance sheet (GAAP accounts) for income tax purposes.

5.2 GAAP is well understood by the accountancy profession, which considers that accounts and profits computed under GAAP provide an accurate reflection of the financial position and profits of a business[47]. However, many small businesses are unaware of GAAP and calculate profits on the basis of income received (rather than invoiced) and expenses paid (rather than liabilities incurred), ignoring both work-in-progress and adjustments for capital expenditure[48]. Indeed, there is some recognition of this among tax agents, with over 60% stating that introducing a form of cash accounting for small businesses would be either important or useful[49].

5.3 For many businesses there are good reasons for preparing accounts which comply with GAAP, for example to give a more accurate reflection of the company's financial position. However, for some of the smallest unincorporated businesses, evidence suggests that preparing GAAP accounts increases the time spent on accounts preparation[50] where a receipts and payments approach may result in figures which are not materially different from those which are produced using GAAP. Also, VAT is not based on profits calculated in accordance with GAAP; very small businesses which are voluntarily VAT registered currently need to cope with this.

5.4 We have been told that accounts seem to be produced by small businesses predominantly for tax purposes. In the OTS survey of tax agents approximately 90% of agents said that the most important reason for preparing accounts for small unincorporated businesses was in order to complete the tax return.

5.5 Although the main reason accounts are prepared appears to be for tax purposes, accounts may also be needed for other purposes, including to obtain personal or business finance, for mortgage applications and in divorce proceedings. These are not frequent events; many of the smallest businesses may never need to produce accounts for these other purposes.

Arguments for change

5.6 For the large number of very small businesses which have few or no capital assets and no stock, the balance sheet prepared as part of full "GAAP accounts" could be considered unnecessary because it will generally provide little, if any, useful information that cannot be derived from the profit and loss account. We also understand that banks and finance houses will usually accept a profit and loss account or copy tax return in support of an application for finance.

---

[47] From the survey of small business tax agents conducted by the OTS in November/December 2011, nearly 20% said that *accounts*" should always be prepared under GAAP".

[48] Research conducted on behalf of the OTS shows that approximately 45% of very small businesses account for income on the basis of cash received, and almost 55% account for expenses on the basis of monies paid out. The proportion that left it to their accountant was 20% and 30% respectively.

[49] OTS survey of approximately 700 tax agents.

[50] The most common response (23%) in a survey of 700 tax agents was that an agent could save between 40 minutes and 60 minutes on each set of accounts.

5.7 The illustration in Box 5.A demonstrates that even with a straightforward business, calculating profit using GAAP involves extra work that could be considered unnecessary when the effect of this on taxable profit, deferred income tax and national insurance liabilities is small. Clearly illustrations could be produced which show larger differences in tax liabilities being deferred or, less commonly, being accelerated.

5.8 The key point is that the vast majority of adjustments which are made to arrive at GAAP profits and, with the exception of disallowable expenses, at taxable profits, result only in timing differences. Over the lifetime of the business the taxable profits will be the same using either method and, unless the timing difference results in a different rate of tax applying, there is no overall loss of tax (or national insurance). For businesses which pay no tax[51] because their profits are lower than personal allowances or they are entitled to other reliefs, using receipts and payments rather than GAAP to arrive at taxable profit would almost certainly have no net effect on tax revenues.

5.9 Research suggests that the businesses under consideration do not usually capitalise items on balance sheets but simply deduct the cost of equipment purchases from income in the same way as other expenses (see paragraph 6.31). Although this is not in accordance with current tax legislation, it does not generally change the tax payable by the business. This is because the Annual Investment Allowance (AIA) gives 100% deduction for most capital expenditure likely to be incurred by these small businesses. The effect of this is that work to identify capital items for the capital allowances claim is largely unnecessary for tax purposes.

5.10 Some businesses will still want to identify capital expenditure and prepare full accounts, including a balance sheet, to show their asset position. The OTS is not proposing anything that will prevent their continuing to do so.

5.11 We recognise that each individual adjustment required to convert cash transactions into GAAP and tax-adjusted accounts may not take much time. However, the cumulative time spent on these, including the decision-making process involved, can significantly increase the overall time and cost of complying with taxation obligations for business and advisers.

5.12 In our agent survey nearly 50% reported that adjustments typically take over 40 minutes for each set of small business accounts[52]. Some reported that over two hours was needed. The most time-consuming aspects were identifying capital and revenue expenditure, capital allowances and private use adjustments.

5.13 We do accept that where taxable profits are deferred, there will be a delay before the Exchequer receives the taxes. However, research by TFC suggests that up to 70% of unrepresented sole traders may be preparing accounts on a receipts basis for income and up to 80% on a payments basis for expenses so the deferral of tax revenues, especially for the smallest businesses, may be less than might be expected.

5.14 When the OTS discussed accounting adjustments with businesses and their advisers it was apparent that where adjustments were made to prepare GAAP accounts for the smallest businesses, as illustrated in Box 5.A, the size of the adjustments did not justify the time spent on them and receipts and payments accounts would not have been materially different.

[51] Approximately 30% of sole traders or partnerships with turnover above £0 and below £30,000 did not pay any income tax or Class 4 NICs in 2009-10 (see paragraph 2.7). However, the data does not show why these individuals had zero liability.

[52] From the OTS survey of small business tax agents

Box 5.A: Comparison of "receipts and payments" and GAAP profit calculations

Abby is a freelance journalist. She operates through an unincorporated business, and she draws up her accounts to 5 April every year. Customers pay direct into her bank account and £19,700 was paid into the account in the year to 5 April 2011. Abby paid £750 (by debit card from her bank account) for a new computer for her business in June 2010. Other allowable business expenses totalled £3,500. Using a receipts and payments accounting method, Abby's profits for tax might be:

	£
Cash received	19,700
Less: Expenses	-3,500
Less: Computer	-750
Net taxable profits	**15,450**

To calculate profits in accordance with GAAP further information is needed and inevitably the calculation is more complex and takes longer. Using GAAP, Abby's income for tax purposes for 2010-11 will be calculated as follows:

		£
Invoices issued (note 1)		20,000
Adjustment (note 2)	Reverse income recognised in 2010/11	-350
Adjustment (note 2)	Include income earned in March 2011 but invoiced after 5 April 2011	450
Turnover using GAAP		20,100
Less: expenses		-3,500
Adjustment (note 3)	For prepaid answering service £200 x 86/91	189
Bad debt relief (note 4)		-500
Net profits using GAAP		16,289
Capital allowances claim:		
Computer	£750	
AIA claimed (note 5)	£750	-750
Taxable profits		**15,539**

Notes

1. On 5 April 2011, customers owed her £1,200 and on 5 April 2012 customers owed her £1,500.
2. Abby had issued an invoice for £350 on 10 April 2010 relating to work completed in March 2010 and for £450 on 7 April 2011 for work completed in March 2011.
3. Abby's tax-allowable business expenses of £3,500 included £200 paid on 1 April 2011 for a telephone answering service. This fee is payable quarterly in advance.
4. One of Abby's client's has gone into liquidation and she has been told that her invoice for £500 will not be paid.
5. Annual Investment Allowance

All items which are not taxed in 2010/11 will be taxed in 2011/12 so the impact of using "receipts and payments" as a measure of profit is the deferral of taxable income of £89. At a marginal rate of 20% income tax plus 9% national insurance, the tax and national insurance deferred until the following year is £26. Most of the above adjustments will need reversing adjustments in 2011/12 so the work in producing GAAP profits is in effect doubled.

5.15 The OTS understands from its discussions with agents that HMRC does not generally seek to adjust taxable profits which are based on receipts and payments rather than calculated using GAAP where the issue is one of timing differences and is not significant. However, there is always the underlying concern that the strict technical position is that HMRC can challenge a profit figure which is based on receipts and payments[53].

Options for change

5.16 There is a good level of support from accountants for the use of receipts and payments accounting for the very smallest businesses. OTS evidence shows that 33% of respondents felt that a ceiling for receipts and payments accounting at or below the VAT registration threshold[54] would be appropriate and a further 8% and 9% favoured the specific ceilings of £20,000 and £30,000 respectively[55]. However, members of the consultative committee thought that initially the upper limit should be lower than the VAT registration threshold, probably at £20,000 and no higher than £30,000.

5.17 For as long as the legislation requires tax to be based on GAAP profits, fully compliant businesses face the cost of calculating profits that way. Other businesses, which save time and costs by producing receipts and payments accounts, or perhaps are ignorant of the detailed rules for GAAP profits, risk penalties and/or face uncertainties. In the interests of both simplification and certainty, the OTS recommends that, **for businesses with turnover of £30,000 or less, a receipts and payments approach may be used for the preparation of accounts on which income tax is to be charged**.

5.18 The reason that we do not recommend a higher starting upper limit is that it would be desirable first to establish the system and build on the experience of businesses with lower turnovers. If it is found that the approach does, as expected, produce simplification and provide certainty without unforeseen adverse consequences, it could then be extended, so that businesses with higher turnovers, particularly simple service-based businesses, could be eligible.

5.19 Some have noted that accounting standards under GAAP have usually been concerned with very much larger and more complex businesses than those which are the subject of this report. The change in wording in 2002[56], from profits which are "true and fair" to profits calculated in accordance with GAAP, seems to have had unforeseen consequences for small businesses. Where in the past profits which were calculated on income received and payments made might have been considered to show a "true and fair" view for a very small business, this no longer applies.

5.20 It could be argued that if the Accounting Standards Board[57] could be persuaded to introduce simple rules for very small businesses, this would become GAAP for those businesses and no legislative change would be required. Similarly, if the reference to GAAP was removed from the legislation for very small businesses and "true and fair" (taking into account all the circumstances of the business) was reinstated, some forms of receipts and payments accounts would be a permissible basis for calculating the tax charge. On the other hand, the phrase "true and fair" does not provide certainty because it requires judgment.

5.21 There are precedents for using receipts and payments accounts. Charities which are not companies are able to use receipts and payments accounting when gross income is not over £250,000[58] and it is also common in other tax jurisdictions as a simplifying measure for

53 See, for example. a recent Tribunal case: http://www.tribunals.gov.uk/financeandtax/Documents/decisions/Smith_v_HMRC.pdf
54 £73,000 in 2011-12.
55 From the OTS survey of small business tax agents.
56 Section 103(5) FA 2002.
57 Part of the Financial Reporting Council.
58 http://www.charity-commission.gov.uk/Library/guidance/cc16btext.pdf.

businesses, although as noted elsewhere, some businesses preferred to continue with the accruals basis.

5.22 It is our view that the necessary changes to the legislation could be relatively straightforward using as a guide the existing legislation for barristers and charities. Some transitional rules would be required and, as acknowledged elsewhere, would introduce some initial complexity. However, we believe that the benefits that the receipts and payments regime could bring justify the changes in legislation.

5.23 There are a number of approaches that can be taken to receipts and payments accounting, some easier for small businesses to deal with than others, but each having differing cost implications for tax revenues. Some approaches may not be in line with existing government policy on matters such as tax relief for capital expenditure and business entertaining.

5.24 Table 5.A summarises some of the options for receipts and payments accounts and their main differences. These three options are described in more detail in the rest of this chapter.

Option 1: "Limited" receipts and payments accounts

5.25 The most basic receipts and payments option would be for small businesses to measure their taxable income based on business sales for which money has been received during the accounting period less business expenses which have been paid during the accounting period. This means that no account would be taken of accruals, prepayments, debtors, creditors, stock and work in progress. As previously noted, survey evidence shows that this is the way in which about 50% of small business accounts are currently being prepared, even though this is not in accordance with legislation.

5.26 However, all other tax rules would continue to apply so that only expenses incurred wholly and exclusively for business purposes are allowable and the rules relating to specific tax allowances and disallowances, loans and interest and for capital and revenue costs would continue to apply. Private use apportionment calculations would also still be required.

5.27 The major advantage of this approach would be to allow a greater number of simplified accounts to be prepared, giving greater certainty to businesses without significant legislative changes. The approach would not, however, remove the need to understand and undertake adjustments needed for tax purposes.

Table 5.A: Summary of options for receipts and payments based accounting

	GAAP profits	Receipts and payments accounting		
		Limited version	Intermediate version	Full version
Overview	Also known as "accruals" basis. Profit is based on sales made and expenses incurred, not cash in and out	Recognition of income and expense is affected. Other tax rules unchanged	As for limited version but capital items may be expensed	All transactions are included on a cash received and cash expended basis
Income	Sales whether money received or not	Sales for which money has been received		
Work in progress	Relevant amount included in sales	Ignored		
Expenses	Expenses incurred deducted from income, even if not yet paid	Deducted from income only when paid		
Accruals	Expenses related to period of account, even where invoices not yet received	Ignored		
Prepayments	Only proportion related to accounting period are deducted	Deducted from income when paid		
Stock	Deducted from income when sold, or used to make a sale, even if not yet paid	Deducted from income when payment has been made		
Capital expenditure e.g. office furniture	No tax deduction for capital costs or depreciation. Capital allowances may be claimed		Deduction claimed in period when money paid; asset sales taxed on receipt	
Expenditure not allowed for tax e.g. entertaining	No deduction allowed.			Deduction claimed in period when money paid
Mixed use assets i.e. business and personal use	Only costs relating to business use are tax deductible			Deduction claimed in period when money paid
Business loan repayments	The interest element is an allowable expense but the capital repayment is not			Deduction claimed for total repayments including capital element[59]

Option 2: "Intermediate" form of receipts and payments accounting (including capital expenditure)

5.28 Building on the "limited" option, we believe it would bring significant simplification if small capital purchases could be expensed so that capital allowances claims would not be needed. This is effectively in place with the AIA but the AIA still requires businesses to identify capital expenditure and make claims, and then make adjustments when the asset is sold, resulting in extra work and complication.

[59] This would also mean that the receipt of the loan money would need to be taxed when received.

5.29 The OTS analysis of information extracted from tax returns shows that AIA claims of over 95% of businesses with turnover below £30,000 are less than £3,000[60]. For a single business with no associated entities, the AIA maximum claim from April 2012 will be £25,000. Consequently, for most small businesses, treating as an expense capital expenditure which would have qualified for AIA will generally have no effect on the timing of the tax relief.

5.30 If the "intermediate" form of receipts and payments accounting is adopted, small businesses will simply expense capital expenditure and, assuming this would all have qualified for AIA, there would be no effect on the timing of the tax relief. For the very few small businesses that spend over £25,000 on qualifying capital equipment in a year, and given the cost of a van or item of farm equipment these will certainly exist, deducting the full amount of capital spent on equipment would mean greater tax relief as compared with the existing basis.

5.31 Cars currently do not qualify for AIA, only writing down allowances (WDAs) which spread the tax relief over a number of years. This means that the cost of a car is not immediately deducted from income in the same way as the cost of other equipment which does qualify for AIA. If the intermediate form of receipts and payments accounting is adopted, deducting the full cost of the car in the year of the purchase would accelerate tax relief compared with the current rules. The fiscal impact of this will need assessing. It should be noted that this acceleration of tax relief does not apply to those small businesses which use a simplified method for dealing with car expenses (AMAPs, see Chapter 6), which we are recommending should be the default basis for cars.

5.32 The treatment of capital expenditure which does not qualify for capital allowances would need addressing for all businesses. However, it is likely to be a particular issue for letting and property management businesses, which would potentially be covered by any new rules. The way forward would probably be to allow purchases of plant and machinery to be expensed (possibly only up to the AIA limit) but purchases of property, with the exception perhaps of fixtures qualifying as plant, should not be expensed. It should be relatively easy for small businesses to identify property costs and remove these from receipts and payments records.

5.33 It should be noted, however, that businesses can currently disclaim capital allowances or not make a claim for AIA and may do so to avoid wasting personal allowances. Represented taxpayers are more likely to be aware of this option than the unrepresented. Using the "intermediate" form of cash accounting could disadvantage these businesses although we believe the numbers affected will be low.

5.34 Different rules may be needed for capital expenditure where there is some private use of the asset. This would mainly apply to motor vehicles (including vans) but could also affect computer equipment and other assets, as illustrated in Annex D. One route would be to allow as an expense an appropriate proportion of the cost in much the same way as the AIA at present.

Option 3: "Full" receipts and payments accounting

5.35 The simplest receipts and payments accounting approach would be for all business-related expenses and income to be included in the business accounts on a paid and received basis. This would mean that receipts such as loan income would become taxable and loan repayments (including the capital element) would become tax deductible. Similarly, tax relief would be given for capital purchases which would not qualify for AIA (for example, most property purchases) and expenditure for which tax relief is not available (for example, entertaining and private use of assets and services).

[60] Based on 2009-10 data for those completing either the full or short self-employment pages of SA return.

5.36 The OTS view is that, although simple for small businesses to understand, this approach may not be appropriate and could result in tax avoidance.

5.37 However, for the size of business under consideration, some of the specific rules (e.g. business entertaining and perhaps even private use) may be of little tax impact and wholly non-business expenses ought to be easy to identify and remove from the calculation. Further work could be undertaken to assess whether the smallest businesses are likely to have expenditure and income of this type. As an alternative, consideration could be given to flat rate disallowances for the disallowable (or disallowable proportion of) expenses of small businesses, using a similar model to chapter 6.

Combining "limited" or "intermediate" receipts and payments accounting with other measures

5.38 Another option would be to have "limited" or "intermediate" receipts and payments accounts combined with other simplification rules for expenses, such as flat rate allowances and other suggestions included in Chapter 6. Some expenses, for example, the mileage rate for cars and flat rate "use of home" allowance could become automatic, removing complexity in the areas in which businesses have told the OTS they have the most difficulty identifying tax-allowable expenses.

5.39 **The OTS view, based on our research, is that this combined approach would offer the most simplification for the smallest businesses.**

Issues to resolve

5.40 Further work will be needed to calculate the fiscal implications of each approach and a number of issues will need to be considered in further detail such as:

- **What is a payment for the purposes of receipts and payments accounting?** Payments may be made in cash, by cheque, through a bank transfer, by credit card, by barter and with funds made available by loan or overdraft. Although it should be obvious in the majority of cases, guidance would be required to clarify what should be included as a payment made or received in receipts and payments accounts. This should be "light touch": the main requirement is consistency rather than detailed rules;
- **Use of receipts and payments accounts for all purposes**: there needs to be consistency between all Government departments so that the same measure of profit is used for all purposes. A starting point could be the guidance for charities (see paragraph 5.21);
- **Size of business** for which receipts and payments accounts would be acceptable;
- **Transitional arrangements** for existing businesses and for businesses leaving the receipts and payments regime in the future;
- **Adjustments that may be required when businesses fail or cease**, in particular when capital expenditure is involved;
- **Compulsion**: whether or not the arrangements should be compulsory;
- **Likely cost and fiscal implications of proposals**; and
- **Guidance on a few specific types of transactions** such as hire purchase.

5.41 **It is particularly important that the same receipts and payments approach is accepted as a measure of business profit for businesses of this size by all government departments**. The provisions would therefore need to apply to income tax, national insurance, student loan repayments, pensions, Universal Credit, grants, bursaries, means-tested assistance and other government programmes. In the absence of such provisions, and if different measures are required for different purposes, the burden on taxpayers would be much increased and simplification, certainty and reduced compliance burdens not achieved.

Size of business

5.42 **The OTS recommends that a business with turnover of up to £30,000 should be allowed to use receipts and payments accounts** and once using the arrangements should be allowed to continue to do so until turnover is above £40,000 – i.e. a significant margin. This would mean that the 2.5 million unincorporated businesses with turnover below £30,000 would not need to use GAAP for calculating their profits.

5.43 Arguments presented to us for using the VAT registration threshold as the upper limit for using receipts and payments accounts were persuasive, but ultimately not convincing. This would have the benefit of aligning to some extent the calculations needed for accounts and for VAT, although for the latter the requirement is to look at turnover for the year to date at the end of each calendar month, rather than only at the end of the accounting year. However, we think that businesses with turnovers over £30,000 per annum are more likely to be involved in more complex arrangements which might not be suited to receipts and payments accounting. Once the regime is established, it should be reviewed and could be extended at a later date.

5.44 As noted in paragraph 5.22, if receipts and payments accounting is introduced, transitional arrangements would need to address the change from GAAP accounts to receipts and payments accounts and also receipts and payments accounts to GAAP accounts. This is not new or particularly complicated because such arrangements are already required for the transition from FRVS to the regular VAT arrangements.

5.45 Transitional arrangements would inevitably introduce some complexity and these need to be kept to a minimum, balancing fairness and simplicity with revenue protection. Any transitional rules should be pragmatic; for many of the smallest businesses the transition itself may not be a major issue.

Optional or compulsory?

5.46 As discussed in paragraphs 4.26 and 4.27 in connection with non-profit bases for taxation, one key question is whether receipts and payments accounts should be mandatory or optional for small businesses. If optional, the existence of choice would bring complexity because businesses wishing to minimise tax would compare the tax charge under each basis. A mandatory arrangement could be considered to be simpler.

5.47 However, research suggests that businesses would prefer an optional arrangement[61]. For growing businesses and certain business sectors, it would seem to be desirable to be able to use GAAP accounts from the outset. If receipts and payments accounting is to be optional, businesses should be required to use it consistently from year to year in the interests of simplicity and fairness, and to discourage "playing the system". It may be appropriate to allow a change of basis only every (say) five years.

5.48 It is our view that the best approach would be to **use receipts and payments accounts as the default for small businesses but to allow opting out where desired**, with limited ability to move between the two bases. Existing businesses which are currently calculating profit using GAAP should be able to continue to do so.

[61] Of the agents surveyed that said cash accounting is either important or useful, 85% felt that it ought to be optional.

Other points

5.49 Receipts and payments accounts are generally likely to be appropriate for only the smallest simple businesses where receipts and payments profits and GAAP profits would not be significantly different. However, for many single person service businesses with turnover much higher than £30,000, the difference between the two bases is also unlikely to be significant so turnover alone is not always a good indicator for appropriateness.

5.50 A receipts and payments option for business profits would apply only to unincorporated businesses, at least to start with. Corporate accounting and reporting currently seem to preclude the cash basis for companies, although this is perhaps something to explore in the light of the work being undertaken at present on accounting rules for small businesses[62] and also in the light of experience with unincorporated businesses.

5.51 We think that if the receipts and payments system is shown to help the smallest businesses, then there would be benefits in extending its application.

Summary of recommendations

5.52 **The OTS recommends that the default basis for profit calculation for businesses with a turnover of up to £30,000 should be receipts and payments.**

5.53 There are several possible approaches to receipts and payments accounts. **Our preference is the "intermediate" version of receipts and payments accounting** i.e. that with the exception of expenditure on property, capital expenditure should be permitted to be deducted as a business expense and that other simplifications set out in chapter 6 should be adopted as well.

5.54 **Where businesses wish to use GAAP for calculating profit, they can opt to do so.**

5.55 **If our recommendations are taken forward, the receipts and payments basis must be accepted for other purposes such as NICs and state welfare claims.**

[62] The European Commission proposal for a "Micros Directive" was agreed by the European Council on 21 February 2012. This proposal establishes a sub-group of small companies which member states may exempt from certain obligations imposed by the 4th Accounting Directive. This deals with the annual accounts of companies with limited liability. See page 19 of
http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/128102.pdf

6 Simpler claims for business expenses

General points and background

6.1 Information obtained from surveys and workshops indicates that there is demand for a more certain and simplified approach to business expenses[63]. Some elements can be dealt with by providing better, more targeted guidance and help. These issues are considered in the OTS paper on HMRC administration[64]. However, some claims for relatively low amounts of expenses are disproportionately time-consuming to calculate because of the fixed cost of collating figures from a number of sources and then preparing a sometimes complicated calculation[65].

6.2 The need to use judgement can lead to uncertainty[66]; some business owners fear that HMRC will challenge their claim and the individual may be liable for tax and penalties[67]. An example is set out in Annex D which gives details of the sometimes awkward technical and practical issues which may need to be considered by the business.

6.3 From our discussions with small businesses and their advisers, the use of both Approved Mileage Allowance Payments (AMAPs) for motor expenses[68] and the 10% "wear and tear" allowance for furnished lettings[69] are popular. This demonstrates that there is demand for simplified schemes which save time, give certainty and, for represented small businesses, reduce costs. These arrangements are also easier for HMRC to monitor and check.

6.4 When considering simplified expenses arrangements, the OTS is focusing on very small and often unrepresented businesses. Our discussions with these businesses suggest that some would opt for a simplified scheme, even if this meant that they could claim slightly less as an allowable expense. It seems to be both because it gives certainty to the business that it is claiming the "correct" amount and also because they would prefer to spend time on other issues. This can be seen in the popularity of the use of AMAPs for motoring costs. We have also been told on a number of occasions that businesses fail to claim expenses they would be entitled to due to concerns over establishing precise amounts and worries about HMRC challenges. Flat rates would obviate such concerns.

6.5 The OTS has considered whether this "one-size-fits-all" approach would work well in practice or if a better alternative would be to improve guidance provided on the treatment of expenses. Which would be simplest in practice for the smallest businesses? The small business owners with whom the OTS spoke valued certainty highly and also said that they found it

[63] From TFC survey data, 44% of small businesses (both represented and unrepresented) said that simpler ways to calculate expenses e.g. rules of thumb or fixed rates would be "very beneficial". Data from the agents' survey showed that 25% think that the introduction of fixed rate allowances is "very important".

[64] See the OTS Small Business Tax Review: Final Report, February 2012 http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm

[65] Evidence from the OTS agent survey indicates 23% of agents spend on average 40 to 60 minutes dealing with adjustments for GAAP and tax.

[66] Approximately 25% of unrepresented sole traders surveyed by TFC do not claim for expenditure that has both business and private use e.g. for mobile phone or home internet connection.

[67] Approximately 40% of all businesses surveyed by TFC agreed with the statement "I'm worried about being investigated and fined for mistakes that I may have made".

[68] TFC research shows that over 50% of unrepresented sole traders with motoring expenses use AMAPs for their tax calculations, and a further 20% do not claim anything for the business use of a personal vehicle. Approximately 30% of agents surveyed use AMAPs for all eligible clients i.e. businesses with turnover below VAT registration threshold. A slightly higher proportion uses the method that saves most tax, despite the additional administrative burden on their client.

[69] As an alternative to the "renewals" basis.

difficult to know which items are eligible for tax relief[70]. Even if guidance is improved significantly, the OTS view is that simplified expenses deductions would provide more certainty and less complexity for those with relatively small expense claims.

6.6 Simplified expenses could reduce HMRC costs of policing the system and give administrative savings for businesses but there is a potential conflict with initiatives to improve record-keeping by businesses. However, the reduced record-keeping would apply only to certain expenses claims and businesses would still need to record income accurately. The OTS view is that for the smallest businesses the benefits derived from certainty and simplicity ought to be the priority.

Should the arrangements be compulsory or optional?

6.7 As noted in the chapters on non-profit measures for tax (paragraphs 4.26 and 4.27) and on receipts and payments accounting (paragraphs 5.46 to 5.48), the issue of whether the arrangement should be compulsory or optional needs to be addressed.

6.8 The simplest approach would be for simplified expenses claims to be mandatory. This approach is already used for employees claiming business mileage, who are unable to claim a higher amount based on their actual costs[71]. However, where there is compulsion to use a new arrangement there will inevitably be winners and losers and this may be seen as unfair.

6.9 Even within the low turnover limit put forward in this paper, there is considerable variation in the expenses claimed by businesses[72]. Also, expenses typically vary from year to year and a fixed (simplified) deduction may be higher or lower than the actual expense incurred in any one year. It is unlikely that over the life of the business the total claimed under a simplified scheme will be the same as that which would have been claimed using actual expenses. Any business with expenses below the fixed amount would be better off and anyone with higher expenses would be worse off.

6.10 The use of an optional system is not without issues. Members of the Consultative Committee and tax agents have suggested that businesses will only use simplified schemes when they save tax by doing so[73]. Under an optional scheme businesses (or their advisers) might make comparison calculations each year and would choose the option with lower tax liability.

6.11 This may be the case for some businesses but the OTS has heard from many others that the main reason they use a simplified approach is because it is easier for them. Furthermore, if there is a requirement to use a simplified scheme consistently from year to year, the "which is best?" calculations could be a one-off.

6.12 It is our view that the best approach would be to have the simplified arrangements and flat rates to be the "default" for those eligible, giving clarity and certainty to the small businesses. Combining this with a receipts and payments regime would achieve greater simplification, as set out in paragraphs 5.38 and 5.39.

6.13 Businesses should, however, be allowed to retain the option to use the actual costs. This approach introduces an element of complexity but also allows those businesses which wish to make more accurate calculations, to do so. However, we recommend that once a business has

---

[70] 50% of small businesses surveyed by TFC said that they had problems finding out which expenses are allowable, and 32% said it was the most significant problem from a list of tax related issues.

[71] Income Tax (Earnings and Pensions) Act 2003, section 230.

[72] For example, annual claims for "rent, rates, power and insurance" for those below £30,000 turnover with the same home address and business address ranged from under £250 at the lower quartile to over £500 at the upper quartile. The mean was over £900 as some businesses claim disproportionately large amounts. These are OTS calculations from 2009-10 HMRC data, excluding businesses that completed the short tax return and those with nil turnover.

[73] The OTS has heard from tax agents that in other areas of the tax system businesses tend to compare their tax position under each system and opt for the regime with the lower tax liability, for example when deciding whether or not to use the Flat Rate VAT Scheme.

elected out of a flat rate regime, it is not permitted to re-enter it. This is a requirement of the "wear and tear" allowance for furnished lettings and use of cars for business.

6.14 We accept that there is risk of loss of tax where businesses which did not previously make a claim (or claimed less than the flat rate) for a particular type of expense now claim the flat rate amount. HM Treasury and HMRC would need to produce a detailed analysis of the potential cost to the Exchequer as part of the consultation prior to any implementation.

The expenses to consider for reform

6.15 In the following paragraphs we consider some of the areas which we have been told cause the most difficulty and worry in practice and outline some suggested simplification measures. It is quite clear that simplified arrangements would not be appropriate or desirable for many types of business expenses, for example goods bought for re-sale, insurance etc.

6.16 The example in Annex D gives a more detailed insight into the practical issues faced by small businesses in calculating their allowable business expenses. It follows the structure of this chapter.

Use of home

6.17 Many small businesses are using the proprietor's home to a greater or lesser extent. Guidance on how to calculate the allowable portion of total home expenses[74] is detailed and phrases such as "a reasonable estimate" do not provide the certainty which many small businesses say they need[75]. Many businesses told the OTS that they are concerned that they may suffer penalties if HMRC does not agree with the estimates which the business has made.

6.18 In the case of childminders, HMRC provides a grid[76] which shows the amount of heat and light, water and Council Tax which can be claimed by reference to the number of hours worked. This is helpful and appreciated by childminders[77]. However, having different grids for different types of businesses as diverse as home hairdressers and book-keepers, builders and ceramic artists using kilns might provide more certainty but not necessarily simplification.

6.19 The OTS view is that matters could be simplified considerably for many businesses by having a fixed amount, which is uplifted periodically in line with home costs. For example, instead of using a strict apportionment of household costs, the business could claim a fixed stated amount per week. This approach would remove the requirement to consider the type, nature and extent of business usage.

6.20 We recognise that there is a significant difference in the cost of using a home for what is essentially only book-keeping work (for, say, a window cleaner) compared with use by someone who works most of their time on their business at home.

6.21 We suggest that a reasonable and workable compromise would be for the default arrangement to be one of two rates; a standard amount and a higher amount. Business could opt out to claim, as now, on proportionate actual expenditure. In the majority of cases it should be obvious to the business whether use of home is extensive or not.

6.22 We believe this approach should provide certainty to the vast majority of small businesses, some of whom are not claiming tax relief for fear of getting their claims wrong.

[74] http://www.hmrc.gov.uk/manuals/bimmanual/bim47825.htm

[75] Over 50% of agents surveyed say that they currently use fixed rates for "use of home" calculations. However, TFC data shows that less than 15% of unrepresented sole traders use a fixed rate, with 25% calculating a proportion of overall household costs, and approximately 45% not claiming anything for minimal use of home.

[76] http://www.hmrc.gov.uk/manuals/bimmanual/bim52751.htm

[77] Observed interviews with childminders undertaken by TFC.

6.23 We accept that having more than one flat rate would introduce complexity because the appropriate rate for a business may not always be free from doubt and any boundary issue can lead to disputes between taxpayers and HMRC. However, our view is that a two-tier system could work well.

6.24 **The OTS recommendation for simplified use of home claims is a default of, say £5 a week, increased to a higher rate of, say, £15 a week where business use is significant.**

Mileage

6.25 Obtaining the information needed and calculating the private use apportionment for use of a vehicle is often time-consuming. TFC research suggests almost 70% of sole trader businesses that claim for the use of a car do so using the simplified arrangement (AMAPs). Data also showed that AMAPs are used by a number of businesses with turnover above the VAT registration threshold: such businesses are not generally entitled to use these rates. This seems to indicate that businesses generally find AMAPs easier than the strict apportionment approach.

6.26 It would be a simplification measure to make AMAPs compulsory for cars being used for business purposes, including those businesses that have turnover above the VAT registration threshold.

6.27 Introducing new mandatory van AMAPs for proprietors who use their vans for personal as well as business use would also be a simplification. Currently, the AMAPs for vans are the same as for cars but we have heard that running costs of vans, especially larger ones, can be considerably higher than those of cars, so we believe it would be appropriate to have a different AMAP for vans for small businesses.

6.28 As noted above, we have also been told that some businesses would like to be able to use actual costs as an alternative. In the interests of fairness to those who have unusually high vehicle running costs or want a more accurate indication of their business expenses, we consider the option to use actual costs should remain.

6.29 **Our recommendations are therefore that:**

- **AMAPs will be the default option, but businesses should be allowed to opt to use precise calculations;**
- **as a simplification measure for those above the VAT registration threshold, they too should be allowed to use AMAPs; and**
- **separate AMAPs should be introduced for vans.**

Expensing of items of capital expenditure

6.30 Although the AIA reduces the complexity of capital allowance computations, there is still work to be done on identifying capital expenditure, claiming the allowances in tax computations and separately disclosing the claims on the tax return. A simplification measure which the OTS recommends is **to allow items of capital expenditure of relatively low value to be treated as revenue expenses**. The OECD notes that this measure may provide significant simplification for small businesses[78].

6.31 This could simplify tax calculations and tax returns for all businesses and is a measure that should be considered for all businesses, and not just the smallest. Many businesses already have a policy to expense items of capital expenditure which cost less than a certain amount but then

[78] See SME Tax Compliance and Simplification, 2008 Background note prepared by the OECD Centre for Tax Policy and Administration, for a meeting of the Working Group on Taxation http://www.oecd.org/dataoecd/22/24/41873897.pdf

have to make adjustments in tax computations. TFC data shows that over 40% of businesses sampled expense capital items, while approximately 25% correctly include these items in capital allowances calculations[79].

6.32 The value limit for small items that can be expensed should be set high enough to cover everyday tools, small items of equipment, etc., suggesting a level of at least £500. However, ideally it should be set high enough to include furniture and computer equipment which may make a figure of £3,000 more realistic. Over 95% of businesses with turnover below £30,000 claimed less than £3,000 in capital allowances in 2009-10[80]. Although as noted above, given that the AIA from April 2012 will be £25,000, perhaps an even higher level is justified.

6.33 It may be that certain items such as vehicles and expenditure on property, for policy reasons, will need to be excluded from this regime. Provided that such items are easily recognisable to the business, this should not unduly complicate matters and there will still be benefits in having the arrangements apply to other items of capital expenditure.

6.34 Treatment of capital expenditure where there is some private use is discussed below.

6.35 If the intermediate or full version of receipts and payments accounting outlined in Chapter 5 was adopted, this measure would not be required for businesses using that regime.

Private use adjustments

6.36 Where there is personal as well as business use of assets and services, a disproportionate amount of time can be spent calculating the business use on the strict basis. Both the total cost and the proportion of use or time used need to be identified. The latter can be difficult to quantify and substantiate, leading to uncertainty and fear of challenge[81].

6.37 Where assets are involved, the "single asset pool" for capital allowances for assets used partially privately has to be carried forward and allowances calculated annually until the asset is disposed of. Where AIA is claimed, annual calculations may not be required but balancing adjustments would need to be made on disposal. If the private use apportionments have changed from year to year, the balancing adjustments will be more complicated to calculate.

6.38 A pragmatic approach could be introduced to simplify these calculations. For example, mirroring the approach used for taxation of employee benefits[82], **where personal use is "not significant" the full costs could be allowed as an expense in the interests of simplification**. HMRC would need to provide robust guidance on this phrase because this in itself can lead to uncertainty. As a corollary to this recommendation, **where there is negligible business use of an asset or service, no claim should be permitted**.

6.39 Alternatively, where private use is not significant, there could be a deemed 10% "non allowable" proportion. Similarly, genuine mixed use could perhaps be claimed on a 50:50 basis as the default position, with an option to prepare precise calculations. The OTS believes this provides greater certainty but the points raised previously about fairness and compulsion need also to be taken into account.

6.40 Data on private use proportions claimed for mixed use assets is limited which means that assessing the impact of the proposed simplification is likely to be difficult.

[79] Of the remainder, the majority either did not know or the question was not relevant, and a small minority either ignored the cost or used an unspecified approach.
[80] OTS analysis of HMRC data.
[81] See Annex D for illustrations.
[82] The Employment Income Manual provides guidance on what is considered "not significant". http://www.hmrc.gov.uk/manuals/eimanual/EIM21613.htm

6.41 Where the use of the asset (as opposed to a service) is mixed, for example in cases where an asset is used partly personally and partly in self-employment, a pragmatic approach could be introduced of a fixed 50% claim for the costs.

Telephone, internet and mobile telephone

6.42 The tax treatment of telephone, internet and mobile telephone is another area in which there is uncertainty and judgement is needed. Identifying on an item by item basis how much use relates to business is often time-consuming and difficult, especially given the large array of contract types, free minutes and "packaged deals". It is an area where tax law and practice has not kept up with developments.

6.43 In the past, virtually every home would have a land line, used to some extent for business. Nowadays mobile phones are the norm and broadband has meant that the days of separate business and private lines at home are rare; at the same time, the motivation for broadband is often for business reasons, even though it facilitates private use.

6.44 **It seems to us that the recommendations in the section on private use above could be helpful simplification for those who find it difficult to ascertain in any reasonable way the business use proportion of their telephone and broadband use**. Alternatives include introducing a single flat rate allowable amount for all mobile phone, broadband and internet costs.

Subsistence

6.45 HMRC's guidance[83] on allowing "reasonable" subsistence costs associated with "occasional business journeys outside the normal pattern" is only partially helpful because it gives no indication of what is considered either "reasonable" or "outside the normal work pattern" and therefore businesses do not have certainty. **The OTS recommends that the guidance in this area for the self-employed is improved to provide greater certainty to businesses about when it is permitted to claim such expenses.**

6.46 In many cases the expense involved is small and infrequent, for example a coffee during a journey or a sandwich at lunchtime. However, it is not clear how this could be simplified in a way that does not compromise the need for proper records of such expenses.

6.47 Employers may reimburse employees flat rate amounts for subsistence without a tax charge arising on the employee. The OTS suggests that consideration is given to a similar approach for the self-employed although the risk of abuse would need to be evaluated carefully.

Flat rate amounts for laundry etc

6.48 Another area of uncertainty is laundry costs[84]. If the laundry is processed at home, an apportionment or estimate is usually needed. **HMRC sets round sum amounts which may be claimed by employees in certain trades[85] and it would seem sensible to allow these amounts to be used by the self-employed in similar circumstances**, rather than estimates or apportionment calculations.

Postage, stationery and related items

6.49 As with subsistence claims, the expenses relating to postage, stationery and computer supplies are often small infrequent amounts and it can be difficult for businesses to keep track of them. In total the amount claimed by the smallest businesses on these items each year may be low.

[83] http://www.hmrc.gov.uk/manuals/bimmanual/BIM37670.htm
[84] Laundry will normally cover cleaning specialised clothing, such as protective clothing and uniforms.
[85] http://www.hmrc.gov.uk/manuals/eimanual/EIM32712.htm and s 367 ITEPA 2003

6.50 In the interests of simplifying record-keeping, **we recommend that consideration be given to allowing a reasonable estimate to be claimed or, alternatively, allowing businesses to claim a fixed amount for small sundry expenses such as postage and stationery**.

Summary of recommendations

6.51 The OTS recommends that pragmatic arrangements are introduced for the following expense types to simplify claims and improve certainty for small businesses:

- Use of home – standard or higher flat rate amount per week;
- Mileage – AMAPs with no upper turnover limit, and new AMAPs for vans;
- Capital items – small items allowed as a deduction rather than claiming capital allowances;
- Private use assets and services – disregard limited private and business use;
- Telephone, mobiles and internet – as for private use, or a standard allowance or "disallowance";
- Subsistence – improve guidance and consider use of flat rates;
- Laundry – same rates as used by employees; and
- Postage and stationery – allow estimates for small amounts or flat rate amount.

6.52 The OTS view is that these flat rates should be the default basis for claims for these items, with the option to use a strict apportionment if desired. Businesses would not be permitted to choose which regime was best for them each year; **whichever method is chosen would need to be adopted consistently in subsequent years**.

7 Conclusions and next steps

7.1 In its small business tax review, the OTS has looked at ways of making it easier for the smallest businesses to understand and deal with their tax obligations. In this paper we have considered certain simplification measures, the advantages and the potential problem areas and made recommendations.

7.2 The options considered were:

- basing the tax (and NIC) charge on non-profit measures;
- simplifying the calculation of profit; and
- simpler and more certain expense claims.

Basing tax on non-profit measures

7.3 Charging only a single set amount of tax for being in business, similar to the television licence fee, would bring enormous simplification to the taxation of small businesses. Alternatively, basing the tax charge on indicator-based measures, such as tables in restaurants, could also reduce the amount of work needed to calculate tax liability. However, the OTS does not believe that either of these ideas would be suitable for the UK business environment.

7.4 A non-profit measure which may be suitable for use in the UK is one based on turnover. Turnover is easier to identify and quicker and simpler to calculate than profit. Some, including members of our consultative committee, strongly oppose this idea. Profit is the conventional measure of business performance (and therefore tax liability) and using turnover is seen as unfair because businesses with the same turnover can have very different profit.

7.5 However, the OTS has also found a good deal of support for the idea. For the very smallest businesses, we believe that the major obstacles to the idea can be overcome. For example, as in other countries, different flat rates according to business sector could be used to address the issue of fairness. Our view is that for some small businesses this approach may be the best way of simplifying tax and we therefore **recommend that more work is undertaken to assess the potential costs and benefits of a turnover based tax.**

Simplifying calculation of profit

7.6 Under current legislation, profits on which tax is charged must be calculated using GAAP and then adjusted for certain items such as capital expenditure and entertaining.

7.7 Evidence suggests that taxpayers, particularly the unrepresented, are unaware of GAAP and of the adjustments needed. Furthermore many accountants have commented that for small businesses using GAAP can be unnecessary and does not produce an outcome materially different from the simpler receipts and payments basis.

7.8 Research shows that receipts and payments accounts are already widely used by the smallest businesses, which demonstrates that this is considered to be a simpler approach than calculating profit using GAAP. **The OTS recommends that this approach should be introduced as the default basis for very small businesses.**

Certainty in expense claims

7.9 Many businesses have told us that they do not understand what they are allowed to claim as a deduction against profit or that they fear that, where judgment is required, HMRC may challenge them and charge extra tax and penalties. Others suggest that the effort of keeping receipts and records for large numbers of small expenditures outweighs the potential tax saving.

7.10 Certain types of expense claims seem to give more problems than others, for example use of home for work, use of vehicles and capital items. Our work concentrated on these areas and recommends ways in which claims for such expenses could be made easier for businesses.

Optional or compulsory?

7.11 Consideration needs to be given to whether simplified schemes should be optional or compulsory. If businesses are given a choice this may add complexity in the form of preparing alternative calculations. However, it does not seem right to direct businesses to use a simplified regime if they wish to prepare the more detailed calculations.

7.12 **It is the OTS view that a "default basis" should be adopted.** Guidance to small businesses would indicate that they should deal with calculations in a particular way but that if they wish to prepare more detailed calculations they can do so. However, businesses will be required to use their chosen regime consistently and not be permitted to switch freely between regimes.

Recommendations

7.13 Our recommendations for simplifying small business income tax are:

- businesses which have turnovers of up to £30,000 should calculate their profits using "receipts and payments"[86] with the option to use profit figures calculated in accordance with GAAP;
- simplified arrangements should be introduced which give certainty to businesses for deductions of certain specified business expenses;
- turnover-based taxes should be investigated further because these have the capacity to simplify significantly tax for the smallest businesses; and
- the definition of income for the new Universal Credit should have regard to changes that may be introduced to simplify tax for the smallest businesses.

Further work

7.14 In order to take the issues forward, further work will need to be undertaken in the following areas:

- review of turnover-based taxes in other jurisdictions to ascertain the views of businesses, government, fiscal authorities and agents on whether and how they contribute to simplifying tax for small businesses;
- calculating the fiscal effect of a move from GAAP profit to profit calculated from receipts and payments, bearing in mind that many small businesses do not currently calculate profit using GAAP; and
- assessing an appropriate level for standard expense amounts for use of home, vehicle use and other expenses such as telephones and mixed use assets.

[86] We refer to "receipts and payments accounting" rather than "cash accounting" because cash accounting means different things to different people. "Receipts and payments" is the name given to similar arrangements used by charities.

A Alternative systems for taxing the smallest unincorporated businesses: terms of reference

A.1 The Office of Tax Simplification's interim report on Small Business Taxation highlighted the fact that many OECD countries have measures in place to reduce tax compliance obligations for small businesses. As part of the final report on small business tax the Government asked the OTS to:

- review simplified tax arrangements for small business used in other countries and assess how these make businesses' tax affairs easier;
- examine the case and demand for similar arrangements in the UK;
- explore arrangements that might deliver simplifications in the UK, and consider whether these could be achieved by legislative or administrative changes;
- consider what size and type of business should come within these arrangements, but not extend to considering incorporated businesses (due to complex interactions with company law); and
- examine whether the simplifications delivered by such arrangements would outweigh the complexities of introducing the change.

A.2 If the evidence supports it, the report will make specific recommendations on alternative systems for taxing small business for the Chancellor to consider.

A.3 The report will have regard to:

- previous consultations on alternative systems for taxing small businesses;
- the wider economic and policy implications of any proposals – including impact on business, wider Government policy and tax receipts;
- the risk of non-compliance and avoidance opportunities; and
- the Spending Review resource constraints on HMRC.

A.4 The evidence to support the recommendations should be quantified as far as possible, and be based on:

- a wide range of evidence, academic research and taxpayer data;
- critical analysis of feedback from the potentially affected population of small businesses and other stakeholders; and
- a recognition that different parts of this business population are affected in different ways.

B Summary of responses to OTS discussion paper on alternative systems

B.1 The OTS received 23 responses to the discussion document ranging from the large accountancy and trade bodies to the smallest businesses and their advisers. In addition, the OTS has spoken to businesses and their advisers at a range of meetings; the various surveys undertaken have also contributed to this project.

B.2 Feedback received can broadly be summarised:

- companies should not qualify for simplified schemes at this stage;
- there is no demand for indicator-based measures;
- "cash" accounting is thought suitable for the smallest businesses;
- there is scope for simplification of some but not all business expenses;
- a significant minority liked turnover-based measures, with or without a percentage expenses deduction, and concerns were largely around the resulting change in individual tax liability. Concern was voiced about the impact on loss-making businesses; and
- the majority view was that any simplified arrangement should be optional, despite the complexity inherent in this approach.

B.3 Other points raised:

- simplification is seen as a "good" thing but simplicity and pragmatism will raise issues of fairness. Any changes, even if leading to a simpler system, will lead to complexity during the transitional period;
- comments were made that changes need to deliver genuine simplification. For example, some see "three line accounts" in tax returns as counter-productive because there are no prompts for detail and information which needs to be considered;
- the upper limit suggested for simplified arrangements varied between the different recommendations, but tended to be at or below the VAT registration threshold;
- a suggestion was made to treat the smallest businesses in a similar way to "rent-a-room" i.e. tax gross receipts with zero or standard deduction for expenses and the taxpayer includes the income in the "other income box" on the tax return;
- the need for HMRC administration improvements was raised by some, and the issue of overlap relief was raised. These points are picked up in the OTS paper on tax administration for small businesses; and
- some respondents voiced frustrations about those who stayed outside (or cheated within) the tax system. They hoped that by making tax simpler and clearer, more would comply with their obligations and HMRC would more easily identify those who do not.

C International examples

C.1 The OTS has looked at arrangements in place for the taxation of small businesses in a number of other countries[87]. Such arrangements include various cash-based options, turnover-based taxes and indicator-based taxes. Our assessment of these alternatives has been limited in nature and aimed at assessing what, if any, features would be worth investigating further for a possible UK equivalent.

C.2 From the work we have done, it is difficult to assess with any certainty whether the arrangements produce simplification and work well in practice. Ideally, we would speak to businesses, advisers and governments to find out more about the workings of the specific systems. It is, however, telling that alternative systems are widespread. In many instances we found that the initial arrangements are revised at a later date to encourage greater take-up or because there is some perceived problem or unfair advantage or disadvantage.

C.3 Our research confirms our view that an alternative system for the UK should be investigated.

International Comparisons

C.4 Both the EC[88] and the OECD[89] have produced reports in recent years considering how different member states have approached simplification of tax systems for small businesses, with some suggestions as to best practice (which goes wider than just tax calculations).

C.5 Within the EU, for income and corporation taxes, simplification methods typically involve:

- some type of "presumptive tax" (i.e. where a rate of tax is applied according to measures other than profit, such as turnover or number of employees);
- cash accounting or another simplified accounting method; or
- applying limited standardised deductions instead of itemised deductions.

C.6 In EU States where companies have to comply with the 4th Accounting Directive, most simplification methods are directed at non-incorporated businesses.

C.7 The OECD report notes that cash accounting methods, including immediate expensing of capital purchases, may significantly reduce compliance costs for small and medium-sized enterprises (SMEs). It lists a number of countries that allow some form of cash accounting, including the US, Germany Austria, Japan and Spain. However, although immediate expensing of all capital expenditure is not permitted; most allow low-cost assets (typically costing no more than US$2,000) to be deducted, with a cap on the total of such costs which may be deducted annually.

[87] We are grateful to the students at the University of Central Lancashire who carried out a research project for a module on taxation during their 2011 autumn term, guided by their lecturer, David Massey. The project was to identify and research alternative small business tax systems around the world. Although this was only at an initial level and based on desktop research, we were impressed by the quality of work produced by many of the students. Their work helped us identify trends and alternatives for further investigation.

[88] Simplified Tax Compliance Procedures for SMEs, June 2007 – a report of the EC Expert Group http://ec.europa.eu/enterprise/entrepreneurship/support_measures/taxsimple/taxsimp_en.pdf

[89] SME Tax Compliance and Simplification, 2008 Background note prepared by the OECD Centre for Tax Policy and Administration, for a meeting of the Working Group on Taxation http://www.oecd.org/dataoecd/22/24/41873897.pdf

C.8 Too recently to be mentioned in the OECD report, New Zealand has been reviewing how it can simplify its tax regime. Since the Government looked at the idea of a cash basis for accounting[90], the New Zealand Institute of Chartered Accountants (NZICA) has been producing its own recommendations to simplify the taxation of their smallest businesses[91].

C.9 Our initial studies have led us to look further at four countries and their alternative systems.

France

C.10 It is important to appreciate that the usual process for setting up and running a business in France is generally more administratively burdensome than in the UK. All commercial businesses need to prepare accounts that are signed off by an "Expert Comptable" (EC), which typically cost €1,000 for a business with €30,000 turnover.

C.11 France has had a "Micro-Enterprise" system for many years and in 2009 introduced the "Auto-Entrepreneur" (A-E) regime, which has some variations on the "micro" regime. Both regimes are optional. They apply only to businesses that have turnovers of under €32,600 for service and professional businesses and under €81,500 for others[92]. There are additional restrictions based on total household income and the business sector. Once business turnover exceeds €34,600 for service and professional businesses and €89,600 for others, the business must change to the normal system for the self-employed of income less expenses ("réel simplifié") and become VAT registered.

C.12 The French Government's aim with the optional small business regimes is to simplify tax for the smallest businesses. In the first year of the A-E system, 300,000 businesses registered but only 45% reported turnover, the others reporting nil turnover. Those in the alternative regimes do not have to have their accounts signed off by an EC which means a considerable saving. OTS discussions with French contacts suggest that the regime can provide an attractive rate of tax and can give an incentive to leave the informal economy. Whether this is successful is not clear: reports vary. One of the biggest perceived advantages of both arrangements is that businesses know exactly what tax and social security costs they will pay on a given level of turnover and this tax is paid quarterly (and in some circumstances monthly) as the income is earned.

C.13 In 2012 the Micro-Enterprise regime taxes 29% of the turnover of sales-based and accommodation supply businesses, 50% of turnover where business provides services and 66% of professional profit. Social security contributions are typically 46%, based on theoretical profits.

C.14 The A-E regime accepts certain percentages of turnover in full discharge of income tax. The percentages are 1% of turnover of sales-based and accommodation supply businesses, 1.7% of turnover where the business provides services and 2.2% of professional profit. There are different flat rate payments in full discharge of social security payments for commercial activities (12%), professionals[93] (18.3%) and service providers[94] (21.3%).

C.15 The normal French business income tax system is similar to the one in UK, with a progressive tax scale on profits calculated under normal rules.

C.16 Businesses are allowed a buffer zone which gives one year's grace before they are forced into the regime réel, which also automatically brings the business into the French VAT regime. Losses are not recognised in the micro regime so there is no tax relief for them which is accepted

[90] See the December 2007 public consultation document: Reducing Tax Compliance Costs for Small and Medium-sized enterprises – A Government Discussion Document. Dec 2007, New Zealand Government.

[91] See http://www.smetax.co.nz/index.htm

[92] 2011 limits.

[93] Professionals whose activity falls under the pension and old age security regime for independent workers.

[94] Service providers are classed as professional profit which fall under the social security regime for independent workers.

as part of the regime. It is possible to start under the "normal" regime and then transfer to the micro regime if the business is under the turnover limit.

C.17 It is known that the regime is not suitable for certain business types, for example service and professional businesses with high costs and businesses with high capital expenditure tend not to opt for the micro regimes.

South Africa

C.18 The South African Government decided that small businesses should not have the same tax compliance burden as large businesses and implemented an alternative optional turnover tax system for small businesses with effect from 1 March 2009. The regime applies to all types of businesses including companies and partnerships, but where income from professional services is greater than 20% of the total, a company or co-operative is not eligible. Certain other businesses are also ineligible.

C.19 Initially businesses could not be registered for VAT as well as turnover tax, but with effect from 1 March 2012 this will be permitted. Another change that has been made is that whereas previously businesses had to remain in the regime for at least three years, now businesses may leave the regime at the end of any tax year. The South African Revenue Service website gives help and guidance for businesses to help them decide whether the turnover tax would be appropriate for the business.

C.20 The tax rates were reduced from 1 March 2011. The rates of tax applying to turnover are 0% on the first R150,000 (£12,325), 1% on the next R150,000 to R300,000 (£24,650), 2% on the next R200,000 to R500,000 (£41,085), 4% on the next R250,000 to R750,000 (£61,627) and 6% on amounts above that to R1million (£82,170). The income from the business is treated separately from other income.

C.21 All businesses using the regime must use the tax year (which ends on the last day of February) as their accounting year. The tax is paid half-yearly: in the tax year and at the end of the tax year.

C.22 The only records required are:

- all amounts received by the business for each year of assessment;
- all dividends declared for the year of assessment;
- all assets with a cost price of more than R10,000 (£822) each; and
- all liabilities that exceed R10,000 (£822) each.

Australia

C.23 Australia introduced an optional "Simplified Tax System" (STS) on 1 July 2001. One of the major "simplifications" introduced was mandatory use of cash accounting by STS taxpayers. This meant that income would be assessable when it was received, and expenses deductible when paid. In practice, the rules were not quite so simple. For example, cash accounting applied to "ordinary" income, but not to statutory income (e.g. capital gains) or certain kinds of deductions.

C.24 In addition, some small businesses preferred to use accruals accounting and many businesses which were using accruals would face significantly increased taxable income in the entry year and were therefore reluctant to enter the regime. As result, the mandatory use of cash accounting by STS taxpayers was dropped from 1 July 2005.

C.25 The Small Business Entities (SBE) regime was introduced on 1 July 2007 for businesses with turnover under A$1 million (£675,470). This harmonised many of the rules and reliefs.

China

C.26 China has various simplifications to its VAT system for small businesses. These in many ways emulate aspects of the UK's simpler VAT systems. What is of more interest to the current study are the administrative alternatives.

C.27 We understand that there is a simplified way of calculating tax for small businesses in China. Local tax authorities assess the amount of tax payable by a small business, according to the state (region) in which they operate, the scale and type of the business and its legal form.

D Business use adjustments example – principles and practical issues

Ali is a surveyor who works from home in a spare bedroom which is also used occasionally for guests. He uses the family's car for visiting clients. He bought a camera which he uses to take pictures for his records of the sites he visits, and he uses this when he goes on holiday and at occasional sports events. He also has broadband and a telephone at home which he uses for his work.

How does Ali calculate the allowable business expenses relating to his use of home, car, camera and telephone/broadband?

Use of home:

In its technical manuals HMRC provides guidance on "use of home" deductions and apportioning costs[95].

In August, Ali starts collecting together all the household bills from various household files.

He finds that the gas and electricity bills are now online only and tries to log on but has forgotten his password. Having obtained a new password, he logs on and finds that only the last 12 months' bills are online so he has to apply for paper copies which take three weeks to arrive and for which he is charged £20.

His annual statement for his mortgage covers the calendar year and not tax year. His lender charges £25 for a certificate of interest paid in the tax year which takes another 3 weeks to arrive.

Ali eventually has a pile of about 50 pieces of paper relating to Council Tax, metered water charges, gas, electricity, cleaning, buildings and contents insurance, mortgage interest and house repairs.

Fixed costs:

Mortgage interest (or rent), Council Tax and insurance are expenses which would be incurred even if there was no business use of the home, so are apportioned according to the area used for the business and the time spent in the area.

Ali's spare room is used all the time to store Ali's surveying equipment and his paperwork and is one of eight rooms in the house. The rooms are all different sizes. Ali works in the room about half of each working week and spends the rest of the time on sites. Guests use the room about 20 days a year but share the room with the surveying equipment and paperwork.

On what basis should Ali claim fixed costs? Should he claim one-eighth of 345/365 of the fixed costs of his home? Should he measure the area of the house and claim the percentage which relates to his office, ignoring the use of the room by guests because his equipment is still in there? Or can he claim one-eighth of the fixed costs because the business equipment is always in the room?

Running costs:

Costs relating to electricity, metered water, cleaning, gas and electricity may vary according to business use and where the use is significant can be apportioned based on usage. How should Ali apportion these costs? Should he base his claim on the amount of time he spends in the room (2.5 days a week)? Alternatively given that the room is still heated and used for his business equipment can he claim one-eighth of the heating costs? What should he then do about apportioning the other running costs?

[95] HMRC Business income manual BIM47800 et seq.

Use of car:

Last year Ali used the AMAP rates for business mileage but he changed his car mid-year and as his turnover is now above the VAT registration threshold he cannot use the AMAP rates any more[96]. He has to calculate the proportion of his car costs which relate to business travel. Unfortunately it wasn't until he read the guidance on completing his tax return that he realised this. He keeps a file for most car expenses but unfortunately threw away all his fuel receipts once he checked them off on his credit card bill.

How will he work out the correct claim for business mileage?

Ali has kept a record of business mileage, and the purchase invoice for the new car shows the odometer reading when he bought the car. However, Ali didn't check the odometer reading at 5 April 2011 and there has been no MOT or servicing since he bought the car so he doesn't know the total mileage for the period to 5 April 2011. He needs this figure to work out the percentage business use of the car. He is worried that HMRC will not accept an estimate.

As regards the fuel costs, he cannot remember what price fuel was, or how many miles per litre his car did. He wonders if HMRC will allow him to estimate the fuel costs and how he can demonstrate that it is reasonable.

Ali pays his insurance annually on 5 July for the year ahead and his Road Tax runs to 30 November each year. Before applying the business use percentage, Ali must apportion his insurance premiums for the year to 5 July 2011 and 5 July 2012, taking 3/12 of the former and 9/12 of the latter to obtain a figure for the tax year. A similar apportionment calculation must be done for the Road Tax costs.

Camera:

Although he bought the camera for the business Ali knows he doesn't use his camera wholly for business and he can only claim tax relief for business expenses. He needs to calculate the allowable business proportion on which he can claim capital allowances (AIA) and wonders what basis he should use.

He could base the business use on the number of personal and business pictures he took but he has no idea how many of each he took in the year because he had no idea that he would need to record this information. Perhaps he could use the proportion of days he used the camera for business and personal use? He can't recall this accurately now either – he knows how much time he spent on holiday but the camera broke down on one holiday so should he take that into account? Perhaps he shouldn't risk making a claim at all because he will not be able to substantiate it.

Broadband and telephone:

Ali has a broadband package which gives free evening and weekend telephone calls. His family use the telephone and broadband when they are at home. There are a lot of incoming calls relating to his business because he doesn't give clients his mobile number. He makes most of his business calls on his mobile because they are free under his mobile contract.

Ali needs to apportion costs according to business usage. He will need to know the overall use, both incoming and outgoing calls and the split of use of the internet. However, his provider doesn't itemise incoming calls or free outgoing calls so he has no idea to what extent the telephone is used for the business or personally or how to find out. The position is similar for the internet: he hasn't monitored the amount of time he uses the internet for business or his family use it and would find it very hard to estimate.

96 See page 3 HS222 (2011).

Office of Tax Simplification contacts

This document can be found in full on our website at:
http://www.hm-treasury.gov.uk/ots

If you require this information in another language, format or have general enquiries about the Office of Tax Simplification and its work, contact:

The OTS Secretariat
Office of Tax Simplification
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 6190

E-mail: ots@ots.gsi.gov.uk

ISBN 978-1-84532-947-1

9 781845 329471 >