Unclassified

HM Revenue & Customs

Research report

Understanding the impact of stopping tax credits on the self-employed: Phase 2

HM Revenue and Customs report 440

Prepared by TNS-BMRB for Her Majesty's Revenue and Customs

March 2015

Behavioural Evidence & Insight Team

About Benefits and Credits (B&C) Design & Customer Engagement

Design & Customer Engagement is part of the Benefits and Credits business area in HMRC.

We work collaboratively with colleagues in the HMRC Universal Credits Programme, across B&C and the wider HMRC to incorporate customer centric design principles by:

- Ensuring customer understanding sits at the heart of processes, products and procedures
- Represent customer needs and seek to influence their behaviour in order to ensure the best possible experience of HMRC
- Ensure HMRC plans and processes are compliant with equality legislation

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Research requirement (background to the project)

Under the Welfare Reform Act 2012, the introduction of Universal Credit (UC) is beginning to replace a range of benefits, including tax credits (TC). When a customer transitions to UC from TC, HMRC will need to finalise their current-year TC award through an assessment of the customer's income for the period of time, within the financial year, during which they were in receipt of TC. For self-employed customers, providing part-year income information can be complex. In early 2014 TNS BMRB undertook research to understand the impact of stopping tax credits on the self-employed and likely support needs for customers. This research informed the development of information and guidance for in-year finalisation requirements and transition to UC.

HMRC commissioned this current research to test guidance around the current year finalisation process and required calculation for self-employed individuals, and to explore support needs of intermediaries and agents, who deal with self-employed tax credits customers. The project explored:

- **Customer comprehension of and responses to the instructions** requiring them to estimate their annual taxable profits and calculate the figure required for finalisation;
- The **issues arising as a result of doing the calculation** and how these might be mitigated;
- The **key questions that customers are likely to have about the calculation**, and how they would want to access information to answer these questions;
- **Views about a potential online calculator** to assist with the finalisation calculation.
- **Responses to different approaches** to providing the calculation steps;
- Any **additional information required** and how customers want to access this;
- **Understanding the perspective of agents and intermediaries**, specifically their support needs to be able to assist self-employed tax credits customers

When the research took place

Fieldwork took place between in 13th February and 12th March 2015. Analysis ran concurrently with fieldwork and findings were presented in March 2015.

Who did the work (research agency)

The research was conducted by TNS BMRB, an independent social research agency for UK and international policymakers.

Method, Data and Tools used, Sample

The research was wholly qualitative in nature and comprised:

- 48 in-depth face-to-face interviews with tax credit customers, of which 8 were pilot interviews and were used to inform modifications to stimulus materials and the discussion guide. Interviews were recruited to reflect a variety of business characteristics and were categorised into the following groups:
    - 13 interviews x Established business (trading more than 1 year), predictable income
    - 20 interviews x Established business (trading more than 1 year), variable income

- 15 interviews x New businesses (trading under 1 year), mix of variability of income

All customer interviews were weighted to no use of agents (18 used an agent and 30 did not use an agent); mix of sector, joint/single claims, age of business.

- 8 in-depth telephone interviews with agents and intermediaries working with self-employed tax credits customers

All respondents were presented with:

- An introductory note on the changes and basic requirement to finalise the award part way through the tax credits year
- 'Scenarios' of different self-employed customers based on steady/ variable/ predictable/ unpredictable income and age of current business
- Detailed calculation instructions
- Timeline based worked examples, based on the income / type of business example that most closely resembled them

Recruitment for self-employed customers and agents / intermediaries was conducted using an HMRC sample.

Main Findings

- A stable and entirely predictable income was rare among self-employed participants, and levels of financial literacy varied enormously.

- There was a lack of clarity on, and concern around, the transition to UC. However, people would comply with HMRC requests for information.

- While the part-year estimate appears logical in theory, in practice it was found to be complex and easily misunderstood.

- Key to ensure clarity on the accounting year, days to factor in and the terminology used – lay English necessary.

- People need to understand **why** they are being asked to make this calculation – and that they will need to do something different to normal

- People need to understand **what** information is needed to do this – and for as much of this to be given to them as possible.

- People need a step-by-step guide on **how** to make this calculation – with examples (and worksheets) that account for all scenarios.

- An online calculator, assuming it works for all, would be an excellent means of reducing the risk of human error.

The context of self-employed tax credit customers

Route to self-employment

The sample reflected a range of paths to self-employment. Some reported an entrepreneurial spirit and actively preferred to be self-employed. Some of these had been self-employed a number of times and/ or established a number of different types of business. In contrast, others seemed to fall into self-employment rather than actively seek it out. In a number of cases, self-employment followed a period of unemployment during which the aim had been to find a job. Some customers did not see themselves as a business, though they had registered as self-employed. They had a single or primary source of income and felt like an employee of their primary client.

Perceptions of being an 'established' business

Generally, trading for more than two years was considered to be 'established', rather than for at least one year. Those trading for less than two years still spoke about themselves as new to self-employment. The first year was generally considered to be a set-up year that was not reflective of future trading patterns. Indeed, some customers reported limited profits, no profits or losses in the first year or two of trading.

It should be noted that some of those who have been trading less than a year were not necessarily new to self-employment. It may have been their most recent venture but not their first venture. This had implications for whether they saw themselves as a start-up or not.

Overall, self-employed customers saw their income and the nature of self-employment to be unpredictable and variable. This was true of both relatively new businesses and those who were more established (trading for more than one year). Customers who had experienced steady income in previous years did not think this was necessarily indicative of the future.

The loss or gain of a single client can be transformative for annual profits, as too can the changing economic climate or the context of the specific sector the customer is operating in. In addition, the personal circumstances of self-employed customers can determine annual profits. Pregnancy and illness were cited as events that customers could not necessarily foresee which would have a significant impact on their income.

Financial management approaches

Self-employed customers reported a mix of financial management approaches ranging from meticulous to haphazard. Most record financial information in some form but this could be anything from keeping formal books, either in physical hardcopy or excel, to making a note of money received in a note pad and keeping receipts in a safe place. Some customers did their accounts as a matter of routine, others as and when they had time (which could be as infrequent as annually). Many in the sample reported only doing their accounts in order to submit their Self Assessment return. As such, accounts were not necessarily finalised at the end of the accounting year.

Often those who adopted a more 'as and when' approach were more established businesses. They once did their accounts as a matter of routine but saw little advantage to this and had become more relaxed as a result of experience and familiarity. Those new to self-employment, in contrast, either adopted a scrupulous approach - partly driven by fear of and unfamiliarity with Self Assessment, or, they were yet to adopt any approach, either because they only recently started trading or because they were unaware of the need to keep accounts.

Not all customers were aware of their accounting year, perhaps reflecting the pattern of making up accounts in time for Self Assessment. The majority reported an April to April accounting year and many of these were unaware that, in theory, an accounting year could be different to the tax year.

The sample, by design, was weighted toward customers who did not use an agent. Those that did have an agent used these for Self Assessment returns rather than for regular book-keeping services. This was predominantly down to reducing costs incurred, with book-keeping seen to be a more straightforward task to manage themselves.

Desire to remain compliant but calculation requirement presents a challenge
Submitting estimates without producing actual end of year figures later felt ‘against the grain’ for many customers and something they were not familiar with doing. Given this, the majority of the sample was keen not to comply with HMRC instructions. However, lack of understanding about the implications of finalisation and the timings of any calculation could impact compliance as people may be more likely to get calculations (or parts of calculations) wrong and therefore submit inaccurate figures.

Those with variable incomes and those most reliant on TCs were especially concerned about the prospect of being over-paid and suggested that they may seek to avoid this by overestimating income. This reflected lack of clarity about their TC award being finalised with many customers unclear as to whether they would be later asked to submit an actual figure for the period covered by the calculation. In contrast, a small minority of customers noted that, if they were not required to submit an actual figure at a later date in order to finalise their award, they may take advantage of this by underestimating income in order to receive a higher award settlement. The reality of the situation was that customers would not have this opportunity to provide an actual figure when finalising their award.

There was concern about the time the calculation will take, especially amongst those who only make up their accounts for the Self Assessment deadline. For these customers, the part year income could effectively mean making up their accounts twice. Seasonal workers, and those who have busier and quieter spells that cannot be predicted by the seasons, were also concerned about the timing of the calculation. 30 days was felt to be potentially insufficient time should they need to provide the part-year income figure during a busy period. Whilst these customer wanted to comply, some suggested that in the absence of time to organise their accounts and undertake the calculation, they might instead submit a figure based on the previous full accounting year.

<u>Agents and intermediaries</u>
Agents raised questions about customers estimating ‘in good faith’. They were concerned that customers with variable incomes will be concerned about providing an estimated figure, regardless of whether the calculation was used to arrive at this. They felt that information should be provided to agents about any legal implications attached to reporting

part-year income. Agents also wanted information about what customers can do if they are not happy with their finalised award, for example, on 'right of appeal'. Echoing the concern of some customers, they raised doubts about customers getting their information together and performing the calculation in within 30 days.

Common issues

Overall, self-employed customers struggled to understand how to make the part-year calculation. Even educated and numerate customers misunderstood the calculation instructions. Those with complicating factors such as multiple self-employment income streams or those were also paying tax through PAYE found the calculation particularly daunting and complicated. A minority of the sample seemed to 'get it' quickly and without much explanation but these were typically highly numerate individuals.

The majority of the sample only had a partial understanding of what would be required of them at the end of the interview and after being exposed to all the stimulus materials. Many felt the need to read the information several times but often this re-reading did not help and could actually make them more confused about what was required. Some customers reported understanding the instructions at the end of the interview but it was clear that in the majority of these cases they still hadn't accurately understood what was being asked of them.

Customers faced three key common issues in response to the calculation:

1. **Understanding the year the calculation needed to be based on and the relationship between the accounting year and the tax credits year**

There was a lack of understanding about the significance of the tax credits year in relationship to their accounting year. Most did not realise that they needed to consider the accounting period ending in the current tax year. As a result, they struggled to identify if their accounting period was before or after the UC claim. Examples that set out accounting periods different to the tax year were not immediately helpful for customers who had failed to understand the logic of the calculation in the first place. Only a few customers in the sample had an accounting year different to the tax year.

2. **Understanding the need to take into account a full accounting year when presenting income for the award period**

Many customers were unclear why they needed to consider two 'sets' of days (number of days in accounting year and number of days in award period) and how they related for the purpose of the calculation. That is, it was not immediately clear from the information presented why it was necessary to consider both the year and the award period. Many assumed that only actual income for the award period would be relevant. Customers were also unclear why a daily rate should be derived from 365 days when not all of these are working/trading days.

3. **Language and terminology**

Many customers had difficulty understanding unfamiliar terms that relate to accounting and tax credits. Some of which were crucial to the accuracy of the calculation. For example, terms like ‘taxable profit’ and ‘accounting period’. In addition, some of the language was considered to be inaccessible or unnecessarily complicated. For example, words like ‘base period’, ‘legislation’, ‘entitlement’ and ‘ceased’.

What customers need to know: WHY?

Before customers are able to engage properly with the calculation instructions, there were a number of ‘why’ questions that they felt they needed to understand. These centred on why TCs were stopping, why they were required to make this calculation rather than HMRC, the implications of providing the part year figure and of providing an incorrect figure (either because they did the calculation incorrectly or because their actual income turned out to be quite different from the figure they submitted).

Lack of clarity on these points was felt to have practical implications for customers’ ability to understand the calculations that follow. That is, a lack of clarity around the reason for finalising TCs could mean customers fail to take on board that this was different from the usual adjustment process. It may also limit customers’ ability to engage with the calculation instructions as their emotional response to uncertainty with regards their future income affected how they processed the calculation information.

On seeing the introductory stimulus explaining the reasons for the requirement, a number of questions and concerns arose:

- What is happening to my tax credits?
  - Will I still get the same amount of money from UC?
  - Why/how does a UC claim start? Does that mean it will be automatic?
  - What does ‘finalised’ mean? Will I owe HMRC money?

- Why is HMRC asking for this now?
  - I’ve already given them income information for this award, why do I need to do it again?
  - Why can’t it be done the following April?

- Why is HMRC asking for the information in this way?
  - Can’t HMRC estimate it for the period based on my latest information?
  - Why is HMRC asking me to give an estimate to make an adjustment? They always do this based on actuals and previous earnings?
  - Why are they asking for length of TC claim? Don’t they know this?

These questions point to a need to clarify HMRC’s role in moving from TC to UC and the implications of finalisation. There is a need to clearly communicate to all customers the purpose of asking them for the information at this point and how it differs from the usual request. Customers need help to understand why this information is different to that which HMRC already hold.

<u>Agents and intermediaries</u>

Overall, agents thought that the "why" introduction was crucial. Agents felt that HMRC (and/or DWP) need to spend time informing customers and intermediaries about the changes (both the transition to UC and the calculation) before they send detailed part-year calculation instructions. Echoing customers' desire to understand the why and the need to mitigate customers' emotional response, agents felt strongly that the receipt of calculation instructions should not inadvertently be the first time that customers hear about the transition to UC. They also felt that it should be emphasised up front that customers were being asked to do something different and that they would only be asked to provide the estimate for the year once and that they would not, later on, be able to provide final figures.

What customers need to know: WHAT?

Customers reported that they would benefit from understanding the logic of what they were being asked to do in order to engage with the calculation instructions – i.e. you will need this specific information for this reason. The 'what' messages need to prime customers to be able to understand and perform the calculation.

The request for a 'part-year estimate' in initial information led to assumptions that HMRC were simply asking for income up to that point in the year. This appeared to contradict later instructions about taking into account a full 12 month period and the award period. The use of the term 'estimate' also caused concern for those with variable incomes and for start-ups who could struggle to provide accurate estimates. The implication here is that greater clarity and consistency in the use of the term 'estimate' is needed in order for customers to feel more confident in their understanding of what this then means.

Key points to make clear when introducing WHAT the customer needs for the calculation

1. The date their tax credits award stopped (this is stated on your letter)
    - Ensure it is clearly marked on the letter where this date is or provide people with an illustration as to where they can find this
    - Where possible, to provide customer with the number of days covering their tax credit award, especially for those who did not start on 6 April (e.g. start-up, new claim)
2. Your financial accounting period (e.g. 1st March through to 28th/29th February[1])
    - Make clear what 'financial accounting period' refers to
    - If using an example, state April-April, as this is what the majority use: otherwise, likely to confuse
    - Make clear exactly which financial accounting period is being referred to
3. Your actual or estimated taxable profit for this 12 month period
    - Make clear what 'taxable profits' are and use terminology consistently (income, taxable profit, etc.)– even established businesses raise questions and this is key for providing correct information
    - Make clear why they are providing a 12 month period for a part year income figure
    - Address concerns (e.g. what are the consequences of under/over-estimating) about 'estimated' income for those who are likely to be sensitive about this

[1] Dates indicated are taken from example provided in current HMRC guidance

Agents and intermediaries
Agents were concerned that, though the description of 'what' was fairly self-explanatory to them, many customers would say that they understand what information they need to collate, but there is a major risk that they, in fact, do not understand. This fear was borne out in practice during research with customers.

They identified that there was room for misinterpretation on each piece of information that customers needed to have in order to perform the calculation (the tax credit cessation date, the "financial accounting period", and the actual/estimated taxable profit). They also pointed to the fact that some businesses did not operate to a 12 month financial accounting period, though this may be termed as a 'business year'. As such, emphasising full accounting period rather than accounting year would be more appropriate. Furthermore, this potentially has implications for the calculation of a daily rate.

What customers need to know: HOW?

Customers who were able to understand the 'why' and the 'what' found the actual calculations relatively straight-forward. These customers were in the minority. Most customers struggled with the first step necessary to perform the calculation – establishing whether their accounting period ended before or after their tax credit claim had stopped. This step was essential to working out what portion of their accounting year, if any, they need to forecast in order to establish a daily rate. Lack of understanding about this key aspect resulted in some customers deciding at this point that they hadn't understood what it is they need to do.

Many of those who had to forecast / estimate between UC claim and end of financial year questioned the logic of this. As mentioned above, many customers felt that they were being asked to determine the indeterminable, given variables that impacted their income and the extent of control they have over these. Those with more unpredictable income and start-ups found the forecast element particularly challenging.

A range of different approaches to making an estimate of future income was suggested. Many established businesses would make an estimate based on the income during that period in the previous financial year. Others (usually those less on top of their records) were likely to give their actual last year's figures (total) rather than calculate.

Step-by-step written guidance worked very well for some people, especially where they were clear on what information they needed and where their business was relatively straightforward. Written guidance supplemented by illustrative examples helped some people envisage what might be required and this appeared to appeal to more visual learners. However, applying the calculation to examples was confusing for people as they were unable to relate to dates and circumstances. Furthermore, because key concepts were not understood, (e.g. relevant accounting year, relevant number of days), one mistake put the whole calculation out.

Pre-printed timelines which already plotted TC award period based on individuals' dates and the tax year could help, in conjunction with other guidance. Customers could use these to plot their own financial year. For customers whose financial year was the same as the tax year (most customers in the sample), an effectively complete timeline could be given.

Agents and intermediaries

Agents felt that the instructions themselves were fairly clear. The key issue is the practicality of actually undertaking the calculation. The examples with timelines were felt to be helpful supporting stimulus but were seen to be the “easy examples” and that actually HMRC need to map out the range of scenarios (e.g. different basis periods, different employment periods, multiple employment types, partnerships, if they have made a loss) that could exist.

Support needs

Based on the information provided to customers in the research, most are unlikely to undertake the calculation confidently without further support. Given the partial nature of most customers’ understanding of what was being asked of them, there is a significant risk that unsupported customers will provide incorrect information.

The majority of self-employed customers said they would turn to HMRC first for support. They would be seeking answers to their questions on the change from TC to UC as well as questions about the calculation itself. Some would be seeking verbal explanation of the written information, where they had failed to understand it. Those who felt they had understood the instructions were seeking reassurance that their understanding was correct and that they had performed the calculation as required. Anxiety about the implications of getting the calculation wrong or reporting a taxable profit figure that does not reflect the reality of their income was a key driver of this.

Some customers would alternatively or additionally turn to knowledgeable family or friends (especially ones who are self-employed as well) or their accountant for advice. However it should be noted that there was no evidence of preparedness to pay an accountant to undertake the calculation, entirely on the grounds of cost. A few mentioned other support organisations e.g. Citizens Advice Bureau.

There was a clear appetite for an online calculator, either to do the calculation or simply as a method of verification. Some customers mentioned this spontaneously during the interviews. A minority who were uncomfortable with computers or who reportedly found the tax credit calculator to be unreliable would not use the calculator. Additionally, there was some concern that the calculator won’t fit specific circumstances and that it would not show their ‘workings’. Overall, however, customers felt that this would increase their confidence in the process and greatly reduced the margin for error in performing the calculation.

Agents and intermediaries

Agents had various support expectations including:

- Various forms of education / information e.g. website dedicated to them, with FAQs, dedicated phone line for queries (rather than general tax credits line) from trained advisers

- Detailed technical guidance (and worked examples) to cover the range of situations customers might be in, especially more complex circumstances
- Clear guidance on implications (especially around estimation) with all relevant regulations

Agents wanted to see both the detail of the original regulations in full as well as an easier to digest interpretation to enable them to explain regulations to customers. They also wanted to see all information that customers themselves will receive, so they can understand what has been asked and plenty of time to plan in advance of the transition period.

Finally, they felt that there needs to be recognition that start-ups will require greater support as these customers will not have experience of running a business *and* will be unclear about their income.

Conclusions

There was a high degree of variation in the extent to which respondents understood the rationale and practical requirements for undertaking the part-year calculation. This presents a significant risk that customers reporting of their part-year income will be avoidably inaccurate. There was consistent feedback from both self-employed individuals and agents around how instructions could be improved, and support provided, in order to support this calculation. Based on feedback from respondents, the key considerations for HMRC are as follows:

Language	Provide the why, what and how	Reduce risk of error
- Assume nothing about business/ financial literacy. Spell out all terminology – even terms that are associated with self employment (e.g. accounting period, financial year, income, taxable profit) - Lay English is needed throughout - Provide a crib sheet explaining all terms used - Use a first person directional tone to reduce the extent to which the instructions feel abstract	- Keep the 'why', 'what' and 'how' separate - Repeat some key messages to ensure they are understood and convey their importance - Clearer step-by-step instructions needed - Provide visual examples accounting for range of scenarios - Simplify in design and layout, e.g. one instruction per clause; avoid block text. - Provide worksheet (or paper calculator) that mirrors examples	- Pre-populate material as much as possible (number of days in Award Period) - Staging transition to UC as near to the end of typical accounting periods may help to reduce the risk of inaccurate estimates. - Steer people to the online calculator - Signpost support - Engage intermediaries early and provide detailed guidance