

Office of
Tax Simplification

**Small business tax review:
Final report**

HMRC administration

February 2012

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Contents

	Page
Foreword	3
Executive summary	5
Chapter 1 Introduction	7
Chapter 2 The context for the review of tax administration for small businesses	11
Chapter 3 Overarching themes of this report	13
Chapter 4 Education and support	17
Chapter 5 Communication and improving the relationship between taxpayers and HMRC	27
Chapter 6 Providing certainty (including finality and closure)	31
Chapter 7 Reducing the burden of fulfilling specific taxpayer obligations	33
Chapter 8 Conclusions and key recommendations	41
Annex A Improving small businesses' experience of the tax system – terms of reference	45
Annex B Evidence gathering for the small business review	47

Foreword

The role that a vibrant small business sector can play in growing our economy should not be underestimated by anyone. However, it does require a certain courage to go out on your own in a world where there are so many hurdles to overcome in the pursuit of business success. As a contribution to trying to make this journey easier for the UK's 4.5 million small businesses, we were happy to accept the Chancellor's challenge to produce recommendations about how the tax system could be simplified for these enterprises.

Following our interim findings in March 2011, the Chancellor asked us to look into three areas as a priority:

- improving administration of the tax system for small businesses;
- looking at new, simpler ways of taxing very small enterprises; and
- examining the case for a new tax relief to make it easier for small businesses, set up as companies, to disincorporate and operate through simpler structures.

This report largely covers the first of these areas while there are separate papers on the other two issues.

To scope this work we, together with HMRC, commissioned independent research into the experiences of over 1,000 of the smallest businesses. We also carried out our own survey of tax advisers and accountants. In addition we worked with the Federation of Small Businesses (FSB) and Professional Contractors Group (PCG) to survey their members. These findings, taken together with information gleaned from the numerous meetings that we held with small businesses, their advisers and HMRC staff in various parts of the country, gave us an enormous body of evidence upon which to base our recommendations.

What really stood out from all this work is that there is no such thing as a typical small business. People set up their own enterprises for many different reasons. However, as a sector, it is fiercely independent and the people in it relish the control they have over their own business affairs. Not all of them want to become tomorrow's "mega-corp". In fact our survey confirmed that 39% did not plan to grow their businesses at all. We also analysed the many things that HMRC has been doing to help small businesses as well as those cases where they got things wrong.

All of these factors inevitably affect the attitude of small businesses about how they handle their tax affairs. At its simplest, what they want to know is how much they have to pay, what they can claim for and where they can go to for help. They also require clear advice that can be relied upon and they don't want to receive an unwelcome tax surprise. In short, they want to feel that they are in control of their own tax affairs. What was also clear to us is that nothing we recommend should get in the way of good business record keeping, a vital ingredient to the success of any enterprise.

We have not come up with a silver bullet that will solve all small businesses' tax problems at a stroke. Instead, our approach has been to present a broad package of common sense simplifications that we hope will be attractive to Ministers and build on the efforts which HMRC is already making to improve the service it gives to this sector. Our hope is that, taken together, all these recommendations have the potential to make life easier for the bulk of small businesses.

Many people have worked tremendously hard to produce these findings. I would like to put on record my enormous thanks to the three OTS team members who wrote the bulk of this review

– Angela Williams, Andy Richens and Anish Mehta. They were ably assisted by Richard Thomas and Caroline Turnbull-Hall, and indeed the whole OTS team who contributed to this work.

I am also extremely grateful to the members of our Consultative Committee who have continued to conduct a very active and lively debate about our emerging ideas. In coming to our conclusions we listened carefully to their views and at times differing opinions. We drew upon these together with an analysis of the evidence and combined them with our own judgement to determine the recommendations which we are now putting forward to the Chancellor.

A handwritten signature in black ink, appearing to read "Michael Jack". The signature is written in a cursive style with a horizontal line above the name.

Rt. Hon. Michael Jack

Chairman, Office of Tax Simplification

Executive summary

As part of the second and final stage of the review of small business tax, the Government asked the Office of Tax Simplification (OTS) to provide a report into small businesses' experience of tax administration. This was to include their interaction with HM Revenue & Customs (HMRC) at key stages of their annual cycle, together with specific consideration of the issues involved in starting a new business, and a review of the areas businesses find most problematic and frustrating. The final stage of this review also covers recommendations for a simpler income tax for the smallest businesses and a disincorporation relief, which are set out in separate papers published alongside this document.

This report builds on the OTS's interim report on small business taxation and is based on the work of the OTS over the past 12 months. It incorporates extensive evidence from:

- The Futures Company (TFC) survey, commissioned by the OTS and HMRC in September 2011, which focused particularly on small unrepresented businesses;
- a survey hosted by the Federation of Small Businesses (FSB);
- a survey of members of the Professional Contractors Group (PCG); and
- a survey of tax agents in November 2011.

These surveys were supplemented by a series of meetings nationwide for small businesses and their tax advisers. The survey results have been shared with HMRC and will provide a reservoir of valuable data to draw on for some time.

The package of OTS recommendations has four overarching themes:

Education and support for small businesses

Evidence suggests that businesses are not always aware of the considerable amount of information and support on tax issues which is available to them. The OTS recommends that more should be done to draw their attention to the tips, guidance and tools available. Targeted, personalised information is more likely to be effective. Businesses should be able to opt to receive updates on relevant tax changes and events, as well as tailored support through intermediaries.

Communication with HMRC and improving the relationship with taxpayers

Difficulties communicating with HMRC can increase costs, create delays and cause confusion. The OTS recommends introducing two-way email communication, with response times within a set timeframe. A further popular improvement requested by businesses would be the introduction of a dedicated small business telephone helpline. HMRC should also continue with its ongoing programme of work on the tone and content of its communication with small businesses to ensure that such communication is meeting the needs of the business. Better tracking of correspondence and other communications would also be a welcome improvement.

Providing certainty

Businesses are entitled to expect clear answers on which they may rely in order to meet their tax obligations. Published information and HMRC staff training should ensure that this need is met. The OTS recommends that where a complex issue is raised, ownership be given to a particular HMRC officer until resolved. The prospect of a penalty for an innocent error leads to unnecessary fear among some small businesses so HMRC should make greater use of suspended penalties.

Making it easier for taxpayers to fulfil their existing obligations

This report makes a number of specific recommendations on improving processes to make tax obligations simpler and easier for those small businesses affected.

The overriding message here is that many small businesses look to HMRC for guidance in tax matters. It is perhaps valid to question whether businesses should look to external tax advisers for the necessary assistance instead. HMRC arguably does not have the resources to do as much as taxpayers and agents would like and its resources are likely to continue to be reduced. It is clear from our research, however, that many small businesses want to be more in control of their tax affairs and they look to HMRC to help them. These businesses want the freedom to decide when to involve external tax advisers.

We think this stance is entirely valid and we have accordingly reflected the needs of those small businesses in many of our recommendations. It will be deduced that the OTS thinks that, as the tax authority, HMRC has an obligation to help taxpayers comply with the tax system: self assessment only goes so far. We are encouraged that many in HMRC recognise these obligations and want to help businesses appropriately. It will clearly be challenging for HMRC to deliver the programme we have outlined but we think that what we have suggested is not all “one way”: there will be payback to HMRC through better compliance and more efficient use of their limited resources.

We have outlined a suggested timetable for delivering our recommendations, taking account of the deliverability by HMRC and the links with ongoing initiatives. We acknowledge that HMRC already has a number of initiatives under way that will address various aspects of our recommendations and the report highlights where these need greater focus or advertising.

The recommendations in this report are summarised in Chapter 8, and are further divided between those that the OTS believes could be introduced in the short term for the immediate benefit of business, those which will need to await the introduction of the single Government domain later in 2012 and those which would be longer term initiatives.

One point to highlight is that those who come to this report expecting to find a single “blockbuster” change that will solve all small businesses’ problems with the tax system will be disappointed. The OTS has found much that is working well with the current tax system but, at the same time, there is scope for changes that will make a genuine difference. Many of the points made in Chapters 4, 5 and 6 are relatively minor, but taken together they will make a material difference. Also, the ten areas listed within Chapter 7 are a significant agenda for change.

It is the view of the OTS that tax administration for small business must be kept under review with any changes evaluated and, where appropriate, improved on. The OTS experience suggests that taxpayers are more willing to offer challenging and candid views when speaking to a third party. There is a clear ongoing role for groups such as the Administrative Burdens Advisory Board to continue to challenge HMRC on administrative issues, and there should also be a mechanism in place to feed back ideas to HMRC for systematic improvements.

Finally, it is important to stress that the role of the OTS is to advise Government and it cannot make policy decisions itself. We have presented these recommendations to the Chancellor of the Exchequer and anticipate a formal response as part of Budget 2012.

1

Introduction

The OTS's approach to the review

1.1 The review of small business tax was one of two projects that the Office of Tax Simplification (OTS) agreed to take forward when the office was first set up in July 2010. The original terms of reference, available on the OTS website¹, set the task of making “recommendations to the Chancellor on how to simplify the tax system, ease administration and reduce uncertainty for small businesses”. This review was to be delivered in two stages: an interim report² by Budget 2011; and a subsequent final report with specific recommendations.

1.2 Expert external secondees were appointed to work with the Chairman, Tax Director and a small OTS secretariat. We also appointed a consultative committee of tax and business experts to advise us on this review (see Box 1.A).

Box 1.A: Consultative committee³

The consultative committee for the small business review was put in place to act as a sounding board for the work of the OTS. This model of working has been used in all of our reviews to date.

The input of the committee has been invaluable and has been a strong challenge to the recommendations that have been considered and developed. Indeed, the involvement of past committee members as secondees on the OTS team, and vice versa, has given consistency and continuity to our work on tax simplification for small businesses.

As with all our reviews, the conclusions made in this report reflect the view of the OTS and not that of the committee. There has not been unanimous agreement in many of the areas covered in the small business review, which reflects the diversity of the committee, the subject matter of the review and the difficulty of the OTS's task.

The OTS would like to thank committee members for their time and their contributions, which have been invaluable.

1.3 A central feature of this review has been our desire to listen to the views of businesses, tax advisers and other interested parties. As part of this, we carried out a series of meetings across the UK with businesses, advisers and Government. We have also used research and surveys to establish the evidence base that underpins this review. The OTS and HMRC jointly commissioned The Futures Company (TFC) to conduct research on the main tax issues affecting the very smallest businesses. The OTS has also conducted its own surveys of small businesses⁴ and of tax agents. These sources of evidence are set out in more detail in Annex B.

¹ http://www.hm-treasury.gov.uk/ots_smallbusinessreview_tor.htm

² The terms of reference specified that the interim report should contain recommendations on the specific issue of IR35.

³ The list of committee members, and minutes of all committee meetings are available at: http://www.hm-treasury.gov.uk/ots_smallbusinessreview_committee.htm

⁴ Through the Federation of Small Businesses and also the PCG.

Interim report

1.4 The initial report on small business tax was published in March 2011⁵. The paper set out some major structural changes that the OTS felt could deliver long-lasting simplification to the tax system. The paper also set out provisional recommendations in other areas of the tax system, as well as two lead options to address complexity associated with the IR35 legislation.

1.5 The Chancellor responded to this interim report in Budget 2011, announcing that HM Treasury and HMRC would take forward work in two of the areas identified in the OTS report. Further details are given in Box 1.B.

Box 1.B: Update on OTS recommendations taken forward from the March 2011 interim report

Income tax and national insurance contributions

In the OTS's interim report on small business in March 2011, we highlighted the major simplification that could result from a merger of income tax and national insurance contributions (NICs). The current system leads to a number of anomalies that provide incentives to change behaviour and take decisions that are wholly tax driven. Indeed, the need for a relief for disincorporation (set out in box 1.C and the paper published alongside this document) could potentially be even greater if this anomaly is removed. A move towards integrating income tax and NICs would also bring significant administrative simplification.

In Budget 2011, following the OTS's interim report, the Government announced that it would consult on options to integrate the operation of income tax and NICs. Since then, HM Treasury issued a call for evidence in July 2011 and subsequently published the next steps for consultation in November 2011⁶. There is a further update expected at Budget 2012.

The OTS welcomes this work. As set out in the OTS's interim report, there are many complications with integration and the Government is right to consult widely before making any changes. Our current project has reinforced the need to make progress on this initiative and we reiterate our previous conclusions.

IR35

The original terms of reference for the OTS's review of small business tax required us to consider the specific issue of IR35⁷. Two lead options were put forward in the interim report on small business tax: either suspend IR35, with the intention of subsequent permanent abolition (subject to the effect on behaviour and fiscal cost); or keep the legislation unchanged but make explicit commitments to improve the administration.

In Budget 2011 the Government agreed to take forward the latter of these two options.

Issues raised with the OTS included the fear of investigation, the length of time an investigation takes and enabling individuals to self certify their IR35 status with a greater degree of certainty. The Government is working on a number of new initiatives including focusing more on those who use personal service companies to disguise employment, rather than on those that may have just an isolated contract that may breach IR35, and publishing guidance to indicate where there is a low risk of falling foul of IR35.

As with income tax and NICs, IR35 is a subject mentioned regularly in our more recent research. We reiterate the need to make substantive progress with the project set up in the wake of our previous report; we understand that changes may be introduced from April 2012, which will be welcome.

⁵http://www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf

⁶ See http://www.hm-treasury.gov.uk/tax_income_nics.htm

⁷ http://www.hm-treasury.gov.uk/d/ots_small_business_tax_administration_tors.pdf

1.6 The OTS was asked to take forward work in the other areas identified in the interim report and agreed terms of reference for the next stage of the project, which is in three strands:

- improving HMRC's tax administration for small businesses⁸;
- a new system for taxing the smallest unincorporated businesses⁹; and
- a possible new tax relief for disincorporation¹⁰.

Final stage of the review

1.7 This document is the main paper in the final stage of the OTS's review of small business tax. It is largely focused on the tax administration strand of the review but brings together the other elements. There is some overlap between the strands – for example, introducing a simpler system for unincorporated businesses may encourage some incorporated businesses to disincorporate. The proposed disincorporation relief would allow them the freedom to choose the simpler tax regime instead, with relief from tax charges at the point of disincorporation.

1.8 In July 2011, the OTS published two technical discussion papers, one covering the issue of a relief for disincorporation¹¹ and the other looking at ways to simplify income tax for the smallest unincorporated businesses¹². A summary of the final recommendations is set out in Box 1.C below, and full details are available in separate papers that are published alongside this document¹³.

Box 1.C: Other strands of the final report of the OTS review of small business tax

Simpler income tax

The report recommends two significant changes to the tax system for the smallest businesses, and that a third be investigated. The two changes are:

- accepting a "receipts and payments" (or "cash") basis for calculating profits for tax; and
- extending the use of flat rate amounts to other expenses apart from mileage.

The report also finds that there is sufficient support for the idea of an alternative system of calculating tax liabilities, probably on the basis of turnover, to warrant a fuller study of the idea.

Disincorporation relief

The report recommends the introduction of a relief for disincorporating a company, i.e. moving from a trade carried on through a limited company to it being continued as a sole trader (or partnership). The aim of the relief is to enable businesses to carry on their activities through the legal form that is most effective in business terms. The relief would cover both the tax charges that would arise on transfer of goodwill and some trade assets to the shareholder(s) and also the potential charge on the shareholder(s) on disposing of shares in the company.

⁸ http://www.hm-treasury.gov.uk/d/ots_small_business_tax_administration_tors.pdf

⁹ http://www.hm-treasury.gov.uk/d/ots_small_business_review_tor.pdf

¹⁰ http://www.hm-treasury.gov.uk/d/ots_small_business_review_tor.pdf

¹¹ http://www.hm-treasury.gov.uk/d/ots_disincorporation_of_small_companies_discussion_paper.pdf

¹² http://www.hm-treasury.gov.uk/d/ots_tax_for_small_business_discussion_paper.pdf

¹³ These papers are available at: http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm

2

The context for the review of tax administration for small businesses

2.1 The administration of the tax affairs of a business will always impose a cost on the business (this is in the nature of self-assessment) and on HMRC. Eliminating this cost would be an unachievable and undesirable objective because the system of self-assessment means that appropriate record keeping and effective enforcement of tax compliance are essential for both Government and the small business community. However, there is scope to make changes that would mean that the small business community could reduce its compliance costs, find it easier to get help and support and have greater assurance that their tax affairs will not be questioned without good reason.

2.2 **The current economic climate places a greater urgency on reducing administrative and regulatory burdens on businesses.** Businesses are facing issues such as low consumer confidence, concerns over access to finance and rising input prices (e.g. fuel). Businesses have told the OTS about the difficulties of achieving commercial success in such an environment and the need to focus their time on being creative and finding new opportunities. Although there is a balance to be struck, the Government has recognised the need for further action on administration and regulation in a number of areas, including tax. **Given the large number of businesses and the disproportionate cost of tax administration¹⁴, simplification measures for very small businesses have the potential to deliver significant benefits to the economy.**

2.3 Improvements to tax administration ought to reduce the financial cost of compliance and also the time that businesses spend dealing with their tax affairs. However, the relationship is not always direct. For example, the use of an agent can reduce the time spent on administration and is seen as essential for many businesses, but comes at a financial cost, while spending more time on administration can have a high opportunity cost in terms of worse business performance if it diverts attention away from the running of the business. Many advisers (and their clients) make the point that the tax system would not function without the input from agents.

2.4 Fear and anxiety are also burdens that are felt by many small businesses in relation to their tax affairs and their contact with HMRC. The Futures Company's survey of very small businesses shows that 49% of the total sample worry that they may have made a mistake with their tax returns, even though they keep good records and are careful filling them in. **This fear is much harder to quantify than time or cost and tends to be less prominent in the policy debate.**

2.5 Improvements to tax administration can be delivered in a way that meets HMRC's own objectives, particularly at a time of reducing Government resources and increasing pressure to close the tax gap. HMRC's role of policing the tax system is made more complicated by the variation in attitudes towards paying tax among businesses. It must strike a balance between not creating fear in innocent people and safeguarding revenue by reducing fraud and evasion. However, the OTS has repeatedly heard the view that all businesses are tarred with a brush that should only be appropriate for the minority of actively non-compliant businesses. HMRC has conducted research to segment taxpayers by their attitudes to tax compliance and is increasingly

¹⁴ As stated in the *Small business taxation* chapter of Volume 1 of the Mirrlees Review, the regressivity of compliance costs is well established in the literature. <http://www.ifs.org.uk/mirrleesreview/dimensions/ch11.1.pdf>

using these findings in its approach to tax administration. This should improve the relationship with the vast majority of businesses that are tax compliant and **the OTS is happy to endorse the strategy.**

2.6 Understanding what causes burdens to arise, and the extent to which they are excessive, has been a key objective of this review. The perception that “innocent errors” will be heavily penalised has come through in the OTS’s qualitative research, for example one small business said “It’s easy but I always worry that I’ve done it wrong and that the tax man will knock at my door – it’s a fear”. This pushes some businesses to get bogged down with “defensive” work to ensure that their tax calculations are robust, even if the tax at risk is minimal.

2.7 Feedback from small businesses suggests that there is a perception that changes to business structure can lead to a step change in administrative burden. Examples include taking on the first employee, crossing the VAT registration threshold and incorporation. Clearly, the perceived complexity of tax administration is not the only factor affecting these choices. The decision to employ staff will need consideration of employment law, and VAT registration will impact the price that a business must charge. Incorporation is interesting as rates of incorporation suggest that many businesses believe that the potential for tax saving outweighs the additional administrative burden (though incorporation does, of course, have other drivers than solely saving tax). **In some cases businesses underestimate the additional burden but discover that reversing their decision (i.e. disincorporating) is currently problematic.** This is the focus of an OTS paper published alongside this report as part of the small business tax review.

2.8 The increasing use of digital and online channels for tax administration is central to HMRC’s strategy and the Government’s wider approach of Digital by Default¹⁵. For many businesses, this has the potential to improve significantly the level of service that they receive. Among businesses that were surveyed online by TFC, many make frequent use of a wide range of online services including: sending and receiving emails (94%); searching for advice for the business (64%); online banking (74%); and viewing and paying bills (61%). **The OTS welcomes HMRC’s online initiatives, but as is recognised by government¹⁶, this work must also address the concerns of those taxpayers with limited IT skills and internet access.** Some businesses have to rely on their advisers to deal with their online responsibilities. Advisers to small businesses have relayed the concern among their clients about the mandatory use of online systems (e.g. for VAT returns).

2.9 Insights from behavioural psychology make it clear that we are more likely to influence someone to make a choice, or adopt a behaviour, that leads to an “improved” outcome if we make it easy for them to make the “right” choice¹⁷. Such insights are particularly effective when thinking about decision making by individuals, which is often the case with small businesses. In many ways this is self-evident, but there are clear examples in tax administration where the system makes it surprisingly difficult to make the correct “choice”. Examples raised in this paper include the processes for paying HMRC and the reliance on postal communication when email would be the preferred method of communication.

¹⁵ For further information see <http://digital.cabinetoffice.gov.uk/>

¹⁶ See the Assisted Digital programme: <http://digital.cabinetoffice.gov.uk/2011/07/28/an-introduction-to-assisted-digital/>

¹⁷ For example, see the Cabinet Office paper Applying Behavioural Insights to Fraud, Debt and Error, http://www.cabinetoffice.gov.uk/sites/default/files/resources/BIT_FraudErrorDebt_accessible.pdf

3

Overarching themes of this report

3.1 The label “small business” covers a large and varied group of almost 4.5 million enterprises in the UK¹⁸. It is unhelpful to think of these businesses as a single group with common preferences when thinking about their interaction with HMRC and the tax system. The OTS’s view is that **tax administration must be better able to cater for the differing, and sometimes opposing, needs of small businesses.**

3.2 Many businesses and tax agents find tax manageable and recognise that HMRC has made improvements which mean that in many ways tax administration is better than in the past. The OTS has also looked into the range of new initiatives that HMRC has recently launched or is to launch in the near future. As set out in this report, these initiatives have the potential to address significant concerns that were raised with the OTS. However, **awareness and communication of these initiatives should be improved.**

3.3 It is also true, however, that **HMRC should do more to understand entrepreneurs and commercial activity, and reflect this in their administration of the tax system.** The views of the very smallest businesses can be difficult and resource intensive to obtain, and tax agents or larger SMEs are often incorrectly used as substitutes for the views of these very small businesses. At the smallest end, many businesses are unrepresented¹⁹ or want to take more control over their tax affairs and therefore need a different level of service to the majority of businesses that choose to rely on professional advice.

3.4 Focusing on individual business owners highlights **the considerable role that emotion can play in HMRC’s relationship with small businesses.** Fear and anxiety are particularly important: the perception that tax requirements are constantly changing and that innocent errors will be punished severely are recurring themes. A bad experience of contact with HMRC can perpetuate these feelings. Businesses and advisers have highlighted the perceived asymmetry in the standards that HMRC expects and those HMRC maintains in its own conduct²⁰. The resulting lack of confidence and trust can generate difficulties with a wide range of administration issues and can deter business owners from engaging with tax issues. Most worryingly, this lack of confidence can persist over the lifetime of the business. **The OTS believes that HMRC can take action to help to overcome the negative presumption about HMRC initiatives by demonstrating a desire to act in the taxpayer’s interest.**

3.5 Businesses already obtain information and advice on tax matters from a wide range of sources. Tailored information, for example from advisers, other business owners or trade associations, is reported to be more salient for business owners that have a range of demanding pressures on their time. **Generic guidance from HMRC that is overwhelming and written in inaccessible language can be counterproductive as it pushes people toward less accurate and less reliable sources of advice.** HMRC has recognised this issue and businesses have told the OTS they have seen some improvements from HMRC’s programme of rewriting letters and guidance for taxpayers. Evidence suggests that many of the smallest businesses are making fundamental

¹⁸ Data available at <http://www.bis.gov.uk/analysis/statistics/business-population-estimates>

¹⁹ OTS analysis of 2007-08 HMRC data on all businesses shows that approximately 35% of unincorporated businesses with turnover below £70,000 did not use an agent. This compares to less than 10% of larger unincorporated businesses.

²⁰ A frequently raised example is penalties for making a “careless” error; businesses are liable for a penalty, while HMRC faces no such deterrent.

errors in what ought to be relatively simple tax calculations. Such errors can contribute to the tax gap²¹, but may also lead to overpayments of tax (see Box 3.A). The OTS view is that both legislative and administrative changes are needed here and it has published recommendations to simplify the calculation of income tax for the very smallest businesses as part of this review (see box 1.C).

Box 3.A: Extracts from The Futures Company research summary report *Understanding small businesses' experience of the tax system*²²

Note: The figures given below are for the entire survey sample, both represented and unrepresented

When asked what they would do if they bought something like office furniture or a computer for use in the business, 42% [of the sample] said they would deduct the total cost of the item as a business expense, which is incorrect. Only 27% chose the correct option, to claim capital allowances or the annual investment allowance. 5% said they would claim nothing and 10% 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% said they would claim nothing, even though they used the item for their business and 6% did not know what to claim. For those who used their home for business or to do their paperwork, 35% did not claim anything and 13% did not know what to claim.

Only a small minority showed clear awareness of accruals 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% gave the correct answer – sales invoiced in the year, whether or not they had been paid for. 47% included only money received in the year, whether or not they had issued invoices, effectively using the “cash” basis. Only 3% 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% of small businesses giving the correct answer “bills received even if not paid in the year”. 56% of small businesses were claiming expenses on a “cash” basis, answering “expenses I have paid for in the year”. Again, only 3% said they did not know the correct treatment.

3.6 The majority of businesses do obtain some professional advice so simplification initiatives should also improve tax administration for agents. Many small business owners would like to feel in better control of tax matters and not need to rely so much on their agents. It is having such control which is cited by many businesses owners as being the key motivation for starting up their own business²³. That is not to say that they would like to stop using an agent altogether, and 62% of the TFC sample would continue to use an agent even if they felt capable of dealing with their own tax affairs. However, **what these businesses wanted was to have the choice: to be able to deal with tax matters themselves or to choose to have someone else to help.** The Government is already planning to offer the option of greater understanding of tax affairs as part of its tax transparency agenda.

²¹ HMRC estimates that SMEs contributed half of the tax gap in 2009-10, when the tax gap was estimated to have been £35billion. Further information can be found in Measuring Tax Gaps 2011, <http://www.hmrc.gov.uk/stats/mtg-2011.pdf>

²² This summary report is available at: <http://www.hmrc.gov.uk/research/reports.htm>

²³ One third of businesses surveyed by TFC said the key motivation for starting their own business was “To be independent and in control rather than working for someone else”.

3.7 In travelling around the country to speak to small businesses and advisers, and also through the wealth of material that we have gathered from our surveys, the OTS has seen the value of creating strong feedback loops to improve issues of tax administration. **Improving HMRC administration for small business is too broad and complex a subject to be entirely dictated from the centre.** The aim is not just to improve the service offered by HMRC and evaluate HMRC initiatives but also to help taxpayers to learn from the experience of other taxpayers. Frequently Asked Questions (FAQs) are an example of such a mechanism but using social networks to disseminate information, and “crowdsourcing”²⁴ to collect information, could be an effective way of engaging with large numbers of taxpayers. The use of social networks for tax issues can already be seen in the level of activity in forums used by freelancers and contractors and also forums for the accountancy profession. Government has recognised the potential of the “crowd” in launching the Red Tape Challenge²⁵.

What is a small business?²⁶

3.8 Returning to the issue touched on in the first paragraph of this chapter, the OTS believes that there is a general need within HMRC, and indeed government more widely, to better target its efforts at sections of the “small business” community. As noted, there are some 4.5 million enterprises in the UK and very few of those rank as “large”. The term small, or “SME”, covers the full range from a company that might, if it wished, warrant a quote on the Stock Exchange²⁷ through to a student who tutors on a part-time basis.

3.9 It is therefore likely that standard contacts or initiatives with the SME sector will reach far more businesses than the real target population. Alternatively, the material will be so bland and generic that it risks achieving little. Either way, many of the businesses contacted in this way will be deluged with information or initiatives and have difficulties finding the right material.

3.10 Accordingly, the OTS thinks there is a clear need to introduce more “grades” within this massive business population. We note, for example, that the EU definition of a “micro” business includes many with up to nine employees, but such businesses would be seen by many as significant enterprises. We used the term “nano” business in floating the idea of a simpler income tax system for enterprises with turnover under £30,000²⁸.

3.11 **The key is that government recognises that the needs of the small business population can differ markedly from the needs of government.** We discuss this further in the following chapters. In saying this, we deliberately use the term “government” rather than simply “HMRC” as there is also a need to coordinate assistance on the same basis across business²⁹.

²⁴ “Crowdsourcing” is an open call for information, most commonly using the internet. It can be used to share and discuss information, ideas, problems and solutions.

²⁵ <http://www.redtapechallenge.cabinetoffice.gov.uk/home/index/>

²⁶ The following four paragraphs outline an issue that is dealt with in full in the parallel report on alternative taxing systems for the smallest businesses, published at: http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm

²⁷ A point made to the OTS in a meeting with the Unquoted Companies Group.

²⁸ There are some 2.5 million such businesses. See our separate report on simplifying income tax for very small businesses at: http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm

²⁹ We note the report of the All Party Parliamentary Group on Micro Businesses, published 20 February 2012 which comes to similar conclusions. This is available at: http://www.annemariemorris.co.uk/pdf/APPG_Micro_Business_Report.pdf

4

Education and support

Overview

4.1 Our research and discussions with small businesses suggest that many small businesses experience significant levels of fear, anxiety and uncertainty about tax matters³⁰. Providing suitable support and guidance to those that need it and doing so early in the life of a business gives HMRC an excellent opportunity to build good relationships, help businesses cope with their tax obligations and increase confidence. We acknowledge that many small businesses will engage advisers, but equally many want to feel more in control of their tax affairs and they look to HMRC to help them.

4.2 The OTS heard from many small businesses that they did not feel that HMRC was giving them enough help to understand and manage their own tax affairs. Many businesses told us that, once they had been through the relatively straightforward process of registering for self-employment, they then felt very much left on their own. They had no further contact from HMRC until their tax return arrived and as this did not need submitting for a further 10 months, it could be up to 22 months from starting in business before they needed to address tax issues³¹. This lack of contact meant that they had little or no understanding of the records that they should have been keeping, what is an allowable business expense, how to complete their tax return or of the date or amount of tax payable. It can also mean that innocent errors made in the early days of a business are not detected until they have compounded markedly and lead to difficulties completing tax returns accurately.

4.3 It should however be noted that, being more than a year old, the businesses in our survey would not have received the same level of targeted support that we are told businesses who have registered more recently are now receiving from HMRC. It does, however, highlight the importance of supporting business owners early in the life of their business.

4.4 HMRC is currently changing education and support to new businesses and introducing new initiatives aimed at helping new and existing businesses include:

- My New Business³²: guidance, information and tools targeted at pre start up and start up businesses, which brings together tax and non-tax assistance for new businesses and for businesses at key points in their life (available from November 2011);
- Online Tax Registration Service: registration for main business taxes in a single internet visit (due April 2012 and October 2012);
- Business Tax Dashboard: ability to view liabilities and payments for the four main business taxes³³ (due April 2012); and

³⁰ Of the sample in the TFC survey, 54% of unrepresented businesses worry about mistakes even if they have kept good records and take care. The proportion of those with agents who report worry is 45%.

³¹ A business which registers on 30 April 2012 would not need to file a return for the 2012-13 tax year until 31 January 2014.

³² <https://online.businesslink.gov.uk/hub/action/render?pagelId=mynewbusiness&site=1000>

³³ Corporation tax, VAT, income tax self assessment (including class 2 NICs) and PAYE.

- targeted help through online webinars and extension of current small scale outbound educational email facility.

4.5 The OTS recognises that HMRC must use its funds effectively and that all initiatives have an associated cost, which has to be funded. It is therefore important for the OTS, where possible, to recommend solutions to identified problems that complement existing HMRC initiatives. However, it is equally important that HMRC’s evaluation of initiatives, both before and after implementation, is conducted in a way that focuses on the needs of their users and target audience.

4.6 In the following sections we are focusing mainly on HMRC’s relationship with unrepresented taxpayers. Businesses can and do engage agents, accountants and tax specialists to assist them with their tax affairs and give them business advice³⁴, and can also purchase tools and software that they can use themselves. We have, however, heard from many small businesses that they would prefer to rely on HMRC³⁵ for information relating to their tax affairs.

Investing time early for future benefit

4.7 Difficulties with record keeping³⁶ and generally dealing with tax matters appear to be most acute in the first few years in the life of a business. Over time confidence improves although, for some, low confidence persists over the lifetime of the business³⁷. From conversations with HMRC staff, businesses and agents, it is clear that those who were well-supported in tax matters in the early years seem to manage better than those who were not.

4.8 It follows that early and appropriate assistance should reduce HMRC’s future costs by reducing the need for telephone contact with questions and reducing other help which might be necessary when businesses struggle with their obligations.

4.9 At this early stage businesses have a lot to deal with, not just their tax affairs. If businesses are going to be able to meet their obligations to file accurate tax returns, they will need appropriate and timely guidance and support. This seems to have been recognised, particularly with the “My New Business” initiative.

4.10 Good business records, appropriate to the needs of the business, are crucial for all sizes of business. Small businesses may not initially seek advice on business records by which time errors may have been made and documents and information lost. We think that HMRC should, when small businesses are first set up, be more proactive in ensuring that they understand precisely what records they should keep and what their obligations are in other respects. It is not sufficient in our view to have information available online, **HMRC should take more responsibility for encouraging and assisting businesses to access the information or take professional advice.**

4.11 In particular new businesses need to be made fully aware of the importance of good business records very early on in the life of the business. Where professional help has not been sought, HMRC is probably best placed to highlight this. At the very least **we recommend that HMRC sends all new small businesses a simple easy to read leaflet setting out the minimum records needed and where further guidance may be found**³⁸. For those businesses that have internet access recommending that they work through the online business records review tool

³⁴ The Institute of Chartered Accountants in England and Wales offers free advice to SMEs through its business advice service.

³⁵ “Because they write the rules” was the reason given by one business.

³⁶ Of those surveyed by TFC, 26% of businesses 1 to 5 years old admitted not knowing how to go about record keeping when they started out.

³⁷ TFC research shows that 54% of the sample were lacking in confidence after 1 to 2 years in business and 42% after 11 to 25 years in business.

³⁸ HMRC send a detailed factsheet “Keeping records for business – what you need to know” <http://www.hmrc.gov.uk/factsheet/record-keeping.pdf> to new contractors but this leaflet is more detailed than we have in mind.

(ensuring that the business is given the URL³⁹) would be a good way to guide new and existing businesses through what records they need to keep.

4.12 HMRC recognises the importance of keeping appropriate and accurate business records and introduced a pilot programme of Business Records Checks (BRC) in 2011. This has recently been reviewed⁴⁰ in the light of criticisms raised and may now be refocused. A series of recommendations was included in the report on the review of the BRC programme, which, if followed through, could help businesses with their record-keeping. In particular we note that the accountancy bodies have criticised some of the advice available on record-keeping and will be working with HMRC to improve this.

4.13 The OTS recommends that support is targeted before, or as soon as, a business registers for a tax, encouraging and helping compliance from the start. Support should then continue throughout the first year and until after the first business tax return has been submitted and the tax paid. By this time businesses will have dealt with a complete annual cycle and be familiar, if not confident, with dealing with it.

4.14 It is the view of the OTS that early, proactive and timely support is likely to give significant long-term benefits and savings. Furthermore, feedback from businesses and HMRC frontline staff should be actively sought to ensure that what is available meets the needs of new businesses.

Better and more targeted help

4.15 A common complaint we heard from small businesses was that the information HMRC provides is not sufficiently well targeted. It can often be hard to find, too general, too all-embracing⁴¹, or there is just too much of it. Businesses have a lot to deal with, not just their tax affairs, so they do not want to spend time reading through material which is not relevant.

4.16 Small business tax information needs are currently not being met, with approximately half of businesses sampled by TFC reporting difficulties knowing what was allowed as a claimable business expense and 30% not making sense of the information given by HMRC. For information to be useful to businesses, it is critical that it is what they need (including appropriate to their size and legal form), easy for them to use and, importantly, that businesses are aware of the material and encouraged to look at it.

The HMRC website

4.17 The HMRC, Business Link and My New Business websites all contain an enormous amount of useful material for small businesses. This material includes interactive tools, e-learning tutorials and video clips in addition to the usual written matter to help businesses and appeal to different learning styles. A recent development is online advice seminars and webinars⁴². These all look helpful for the audience at which they are aimed but there is so much there⁴³ that it might also be overwhelming for a new business. HMRC should evaluate the effectiveness of both the subject matter and how these information sources are communicated to small businesses.

³⁹ Currently available in the section "Find out what records you should be keeping" on the Business Link website:

<http://online.businesslink.gov.uk/bdotg/action/logicToolStart?itemId=1085697565&r.l1=1073858808&r.l2=1085697567&r.s=sc&type=BLTTOOL>

⁴⁰ See <http://www.hmrc.gov.uk/businessrecordscheck/review.pdf>

⁴¹ See our earlier comments about the need to stratify the business population and hence target the help on the appropriate sector.

⁴² See <http://www.hmrc.gov.uk/press/online-advice.htm>

⁴³ We understand that there are over 1,200 hours of "teach yourself" business videos and tutorial help on business related topics including tax.

4.18 Feedback from small businesses indicates that many of those who would benefit do not know what help and advice exists or where to find it⁴⁴. Common complaints include poor signposting of information on the HMRC website, an unhelpful search facility on the HMRC website and HMRC staff not highlighting where guidance may be found.

4.19 Businesses would like to be proactively advised of the tips and tools which would be relevant to them and there is particular demand for tools or simple guides to assist in recording expenses and understanding what expenses can be deducted from income.

4.20 Frequent Asked Questions (FAQs) are published on the HMRC website on areas of difficulty but their ease of use varies considerably. For example, the IR35 FAQs are now well set out under sub-headings whereas, for example, those relating to online services, although categorised by tax or subject, would benefit from having further headings.

4.21 There is much that could be done to reorganise material and the links within it so that it is geared to events rather than subject areas. For example, a business will want assistance to do something such as complete a return, calculate a bill etc; so it wants the answer to the question "How do I....?". More or better signposting to the answers would help greatly.

4.22 It is also worth noting that we have been told, predominantly by agents, that the HMRC website and online services are not always up to date. This is unhelpful and wastes time for businesses. For example, incorporated businesses and agents reported to us the inconvenience caused by the online corporation tax filing software not being updated until October 2011 for the change in rate announced at Budget 2011⁴⁵. We sympathise with the task HMRC has of keeping such a huge volume of material up to date, but **we recommend that HMRC should ensure that changes are incorporated into the HMRC website and software on a more timely basis than in the past**. Some of our recommendations on better signposting of material may also help users of the HMRC website.

Three line accounts

4.23 Many businesses take advantage of the option to use the "three line account" when completing their tax return⁴⁶. However, the real difficulty often lies in identifying the figures to put into the return rather than completing the return itself. The OTS received comments that the three line account encouraged businesses to over-simplify matters and not consider tax adjustments, for example for personal expenses and capital expenditure.

4.24 Small businesses tell us that they need more help to arrive at the figures to complete the return. However, the guidance for completion of the short self-employment pages, which is aimed at small, simple businesses, is relatively limited⁴⁷ as compared with guidance on completing the full self assessment pages⁴⁸. The latter has more information about allowable business expenses and how to calculate them, and this is set out in a more reader-friendly way.

4.25 Although there is an argument that simple three line accounts are counter-productive, we know it does save time and worry (for example about which box to put which figure in) for many businesses. What is needed is not that these small businesses should complete the detailed self assessment pages, but that they should be able to find help easily and be actively

⁴⁴ As an example, in OTS meetings and survey work many businesses suggested that HMRC should provide guidance, factsheets and a calendar of key tax dates, information that already exists.

⁴⁵ We accept that strictly the change was not effective until Royal Assent but there was then a further delay before the software update.

⁴⁶ It is available to those with annual turnover from self-employment or UK property that is below the VAT registration threshold (£73,000 in 2011-12). In 2009-10, 43% of sole traders below the VAT threshold took up the option of using the "three line account".

⁴⁷ HS222 <http://www.hmrc.gov.uk/helpsheets/hs222.pdf>

⁴⁸ HS229 <http://www.hmrc.gov.uk/helpsheets/hs229.pdf>

encouraged to use appropriate worksheets to identify the amounts to include in the three line accounts⁴⁹.

4.26 There could also be benefits in alerting businesses to common errors made in tax returns and how these can be avoided.

Calculating and paying tax liabilities

4.27 Knowing how much tax they will need to pay is something that worries many businesses and they find it difficult to get guidance on this⁵⁰. The OTS appreciates that this is not an easy question to answer because it depends on so many factors but, if HMRC wants to be able to collect tax when it is payable, businesses need to be able to estimate how much they will need to pay (and be able to pay it easily, see paragraphs 7.14 to 7.16). HMRC has a help sheet to assist the self-employed in estimating tax but it is not easy to find⁵¹. Although basic, it is at least a guide for businesses and its existence could be more widely publicised.

4.28 Needing to know how much tax and national insurance will be due is a particularly acute problem for unincorporated businesses in their first year of operation. Often the proprietor is moving from a PAYE environment and will now, for the first time, have to budget for tax and national insurance payments and remember to reserve enough money over a lengthy period.

4.29 Although the cash flow benefit of a long delay before the first tax payment can be helpful, we do wonder whether it is ultimately the right answer to helping new businesses in the first months. **The OTS view is that businesses should be encouraged to put funds aside for their tax liability from the start of their business.**

4.30 We heard from businesses and agents that some businesses would prefer to start paying their tax more regularly, and sooner, after the business starts. In addition, many small established businesses have told us that they want to budget for their tax liabilities, for example through a regular payment facility or deposit scheme. Such tools are already available from banks and also from HMRC, although TFC's survey showed that 80% of businesses were unaware of the existing HMRC Budget Payment Plan⁵² and over 80% of those who knew about the plan did not use it. We suggest that further work is undertaken to ascertain what would be the most helpful way to help small businesses plan for their tax liabilities.

4.31 Businesses have also told us that they find it hard to understand the way payments on account work and how tax payments can fluctuate considerably when their profits vary from year to year. This in turn often leads to payment difficulties where the amount due in January is much higher than in previous years. Box 4.A illustrates the effect that a fall in and rise in profits (and therefore tax liability) could have on the payments due. It shows just how difficult it is for small businesses to understand and manage these fluctuations in tax payments. Many, of course, turn to professional advisers. **We recommend that HMRC is more proactive in advising small businesses about the way payments on account work in practice**, particularly immediately after the end of the tax year in which the business was set up, before the first payments on account will be due. We note in passing that HMRC's encouragement to taxpayers to sign up for a direct debit service does not assist in this area at all.

⁴⁹ See the discussion in the parallel report on simpler income tax for the smallest businesses at: http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm

⁵⁰ Approximately 20% of small businesses surveyed by the OTS have difficulty knowing how much tax they will need to pay. From our own discussions with businesses, this can be a source of worry and businesses find it difficult to get guidance on this issue.

⁵¹ The link to "Budgeting for your first self-employed tax bill" can be found at <http://www.hmrc.gov.uk/selfemployed/register-selfemp.htm>

⁵² The Budget Payment Plan is a regular but flexible arrangement under which the taxpayer pays amounts in advance towards future self assessment instalments.

Box 4.A: Example of how tax payments fluctuate

Tax year	Tax and class 4 NIC liability
Tax year 2011-12	£2,000
Tax year 2012-13	£1,500
Tax year 2013-14	£2,500

The first accounts are to 5 April 2012. Assuming that the taxpayer does not apply to reduce the payments on account, the tax and NIC payments which are due would be as follows:

Date	Description	Payments due
31 January 2013	Balancing payment for 2011-12	£2,000
	First payment on account for 2012-13	£1,000
	Total due (21 months after start)	£3,000
31 July 2013	Second payment on account for 2012-13	£1,000
31 January 2014	Overpayment for 2012-13 ⁵³	£500CR
	First payment on account 2013-14	£750
	Total due	£250
31 July 2014	Second payment on account 2013-14	£750
31 January 2015	Balancing payment for 2013-14	£1,000
	First payment on account for 2014-15	£1,250
	Total due	£2,250

Communications

4.32 Of businesses that were between one and two years old, 30% of those sampled by TFC wanted more personalised communication from HMRC, by way of email, social networking, newsletters and “chat room” facilities. The business owners told us that they want to receive information which is timely and relevant to them. Help could be given in a variety of ways, from simply sending email reminders and information relevant to the time of the tax year, to having online HMRC panels and forums, workshop training and exploiting social media channels. Existing businesses which are struggling with their tax obligations could be invited, or indeed encouraged, to join the education and support system when errors are identified on returns, or on their request.

4.33 Where there have been relevant initiatives to help businesses, these could sometimes have been done in a more “taxpayer focused” way. For example, there is a facility on BusinessLink to set up a customised calendar with email reminders⁵⁴, but many businesses are not aware of it.

⁵³ Assumes amount is left on account and not repaid to taxpayer.

⁵⁴ <https://online.businesslink.gov.uk/bdotg/action/myBusinessTools?topicId=1082235004>

This tool could be even more useful to many businesses if it could be exported to electronic calendars.

4.34 Prompts for payment dates and tax returns such as email reminders of important deadlines have also been mentioned as a way to help small businesses keep on top of their tax obligations. Again, this facility exists⁵⁵, but businesses seem unaware of it.

4.35 HMRC's initiatives for education and support are mainly channelled through the website and online services. For many businesses, and subject to our earlier comments about difficulties in finding material, this is the most effective method of communication. However, the OTS has heard concerns within the small business community about the increasing tendency to offer only online services. Where the digital channel is going to be the only source of information it is clear that those who are not comfortable using a computer, those who do not have internet or broadband access, and those whose access is unreliable or very slow will be disadvantaged.

4.36 The OTS welcomes the work that HMRC has been doing to support new businesses and other initiatives which we understand will be introduced over the next year or so. However, all this work should be properly evaluated to ensure that any support is meeting the widely varying needs of small businesses and is easy to access and use. In particular there is no point in having good tools and help if they are difficult to find or do not answer the questions and needs of the users at which they are targeted.

4.37 The OTS recommendations are:

- **More needs to be done to connect businesses with the information and tools they want and need. Investment in educational material and creating tools is wasted if the target audience is unaware of them or cannot find them;**
- **Ensuring that businesses can find and use the online information and help on business expenses claims and on record keeping could increase the accuracy of business tax returns and this in turn could lead to reduced HMRC costs through reduced contact from businesses;**
- **A worksheet should be introduced to help small businesses work through their business expenses methodically and claim only for those items which are allowable business expenses⁵⁶;**
- **Personalised and more targeted updates and information would save businesses considerable time and help them comply with their tax obligations; and**
- **For those who cannot obtain information from the HMRC or related websites, increased assistance is necessary which should have regard to individual circumstances.**

Keeping businesses up to date with tax changes

4.38 Unsurprisingly, businesses find it difficult to keep up to date with changes to tax legislation and practice, with 29% of TFC's sample stating this. It is unrealistic of HMRC to expect small businesses, and indeed most other taxpayers, to do so. Furthermore, those businesses which were actively trying to keep up to date told us that they were often thwarted by HMRC's

⁵⁵ <https://online.businesslink.gov.uk/bdotg/action/myBusinessTools?topicId=1082235004>

⁵⁶ Any such worksheet and associated guidance should concentrate on these current problem areas: travel, subsistence, use of home, telephones, internet, mobiles (including smart phones), private use of assets, computer equipment and consumables and capital items. It should also cover the issue of work in progress, accruals and prepayments as a prompt for businesses to consider these points as well. However, if the recommendations in our paper on simpler income tax are taken up, businesses on the simplified regime would need far less of such guidance.

approach to disseminating information and found it difficult to tell what they needed to know and what was not relevant.

4.39 HMRC relies very heavily on its website and BusinessLink to communicate information and it seems to expect businesses to browse its website regularly. This is not, in the view of the OTS, an appropriate or reasonable approach. HMRC should assist small businesses to keep up to date by signposting information which they need to know and signposting only that information which is likely to be relevant. This applies equally to other taxpayer sectors.

4.40 Many businesses were unaware of the facility to opt into email updates and reminders on the BusinessLink website and it is not clear to what extent the update service would be relevant to small businesses.

4.41 There is also an RSS feed facility to notify HMRC website changes, and the OTS suggests that HMRC explores to what extent that could be used to keep businesses updated better.

4.42 The “What’s New” section on the HMRC home page makes no attempt to categorise items, even on a very basic level. Updates on aggregates levy and excise duties will be scattered among those on income tax, child benefit and ring-fenced oil industry trades.

4.43 To make life easier for small businesses and others, the OTS recommends that “What’s New” items:

- are categorised so that businesses, individuals and others can quickly identify what may be relevant to them;
- always have a heading which give a clear idea of the subject matter and the tax or duty involved;
- include a short summary piece which expands and not simply repeats the title; and
- should explain the effect of changes with signposting to further help.

4.44 Most importantly, HMRC needs to do more to communicate changes to businesses in ways that will reach the businesses and will help the businesses to understand and implement the changes whether they have internet access or not. **We think a regular digest, perhaps monthly or quarterly, of relevant changes⁵⁷ would be welcomed if this was material that small businesses really needed to know.** The opportunity could also be taken to remind businesses about important deadlines and perhaps provide useful tax-related tips for small businesses. There is already an established employers’ update, so a similar format could be followed although as this is an internet only update, a similar approach for a small business update would exclude all those who do not have internet access.

Tailored support delivered through intermediaries

4.45 19% of businesses surveyed by TFC, mainly the unrepresented, would like their trade body and HMRC to work together to provide information and support. HMRC already works with The National Childminding Association (NCMA) and other organisations to provide joint guidance on tax matters. Feedback from childminders about this joint guidance was very positive and TFC’s research indicates that childminders are more likely to attend a workshop and training than other businesses and that they are more likely to find self assessment easy to deal with. Although it is not wholly valid to extrapolate from a single example, this does suggest that emulating this route more widely could be very helpful to businesses.

⁵⁷ For example if the disincorporation relief recommended by the OTS is taken forward this could be an ideal way to communicate the availability of the relief to those that are most likely to benefit.

4.46 Considerable benefits can be achieved by working in this way:

- guidance on keeping records and allowable expenses can be made more business-specific e.g. for childminders, matters relating to trading stock can be ignored and practical ways of keeping records specific to childminders can be suggested;
- only tax changes relevant to the trade or business are highlighted and therefore are much more likely to be read;
- by working with an organisation that is at the centre of an existing network, it should be easier and less costly for HMRC to deliver tailored advice to businesses; and
- businesses can be reminded to focus on tax matters at the same time as they are researching other matters which are also important to their business e.g. those letting property to students may initially be concerned with meeting other obligations such as rules relating to fire precautions and overlook tax matters.

4.47 The OTS recommends that HMRC continues to identify those trade and business sectors that it knows are more likely to have difficulties with tax-related matters and works with trade bodies to provide appropriate, targeted and user-friendly advice.

5

Communication and improving the relationship between taxpayers and HMRC

Overview

5.1 Communication and improving the relationship between businesses and HMRC featured highly in all surveys carried out. As noted in paragraph 4.1, many small businesses experience fear and anxiety about their tax affairs and this may continue throughout the life of the business. Furthermore, many businesses and their agents are unhappy with the method, content and tone of HMRC's communication.

Email and other online communication

5.2 Businesses and their agents would like to be able to have two-way communication with HMRC by email with an expectation of a response from HMRC within a set timeframe. This was the most popular improvement suggested in all our surveys. **The preference is a facility to email named individuals within HMRC; we accept this may not be possible but businesses would, we think, be happy if there was a generic "smallbusiness@HMRC" email address to use.**

5.3 HMRC has advised the OTS that it is developing a new outbound email capability which is expected to better target small business needs and is planned to be working from April 2013. It is also piloting email with a number of agents (by 31 March 2012). We do appreciate HMRC's concern about security issues and therefore suggest that HMRC reviews the way in which other large customer service organisations such as banks deal with security and two-way email and, with the benefit of that experience, introduces trials of two-way email for other user groups including small businesses.

5.4 HMRC could also investigate other methods of online and electronic communication. For example, an online chat facility (instant messaging) might work well for non taxpayer-specific queries such as locating information on the website, although clearly it would be better for the website design to make this unnecessary.

5.5 The use of social networking, for example through an online forum moderated by HMRC experts, is another option that could be explored as a way of improving information and increasing tax awareness for small businesses.

Telephone

5.6 Businesses would like a reduction in the amount of time it takes to speak to an adviser⁵⁸, with many businesses⁵⁹ wanting a dedicated small business helpline. HMRC has reported improvements in telephone answering performance: between April 2011 and January 2012,

⁵⁸ From FSB survey results.

⁵⁹ TFC survey 37% would find this very helpful, 18% somewhat helpful.

73% of calls to the general enquiry lines were answered with average waiting times of just over 5 minutes⁶⁰. Time spent trying to contact HMRC could be put to better use running the business.

5.7 The OTS would like to see continuing improvement in the performance of the HMRC contact centres to help businesses resolve questions more quickly and easily. The crux of the matter here, and with postal communications (see below), is that the issue should be solved in a single contact. Having to call (or write) again to conclude a matter is inefficient for all. At the same time, all accept that not everything can be solved in a single call; in these cases, HMRC should commit to contacting the business or giving them a named contact to come back to.

5.8 Businesses have told us that even when they look at the HMRC website for information, they are not always confident that they have understood it and will telephone HMRC for reassurance. This uses time which contact centre staff could spend on taxpayer-specific questions which cannot be dealt with online. Given that businesses are not always able to find the answers they need on the website, **the OTS recommends the introduction of a dedicated small business helpline**. This could perhaps be addressed in a similar way to the Agent Dedicated Line (ADL). Calls to the ADL are, we understand, routed to more experienced staff in call centres. If a dedicated small business helpline was introduced, calls could perhaps be routed to those contact centre staff who have more experience with business tax matters.

Correspondence

Addressing the clarity and tone of communication

5.9 The OTS has heard from small businesses that they do not always understand correspondence that they have been sent by HMRC, although there seems to have been some gradual improvements according to businesses we surveyed (but some agents report the opposite). Poorly designed forms and poorly worded correspondence waste business time and may result in more contact with HMRC, with costs on both sides. This can be exacerbated by incorrect HMRC telephone numbers on the correspondence, which frustrates the business when trying to deal with the issue.

5.10 The evidence obtained by TFC for the OTS indicates that HMRC correspondence is often perceived to be very confrontational, particularly correspondence relating to outstanding tax liabilities. Businesses often receive letters that start with the premise that they have done something wrong rather than that something might be wrong.

5.11 Similarly, when enquiries are made into returns, penalties are mentioned from the outset, before any errors have been established, while references to repayments should an overpayment be found are not given equal weight.

5.12 In many cases the correspondence could be improved by more careful consideration of what the reader is likely to want to know and how they are likely to feel if they received that communication. The OTS understands that HMRC is making efforts to address both the clarity and tone of communication and the OTS has recently seen examples of well written letters. If this trend continues, it could help improve the relationship between HMRC and businesses, which would be of mutual benefit⁶¹.

5.13 Agents and businesses would like the ability to submit all forms and returns online but this facility needs to allow blank forms to be printed, partially completed forms to be saved and

⁶⁰ HMRC statistics for period April 2011 to January 2012.

⁶¹ The recent paper by the Behavioural Insight Team in the Cabinet Office gives the results of a number of trials on the effectiveness of different approaches to written communicating with taxpayers. See *Applying behavioural insights to reduce fraud, error and debt* available at: <https://update.cabinetoffice.gov.uk/resource-library/behavioural-insights-team-paper-fraud-error-and-debt>

forms to be emailed (for example to an agent) for review before submission. Those who do not use online services will still need to be able to submit forms on paper.

5.14 The OTS recommends that HMRC continues work on the forms, letters and statements which it sends to businesses to make them more taxpayer-focused, using language that is easier to understand and which is less confrontational.

Time taken to deal with correspondence

5.15 Agents in particular were unhappy about the time taken for correspondence to be dealt with. Current targets for dealing with correspondence⁶² do not appear to be in line with what would be expected from commercial organisations and it should be remembered that taxpayers have no choice over who they contact regarding their tax affairs, a point made frequently to the OTS. Delays in dealing with post lead to telephone calls chasing progress and/or further correspondence which impacts the speed with which other matters can be dealt with.

5.16 The OTS understands that HMRC is taking action to improve processing of incoming post and is also creating a tool to enable agents to ascertain expected response times⁶³. The latter, while not directly improving the time taken to deal with correspondence, will at least assist in managing expectations and should result in fewer progress-chasing calls for HMRC to deal with.

5.17 We also reiterate the need to aim for “single handling”, as referred to above (see paragraph 5.7), i.e. that the aim should be for HMRC to respond to the enquiry fully the first time. It can be irritating for businesses to find that only part of their enquiry has been answered and that they now have to chase the missing information, which often involves waiting for a follow-up letter to work through the postal process, resulting in further delays.

5.18 The OTS view is that **postal contact should not be the sole means of communication**, but whether by post, email or online, **the response should be timely and complete**.

Copy correspondence

5.19 Agents provide significant assistance to businesses and to HMRC by helping businesses deal with their tax affairs. Due to cost cutting measures, copies of most taxpayer correspondence are no longer sent to agents and, as a result, the agent is often unaware of correspondence that has been sent to the taxpayer.

5.20 Agents raised the issue that they were engaged in order that the client would not have to get involved in tax administration. Clients often overlook paperwork from HMRC, not least because they assume that their agent has also received the correspondence and will be dealing with it.

5.21 Although individual coding notices, tax statements, liabilities and payments are currently available for agents to view online, no alert is issued to the agent when a coding notice or statement is issued, so this is of no practical help unless the agent visits each client’s online record every day.

5.22 Some agents would like to be able to opt to receive paper copies of certain correspondence. Similarly, many clients of agents would be happy to opt for a single notice to go to their agent rather than themselves, if it is only possible for one copy to be sent, although we accept this raises issues about HMRC obligations to notify the taxpayer which will need addressing.

⁶² HM Revenue & Customs aims to deal with 80% of Income Tax and National Insurance correspondence for individuals within 15 working days and 95% within 40 working days. <http://www.hmrc.gov.uk/yourquestions/targets-correspondence.htm>. HMRC evidence to the Treasury Select Committee shows that they handled around 22 million letters and forms in 2010-11.

⁶³ See <http://www.hmrc.gov.uk/news/hmrc-service-del.htm>

5.23 The OTS recommends that an email alert which identifies the client and the type of correspondence is sent to agents when correspondence has been issued to a client and that HMRC explores agents being able to receive correspondence in place of their client.

Correspondence tracking

5.24 It imposes costs on taxpayers, agents and HMRC when HMRC advisers are unable properly to track previous conversations and correspondence with the taxpayer. Conversations have to be repeated and/or correspondence re-sent. When issues are complicated or will take some time to resolve, matters become worse because the taxpayer or agent needs to make contact each time with the contact centre rather than the person dealing with the issue. Complex situations do not arise frequently, but when they do it is enormously frustrating and wastes time for the businesses, agents and HMRC.

5.25 We can also see time and cost saving benefits in providing online access, for example through the Tax Dashboard, to notes of conversations so that HMRC, businesses and their agents have evidence of what was discussed. However, we recognise that there would be significant cost implications and this would not be as high a priority as other suggestions.

5.26 The OTS suggests that matters could be improved by:

- allocating a named contact to take responsibility for ensuring particular issues are dealt with to conclusion; and
- better tracking of, and access to, correspondence using unique referencing and, ideally, by providing access for contact centre staff to scanned copy correspondence.

Converting feedback into improvements

5.27 There currently seems to be no formal process by which businesses can suggest to HMRC ways to improve their interactions. **We recommend that HMRC considers ways in which businesses, agents⁶⁴ and its own staff can make suggestions to improve matters relating to the interaction of businesses with HMRC.**

5.28 Equally importantly, feedback should be actively sought by HMRC on improvements made to ensure that they meet the needs of businesses or whether further change is needed.

⁶⁴ Agents do have processes through "Working Together", which is a joint initiative between agents and HMRC which provides a forum to raise operational issues and problems.

6

Providing certainty (including finality and closure)

Overview

6.1 Survey evidence found that businesses experience an underlying fear of getting things wrong when dealing with their tax obligations, with nearly 50% of the small businesses questioned worrying that they have made a mistake on their forms, even though they kept good records and took care when completing them.

6.2 When a small business wishes to raise a question with HMRC, it is entitled to expect clear and simple answers, on which it can rely in order to meet its tax obligations.

Businesses experience on certainty

6.3 Some 23% of businesses surveyed by TFC experienced difficulty obtaining a definitive answer from HMRC, with 30% having difficulty making sense of the answer and only 45% having confidence in the answer received. There is also evidence of different answers being received to the same question.

6.4 This can cause significant frustration for the business, with the likely result of increasing their reliance on professional advisers when they may prefer to keep control themselves.

6.5 The OTS recommends a review of the training provided for HMRC staff with a view to improving the quality of their answers so that businesses may have confidence in the information provided. Ownership of complex issues by a particular individual, recommended in Chapter 5, could also help here. The OTS recognises that there will be costs to HMRC for this recommendation but considers that this, coupled with better tracking of correspondence, would help reduce time wasted on follow up calls, and thus reduce costs for HMRC.

VAT questions

6.6 A particular issue seems to be obtaining confirmation of the VAT status of a new or unfamiliar product. We were often told that attempts to get advice were simply met with an instruction to refer to the HMRC VAT guides. There is every chance that the business, and/or its adviser, has already done that and the call is prompted by the fact that the guide does not cover, or does not seem to cover, the point. Such an enquiry can be a serious matter for a small business which needs to know how to price a product or service.

6.7 The OTS believes HMRC needs to be able to give clear guidance on such enquiries, which can be relied on by the business. We recognise that HMRC will be concerned about advising when it may not have been given full facts. This can be addressed by HMRC writing to the business to set out its understanding of the facts and the ruling and explaining that if the facts as understood are wrong in any way the ruling may be invalid, in which case the business should apply for a revised ruling.

6.8 If the VAT treatment of the supply is queried later, the business will have a ruling on which to rely. If HMRC changes its mind about something on which it has ruled, any change should only apply from the time that the change in view was communicated to the business. Thus the business gets protection and certainty.

HMRC rulings

6.9 In the OTS Small Business Review interim report, a recommendation was made for a rulings service to be introduced to provide certainty to business on areas of difficulty. The VAT issues raised above would be an example and whether the prospective purchase of fixtures and fittings would qualify for capital allowances would be another.

6.10 The legislation provides for a number of statutory areas where HMRC offers a clearance procedure. Additionally, a non-statutory business clearance procedure is available from HMRC where there is material uncertainty around the tax outcome of a real issue of commercial significance to the business itself⁶⁵. This will not cover tax advice nor the effectiveness of tax planning schemes and small businesses should not expect that.

6.11 This service is very useful to advisers but unrepresented small businesses seem to be unaware of it. It is unclear from the HMRC website page whether the service would cover the two examples listed in paragraph 6.9 above. **The OTS recommends that the service should be better advertised to businesses** and be clearer in setting out the scope of the service and the alternatives available where the issue concerned is outside its scope.

HMRC enquiries

6.12 Enquiries are a necessary policing tool for HMRC to protect tax revenues. However, enquiries can cause significant stress for businesses over quite long time periods⁶⁶.

6.13 Linking in to HMRC's new Single Compliance Process⁶⁷, **the OTS recommends the introduction of a timetable for settlement to be discussed on opening an enquiry and that this should be reviewed quarterly.**

6.14 Penalty rules⁶⁸ include the option of suspended penalties for careless errors provided that conditions for improvement can be agreed with the taxpayer. These provide an excellent tool for encouraging businesses to get things right in the future.

6.15 The OTS has found evidence that HMRC officers are not always following their guidance and look for reasons not to suspend penalties, rather than seeking conditions for agreement to suspend. We understand that by around April 2012 all HMRC staff will have attended training in this area which it is hoped will resolve this issue. **The OTS recommends that HMRC makes checks to ensure that penalties have been suspended where appropriate.** Given that the new penalty regime was introduced between April 2008 and April 2009, the OTS believes that this training should have been more timely and issues such as this should be part of the review recommended in paragraph 6.5.

6.16 We think there is a need for a general review of HMRC enquiry and discovery powers. **A point made to us regularly by small businesses and their advisers is their desire for certainty and closure.** They want to know that they have settled their tax liability for the year in question and can move on. At the same time, all parties accept the need for HMRC to have enquiry and discovery powers to police the self assessment system.

6.17 There is a balance to be struck here and the best way forward is probably a formal review, particularly of discovery powers, as part of the ongoing review of HMRC powers. We hesitate to make specific recommendations ourselves given the limited work we have done in this area and the complex nature of the issues involved.

⁶⁵ <http://www.hmrc.gov.uk/cap/links-dec07.htm>

⁶⁶ In the OTS survey of PCG members, 18% of those who had been through an HMRC enquiry said that it lasted more than 12 months.

⁶⁷ <http://www.hmrc.gov.uk/news/scp-120202.pdf>

⁶⁸ FA 2007 schedule 24 paragraph 14.

7

Reducing the burden of fulfilling specific taxpayer obligations

Tax payment allocation errors

7.1 Businesses and agents report that considerable difficulties arise where, for any reason, tax payments are misallocated. It can affect the amount of money that is available to the business, and this loss of liquidity can lead to commercial difficulties. TFC data shows that 8% of businesses surveyed reported this is one of the three biggest problems that they face, while the proportion was higher for businesses with higher turnover and those that are incorporated. 60% of agents felt that they should be able to reallocate payments on behalf of a client, and nearly half felt that there should be a single reference number for all of a business's tax payments.

7.2 Misallocation can occur as a result of HMRC auto-allocation (for example when PAYE payments are made earlier or later than usual) or can be the result of the taxpayer using the wrong payment reference. The misallocation can be within a tax to the wrong period (eg PAYE, corporation tax) or across taxes when payments are sent to HMRC with the wrong payment reference. In some cases the payment can be credited to the wrong taxpayer.

7.3 Reallocation between different taxes seems to be particularly difficult and time-consuming to arrange, if it can be done at all, causing additional stress to taxpayers and unnecessary contact with HMRC. In many cases the taxpayer is being threatened with penalties and aggressive debt collection processes on one head of tax when the payment is being held as an overpayment on another tax.

7.4 The OTS recommends that HMRC should introduce arrangements which make it easier for taxpayers to arrange for payments to be re-allocated correctly⁶⁹. Ideally taxpayers should be able to do this online themselves. Similarly, a single tax account covering all taxes could be a good solution. The OTS recognises that there will be many technical and practical issues to be worked through, such as how penalties and interest will be dealt with.

7.5 In the meantime HMRC should introduce, as a matter of urgency, arrangements to make reallocation of tax payments easier and less time-consuming for taxpayers, agents and HMRC to deal with. We believe that in the short term the best way forward would be to introduce a structured email, together with associated streamlined HMRC working procedures for the reallocation process so that it is dealt with swiftly and efficiently. For those without internet access, staff at contact centres should be enabled to complete the structured email on behalf of callers.

VAT stagger dates and Flat Rate Scheme

7.6 Currently businesses are allocated a "stagger date" (the quarterly VAT return periods) when they register for VAT. They can choose to have this changed by writing in after the initial allocation is made and many businesses choose to do this so that the stagger date coincides with the business accounting period end. Some businesses are unaware of this option which could make matters easier for them. The current process means that both the business and

⁶⁹ We understand that this will be considered, for agents, as part of the "self serve" element of HMRC's Tax Agent Strategy initiative.

HMRC are involved in changes, which would be unnecessary if the stagger date choice was part of the registration process.

7.7 Similarly, if businesses wish to use the Flat Rate VAT Scheme (FRVS) from the date of registration they have to apply on a separate form, ideally after they have received their VAT registration number. This process seems an unnecessary extra step for small businesses, which could in our view become part of the VAT registration process.

7.8 In the case of both stagger dates and the FRVS, applying for both as part of the registration process and having both in place from the date of VAT registration is a simplification, which would provide benefits both to businesses and to HMRC. Furthermore, it would raise the profile of the FRVS scheme for new small businesses which might otherwise be unaware of it.

7.9 The OTS recommends that when a business applies for VAT registration, as part of the registration process, the business should be able to choose, if it wishes, the stagger date for its VAT returns and also to indicate that it would like to use the VAT Flat Rate Scheme. The OTS understands that this change will be incorporated into the new VAT online process from the autumn, but recommends this should similarly apply to paper registrations.

Nil PAYE returns

7.10 Some employers find it a burden to have to report periods in which no PAYE tax is due (“nil PAYE returns”)⁷⁰. Furthermore, if such a report is not made, employers can be pursued for estimated amounts of PAYE tax and national insurance which they are told are overdue but which they do not recognise and which are not stated in correspondence to be “estimated”; penalties may also arise. This causes confusion, worry and unnecessary contact with HMRC and unnecessary burdens on business generally. We can understand that HMRC needs to know a business’s PAYE position but greater regard is needed for the position of the smallest businesses which may not need to make PAYE tax payments to HMRC every month or quarter.

7.11 One route that may help is to set up a facility for businesses to notify that there will be no PAYE tax due in the following period.

7.12 The OTS recommends that HMRC should as a matter of urgency review the wording of the notices that are sent to businesses that have not made PAYE tax payments, to make it clearer:

- what is being sent is an estimate, because no PAYE tax payment has been received;
- how the business can displace this estimate; and
- a helpline number.

7.13 There is a “nil PAYE return” submission facility on the HMRC website but this still takes time and requires the employer to have internet access and to have their PAYE Accounts Office reference to hand. Consequently, the OTS recommends that HMRC consider whether it is really necessary for employers to submit nil PAYE returns.

Paying tax

7.14 Some businesses have commented that they find the process of paying tax unnecessarily burdensome and, in some cases, lacking in certainty. Some question why HMRC seems to make it so difficult to pay tax and comment on the myriad of references and numbers they need to use. When asked for a single idea of their own to improve tax administration, 12% of small

⁷⁰ In the OTS survey of tax agents, two-thirds of respondents marked “Not having to submit nil payment notifications for PAYE each month when nothing is due” as one of the three most important suggestions for reducing administrative burdens. This was the most popular of the suggestions put forward in the survey.

businesses surveyed on behalf of the OTS responded with suggestions around making it easier to pay HMRC.

7.15 We believe improvements could be made to simplify matters for businesses, save them time and improve their confidence in using the systems in place. We understand HMRC's desire to receive payments electronically and discourage cheque payments by post but many small businesses do not wish to, or have the facilities to, use online banking⁷¹. HMRC procedures clearly have to have regard to HMRC's needs, but these need to be tempered with the burdens they place on business and in particular with an appreciation of the way many small businesses operate.

7.16 The OTS has the following recommendations:

- 1 **A facility to obtain bank giro payslips.** The OTS has heard from businesses and agents that although HMRC attaches bank giro payslips to return and payment reminders, if these go astray for any reason it is no longer easy for businesses to pay their taxes by cheque or cash at a Post Office or bank. The payslip which HMRC does make available online can only be used to send a cheque by post to HMRC. We have been told that it would not be possible to enable businesses to print a copy bank giro payslip due to bank recognition requirements. Taxpayers must therefore call HMRC to ask to be sent a duplicate. **We recommend that a facility should be provided on the HMRC website so that duplicate bank giro payslips can be requested for taxpayers using a single click box.** Ideally this should be from the taxpayer's records so it is pre-printed with the taxpayer reference.
- 2 **Overhaul the payments screens which businesses see when they make online payments.** We have heard that many of the screens seen during the payment process are confusing or have inappropriate text given the route by which the business reaches the page. For example, the "direct debit" pages are aimed more at someone making regular payments and thus confusing for those who are trying to make a single payment.
- 3 **Facilitate the payment of tax once a return has been submitted,** for example by having a direct link from the page which confirms that the return has been submitted, rather than having to access another part of the HMRC website to arrange payment.
- 4 **Providing email acknowledgements of payments made.** Businesses told us that they want the certainty of knowing that a payment has been received safely by HMRC; this is particularly the case close to the deadline for payment. They receive a timed acknowledgement when making tax returns or paying using the HMRC Billpay facility, but not when making tax payments through the banking system, for example using online banking. As it can take several days for the HMRC website to update to show receipt of a payment made through the banking system, businesses often call HMRC to ensure a payment has been received safely. Some businesses would ideally like an immediate acknowledgement when HMRC receives their payment. We appreciate that there are cost and practical implications to providing this and recommend that HMRC explores ways in which it can provide timely reassurance to taxpayers.
- 5 **Remove the requirement to re-input user ID and password when making payments.** Currently businesses log in by entering their user name (which is not one they are

⁷¹ TFC research showed that 12% of those surveyed do not use internet banking. This was significantly more likely to be true for business owners who are over 55 than it was for those between 18 and 24.

able to choose and is therefore difficult to remember) and their password to make a payment. They are then required to re-enter this information immediately before paying. This seems an unnecessary and irritating step given that security has already been passed.

- 6 **The OTS additionally recommends improved guidance on what evidence is acceptable as proof that a tax payment has been made.** This should cover proof of posting a payment and also proof of all other methods of payment.

Accounting period on business start up

7.17 During our research, businesses and their agents commented that where an unincorporated business uses an accounting period end which is not 31 March or 5 April, dealing with self assessment returns and overlap relief is more complicated and not well understood.

7.18 The OTS recommends that HMRC makes the default period end for a new unincorporated business 31 March or 5 April. This would be particularly helpful to many unrepresented taxpayers who tend to find dealing with overlap relief and apportioned profits difficult. We recognise that some businesses, on the advice of their adviser or for commercial reasons, may wish to choose another period end and this should, of course, be permitted. However, such businesses should be made aware that this could make their tax return more complicated to complete.

7.19 We acknowledge that the position of incoming partners can similarly be difficult, and commercial reasons may make it less easy to accept a 31 March/5 April period end.

Forms P11D

7.20 Forms P11D⁷² seem to be a particular problem area for businesses⁷³. We were regularly told that completion of the forms is onerous, although this is more a result of the underlying work needed to arrive at the figures to enter on the form than the actual completion of the form.

7.21 P11D dispensations⁷⁴ are available to reduce the work for businesses but many eligible businesses do not apply for them and those that do may not have had them updated for many years. There is also evidence that businesses are not always aware of whether a dispensation is in force for certain stated expenses.

7.22 The OTS recommends that HMRC should review the form P11D and underlying guidance to ensure that it is relevant to the issues that face employers today. Through discussion with those that complete the form, HMRC should identify how the guidance and the layout and boxes can be improved to make it easier for employers to complete. Consideration should be given to introducing, alongside an improved P11D, a “simple” (or “short”) version of the P11D, which includes the three or four most common items.

7.23 Given that in the vast majority of cases inclusion of reimbursed expenses on a P11D has no effect on an employee’s taxable income (because a claim is made for the reimbursement to be treated as a tax-deductible expense), **the OTS also recommends that reimbursed expenses should not be included on the P11D.** Completing the forms creates a significant additional administrative burden on employers and on HMRC. Furthermore PAYE codes generally need to

⁷² Employers are required to make a return to HMRC (form P11D) of expenses reimbursed to directors and to employees earning more than £8,500 a year. Details of benefits provided e.g. company cars and medical insurance must also be included on the form.

⁷³ TFC survey showed that for those completing P11Ds, 28% find it difficult. This was higher than for NICs, income tax self-assessment, VAT, corporation tax and PAYE. There was no statistically significant difference between those that use an agent for P11Ds and those that do not.

⁷⁴ Where the reimbursement of expenses should not give rise to a tax or NICs liability and provided certain conditions are met, employers can ask HMRC to issue a P11D dispensation. This means that they do not have to provide details of the reimbursed expenses on form P11D.

be revised at least twice each year because the reimbursed expenses and the corresponding claims are processed independently of each other. This often causes what should be unnecessary contact between the employee and HMRC.

7.24 Our suggestion for implementing this change would be **to make the default position one where all employers are deemed to have a dispensation for reimbursed expenses**. HMRC could then deal in different ways with those employers from which it will need further information.

7.25 An alternative approach to the issue of expenses on P11Ds might be to allow the claim for the expenses to be included as part of the P11D process because in most cases the employer will be aware of the need for the claim.

7.26 We have considered whether small businesses should be allowed more time to complete P11Ds. Given the needs of both HMRC and employees for the information contained in the forms, we are not persuaded this is necessary.

7.27 Although the legislation allows a window of time to correct errors on form P11D, it is not possible to amend them online. The OTS recommends that amending P11Ds should be brought in line with other PAYE forms and returns so that amendments can be made online.

7.28 Our other recommendations in connection with P11Ds are that:

- HMRC should be more proactive in suggesting P11D dispensations to small employers and in explaining what is involved and making the application procedure as simple as possible;
- HMRC could usefully publish a list of common P11D errors and problem areas; and
- it is in the interests of both the business and HMRC that a P11D dispensation is reviewed and reconfirmed every (say) five years.

VAT: international trade issues

7.29 VAT on international trade was an issue identified in our interim report and is therefore an area that the OTS has investigated further. We have regularly heard that small businesses are far more likely to be involved in international trade than used to be the case, for example by trading over the internet. Such activities may only be occasional, but it does mean they often have difficulties understanding the VAT implications of selling goods or providing services internationally⁷⁵.

7.30 The problems faced by small businesses in this area seem to be exacerbated by the inability of these businesses to get a definitive response to their questions from either the HMRC VAT Helpline or the HMRC website. The issues fall into two broad categories:

- 1 Do I have to charge VAT on this supply and, if so, what is the correct rate of VAT?
and
- 2 What do I have to do regarding VAT registration and compliance in the other country?

7.31 We have heard that the uncertainty and practical difficulties faced by these businesses are a real barrier to expanding their businesses. The costs of getting things wrong can be considerable and uncertainty causes worry. We accept that the range of possible questions can be extensive

⁷⁵ Although such businesses will usually have external advisers, often they will not be engaged to assist with VAT. Additionally, many advisers will have little knowledge of international VAT matters. The fact that these issues only arise occasionally make them even more difficult for a small business to resolve.

but we do not think that should preclude the Government from making relevant assistance available.

7.32 The OTS recommends that guidance on VAT on international business is improved so that most small businesses can obtain the answers to their questions with certainty in language that they can understand. This will be a significant task and is not necessarily one for HMRC alone. However HMRC is the obvious channel to disseminate information. Indeed, there needs to be a “joined up” approach to this issue across relevant government departments.

7.33 The aim should be that there is an easy route for a small business to find help with the question “I am making my first sale/purchase internationally. What VAT implications arise and how do I ensure I am dealing with it correctly in the UK and in country X?” There have been recent improvements on the HMRC website to help with this question but more needs to be done so that businesses can be certain of the right answer.

7.34 The OTS also recommends that HMRC provides more guidance to those businesses who may need to be registered abroad to help them find the right points of contact in the overseas authority. There has been a recent update to the HMRC website to provide a link to information on VAT in EU states but again, this is not as helpful as it could be. We think that HMRC should, perhaps as a joint project with the other tax authorities across the EU, or via the European Commission, aim to produce a guide to such contacts and to VAT registration thresholds and rates in other EU states. In addition, we think that there should be a standard enquiry form for a business to complete when requesting guidance. A common form and approach would surely help all those involved. Clearly we recognise that this would be a major undertaking but if small businesses are to compete in the international market they will need this information which they tell us is not currently readily available.

Class 2 national insurance contributions (NICs)

7.35 As noted in the OTS’s interim report, it could save HMRC and small unincorporated businesses costs if the class 2 NICs were brought within the self assessment process in the same way as class 4 NICs. Given the contributory principle behind class 2 NICs and the delay before the SA return is submitted and the tax and NICs paid, it appears that some form of “deeming” provisions would be needed so that those who are registered self-employed are deemed to have paid the contributions.

7.36 Our research indicates that understanding and paying class 2 NICs is not an issue which gives much difficulty⁷⁶ but we still believe that, although not a priority, there could be simplification and cost reductions for HMRC and small businesses in looking at combining the collection process as part of the SA return.

7.37 We appreciate that this area may be covered in the current project looking at combining the operational aspects of PAYE and NICs.

National insurance deferment applications

7.38 Where an individual has both employment income and self-employment income they may pay more than the maximum NICs in a tax year. When this happens the overpayment should be identified automatically by HMRC some time after the self assessment return is filed. Alternatively, the individual may apply for a refund although it is not uncommon for people not to realise that they have overpaid.

7.39 Rather than paying contributions directly (class 2), through PAYE (class 1) and through SA (class 4) and then applying for a refund after the tax year end, individuals can apply to defer

⁷⁶ Approximately 50% of those in TFC’s survey found paying PAYE and NI easy.

class 2 and class 4 NICs until the liability for the year can be accurately calculated. This is a paper-based process involving the taxpayer completing forms in advance of the tax year.

7.40 Where the expected self-employment income is less than a certain amount, the individual cannot apply for deferment but must instead apply for a small earnings exception. If earnings are then above the estimate, class 4 NICs may be overpaid. It is the view of the OTS that, rather than have a separate process for those in these circumstances, taxpayers should be able to deal with their class 2 and class 4 national insurance contribution liabilities as part of the SA return process and not need to either estimate their income in advance or apply in advance for deferral.

7.41 The OTS recognises that the numbers affected⁷⁷ may not warrant the cost of implementing the scheme although the number of those in this situation is likely to increase given changes in working patterns. We therefore suggest as an alternative that:

- the applications for deferral should no longer need to be made annually but remain in place indefinitely, or for a number of tax years before needing to be renewed. This would relieve the small unincorporated business of an administrative burden and save HMRC costs;
- the deferral process can include also those who may have lower earnings and not just those who exceed the small earnings exception threshold. In this way those with both self employed and employed earnings who may overpay NICs as a result, will not have to concern themselves with the actual level of their self employment income or use different forms in different years; and
- consideration is given to converting the process to an online one.

7.42 Again, we accept that this issue may be subsumed into the PAYE/NIC integration project.

Agent authorisation procedures

7.43 OTS research indicates that agents (and their clients) still find that agent authorisation procedures (form "64-8") do not meet their needs. The OTS is aware that HMRC is working with the professional bodies on this issue and therefore makes no specific recommendations other than to endorse the need for this to be improved.

7.44 In brief, the problems cited to us include:

- authorisations disappearing from taxpayer records;
- long delays in processing forms 64-8 for non-self assessment cases;
- lack of online forms 64-8 for non-self assessment cases;
- online form 64-8 application not dealing with all heads of tax or tax credits;
- difficulties over having two or more agents authorised (whether for different or overlapping areas); and
- difficulties over appointing an agent for a particular period or problem.

7.45 By 31 March 2012, HMRC has committed to "improving the processing of forms 64-8. This will include a review of the end-to-end process, starting at the agent's office and the type of form used, through to where the forms are sent to, and how quickly they reach the correct destination for processing." This is part of the Joint Initiative on HMRC Service Delivery⁷⁸.

⁷⁷ HMRC figures indicate that the number of deferrals for class 2 and class 4 NICs were 35,918 in 2009/10, 35,204 in 2010/11 and 29,694 in 2011/12.

⁷⁸ <http://www.hmrc.gov.uk/news/hmrc-service-del.htm>

8

Conclusions and key recommendations

Overview

8.1 The overriding message emerging from the extensive surveys undertaken on behalf of the OTS is the need for HMRC to strengthen support to small businesses, particularly in the early years. By targeting support at the time of registration and until the first tax return has been filed and the tax paid, small businesses will be better equipped to deal with their obligations. This in turn should lead to businesses having greater confidence in tax matters, better tax compliance from the outset and also improve relationships between businesses and HMRC which will continue to benefit both over the lifetime of the business.

8.2 Chapter 4 outlined new HMRC initiatives aimed at new and existing businesses, including:

- My New Business: tax and other guidance, information and tools for new businesses;
- Online Tax Registration Service: registration for main business taxes in a single visit;
- Business Tax Dashboard: ability to view liabilities and payments for four main business taxes;
- targeted help through online webinars; and
- extension of the current small scale outbound educational email facility.

8.3 However, the message from small businesses is that they are not made aware of this help and guidance. For example, sometimes there is a link to the My New Business guidance from the HMRC homepage but there is not a permanent link. The OTS recommends that the new single Government domain project⁷⁹ addresses this current disconnect between the very useful information that has been developed by HMRC and the potential business user.

8.4 The OTS recommendations are set out in detail in Chapters 4 to 7 of this report. Addressing this information disconnect is seen by the OTS as a priority. It would bring immediate benefits both for business owners who will waste less time searching for answers to questions (enabling them to concentrate on running the business) and to the Exchequer, which would benefit from better compliance and less need for costly involvement later.

8.5 The OTS recognises that although it should be possible to introduce some improvements in a relatively short timescale, others will involve major costs or take longer to implement for other reasons, particularly technological. The OTS has therefore divided the recommendations between those that:

- may be implemented in the short term, bringing about early administrative improvements for small business;
- must await the introduction of the new single Government domain; and

⁷⁹ For further information see: <http://digital.cabinetoffice.gov.uk/>

- will take longer to implement, but it should be emphasised that these are equally crucial to the needs of small businesses.

Recommendations for early implementation

- Proactive provision of the guidance, tips, and tools that are available to assist small businesses, starting at the time the business registers, and including those without internet skills or access (paragraphs 4.7 to 4.14);
- introduce two way email communication between businesses and HMRC, with response times within a set timeframe; of the suggestions listed in each survey, this was the most popular improvement for dealing with HMRC (paragraph 5.2);
- targeted and personalised updates on tax changes and on relevant events in the annual tax calendar. If this is taken forward as an email initiative, equivalent support will be needed for those without access to email (paragraph 4.33);
- extend the current initiatives on tailored support through intermediaries and encouraging more trade bodies to be included in the programme (paragraphs 4.45-4.47);
- introduce default accounting period end of 31 March (or 5 April), with the option to choose another date (paragraphs 7.17-7.19);
- facilitate reallocation of tax payments e.g. through use of structured email (paragraph 7.5);
- improve awareness of the business clearance facility and clarify when small business may use it (paragraph 6.11);
- extend business clearance to improve coverage of VAT questions and incorporate written confirmation of rulings (paragraph 6.7);
- allow all forms and returns to be submitted online but include also provision to save part completed forms and to print forms before (as well as after) submission (paragraph 5.13);
- undertake more work to make language on forms, letters and statements more taxpayer focused, easier to understand and less confrontational (paragraph 5.14); and
- change the VAT registration procedure to allow choice of stagger date and immediate use of the flat rate VAT scheme (paragraph 7.9).

Recommendations for improvements linked to the introduction of the single Government domain (and improving the HMRC website)

- General improvements to web-based guidance including:
 - improvement of the search function (paragraph 4.16);
 - displaying “What’s New” by subject area (paragraph 4.43); and
 - improved layout of FAQs where still available on the HMRC website (paragraph 4.20);
- introduction of panels, forums, webinars and workshop training, and actively encouraging new businesses and those who have made compliance errors or appear to have problems with their tax obligations to take advantage of these (paragraph 4.32);

- email notifications to agents when correspondence is issued to clients (paragraph 5.23);
- removal of need to submit nil PAYE returns (paragraph 7.13);
- improve tracking of correspondence and introduce facilities to view more correspondence online (paragraphs 5.25 and 5.26); and
- on payment of tax (paragraph 7.16):
 - overhaul payment screens to make them easier to understand;
 - introduce online facility to request personalised Bank Giro Payslip;
 - facilitate payment at the point of Self Assessment return filing;
 - introduce email acknowledgement of payments received by HMRC; and
 - review need to re-input user and password when making payment.

Recommendations for improvements necessary in the longer term

- Improve telephone waiting times and introduce a dedicated small business helpline (paragraph 5.28);
- improve HMRC staff training, to achieve:
 - accuracy and consistency of, and confidence in, information provided (paragraph 6.5); and
 - a less confrontational tone (paragraph 5.14);
- introduce a timetable for enquiry work settlements and increase the use of suspended penalties (Chapter 6), perhaps linked to the single compliance project (paragraph 6.13);
- review national insurance processes for the self-employed to:
 - include the collection of class 2 and class 4 NICs as part of self assessment (paragraph 7.35); or
 - remove requirement for annual class 2 and 4 NICs deferment applications and small earnings exception applications for those with class 1, 2 and 4 earnings which would result in overpayment of national insurance (paragraph 7.41);
- introduce an arrangement whereby businesses with a complex or involved tax issue can deal with one named person at HMRC (paragraph 5.26); and
- review forms P11D to:
 - consider whether reimbursed expenses could be excluded from the form (paragraph 7.23);
 - consider whether employee expense claims should be included on the form (paragraph 7.25);
 - improve guidance notes on completion of the form (paragraph 7.22);
 - proactively encourage the use of dispensations (paragraph 7.24);
 - enable amendments to be submitted online (paragraph 7.27); and

- consider introducing a simplified, short version of the form for some users (paragraph 7.22).

Conclusion

8.6 HMRC is developing a number of initiatives that can offer the improved and targeted support that small businesses need. However, the message is that businesses are not being made aware of many of them and that this would be particularly beneficial to businesses in their early years. HMRC's priority should be to ensure that information on tax is clear, relevant, readily accessible and timely.

8.7 The OTS has identified other areas in which improvements can be made to the administration of the tax system for the benefit of businesses and HMRC. Some will have more limited impact but nevertheless will improve the interaction of some businesses with HMRC and thus be worthwhile.

8.8 Using the resources it already has, HMRC has an excellent opportunity to build good relationships with businesses, help them cope with their tax obligations and increase their confidence and satisfaction with the tax administration system. We think that the benefit to HMRC of the approaches outlined will be to enable better targeting of its resources.



Improving small businesses' experience of the tax system – terms of reference

The Office of Tax Simplification's interim report on Small Business Taxation highlighted a number of areas where the administration of the tax system could be improved to benefit small business and in particular to provide clearer communications and greater certainty.

Small businesses play an important role in the UK economy and the Government wants to make it as easy as possible for them to comply with their tax obligations and minimise the administrative cost and burden of doing so.

As part of the second stage of the review of small business tax, the Government is asking the Office of Tax Simplification to take forward this part of its work and produce a further report that:

- examines and presents small businesses' experience of tax administration and their interaction with HMRC at key stages of their annual cycle, together with specific consideration of the issues involved in starting a new business;
- documents the areas businesses find most problematic and frustrating, including an assessment of the time and costs involved;
- considers the barriers that prevent them from getting certainty in their tax affairs;
- develops a range of specific interventions to address these problems; and
- considers all relevant taxes within this project.

Reflecting the operational impact of any recommendations, and HMRC's shared interest in improving the administration of the tax system for small business, OTS will work closely with HMRC in developing its evidence base and recommendations. It is envisaged that OTS will commission a survey or external research to support this work, and will meet with small business and their advisers directly.

In particular, the project will focus on:

- both the smallest businesses (particularly the unincorporated and those not represented by agents) and larger ones represented by agents, to see if different solutions are indicated;
- the end to end journey of businesses' interaction with the tax system, sources of complexity and how the taxpayer experience can be made more simple;
- HMRC's channels of communications with these taxpayers and their agents where they are used;
- the clarity of information received by taxpayers and whether further steps could be taken to provide greater certainty;
- where there are specific points in HMRC's processes that are a source of common error or concern, and how these can best be tackled; and

- the burdens associated with providing HMRC with the information required under the law.

This project will form part of the OTS's final stage work on small business taxation. Recommendations will be set out in a report submitted to the Chancellor of the Exchequer ahead of Budget 2012.

These recommendations should be focused on the administration of the tax system and should have regard to:

- HMRC's existing programmes of work to improve tax administration;
- risk of non-compliance and avoidance opportunities;
- requirements placed on small businesses by other parts of government and any scope to align reporting requirements; and
- the Spending Review resource constraints on HMRC.

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

- a wide range of survey evidence, modelling and taxpayer data;
- a framework and criteria for deciding how to evaluate problems and solutions;
- critical analysis of feedback from taxpayers and stakeholders;
- comparisons with overseas tax systems; and
- recognition that different parts of this business population are affected in different ways.

B Evidence gathering for the small business review

B.1 The OTS team has heard a wide range of views while developing this report. A key part of our ethos has been to meet with as many people and groups as possible and put the question of simplification to a wide variety of audiences. As part of this, we have continued to travel across the country to meet with businesses and their advisers, building on the meetings that were held in the run up to the interim report⁸⁰.

B.2 We also published discussion papers on *Simpler income tax for the smallest businesses*⁸¹ and *Disincorporation relief*⁸², and received feedback on these documents that has been reflected in the final reports published alongside this paper.

B.3 Several pieces of quantitative research have been produced, and a brief outline of these is included below. Relevant findings have been included in the main body of this paper, and referenced accordingly.

Research by The Futures Company⁸³

B.4 In September 2011, the OTS and HMRC commissioned The Futures Company (TFC) to conduct a research project to inform the OTS's review of small business. This builds upon existing research work held by HMRC. The key objective in this research was to target the very smallest businesses, as their views are acknowledged as being the hardest to obtain. In 2007-08, there were over 3 million unincorporated businesses with turnover below £70,000 in the UK⁸⁴.

B.5 The prior assumption was that very small businesses will differ in terms of their requirements on tax administration (and tax policy more generally). This has been borne out in the research findings.

B.6 In the qualitative phase, group discussions were held with businesses, advisers and HMRC frontline staff. A number of in depth interviews were also held with businesses to map out their interactions with HMRC and identify potential sticking points. Based on the findings in the qualitative phase, a questionnaire for quantitative research was developed.

B.7 Over 1,100 businesses were sampled in quantitative work: over 50% of these businesses had turnover below £30,000 per annum, and the entire sample had turnover below £1 million per annum. The vast majority were unrepresented and had fewer than two employees. Approximately 90% spent less than £1,000 per annum on complying with their tax affairs. The sample represented a wide range of regions and business sectors (see chart B.1).

⁸⁰ See Annex F of http://www.hm-treasury.gov.uk/d/ots_small_business_interim_report.pdf

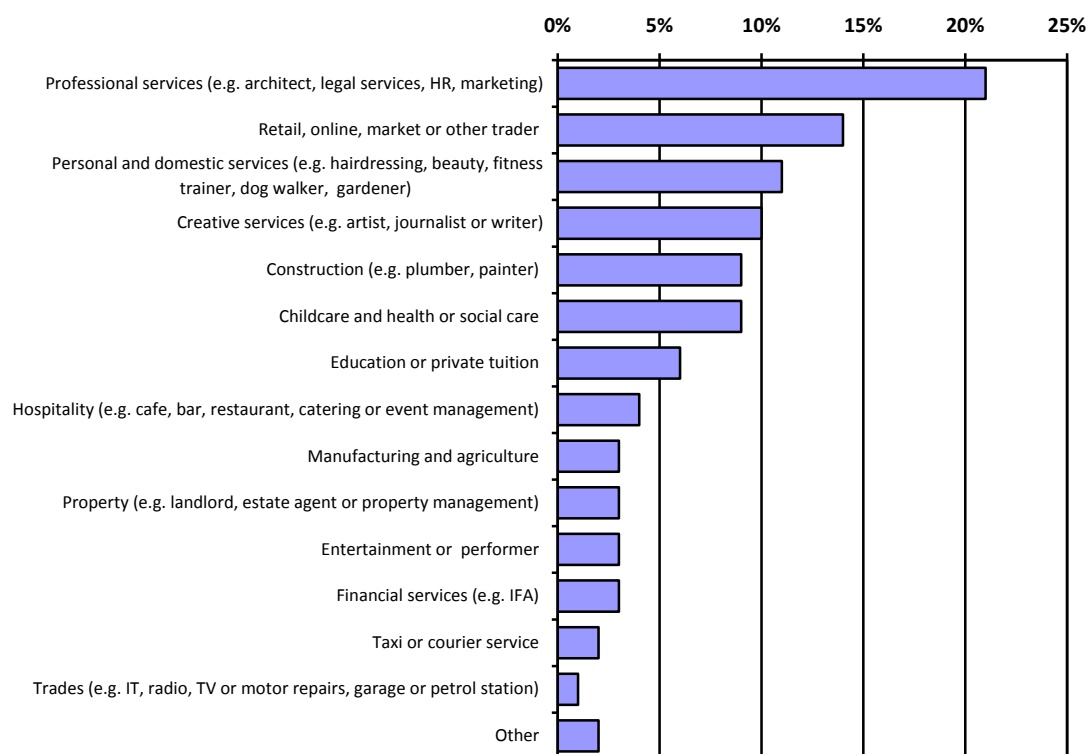
⁸¹ http://www.hm-treasury.gov.uk/d/ots_tax_for_small_business_discussion_paper.pdf

⁸² http://www.hm-treasury.gov.uk/d/ots_disincorporation_of_small_companies_discussion_paper.pdf

⁸³ The summary report is available at: <http://www.hmrc.gov.uk/research/reports.htm>

⁸⁴ Based on OTS analysis of HMRC data.

Chart B.1: The range of sectors represented in TFC's research



Source: *Small businesses' experience of the tax system*, The Futures Company/Lightspeed Research, November 2011

B.8 The findings from this research have been used in the small business review final report, informing the work on tax administration and also the papers on simplifying income tax for small businesses and disincorporation. A summary of the research findings is available on the HMRC website⁸⁵, and can be accessed via the OTS website⁸⁶.

Survey of Federation of Small Businesses (FSB) members

B.9 In September 2011, the FSB agreed to allocate part of their regular members' survey to the OTS. The OTS designed questions focused on issues of tax administration. The survey was available online between 12th and 23rd September 2011.

B.10 The sample consisted of 1,673 members of the FSB Voice of Small Business Panel. These businesses are officially classed as small, but as a whole had clear differences with the sample for The Futures Company research: approximately 80% had more than one person working in the business and over half operate through a limited company.

B.11 Where relevant, the findings have been included in the main body of this report. However, it is also worth mentioning here that many FSB members felt that poor administration of the tax system presents an obstacle to commercial activity. Fear and anxiety cause particular problems, and are often difficult to capture when measuring costs and benefits. A number of respondents choose to use an agent as it allows them to outsource this fear, although it also means that business owners may have no engagement with their tax affairs.

⁸⁵ <http://www.hmrc.gov.uk/research/reports.htm>

⁸⁶ http://www.hm-treasury.gov.uk/ots_smallbusinessreview.htm

Survey of Professional Contractors Group (PCG) members

B.12 In November 2011, the OTS launched its own survey for PCG members. The questions were the same as for the FSB survey, although there were some additional questions to find out more about experiences of the HMRC enquiry process. The survey closed in mid December 2011.

B.13 582 responses were received. The vast majority of respondents (95%) were from limited companies and over 60% did not have anyone other than the proprietor working in the business.

B.14 Despite their small size, these businesses were far more likely to have professional representation (75%) than the businesses surveyed by the TFC. Nearly 70% spend between £1,000 and £5,000 per annum on complying with tax obligations.

B.15 As with other sources of evidence, there were polarised views on the quality of HMRC's help. The key point was that a significant proportion have very little direct dealing with HMRC. As a result, problems with tax administration tend to have impact via higher professional fees.

Survey of tax agents

B.16 In November 2011, the OTS launched a survey for tax agents. This was circulated to members of a wide range of tax agent and accountancy bodies. The survey closed in mid December.

B.17 There were over 700 respondents to the survey. Virtually all of the participants had at least some clients with turnover below £250,000 per annum, and over half dealt exclusively with businesses with turnover below this threshold. 60% of the sample had at least 50 clients. For 85% of respondents, the majority of the clients were unincorporated.

B.18 The view of agents tended to be different from that of businesses. Agents put a higher premium on timely responses and had less faith in the accuracy of advice that they receive. Agents also feel that the cost of poor administration is often borne by them, rather than passed on to their client. As might be expected, agents also saw less value in HMRC providing guidance to small businesses.

Office of Tax Simplification contacts

This document can be found in full on our website at:

<http://www.hm-treasury.gov.uk/ots>

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