Office of
Tax Simplification

A simpler income tax for the smallest businesses:

a discussion paper

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Preface

Subject of this consultation	The Office of Tax Simplification has identified the taxation of income from the smallest unincorporated businesses as an area with scope for simplification. The main purpose of this paper is to set out possible options for a simplified system for small unincorporated businesses so that interested parties can comment on whether such a system is desirable and would deliver simplification.
How did the OTS get to this stage?	This paper builds on the interim report on small business tax that was published on 10 March 2011. The interim report was informed by a series of workshops with small business held across the UK.
Scope of this consultation	The consultation seeks views on the need for simplification in this area of taxation and on the desirability of each of the options.
Who should read this?	Proprietors of very small unincorporated businesses; advisers to small unincorporated businesses; representative bodies.
Duration	The consultation will run for 10 weeks from 28 July 2011. The closing date for responses is 7 October 2011.
How to respond	Responses should be sent via email to: OTS-SmallBusiness@ots.gsi.gov.uk Alternatively, please use the postal address: Review of small business tax Office of Tax Simplification 1 Horse Guards Road London SW1A 2HQ
Additional ways to be involved	As part of this consultation, the OTS will be hosting a series of meetings and workshops in September and October 2011. The OTS welcome offers for meetings from interested parties.
After the consultation	The work on an alternative system for the smallest business is part of the second stage of the OTS review of small business tax. This will be published before Budget 2012. Between the end of this consultation and publication of the final report, the OTS will refine options and develop the evidence base to support any recommendations. The OTS is an advisory body and it will be up to the Chancellor to decide whether or not to take forward our proposals. If he does, then the OTS would envisage a further period of more detailed consultation and the publication of draft legislation, in line with the Government's approach to tax policy making.

Contents

Executive summary

There are 3 million unincorporated businesses in the UK that have a turnover of £70,000 or less, including approximately 2 million with a turnover of £20,000 or less. Although these are the smallest businesses in the UK, they form a vital part of the UK economy. However, these very small businesses bear a disproportionate burden when dealing with their tax obligations, and are the least likely group to have the training, skills and time to cope with their obligations.

The Office of Tax Simplification is looking at possible ways to simplify the tax obligations of these smallest unincorporated businesses. This work follows on from the first stage of our study of small business taxation, published in March 2011[1].

Our focus for this project has been on income tax, given that the businesses we are primarily considering are below the VAT registration threshold and will have few, if any, employees. (We will return to these other taxes in another phase of our work.) In this paper, we are aiming to:

- identify simpler tax compliance procedures; and
- consider alternative ways of calculating the tax liability, which might be a simplified profit calculation, or more radically, measures that are not based on profit.

Under current rules, businesses must prepare accounts that show profits arrived at using generally accepted accounting practice ("GAAP") and then make any necessary adjustments which are required for tax purposes.

There have been a number of initiatives to simplify accounting and taxation for businesses, some of which are ongoing. In addition, there are already a number of simplified schemes and easements within the tax system that could perhaps be extended.

In this report, the OTS sets out a range of options for taxing the smallest businesses, some of which may not be appropriate for the UK. However, it is important to publicise the variety of approaches that could be used and canvass the views of businesses on whether these would represent a simplification for them.

The OTS is keen to hear from unrepresented business owners, as well as those with professional help and their advisers: Which arrangements are likely to make dealing with their tax obligations easier, less time-consuming and provide more certainty? What views are there on the advantages and disadvantages of the various possible arrangements?

Using feedback from this consultation and from a series of meetings and workshops that we will be holding in the next few months, together with the results of surveys and analysis of HMRC data, the OTS will be preparing a report and recommendations which will be published ahead of Budget 2012.

[1] http://www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf

1 Introduction

1.1 There are approximately 3.5 million sole trader and partnership businesses in the UK that fall within the official EU categorisation of "micro"[2]. Of these, over 3 million have turnover of £70,000 or less and approximately 2 million have turnover of £20,000 or less.

1.2 These businesses will include a very wide range of trades, occupations and professions[3], from the smallest hobby business through to those who are full-time self-employed with several staff. They also range from a part-time addition to a main employment to businesses that provide the sole source of income for the proprietor. The vast majority of businesses with the lowest levels of turnover have no employees and are effectively one person operating alone[4].

1.3 It is well documented in the literature on small business taxation that the burden the tax system places on businesses is proportionately greater for the smallest businesses[5]. Discussions the OTS had with businesses across the country indicated that those running the smallest businesses are less likely to have the training, skills and time to cope with their tax affairs.

1.4 The current basis of taxing businesses is that tax should be determined from profits calculated according to accounting rules that have developed over time. However, this is only one of a number of options that could be used. The starting point is of course that accounts tell the proprietors how their activities are faring. Many businesses need properly prepared business accounts to assist business decision making and to help in raising finance for themselves and their business. The accounts then lead into dealing with their tax obligations. However, some of the small business proprietors the OTS has spoken to say that they have no need for detailed accounting information and do not need accounts except for the purposes of preparing their tax returns. The OTS has had similar comments from a number of advisers.

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

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[2] The official EU definition of a micro business is a business that has: 9 employees or fewer; and either (or both) turnover or total assets below €2 million. http://europa.eu/legislation_summaries/enterprise/business_environment/n26026_en.htm

[3] We have included property businesses in our analysis. Income from property has, since 1995 and subject to a few differences, been taxed on the same basis as trading income. It therefore follows that any simplified system could apply also to property letting businesses.

[4] 2009-10 data in table A.1 of annex A shows that over 90% of sole traders with turnover below £70,000 per annum appear to have no employees, and that this proportion is even higher for lower turnover thresholds.

[5] See, for example, Chapter 5 of "Taxation of SMEs: Key issues and policy considerations, OECD tax policy studies no. 18" (2009)

Box 1.A: An example of a business that may benefit from a simplified tax system

It is perhaps worth setting out an imaginary example to put these arguments and situations into context.

Suppose a teacher on PAYE with no other tax complexities does a few hours of private teaching in term time – say 3 hours a week for 30 weeks, with assumed rate of £30 per hour, so total income of £2,700 for a year.

In strictness, the teacher would have to look at basis periods, use of home, cost of equipment, travel etc and develop accounts for the activity.

Engaging an accountant would involve the accountant setting up the teacher as a client with a proper engagement letter, involving money laundering checks and other procedures. This is unlikely to be attractive to either side. The result may well be that no return is made of the income: indeed HMRC are currently citing problems around the taxation of coaching and tutoring activities.

Such a person needs to be able to self-assess his or her own liability, ideally with a very simple system. The basis, as discussed in this paper, could be taxation based on cash income, some actual expenses and some flat rate deductions. Are GAAP accounts really needed or realistic in such circumstances? Could a rough and ready basis of taxation, based on some resemblance to the teacher's income be contemplated?

1.6 The OTS has chosen to investigate whether there is a suitable alternative method for taxing income from small unincorporated businesses (i.e. the self-employed and partnerships but not companies), which would make it easier for these businesses to understand and deal with their tax obligations.

1.7 We have chosen not to look at small companies at this stage because of potentially complex interactions with company law.

1.8 In this document, the OTS is setting out a wide range of possible options which have been or are being used in other jurisdictions. The options may not be appropriate for UK businesses but it is important that they are considered and the pros and cons evaluated.

1.9 Options for turnover ceilings that the OTS is considering for determining eligibility for a simpler system are £20,000, £30,000 and the VAT registration threshold (£73,000 in 2011-12) which would cover 2million, 2.5 million and 3 million sole traders and partnerships respectively (see Annex A).

Background

1.10 Over the years an extensive and complex tax code for business income has developed. Individuals pay income tax and Class 4 National Insurance Contributions ("Class 4 NICs") on business profits which must be calculated using ("GAAP")[6] and then adjusted for tax purposes. In this paper, references to income tax should be read as including Class 4 NIC where it would be payable.

1.11 Profit is the driving force behind most business activity and is the commonly used measure of the performance of a business. However, this need not be the basis for the tax charge for the very smallest businesses. The OTS has been told by businesses and their advisers that the preparation of

[6] See paragraph 1.15 below.

accounts using GAAP and undertaking the associated tax adjustments can be time-consuming and is often complicated. This complexity increases the likelihood of errors, and rectifying these places a further burden on the business and on HM Revenue & Customs ("HMRC").

1.12 A more pragmatic measure could be used for the calculation of the tax charge on the smallest businesses, as is done in other jurisdictions (see Annex B). Indeed, the UK tax system already has some well-used simplified schemes for small businesses and employees, as set out in Annex C of this document.

1.13 Reasons often cited for businesses needing to prepare accounts are that as they grow and when they need finance, they will need business accounts to determine profitability and for management purposes. Evidence suggests, however, that the majority of small businesses do not grow[7], nor will all small businesses need to access finance. Furthermore many of the smallest businesses are not the proprietor's main source of income[8], being in the nature of a hobby or small subsidiary source of income. For these businesses accounts are needed only to comply with tax obligations, so is it necessary or appropriate to have accounts prepared under GAAP?

1.14 There is diversity of opinion on whether the tax charge can be calculated using measures other than accounts prepared in accordance with GAAP. Many members of the OTS consultative committee for the review of small business taxation strongly believe that all businesses should prepare accounts using GAAP and others believe equally strongly that there is a case for a simplified approach for the smallest businesses.

Current accountancy and tax requirements and related initiatives

1.15 The profits of a trade must be calculated in accordance with GAAP but for tax purposes certain adjustments may need to be made[9]. Accounts prepared using GAAP are different from accounts prepared on the 'cash basis'. Accounts prepared on the cash basis include only money spent and money received during the accounting period. When accounts are prepared using GAAP, a number of adjustments need to be made to the cash accounts, for example in respect of:

- invoices issued, whether or not payment has been received;
- the value of work undertaken but not yet invoiced;
- costs incurred whether or not payment has been made;
- stock and work in progress;
- capital purchases and depreciation; and
- loan repayments and interest.

1.16 Adjustments for tax purposes will include, for example:

- excluding certain expenditure such as that on entertaining and relating to private use of items;
- excluding depreciation charged in the accounts and claiming capital allowances where appropriate; and
- adjusting for goods or services taken for own use by proprietor.

[7] According to the Department for Business, Innovation and Skills small business survey, in 2010, 28% of SME employers experienced turnover growth relative to 12 months previously. Pre-recession this was higher at approximately 40% in 2006 and 2007. Micro businesses were the least likely to have turnover growth of the population surveyed. Initial OTS analysis of business turnover in 2007-08 and 2008-09 showed that very few businesses had turnover growth between these years. See paragraph 3.9 and Annex A.

[8] OTS analysis of HMRC data shows that almost one in four sole traders with turnover below £20,000 per annum obtain less than 10% of their total income from trade profit.

[9] Income Tax (Trading & Other Income) Act 2005 section 25

1.17 The OTS has been in discussion with the Department for Business, Innovation and Skills ("BIS") and the Financial Reporting Council over their work on reducing accountancy and reporting requirements for small businesses, including companies. The OTS is also aware of the discussions at the European Union level over simplified accounting standards for micro entities[10].The OTS view is that such proposals have the potential to deliver simplification, for example if businesses could prepare accounts based on receipts and outgoings with no adjustments for accruals, prepayments, work in progress etc.

Some points of caution

1.18 Any new system would present issues to be addressed. For example, introducing different rules for different sizes of businesses can create perverse incentives to remain below the turnover threshold used to set the boundary. It should also be noted that as well as income tax and Class 4 NIC, tax credits are currently based on tax-adjusted profits so changes could affect entitlements to these as well. Legislation would also need to set out the process of transition between the simplified system and the regular tax system. These issues are not seen as insurmountable by the OTS and are set out in more detail in Chapter 3.

1.19 The OTS must also have regard to the wider objectives of tax policy, and set out the potential risks of any recommendation, including the impact it may have on tax revenues, business growth, tax avoidance and also tax evasion.

1.20 Many members of the OTS small business consultative committee see simplified schemes as rewarding those who cannot be bothered to keep records. Others suggest that an alternative system may make it much easier for the smallest businesses to comply with their tax obligations and that some current record-keeping requirements and some calculations are unnecessarily onerous.

1.21 One of the most frequent comments made to us by small businesses in our consultation last year was that there was too much change in the tax system. Any change introduces complexity in the form of transitional issues, and new rules that people need to get used to. It is therefore important that any change the OTS considers produces real long term simplifications that outweigh the complexity of transition.

1.22 The OTS recognises that all businesses suffer complexity in the tax system. In our other strands of work on small businesses, the OTS will look to address other issues raised in the interim report on small business. However, in this document the OTS does not include the taxation of small companies because there are other issues which have to be considered where companies are involved, including company law requirements.

[10] The proposed Directive is to exempt very small businesses from the scope of the 4th Company Law Directive. The EU Compromise Agreement on the proposal (http://register.consilium.europa.eu/pdf/en/11/st10/st10642.en11.pdf) suggests a new definition of "micro-entities" covering businesses that do not exceed: a balance sheet of €250,000, a net turnover of €500,000 and an average of 10 employees during the financial year in question.

2 Options for change

2.1 In Annex A of the interim report of the review of small business tax published in March 2011[11], four options were put forward for an alternative approach to the taxation of the smallest unincorporated businesses.

2.2 These options fall into two broad categories:

- Changing some existing rules to ease complexity in certain areas (A); and
- Using non-profit measures as the basis for taxation (B).

2.3 OTS analysis of 2007-08 HMRC data shows that 900,000 businesses with turnover below £20,000 per annum do not use an accountant or tax agent. A simplified scheme may increase the likelihood that these unrepresented businesses submit accurate returns. It could reduce the time and cost of complying with tax obligations, and may also increase the number of businesses that are able to deal with their tax obligations without external advice.

2.4 The options are set out in more detail in Tables 2.A and 2.B on the following pages. The OTS seeks the views of businesses and their advisers on the points raised, on other options not included and on whether the main potential issues, positive and negative, have been identified. In assessing these options, the following questions are particularly important:

Questions for consultation:

1. Do you think that businesses would want to take advantage of a simplified system? If you run a small business, would you be interested, and if so, why? Would you still be interested if you pay more tax as a result?
2. Are there any other, better options that have not been set out?

(A) Changing some of the existing rules to ease complexity in certain areas

2.5 One approach to simplification would be to retain profit as the measure upon which the tax charge will be based but instead of applying GAAP, as currently required, relax this requirement and, for the smallest businesses, allow a simpler approach to the calculation of profits.

2.6 Options to consider include:

- Cash accounting
- Fixed rate (%) and / or fixed amount (£) deductions for certain expenses
- Fixed rate (%) and / or fixed amount (£) deductions for total expenses
- Allowing small expenditures on capital items to be treated as a revenue expense[12]

[11] http://www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf

[12] Although the annual investment allowance ('AIA') has alleviated some of the issues associated with small capital expenditures, there continues to be the requirement to identify capital expenditure and prepare the capital allowance calculation.

2.7 The OTS is aware that the proprietors of many small businesses, particularly unrepresented and unincorporated businesses, do not understand the requirements of GAAP. If, instead of preparing their accounts in accordance with all accounting rules, these smallest businesses could prepare business accounts and tax returns taking account only of monies received and monies expended – the 'cash basis' of accounting - the time-consuming and sometimes complicated accounting adjustments made to figures for prepayments, accruals, work in progress and other items would not be required.

2.8 Allowing the use of fixed deductions for certain expenses could reduce the amount of work required to produce accounts and give more certainty over what are allowable expenses. Smaller businesses in particular are likely to own assets and incur expenses which relate only partly to the business. Examples of these are the costs of providing a home office or workroom, use of a vehicle, use of telephones and so on. The rules relating to what is, and what is not, an allowable business expense can be difficult to apply in practice and the calculations can be onerous.

2.9 The time cost of collecting the data and performing the necessary calculations may be out of all proportion to the tax relief being claimed. For example, the use of home calculation for a small business may take two hours, including assembling receipts and invoices and calculating apportionments, for a claim of £500 giving tax relief at 20% of £100.

Table 2.A: Outline of options for changing existing rules to ease compliance in certain areas

<table>
<tr><th>Policy</th><th>Cash accounting</th><th>Fixed rate deductions for expenses</th><th>Fixed amount deductions for expenses</th><th>Treat small capital expenditures as allowable revenue expenses</th></tr>
<tr><td rowspan="2">How it works</td><td rowspan="2">Businesses prepare accounts based on income and outgoings with no adjustments for accruals, prepayments, work in progress etc.</td><td>Businesses are allowed, for certain expenses, to deduct a percentage of, for example turnover, instead of recording actual amounts expended.</td><td>Businesses are allowed, for certain expenses, to deduct a fixed amount instead of recording actual amounts.</td><td rowspan="2">Small items of capital expenditure, say up to £200 per item, are treated as a revenue expense rather than capital expenditure. Currently items of capital expenditure, no matter how small, are dealt with under the capital allowances legislation.</td></tr>
<tr><td colspan="2">Could be used for items where there is private use instead of preparing accurate apportionment calculations.</td></tr>
<tr><td>Benefits</td><td>• Easier for non-accountants to understand.
• Straightforward to prepare accounts. No year-end adjustments.
• Taxes income only when realised and received.
• Consistency with VAT cash accounting scheme.</td><td colspan="2">• Record-keeping requirements reduced for eligible expenses; less time spent keeping, filing and processing certain expenses receipts.
• Replaces complicated calculations e.g. for private use of assets with a simple one.
• Reduced compliance costs for HMRC; where used for items which need to be apportioned, less argument about appropriate proportions.</td><td>• Record-keeping and calculation requirements are reduced.
• Less work and potential cost reductions for HMRC.
• Capital allowance calculations may no longer be required.</td></tr>
<tr><td rowspan="2">Potential disadvantages</td><td rowspan="2">• Capital expenditure would have a significant impact on taxable profits. However, the smallest businesses are generally able to claim AIA so there is no real fiscal effect[13].
• HMRC would need to set out rules for certain items e.g loan repayments or entertaining.</td><td>• Percentage deduction more difficult to calculate than fixed allowances.</td><td>• If fixed amount varies with turnover, it may be fairer but more complex.</td><td rowspan="2"></td></tr>
<tr><td colspan="2">• Calculations to decide which is best, adding to time spent.
• Does not reflect actual expenditure so there will be ‘winners and losers’. There is a risk that businesses only choose to participate if their tax liability falls.</td></tr>
</table>

[13] HMRC statistics show that the Annual Investment Allowance effectively gives 100% tax relief for the capital expenditure (excluding cars) of 99% of unincorporated businesses. There may be some fiscal impact from car purchases, where AIA cannot be claimed.

Likely behavioural effects	• Expenses paid promptly and income receipts deferred especially at year end.	• Use of actual expense rather than fixed deduction where this reduces tax liability. • Some businesses may accept a higher tax liability in return for less time consuming administration.	

Fiscal impact	• In year of change there may be one-off deferral of revenue.
	• Tax relief will be given for certain costs which are not currently tax deductible e.g. entertaining costs, certain lease expenses and personal elements of business expenses.
	• Full deduction from profits of a car with mixed personal and business will lead to significant loss of tax revenue. Another approach might be better e.g. a rate for business miles.
		• Any negative fiscal impact of using 'best' option could be reduced if:
		    • the arrangement has to be used on a consistent basis from year to year; and
		    • the amount of the permitted deduction is set in such a way as to provide a simplification incentive without being too generous.
			• Essentially a timing difference resulting in accelerated tax relief although many such items would attract AIA so no fiscal effect.

	The owners of unincorporated businesses with turnover below £20,000 per annum contribute approximately £3.8bn in revenue from income tax and Class 4 NICs. This increases to £9.0bn for businesses with turnover below £70,000 per annum[14].		
Winners and losers	The resultant timing differences will generally benefit businesses.	Would not reflect differences in cost base in different geographical areas. As noted above where allowed amount is greater or less than actual spend, there would be winners and losers.	Not likely to have a significant impact for smallest businesses.

[14] Based on OTS analysis of 2009-10 HMRC data. We have only included; individuals where the total turnover from all businesses that the individual owns falls below the threshold. As shown in Annex A, the majority of small business proprietors own only one business.

(B) Using non-profit measures as the basis for taxation

2.10 A more radical approach to the taxation of the smallest businesses would be to use, as some countries do, non-profit measures as the basis for taxation. The tax charge could be calculated on:

- Turnover, which is used as the basis for taxing small businesses in a number of countries, including France, Poland and South Africa. Variations include using adjusted turnover, for example, by removing employment related expenditure, and using a previous year's profit figure uprated by a specified amount.
- A flat charge on the business, comparable to the TV licence fee, where there is a single fixed tax charge for being in business. This approach is used in a number of Central and Eastern European countries.
- "Indicator based" measures where, for example, the tax charge is fixed by reference to number of tables in restaurants, the footprint of the business premises, or the number of employees. Indicator based measures are used in Spain and in Poland.

2.11 Although such non-profit measures are used in other countries, many members of the consultative committee strongly believe that such measures would not be appropriate for UK businesses. Others suggest that there might be a place for these methods in simplifying tax for the smallest businesses. Further research is needed to understand how these measures work in other countries and how successful they are in simplifying taxation for the smallest businesses.

2.12 The OTS is particularly keen to hear the view of small businesses themselves on the use of non-profit measures as a basis for taxation.

Table 2.B: Outline of options for non-profit based measures as the basis of taxation

<table>
<tr><th>Policy</th><th>Turnover or adjusted turnover</th><th>Flat rate charge</th><th>“Indicator” based measures</th></tr>
<tr><td>How it works</td><td>Tax is levied on turnover, adjusted turnover, or turnover from a previous year[15].</td><td>The business is charged a flat rate amount. This amount might vary according to the business sector.</td><td>The tax charge is determined by indicators e.g. tables in restaurants, number of employees.</td></tr>
<tr><td rowspan="2">Benefits</td><td colspan="3">• Transparency - a simple and predictable tax charge which can be readily understood and straightforward to calculate; in some cases there will be certainty from the outset over the tax liability for the year.
• Business proprietors do not need specialist knowledge and understanding of accounting principles and tax rules.
• Simpler returns with reduced scope for errors.
• Minimal work required to deal with tax obligations so business owners can spend more time doing business and generating income.
• Businesses can manage their tax affairs without incurring professional costs.
• It would be potentially cheaper for HMRC to administer because it only needs to look at one measure, not both receipts and expenses.</td></tr>
<tr><td>• Charges based on turnover would mean a lower cost of transition to the regular system as compared with a flat charge or indicator-based measures.</td><td colspan="2">• For new businesses the cost of learning to deal with tax obligations exists no matter how the liability is calculated. Under a simplified system, dealing with many of the more complicated aspects is deferred, perhaps indefinitely.</td></tr>
<tr><td>Potential disadvantages</td><td></td><td colspan="2">• Considerable issues when moving to a profit-based tax system when business grows.</td></tr>
</table>

[15] Turnover would need to be defined.

	• No relief for accounting losses might be economically undesirable. It has been recognised that risk taking, new businesses benefit from tax relief on losses, with many businesses generating insufficient revenue to cover the cost of the initial investments in the business[16]. Self-assessment data from 2007-08 shows that 9% of sole traders and 13% of partnerships made losses[17]. • No accounts are required and therefore these are not available for other purposes e.g. obtaining loans. • Some advisers feel that relaxing record keeping requirements will mean that business owners will have less understanding of the true financial position of their business. • If the rate of tax depends on the business sector, it will influence how businesses will categorise themselves and may also result in uncertainty. For example, some businesses have told the OTS that they had difficulty deciding into which business category they fell in the VAT Flat Rate Scheme. • There will be considerable costs of change for HMRC because detailed new guidance would be needed and appropriate definitions, percentages and amounts would need to be determined.	
Likely behavioural effects	Distortion to behaviour would shift from profits levels to turnover levels.	Would reduce economic distortions based around profit or turnover levels – for example restricting business activity so as not to go over the higher rate threshold/NIC threshold/personal allowance/VAT threshold.
Fiscal impact	• In theory, it could be revenue neutral, with tax receipts dependent on the specific rates and thresholds chosen. • However, it may be difficult to set appropriate rate(s) for the different business sectors and for fiscal neutrality[18]. • Might reduce the "tax gap", if businesses had fewer ways of manipulating their tax base (e.g. by inflating expenses or suppressing receipts) and less chance of making errors. • A simpler system will impact on tax evasion: people may be encouraged to leave the black economy, or relaxed record keeping requirements may lead to greater evasion. • A simpler system for unincorporated businesses might reduce the number of businesses incorporating to save tax and NI. • The owners of unincorporated businesses with turnover below £20,000 per annum contribute approximately £3.8bn in revenue. This increases to £9.0bn for businesses with turnover below £70,000 per annum[19].	
Winners and losers	• Any change to the system would provide incentives for behavioural change and may skew competition. • Tax credits claimants might have very different award levels based on the new measures. • These options would appear to favour industries with high profit margins[20].	

[16] This point is mentioned in the 2009 OECD Policy Studies paper "Taxation of SMEs: Key issues and policy considerations".

[17] OTS analysis of HMRC data.

[18] Under an optional scheme, once the rate has been set, it is possible that businesses only opt into the scheme if their tax liability falls as a result. This means that the "appropriate rate" for the population that choose the scheme should actually be higher than the "appropriate rate" for all that are eligible.

[19] See page 12 and Annex A for a description of this data.

[20] For example, traders of goods are likely to lose whilst providers of services may benefit: other countries address this by having different rates for different business types.

Questions for consultation:

3. What aspects of preparing accounts and adjusting them for tax purposes take the longest? To what extent would any of the options mentioned in this document make matters simpler and quicker?

4. When preparing tax returns do you prepare the business income figures in accordance with the rules outlined in paragraph 1.15 i.e. GAAP, tax adjusted? If not, why not?

5. Do you use the following and why (if you are an agent please indicate what proportion of your clients use the following)?

    i. Fixed rate (40p up to 2010/11 or 45p for 2011/12) per mile for mileage expenses in a self-employed business.

    ii. Estimates for certain expenses (it would be helpful to know in which categories of expenses and why, and also how you arrive at the estimated amount claimed).

    iii. The VAT Flat Rate Scheme.

6. Would you prefer to use a flat rate deduction (i.e a stated amount e.g. £100) for certain expenses or an amount which is a percentage of turnover? Which categories of expenses (e.g. travel, subsistence, postage and stationery, goods for resale, telephone) would this work best for? What advantages and disadvantages can you see?

7. Where there is private use of an asset (e.g. cars, equipment, home), businesses currently have to prepare detailed calculations to find the business element of an expense. What is your, or your client's, view of the advantages and disadvantages of using a specified flat rate amount and would you, or your client, prefer to use such a rate?

8. In your view, would the simplifications delivered outweigh the cost of transition and other complexities?

3 Defining eligibility for an alternative system

Size of the business

3.1 The OTS believes that any alternative system should be restricted to the smallest unincorporated businesses (sole traders and partnerships), because they face the highest compliance cost relative to tax liability. However, the UK does not have a suitable definition for these very small businesses.

3.2 There are approximately 3.5 million unincorporated businesses in the UK that meet the EU micro-business criteria[21]. It is clear that there are significant differences within this group of businesses, both in terms of size and business type. The business may be the sole or main source of income or more in the nature of a hobby. It may be a larger concern with higher overheads and its own premises which employs several staff members. Micro businesses will include for example:

- individuals with self-employed income from occasional activities such as writing, consultancy, internet-based trading, lecturing or home tutoring;
- part-time and full time workers such as hairdressers, shopkeepers, beauticians, odd-job men, child minders, medical consultants, taxi drivers, journalists, IT consultants, engineers, builders or actors; and
- larger businesses that employ staff such as manufacturers and professional firms of solicitors, architects and the like.

3.3 The use of a turnover based threshold is a rather blunt tool but there needs to be some measure to target the scheme at the very smallest businesses, which are those most likely to face disproportionate administrative burdens. At present, the OTS is considering three options for the turnover threshold: £20,000 per annum; £30,000 per annum; or the VAT registration threshold (£73,000 per annum in 2011-12). The OTS would welcome views on which level is most appropriate, or if another level should be proposed, and whether other criteria should be included, for example, number of employees.

3.4 Larger, more complex businesses would pose additional difficulties to the design of a new system, and the implications of moving from the existing basis of taxation and accounts preparation is likely to be more significant for larger businesses.

When should turnover be assessed?

3.5 For VAT registration, turnover is assessed on a rolling 12 month basis, and businesses are also expected to anticipate if they will exceed the registration threshold in the next thirty days. While this is a system that many UK businesses are familiar with[22], many new and small businesses that are below the VAT registration threshold do not need to be aware of the rolling 12 month basis used for VAT.

[21] A business is defined as "micro" by the EU if it has: 9 employees or fewer; and either (or both) turnover or total assets below €2 million.

[22] Data from 2009-10 shows that approximately 45% of the 2 million VAT registered traders were voluntarily registered and had annual taxable turnover of £0 to £68,000 (the 2009-10 VAT registration threshold). This includes incorporated businesses, which are outside of the scope of the policy options presented in this paper.

3.6 The point at which turnover should be assessed when deciding if a business can use a simplified scheme may therefore be better based on the turnover for the tax year, or for the accounting period being used when this is not the tax year, rather than a 12 month rolling basis.

3.7 Very often turnover is not known until after the end of the accounting period, often many months after the accounting period end. If a measure is to simplify taxation for small businesses, the business would generally need to know, from the beginning of the accounting period, whether it can use the simplified scheme. This would mean that entry to the scheme would need to be based on the previous year's turnover or an average of several previous years, although this in itself would add to complexity. Such a scheme would then need to define how new businesses would be treated.

Leaving the system

3.8 Once businesses are using the simplified system, there would need to be a mechanism for moving businesses into the normal tax system once turnover exceeds the threshold. This mechanism should be designed so that it does not apply to businesses with temporary increases in turnover. The VAT Flat Rate scheme allows businesses to remain in the scheme at a much higher turnover level than that at which they would have been permitted to join the scheme. It would seem appropriate to allow a similar arrangement for the simplified small business tax system so that businesses which have turnover around the threshold avoid moving into and out of the scheme from year to year.

3.9 There is evidence to suggest that many of the smallest businesses remain small, and that growth is the exception rather than the norm. OTS analysis of HMRC self-assessment data shows that for unincorporated businesses, almost 98% of businesses with turnover in the range £1-£70,000 in 2007-08, had turnover in the same range in 2008-09.

3.10 However, the design of any simplified arrangements will still need to have regard for those that will move into or out of the scheme. As well as the existing smallest businesses, those joining the scheme would include businesses that are shrinking, for example as the proprietors near retirement, or a change in circumstances such as the proprietor entering employment.

Optional vs. compulsory

3.11 Where an alternative system could offer benefits for some but not all businesses, it may not be appropriate to introduce changes that are mandatory. An optional scheme poses additional issues that would need to be resolved:

- The scheme must be designed in a way that minimises the difference in tax liability between the alternative system and the regular system.
- Where an arrangement is optional businesses will want to consider whether the arrangement will benefit them or not. This would not then be a simplification because two calculations would be undertaken instead of one. However, if the alternative system offers obvious and significant administrative savings, very small businesses may choose to take up the scheme and reduce the overall cost of tax compliance regardless of resultant tax liability. Analysis of SA returns shows that over 85% of proprietors of businesses with turnover in the range £1-£70,000 have a tax liability of less than £5,000. It is likely that the tax- allowable expenses of most of these businesses will also be low and the work involved in ascertaining private use elements for use of home, vehicles, telephone etc calculations are time-consuming for what will be a relatively small claim.
- There would need to be a mechanism to prevent businesses from opting in and out of the simplified arrangements on a regular basis. For example, the business could

be required to continue to use the system until it exceeds the threshold, or to use the system for a stated number of years.

Complexity of transition between systems

3.12 Simplification is a concept with many dimensions, and any given change may deliver simplification from one perspective but increase complexity through another. The OTS has heard a strong view, for example from members of our consultative committee, that developing policy based on thresholds or boundaries in the system introduces further complexity. The tension here is between reducing compliance costs for very small businesses at the cost of skewing business decisions by introducing a different system exclusively for businesses with certain characteristics.

3.13 The impact of introducing a new turnover threshold will depend on the level that is chosen. Aligning with the VAT registration threshold may avoid an increase in the number of "cliff edges" in the system that taxpayers have to be wary of, but would also increase the size of the advantage of being below the threshold. Furthermore, as noted above, the VAT registration threshold is on a rolling 12 month look-back definition of turnover whereas turnover for accounts purposes is turnover to the accounting period end.

Companies

3.14 As noted above, this document is not considering simplifying the system for the smallest companies. However, it may be appropriate to consider whether changes suggested for the very smallest unincorporated businesses could be applied in a corporate context where company law allows.

3.15 The OTS also believes that it would be worth exploring to what extent simplifying the taxation of small unincorporated businesses would motivate some small companies to 'disincorporate', notwithstanding the current tax and NI advantage to running businesses through companies and drawing dividends. Some small companies find it difficult to disincorporate because of potential tax charges, and the OTS is currently exploring whether a disincorporation relief is desirable. A discussion paper on this subject is being published alongside this paper.

Questions for consultation:

9. For the purposes of using a simplified scheme for taxation, at what level do you think it is appropriate to set the threshold for being able to use it and why? And at what level should the business cease to use a scheme? Should this apply the first year after the threshold is reached or the year after that?
10. When should businesses be permitted to change from the simplified scheme, for example after a period of years and/or on stated events? How many years and which events?
11. If the VAT registration threshold is used to determine whether the simplified scheme can be used, should a rolling 12 month total be used in the same way as for VAT?

4 Next steps

How to respond

4.1 The OTS welcomes answers to the questions listed in this document and any wider comments on the options in this discussion paper.

4.2 Responses should be sent by e-mail to OTS-SmallBusiness@ots.gsi.gov.uk, or by post to:

Anish Mehta

Review of small business tax

Office of Tax Simplification

1 Horse Guards Road

London

SW1A 2HQ

4.3 Comments should be received by 7 October 2011.

Confidentiality disclosure

4.4 Information provided in response to this discussion document, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

4.5 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, among other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If the OTS receives a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding the OTS.

The OTS will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

A Background data on small unincorporated businesses

A.1 The OTS has produced some initial analysis of the small businesses that are included within the proposed turnover thresholds for the alternative system. Key summary statistics are set out in Table A.1. Some headline messages from the analysis include:

A.2 Approximately 85% of very small businesses are unincorporated. There were approximately 2 million of these businesses with turnover below £20,000 in 2007-08[23].

A.3 Initial OTS analysis shows that the vast majority of unincorporated businesses would not have moved through one of our proposed turnover thresholds between 2007-08 and 2008-09[24]. Of the businesses with turnover below £20,000 in 2007-08, one in eight businesses had turnover above £20,000 in 2008-09. This proportion falls significantly as the threshold is raised, with approximately one in forty breaching a £70,000 turnover threshold[25].

A.4 Owners of the smallest unincorporated businesses are an important source of tax revenue, with owners of businesses with less than £20,000 turnover paying £3.8bn to the Exchequer in income tax and Class 4 NICs in 2009-10. However, on average they each have a relatively small tax liability. For businesses with turnover below £30,000 per annum, approximately 90% have tax liability of less than £5,000 p.a. Total revenue from income tax in 2009-10 was £147.5bn[26].

A.5 The proportion of businesses without agent representation is highest at low turnover levels and nearly 900,000 unincorporated businesses with turnover below £20,000 per annum (44%) deal with tax matters themselves.

A.6 Just less than half of businesses with turnover below £20,000 per annum take advantage of the option to submit three line accounts. Approximately one quarter of all businesses using three line accounts do not claim for any business expenses in their self-assessment tax return.

A.7 The vast majority (approximately 95%) of sole traders have a single business. Almost one in ten individuals that own a sole trade business with turnover between £0 and £5,000 has more than one business: this is higher than for any other turnover band.

A.8 The very smallest businesses are unlikely to have any employees (as indicated by a nil entry for employee related allowable expenses on their SA tax returns). Although the likelihood of having employees increases with the turnover of the business, approximately 70% of businesses with turnover between £60,000 and £68,000 per annum do not appear to have any employees.

A.9 As turnover grows, taxable profit is more likely to form a larger proportion of overall individual income. Almost a quarter of sole traders with turnover below £20,000 per annum derive less than 10% of their total income from trade profits i.e. from running a business. For over 45% of the same group taxable profit is between 90 and 100% of their total income.

[23] Of which less than 10% had nil turnover.

[24] This data may not be representative of changes in turnover between other years, particularly given the impact of the recession on business activity. Further analysis will be needed to determine the frequency with which businesses cross the proposed turnover thresholds.

[25] Data on the £70,000 threshold will be affected by behavioural effects related to the VAT registration threshold and business turnover. The VAT registration threshold was £67,000 in 2008-09.

[26] See table C.3 of Budget 2011: http://cdn.hm-treasury.gov.uk/2011budget_annexc.pdf

Table A.1: Provisional OTS analysis of the unincorporated business population under selected turnover thresholds (2009-10 data unless otherwise stated)

		Turnover per annum		
		Under £20,000	**Under £30,000**	**Under £70,000**
Unincorporated businesses[27,28]	Total	2,030,000	2,490,000	3,120,000
	(% of all businesses below turnover threshold)	86%	87%	84%
	Sole traders	1,880,000	2,310,000	2,860,000
	Partnerships	150,000	180,000	270,000
Crossing the turnover threshold[29,30]	Upwards[31]	13%	8%	2%
	Downwards[32]	12%	14%	11%
	Stay below threshold	87%	92%	98%
Total income tax liability[3,33]		£3.8bn	£5.4bn	£9.0bn
Average income tax liability[3,7]	Sole traders	£2,000	£2,300	£2,900
	Partnerships[34]	£5,400	£4,700	£4,000
Proportion of business owners with tax liability below£5,000[3,35]		91%	91%	86%
Proportion without agent representation[1,2,36]		44%	40%	34%
Proportion of sole traders using three line accounts		47%	45%	43%[37]
Proportion of sole traders that own one sole trader business		94%	95%	95%[11]
Proportion of sole traders without employees		98%	97%	94%[11]
Proportion of sole traders with 0-10% of total income[38] from trade profits		23%	20%	17%
Proportion of sole traders with 90-100% of total income[10] from trade profits		47%	52%	57%

[27] 2007-08 HMRC data.

[28] Includes businesses with nil turnover. In 2007-08, there were approximately 170,000 sole trader or partnership businesses with nil turnover.

[29] Excludes businesses with nil turnover.

[30] OTS analysis of business turnover in 2007-08 and 2008-09 HMRC data.

[31] The data shows that 13% of the businesses with turnover below £20,000 in 2007-08 had turnover above £20,000 in 2008-09. Therefore, 87% stayed below the turnover threshold.

[32] This data shows businesses that had a fall in turnover: 12% of sole traders and partnerships with turnover above £20,000 in 2007-08, had turnover below £20,000 in 2008-09.

[33] 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, CIS payments, SA payments on account, tax credits on interest and dividends and other reductions in tax liability.

[34] Average tax liability for proprietors of partnerships is highest in the nil turnover band and the £1-£5,000 turnover band.

[35] Sole traders and partnerships. Tax liability covers income tax and Class 4 NICs due for the tax year before deducting PAYE, CIS payments, SA payments on account, tax credits on interest and dividends and other reductions in tax liability.

[36] Covers sole traders and partnerships.

[37] For turnover below £68,000.

[38] Total income also includes: employment income; income from savings, shares and securities; taxable benefits in kind; profits from property; pensions and annuities; income from trusts and settlements; and other taxable income. It does not include non-taxable state benefits.

B International examples of alternative systems for taxing income

B.1 Many countries have recognised that the regressive nature of administrative burdens can place a high tax compliance cost on very small businesses, which may not be justified given the level of tax liability. This section sets out international examples of simplified schemes, following the categorisation set out in Chapter 2 of this document.

B.2 It is important to note that the objective of the OTS is to deliver simplification, and not to reduce (or increase) overall tax revenues. As noted earlier, there may be winners and losers under an alternative system, but the intention is to deliver options that are broadly revenue neutral. A number of countries, including the UK, have reduced profit-based tax rates for small businesses (or businesses with small profits) but these are not considered below.

Changing some existing rules to ease complexity in certain areas

Belgium – Simplified calculation of profits[39]

- Optional system that allows for the profit of a small business to be estimated on the basis of similar businesses. Participants in the scheme are not required to keep records of their sales and expenses.
- The scheme is restricted to unincorporated businesses with turnover below €500,000 per annum, excluding VAT. It is only available to businesses within a number of specific sectors.
- The estimate of profit is determined by sector specific indicators. However, the tax authority can tax the actual profit if it can demonstrate that it is considerably higher than under the simplified scheme.

Germany[40]

- Simple cash accounting is allowed for unincorporated businesses below a turnover (€500,000) and profits (€50,000) threshold. Profits are then calculated from cash receipts and expenses.

Austria[41]

- For small unincorporated businesses, a simplified calculation of the tax base is available. It is based on turnover, but has a simplified calculation for "deductible expenses", which is taken as 12% of turnover (up to a maximum of €26,400). Wages and gross input costs are also removed as part of the profit calculation.

[39] http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=3431
[40] http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=3431
[41] https://www.bmf.gv.at/Steuern/TippsfrUnternehmeru_7722/Pauschalierung/Pauschalierung.htm

- The simplified regime applies to businesses under a turnover threshold that varies by business sector, with the general threshold being €220,000.
- The decision to depart from the alternative regime is binding for 5 years.

Czech Republic[42]

Lump sum deduction of expenses

- Expenses can be estimated using a trade-specific proportion of gross income. Such businesses do not need to keep a record of their expenses.

Estimated liability

- Businesses below a turnover threshold of CZK 1 million (2007 threshold, approx £37,000) and without any employees can elect for a system with estimated liability for the year ahead. The measure of turnover is based on the previous three tax periods.
- The business is required to submit estimated turnover and expenses information. There are lower bounds for the tax liability: both an absolute lower bound and a requirement that the tax base must be at least as big as it would be under the optional lump sum scheme.

United States[43]

- As a general rule, taxpayers are required to compute their income for tax purposes using one of the permissible methods, of which one is the "cash receipts and disbursements method". Use of the cash method is limited however, but in the case of individuals only where a tax shelter is involved.
- The general rule is qualified where a taxpayer keeps books, in which case the method to be followed for tax purposes is the method used in the books. But nothing prevents an individual from keeping their books on a cash basis.

Australia[44]

- Two methods of accounting are recognised as appropriate for Australian tax purposes, cash and accruals. The method to be used is the one that best reflects income. The view of the Australian Tax Office is that business income should be on an accruals basis unless the business is one of providing knowledge or skill. Even then, accruals basis is deemed to be more appropriate if there are employees or equipment, stock or other circulating capital.
- There is also an optional Simplified Tax System ("STS") for small businesses[45]. Before 1 July 2005 there was a modified cash accounting method available to STS businesses, but since that date it has not been available to new businesses.

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[42] http://ec.europa.eu/enterprise/newsroom/cf/_getdocument.cfm?doc_id=3431

[43] Sections 446 & 448 IRC 1986

[44] Taxation Ruling TR 98/1 and Division 328 ITAA 1997

[45] http://www.ato.gov.au/content/downloads/nat6459.pdf

Using non-profit measures as the basis for taxation

France[46]

- "Auto entrepreneur" system for the self employed[47], which aims to simplify business ownership in a number of ways, including taxation. VAT registered businesses are excluded. In 2010, three-quarters of new sole trader businesses were set up under the auto entrepreneur system.[48]
- Thresholds are reviewed annually. For 2011, the revenue thresholds are:
    - € 81 500 for trade activities and the provision of accommodation (hotels, guest houses, cottages, furnished accommodation).
    - € 32 600 for the provision of services and the professions covered by non-commercial profits (BNC) and industrial and commercial profits (BIC).
- There are flat rates based on turnover for social security contributions (+ income tax) of 12% (+1%), 21.3% (+1.7%) and 18.3% (+2.2%) for sales, services and professional businesses respectively.
- Businesses can be removed from the scheme if they exceed the above turnover threshold in the first year. After the first year, businesses become ineligible if they exceed a higher turnover threshold.
- Businesses under this system do not need to make the usual profit declarations, but instead report revenue, capital gains or losses, the location of the business and the number of employees.

Spain – "modulos" system[49]

- An indicator based tax that applies to unincorporated businesses.
- The business turnover must be below €450,000 per annum, and purchases must be less than €300,000 per annum. Also, the business must be within one or more of nine business activities.
- A distinction is made between farming activities and non-farming activities. For non-farming activities, the tax calculation takes in a number of factors (or "modules"), including the amount of labour input, energy consumption, size of business premises. There is a fixed minimum amount of tax liability.
- For businesses that elect to leave this simplified system, they are not allowed to return to the scheme within three years.

[46] http://pme.service-public.fr/actualites/zoom/avantages-micro-entreprise.html
[47] The self employed are defined as unincorporated businesses in non-farming sectors.
[48] http://www.insee.fr/fr/themes/document.asp?reg_id=0&ref_id=ip1334
[49] Taxation of SMEs: Key issues and policy considerations, OECD tax policy studies no. 18, 2009.

Poland[50]

Tax card (karta podatkowa)

- A flat rate payment made by unincorporated businesses to substitute for personal income tax. Restricted to certain business sectors, and businesses that do not conduct any activity outside of Poland.
- Tax liability is determined by factors such as the type of activity, the number of employees, and the population of the locality of the business.[51]
- These businesses do not need to keep accounts or declare the income received.

Lump sum turnover-based tax

- Available to owners of unincorporated businesses (sole-traders and partnerships) with turnover in the previous year below €150,000 (in 2011). Tax liability is based on turnover without any deductions for costs.
- Taxpayers must keep a simplified register of revenues and purchases, which are submitted to authorities at the middle and end of the year.
- The rate depends on the activity[52], with rates ranging from 20% in professional occupations to 3% in trade and catering services.

South Africa[53]

- Alternative, simplified tax system introduced with effect from March 2009. The business must have turnover below R1 million (£78,000) to be eligible, but it is not restricted to particular legal forms. In the first year of operation (2009-10), the scheme had been taken up by 10% of eligible businesses.[54]
- Tax liability is determined by bands of annual turnover, as set out below:
  - **R0 - R150,000:** 0%
  - **R150,001 - R300,000**: 1% of each R1 above R150,000
  - **R300,001 - R500,000:** R1,500 + 2% of the amount above R300,000
  - **R500,001 - R750,000:** R5,500 + 4% of the amount above R500,000
  - **R750,001 and above:** R15,500 + 6% of the amount above R750,000
- Businesses can voluntarily leave the simplified system at the end of the tax year but are not allowed to return. Originally businesses registered for VAT were ineligible, but this will be changed from March 2012.
- There are also restrictions on business activity. Personal service providers and "labour brokers" are not eligible, and there are restrictions on the amount of income earned through asset disposal and through professional services.

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[50] http://www.mf.gov.pl/index.php?const=3&wysw=4&sgl=2&dzial=133

[51] For 2011, there were approximately 100 different business activities, each with multiple rates depending on other characteristics of the business. Source: http://www.mf.gov.pl/_files_/podatki/od_osob_fizycznych/pit_2011/stawki_karty2011nowepkwiu.pdf

[52] http://www.mf.gov.pl/index.php?const=3&wysw=4&sgl=2&dzial=133

[53] http://www.sars.gov.za/home.asp?pid=43122

[54] Annual Report 2009-10, South Africa Revenue Service.

Various Central and Eastern European countries – lump sum taxation[55]

- A number of Central and Eastern European countries have a system of lump sum taxes for smaller businesses[56]. Countries that use a lump sum tax include: Albania; Armenia; Belarus; Bulgaria; Croatia; Georgia; Hungary; Kosovo; Lithuania; Serbia; Ukraine.
- In most cases, there is a turnover based criterion for eligibility, which is usually based on turnover in the previous year. The number of employees and the size of the business premises are also used by some countries to determine eligibility.
- The type of business activity and the location of the activity are also often used to determine the specific rate paid.

[55] http://www.fiscalreform.net/images/Library/tax+-+sme+paper_michael+engelschalk.pdf

[56] Blažić, H., Dimitrić, M. and Škalamera-Alilović, D., 2006. "Lump Sum Tax for Small Businesses: The Case of Croatia". Proceedings from the 14th NISPAcee Annual Conference.

C Existing simplified schemes and arrangements in the UK

C.1 There are already a number of simplified schemes and easements within the UK tax system. Some are listed here:

Fixed rate business mileage allowance[57]

C.2 Where there is both private and business use of a vehicle, instead of calculating the proportionate cost of using of a vehicle for business purposes, a fixed amount may be claimed per business mile. This scheme is available only to unincorporated businesses that have turnover of less than the VAT registration threshold. Taxpayers must use the mileage rate basis consistently from year to year and can only change to or from an actual cost basis when a vehicle is replaced. If the turnover of the business increases and exceeds the VAT registration threshold, then the taxpayer has to continue to use the mileage rate basis until the vehicle is replaced.

Flat rate expenses allowances for employees[58]

C.3 Flat rate deductions are amounts that HM Revenue & Customs (HMRC) has agreed as amounts which can be claimed each year by employees in different trades. Employees may keep records and claim the actual tax allowable costs if they prefer. A list of flat rate expense deductions is given at http://www.hmrc.gov.uk/manuals/eimanual/eim32712.htm. Where an industry is not listed, a standard amount of £60 may be claimed by employees for the laundry costs of uniforms or protective clothing.

Use of home for business[59]

C.4 HMRC guidance allows for a proportion of fixed costs, and a reasonable proportion of running costs. Where the claim is minor, a reasonable estimate is acceptable.

Reimbursing additional household expenses incurred by employees[60]

C.5 Employers may reimburse an employee for additional household expenses such as gas or electricity charges incurred where the employee has to work from home because either the facilities needed aren't available at the workplace or the work requires the employee to live too far from their workplace for it to be reasonable for them to travel there on a daily basis. Where the reimbursement does not exceed £3 per week no supporting household receipts are required.

VAT cash accounting scheme[61]

C.6 VAT is usually payable by reference to when an invoice is issued and when an expense is incurred. Businesses using the Cash Accounting Scheme do not need to pay VAT until their customer has paid them but cannot reclaim VAT on purchases until they have paid for them.

[57] http://www.hmrc.gov.uk/manuals/bimmanual/BIM47701.htm and HS222 2011 Page 3
[58] http://www.hmrc.gov.uk/manuals/eimanual/eim32712.htm
[59] http://www.hmrc.gov.uk/manuals/bimmanual/bim47825.htm
[60] http://www.hmrc.gov.uk/manuals/eimanual/EIM01476.htm
[61] http://www.hmrc.gov.uk/vat/start/schemes/cash.htm

This is generally beneficial for the businesses because it assists with cash flow particularly where customer debts turn bad.

C.7 Businesses with VAT taxable turnover of up to £1.35million can use the Cash Accounting Scheme for VAT until their taxable turnover exceeds £1.6million. Business accounts for income and corporation tax purposes need to be prepared under GAAP.

VAT Flat Rate Scheme[62]

C.8 Instead of working out the VAT due on sales and the allowable VAT on purchases, then paying over the difference to HMRC, businesses using the Flat Rate Scheme pay a flat rate percentage of turnover to HMRC. The flat rate percentage used depends on the sector in which the business operates. The scheme does not require analysis of either expenses paid or invoices issued, so record keeping requirements are significantly reduced. Although under this scheme VAT is not reclaimed on purchases, the scheme does allow VAT on certain large capital purchases to be reclaimed.

C.9 The VAT Flat Rate Scheme can be used by businesses with VAT inclusive turnover of up to £150,000 and businesses can continue to use the scheme until their VAT exclusive turnover exceeds £230,000. 2010 data shows that approximately 15% of eligible traders were registered for the Flat Rate Scheme. Business accounts for income and corporation tax purposes still need to be prepared under GAAP.

Assets of low value and/or short life

C.10 Many businesses have an accounting policy of 'expensing' items which cost less than a certain amount, sometimes up to £500 or more, because it saves the business keeping detailed records of large numbers of small value assets. Tax law does not permit a business to deduct capital expenditure from turnover. The business may instead claim capital allowances at prescribed rates which include a special regime which can be used for assets of short life. For small items of capital expenditure, this can lead to the need to undertake capital allowance computations each year in respect of relatively small amounts of expenditure.

C.11 In practice HMRC allows businesses to 'expense' items which have an estimated life of less than one year (per HMRC manual Business Income Manual 35415).

Overnight subsistence allowances paid to lorry drivers[63]

C.12 HMRC will accept that certain amounts may be paid free of tax to lorry drivers to cover overnight subsistence costs without the need to provide evidence of expenditure. Where the lorry has a sleeper cab the amount payable is reduced.

Expenses of Local Government Councillors[64]

C.13 Special arrangements exist for the taxation of various allowances and claims of Local Government Councillors. These include a permitted allowance of £135 (from 2002/03) for use of home.

Incidental overnight expenses

C.14 Reimbursement of expenses of a personal nature, for example laundry, toiletries, use of television, incurred by employees while away overnight on business give rise to a tax liability on the individual. Section 241(3) ITEPA 2003 exempts this liability from tax where the total amount

[62] http://www.hmrc.gov.uk/vat/start/schemes/flat-rate.htm#2

[63] See HMRC Employment Income Manual EIM66110

[64] HMRC Employment Income Manual EIM65955

is less than £5 per night in aggregate for trips in the UK or £10 per night in aggregate for trips abroad.

Three line accounts

C.15 When reporting taxable profits to HMRC, instead of providing a full breakdown of expenses to HMRC as part of the annual tax return, businesses with turnovers of less than the VAT registration threshold may provide summary information in the form of 'three line accounts'. The obligations to prepare accounts in accordance with GAAP and make all necessary tax adjustments remains, so some argue that the value of the simplification is relatively limited.

D Previous initiatives to simplify the taxation of business income

Policy history

Simplification review: Corporation tax calculations and returns for smaller companies (November 2008)[65]

D.1 Use of statutory accounts incorporating tax obligations (new accounting standard)

- Idea dropped as respondents felt not real simplification – companies accounts need to be Companies Act compliant, making the accounts produce the profits chargeable to tax merely moved burdens rather than truly simplifying them.

D.2 Flat rate tax allowances

- It was felt a significant number of businesses would lose out, the possibility of a voluntary scheme would mean keeping usual records in deciding whether to opt in, which was not considered simplification and the idea was not pursued.

D.3 Calculating tax on a cash flow basis

- Whilst business representatives were not against this for the very smallest companies, there was no widespread agreement given Companies House and bank requirements for accruals basis.

D.4 For the reasons stated these suggestions were not taken forward at that time.

Corporation Tax Reform consultation document (August 2003)

D.5 Align the Corporation Tax system more closely with the accounts, taking into account developments in accounting standards

- The thread on this was not taken forward while new International Accounting Standards were being developed.

D.6 Schedular reform

- The central proposal based on merging trading income, property income and miscellaneous (Schedule D, Case VI) income into one business operating source was strongly rejected by respondents, as retaining previous complexities without gaining real benefits. The notation of the schedules and cases was however dropped as part of the Tax Law Rewrite, but underlying rules were retained.

D.7 Aligning expense regimes of trading and investment companies

- Introduced from April 2004 (by Finance Bill 2004) and included at s1219 CTA2009.

[65] Followed a discussion document for businesses and representatives announced in Budget 2008.

D.8 Replacing chargeable gains on capital assets with accounting treatment

- The thread on this was not taken forward while new International Accounting Standards were being developed.

D.9 Capital allowances v depreciation

- Budget 2004 announced decision to keep capital allowances (modernised from April 2008) and revamp those for cars (from April 2009) to an emissions-based system.

D.10 Leasing regime

- Revamped and introduced with effect from April 2006.

Earlier reviews

D.11 These included the Large Business Taxation Consultation in July 2001, resulting in the introduction of the intangible asset regime from April 2002, the Substantial Shareholder Exemption introduced by Finance Act 2002, and the Taxation of Foreign Dividends, which were not exempted until July 2009.

D.12 An earlier Inland Revenue Technical note on Small Business Taxation in March 2001 reviewed accounts basis for tax, treating rental income as a business and commercial depreciation against capital allowances. With the exception of treating rental income as a business, these were not taken forward.

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