



***Research report***

**Understanding small businesses'  
experience of the tax system**

**February 2012**

This research was commissioned by the HM Revenue & Customs (HMRC) Behavioural Evidence and Insight Team and Business Customer and Strategy Directorate on behalf of the Office of Tax Simplification

### ***About Business Customer and Strategy (BC&S)***

Business Customer and Strategy (BC&S) is part of Business Tax, and is responsible for developing HMRC's programme of SME customer research.

BC&S aims to maximise business customer compliance for HMRC at best cost for both HMRC and the customer, and so support HMRC's strategic objectives to ensure that businesses pay the right amount of tax, whilst at the same time improving customers' experience and the overall UK business environment.

### ***About the Office of Tax Simplification***

The Chancellor and Exchequer Secretary launched the Office of Tax Simplification (OTS) on 20 July 2010 to provide the Government with independent advice on simplifying the UK tax system with the objective of reducing compliance burdens on both businesses and individual taxpayers.

The Office has been established as an independent office of HM Treasury for the life of the current Parliament and draws together expertise from across the tax and legal professions, the business community and other interested parties.

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## *Research requirement (background to the project)*

This research focusses on the smallest end of the business population (those with fewer than ten employees and turnover under £1 million), and those who try to deal with most of their tax matters without outside assistance.

HMRC jointly commissioned this research with the OTS to inform the OTS's review of small business taxation.

Specifically research was required to focus on:

- the end-to-end journey of businesses' interaction with the tax system, sources of complexity and how the experience can be made more simple
- HMRC's channels of communications with these businesses and where further steps can be taken to improve clarity of information
- specific points in HMRC's processes which are a common source of error or concern and how these can best be tackled
- the burdens associated with providing HMRC with the information required under the law
- understanding difficulties in obtaining certainty (including finding the correct answer and having finality in tax affairs)
- communication channel issues relating to written, phone and online communication and transactions with HMRC

## *The agents and research timings*

The research was conducted by The Futures Company between August 2011 and January 2012

## *Method, data and tools used, sample*

### **Phase 1: evidence review**

- Expert interviews
- Desk research/literature review

### **Phase 2: qualitative research**

- Four group discussions, 90 minutes duration each, six respondents in each:
  - group 1: HMRC contact centre staff all dealing with small business enquiries
  - group 2: agents who represent small businesses with regards to taxation
  - group 3: small businesses (newer - trading for one-three years)

- group 4: small businesses (more established - trading for over three years)
- Twenty depth discussions, 90 minutes duration each, all completed a scrapbook task prior to their interview.
  - General criteria:
    - Small business owner/director responsible for looking after the business' accounts and taxation.
    - Mix of industry types.
    - Annual turnover of less than £100,000, including representation of those with an annual turnover of less than £20,000.
    - Spread of levels of confidence with tax affairs.
    - Spread of attitudes to compliance.
    - Mix of agent usage.
  - Specifically:
    - Twelve small businesses with no employees, eight small businesses with one-five employees.
    - Fourteen unincorporated, six incorporated.

### **Phase 3: quantitative research**

- Twenty minute online survey with 1,102 small businesses:
  - 884 with 0-2 employees, 218 with 3-9 employees
  - self-employed or the owner/part-owner of a small business with sole or shared responsibility for the business' account and tax matters
  - accountants and tax advisers screened out
  - in business for at least a year
  - annual turnover less than £1 million
  - 84 per cent had annual turnover of less than £70,000

## ***Main findings***

### **a) Understanding the context for small business customers**

The research indicated that people start up their business for a number of reasons:

- 32 per cent started up to be independent and in control rather than working for someone else
- 23 per cent started up to find work when unemployed or made redundant
- 18 per cent started up to be able to fit work flexibly around other commitments
- 12 per cent started up to make money out of what was previously a hobby or area of interest

Control is a key motivation for starting a business. Many are motivated by lifestyle and circumstantial factors. Pure entrepreneurial drive is the main motivation for only a few small businesses. For many, it has not been their choice to set up a business and this group may require additional support in order to meet their tax administration requirements.

There are significant differences in outlook and ambition. Not everyone aspires to grow. 39 per cent plan to maintain the business at its current size compared with 43 per cent who plan to grow the business. Those who want to stay steady and those who want to grow have different priorities.

The small businesses sampled are a diverse group with multiple roles and commitments; 32 per cent of those with small businesses are also employed, 28 per cent of those with small businesses are also looking after their home/a family. 7 per cent are retired. Support and empathy from HMRC around more complex personal circumstances would be welcomed.

It's important to remember that tax is just one of many responsibilities that small businesses have to manage. Managing tax comes alongside multiple challenges including generating business, chasing payments, meeting industry standards and complying with regulation.

## **b) Difficulties with tax**

Many people find tax mostly straightforward (50 per cent of sole traders find self assessment easy to deal with) and in the qualitative research people consistently said that it is better than it used to be.

However, tax is perceived to be relatively difficult compared to the many other obligations small businesses have. The main difficulty when starting up was finding enough customers/work to keep the business going (36 per cent agreed) and second to that, 23 per cent found filling in the first tax return difficult. This is high in comparison to opening a bank account (2 per cent found it difficult) and complying with other legal requirements (10 per cent found it difficult).

Motivations for incorporation vary - to reduce liability, increase credibility, requirement for certain clients/contracts, professional advice to do so, or as some people said because 'it's the norm'. But people may not be aware of the consequences and become incorporated without being fully informed of what it means for them. The result is that some then want to unincorporate. 14 per cent of incorporated businesses surveyed said that they would prefer to operate as unincorporated.

Even amongst the most 'sorted' (who do not find tax difficult), there is an underlying fear of getting things wrong, 49 per cent of small businesses worry that they may have made a mistake with their tax form even though they keep good records and are careful filling it in, and 38 per cent are worried about being investigated and fined for mistakes they may have

made. 'Horror stories' about enquiries and fear of penalties can make small business owners overly anxious.

Levels of anxiety are lower, but still significant, for those who use an agent to help with tax administration. The percentage of sole traders doing Self Assessment who agreed with the statement 'Even though I keep good records and am careful filling in my form, I worry after I have submitted it that I might have made a mistake' was 54 per cent for those not using an agent compared with 45 per cent for those who do use an agent.

Whilst confidence grows over time it still remains relatively low, the fear of HMRC remains throughout the lifetime of a business. A small number of common drivers usually account for higher levels of confidence:

- effective start up help ensuring good set up and clear view ahead
- practical and realistic record keeping system
- reliable and accessible sources of information and advice
- existing skills including previous experience, literacy and numeracy

Those who lack confidence are more likely to have experienced a number of difficulties when dealing with tax. The most common issues are understanding expenses and making sense of the forms and information coming from HMRC.

The majority of small businesses have only a few tax obligations to fulfil (National Insurance and Self Assessment) and find dealing with tax straightforward, however, there is still a significant number of those who have only a few tax obligations to fulfil that struggle to deal with them. It is important to recognise that lack of confidence exists across different levels of complexity of business set-ups.

### **c) Experience of getting started**

The business start-up phase is especially daunting and people can feel isolated. There is a desire for 'hand holding' and guidance at the start of the new business journey in particular, to ensure small businesses know what to do to fulfil their requirements to be compliant and how to get it right.

When starting out, people seek information and advice from a wide range of sources. HMRC's website and written guidance is the most commonly used source of advice.

Tax is an area of difficulty for around a third at the start - 26 per cent agreed that knowing how to go about record keeping was difficult when starting out, and 35 per cent agreed that filling in their first tax return was difficult (vs. 27 per cent who agreed it was easy).

### **d) Use of advisors**

Tax advisors were used by 42 per cent of the sample. The most common reason for using an advisor is the belief that tax is too complicated to do alone:

- 'Tax is too complicated; I don't have the skills and expertise required' (64 per cent agree)
- 'It saves me time which I can spend doing other things which are more important to the business' (44 per cent agree)
- 'It saves me money by making sure I am claiming for all the allowances and expense available' (54 per cent agree)
- 'They are there to give me advice and support if I have any problems' (54 per cent agree)
- 'The risk of making a mistake is too great if I don't' (53 per cent agree)

The majority of those interviewed were reluctant to cut ties with their accountant, but some would like more control. Of those who use an advisor:

- 62 per cent would always want to use an accountant to do their taxes
- 20 per cent would like more control over aspects of their tax affairs, but might still choose to use an accountant
- 17 per cent would ideally like to deal with tax affairs themselves

Some small business owners want to retain as much control of their tax affairs as possible, and would prefer to limit their dependence on advisors.

There is a large variation in how much people pay to deal with their tax affairs; the majority of small businesses using an agent pay over £250 per year and a significant minority pay in excess of £1,000 per year. Over half of those using an agent to deal with VAT, Corporation Tax or PAYE have costs in excess of £1,000 per year.

#### **e) Record keeping**

There is a range of ways in which people are keeping their records, from storing receipts in a box to logging every purchase in a dedicated account book. Some are in favour of software, whilst others are less confident with computers and prefer a paper based method. While some have found a way of record keeping that suits their personal style, there is a keen appetite for tips around record keeping as well as an interest in free tools that make it easier to keep good records.

There is a lack of certainty around record keeping and management of accounts, which leads to anxiety. 26 per cent of small businesses aged one-five years found it difficult to know how to go about record keeping when they started out and 24 per cent of small businesses say that they find it difficult knowing what receipts and records they need to keep as proof in case they are subject to an enquiry.



Most (65 per cent) say they would keep records even if they weren't required to do so for tax purposes. However, a significant minority of small businesses (13 per cent) are only keeping records for tax purposes. In their eyes it is an additional request from the Government rather than something that benefits the business.

#### **f) Expenses and other tax rules**

Lack of certainty around what expenses can and can't be claimed is a big concern; 49 per cent of small businesses say that they find it difficult knowing what is allowed as a claimable expense. Businesses feel that they do not get guidance that reassures them that they are getting expenses right. When asked what HMRC could do better 44 per cent of small businesses said that they would find simpler ways to calculate expenses very helpful (eg, rules of thumb or fixed rates for different types of business).

Claimable expenses is the most common difficulty people experience in dealing with tax, even among established businesses. It also remains a problem for those using an agent to help with Self Assessment: 52 per cent of this group mentioned it as an area of difficulty.

In this sample it seems that a proportion of small businesses could be over or under-claiming their expenses. When asked how they would treat certain expenses in a number of different scenarios, a significant number gave the wrong answer or didn't know.

For example, when asked what they would do if they bought something like office furniture or a computer for use in the business, 42 per cent said they would deduct the total cost of the item as a business expense, which is incorrect. Only 27 per cent chose the correct option, to claim capital allowances or the annual investment allowance. 5 per cent said they would claim nothing and 10 per cent said they didn't know what to do.

When asked what they would claim for something used for business as well as personal use, such as a mobile phone or home internet connection, 20 per cent said they would claim nothing, even though they used the item for their business and 6 per cent did not know what to claim. For those who used their home for business or to do their paperwork, 35 per cent did not claim anything and 13 per cent did not know what to claim.

A small minority showed clear awareness of accrual accounting, but this may be in part due to the cash nature of many small businesses. When asked which sales or income they included in their accounts or tax return for the year, only 25 per cent gave the correct answer - sales invoiced in the year, whether or not they had been paid for. 47 per cent included only money received in the year, whether or not they had issued invoices, effectively using the 'cash' basis. Only 3 per cent said they did not know the correct answer.

The awareness of generally accepted accounting principles ('GAAP') is even lower on the question of which expenses can be claimed in the business accounts, with only 8 per cent of

small businesses giving the correct answer - 'bills received even if not paid in the year'. 56 per cent of small businesses were claiming expenses on a 'cash' basis, answering 'expenses I have paid for in the year'. Again, only 3 per cent said they did not know the correct treatment.

### **g) Difficulties with specific types of tax**

The majority find tax straightforward. However some do have difficulties and some types of tax are more difficult than others:

- the large majority (77 per cent) find National Insurance easy to deal with and are confident that they are getting things right (89 per cent)
- nearly one fifth of businesses say that they have difficulties or lack confidence in dealing with Self-Assessment, VAT, Corporation Tax or PAYE for employees
- a particular problem area is completing the form P11D (employees' expenses payments and benefits), with 28 per cent of those who deal with it finding it difficult

The majority of businesses spend at least some time each month dealing with tax and the majority feel that the amount of time that they spend on tax is reasonable, although less so for VAT and PAYE.

People would welcome less change overall with 29 per cent of small businesses saying that they find it difficult keeping up with the changes in the tax rules that affect them. Greater personalisation of updates could help to save customers time trawling through things that are not relevant.

### **h) Cashflow**

Managing cashflow in preparation for tax payment can also be a struggle for some: 22 per cent of small businesses say that they find it difficult knowing how much they will need to pay in their next tax bill, and almost half say they don't usually put money aside in order to be ready to pay their tax bill (for example, in a separate bank account).

Support and guidance for businesses on how to manage cashflow in a way that better prepares them for their end of year tax payment, would help alleviate stress and anxiety and potentially increase the likelihood that people can pay on time. Many (36 per cent) estimate how much money to put aside by referring back to the previous year's tax bill but advice on how to estimate their tax bill more accurately could help businesses avoid running into problems.

There is very low awareness (20 per cent) of HMRC's Budget Payment Plan. 20 per cent of those who are aware of the Plan use it.

### **i) Communications with HMRC**

The experience of dealing with HMRC is often more positive than anticipated and customers often said they felt it has improved in recent years. Misconceptions about the experience of dealing with HMRC are common. In reality people often find HMRC to be more helpful and less 'scary' than they imagine.

However, a significant minority do not believe that HMRC is really on their side: 11 per cent have experienced difficulties with the tone of communication from representatives of HMRC and 70 per cent of those do not believe HMRC has a genuine interest in helping them as a small business.

Small businesses rely on HMRC's website and written guidance as a key source of information and HMRC plays a key enabling role for small businesses, both in their critical start-up phase as well as on an ongoing basis over the business lifecycle. But there is a strong desire for more proactive contact including updates and reminders between deadlines.

People can also be frustrated by difficulties in getting clear and simple answers to questions from HMRC:

- 23 per cent of people agree that they have experienced difficulties getting a definite answer to a question they have about tax
- 30 per cent say they have difficulty making sense of the information given by HMRC
- only 45 per cent agree that they have confidence that HMRC staff give the right answer to their questions

Whilst many have experienced no problems, some small businesses can be disappointed in the quality and clarity of the response they get to questions from HMRC. This can cause significant frustration and increase reliance on other advisors.

#### **j) Exploring interventions that could help small businesses**

Of a range of new or enhanced intervention ideas that were asked about, improved contact with HMRC and the simplification of expenses were the most popular.

Popular suggested interventions are those which facilitate better contact with HMRC included:

- small businesses want HMRC to be more accessible and easy to contact
- rapid email responses (within a set time frame) are favoured by most
- a dedicated small business phone line with specialist expertise and understanding was also a very popular idea, as was improvements to the HMRC website

Small businesses expect to invest time managing their tax, but tools which minimise this time whilst increasing self-sufficiency are also popular.

A more empathetic and flexible approach from HMRC would also be welcome.