Office of
Tax Simplification

Simplifying everyday tax for smaller businesses:
a further business lifecycle review

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Foreword

In July 2018 the Chancellor asked the Office of Tax Simplification (OTS) to carry out a review focusing on the day to day experience of businesses in dealing with tax, especially those smaller businesses which struggle the most.

The review follows on from the OTS's Business Lifecycle review, published in April 2018, which focused on external events such as raising capital and changes of ownership, and related tax charges and reliefs.

Small businesses make up over 99% of the 5.7 million businesses in the UK. Three-quarters of these do not employ anyone other than the owner. So it is unsurprising that administrative work on dealing with tax can loom disproportionately large in the context of the daily pressure of running the business.

Our recommendations cover five themes:

- providing simple step-by-step guidance about the key things a business needs to do in its early days to help things run smoothly

- improving the operation of the PAYE system

- implementation of HMRC's Agents Strategy

- improving the mechanics of the Corporation Tax return process

- ensuring that tax changes are built on an understanding of business processes

The OTS would like to thank Eileen Rafferty, who led the review, supported by Peter Allen and Andy Richens, and by Bill Dodwell (who was a member of the OTS team working on the review prior to his appointment as Tax Director). The review has been guided by OTS Head of Office David Halsey and former Tax Director Paul Morton. We are also very grateful to our HM Treasury and HM Revenue and Customs colleagues, our Consultative Committee members and all those who have willingly given time, ideas, challenge and support.

Kathryn Cearns, OBE
OTS Chair

Bill Dodwell
OTS Tax Director

Executive summary

The Office of Tax Simplification (OTS) is the independent adviser to government on simplifying the UK tax system. The work of the OTS is rooted in improving the experience of all who interact with tax. The OTS aims to improve the administrative process – which is what people actually encounter in practice – as well as simplifying the rules. These are often of equal importance to taxpayers and HMRC.

In July 2018, the Chancellor asked the OTS to carry out this review, focusing on ways to simplify the everyday experience of businesses dealing with tax, particularly for smaller businesses with fewer than 10 employees and an annual turnover of less than £2 million (see Annex A). The review covers events such as starting up in business, registering for and paying tax, taking on a first employee and dealing with more complex tax matters as the business grows.

The review complements the OTS business lifecycle review[1], which addressed tax charges and reliefs applicable at key stages during the life of a business, focusing on external events such as the raising of capital or a change in ownership.

The OTS carried out extensive research for this review, meeting businesses and advisers across the UK, coupled with an online survey and call for evidence.[2] Annex C lists contributors to the review. In addition, the OTS set up a Consultative Committee to provide advice (see Annex B).

Structure of the review

The chapters of this report work through the stages a small business might go through and its engagement with the tax system at each stage. This is the first time the interactions between the tax system and small businesses have been explored in this way. The review is informed by anonymised case studies which are based on real experiences.

The OTS notes that, while tax is one source of complexity, many other rules and regulations contribute significantly to the overall pressures on small businesses. Where appropriate the review notes these in order to inform the analysis. However, the review's recommendations generally only address matters where tax is the primary focus.

Headline findings and recommendations

Small businesses face many tax and regulatory challenges. These challenges are most acutely felt at key growth stages, particularly:

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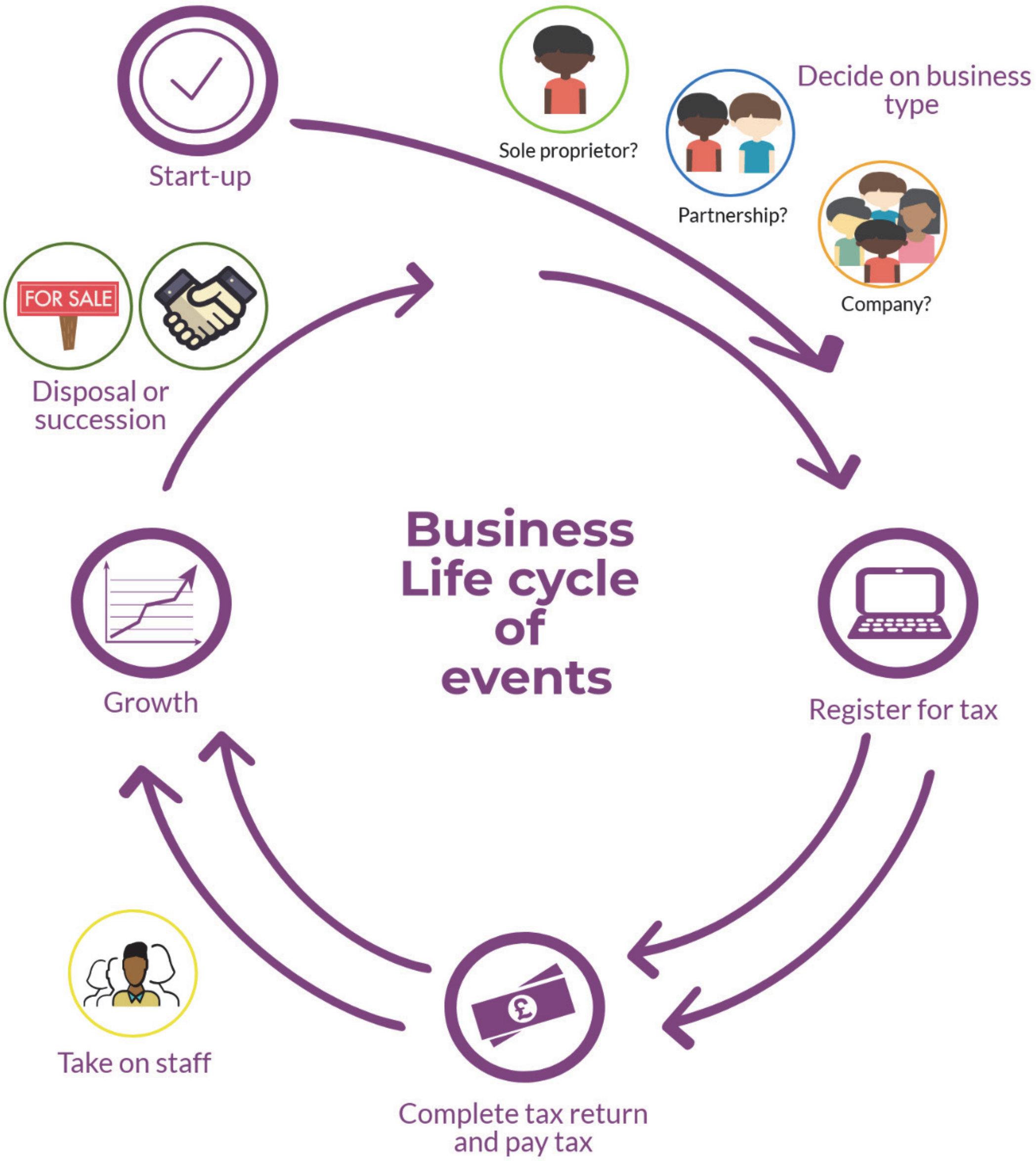
1 https://www.gov.uk/government/publications/simplifying-the-taxation-of-key-events-in-the-life-of-a-business

2 https://www.gov.uk/government/consultations/ots-business-lifecycle-review-call-for-evidence-and-survey

- start-up, when the new business owner has to get, service and keep clients, get paid for their services, and develop a viable business model
- registering for tax, and
- taking on a first member of staff, which involves a significant increase in responsibility, administrative process and cost

The diagram below shows these and other (although not necessarily all) common business life events, the tax treatment of which will be explored in this report.



Source: OTS

The recommendations are focused on ways to improve the experience of smaller businesses in these and other key stages, across five major areas.

1. Support for small businesses, focusing on start-up

Starting up in business is challenging in itself. Most businesses in their early stages are preoccupied with survival – finding customers and servicing them, establishing relationships with suppliers, getting paid and managing cash flow. It can be up to 18 months before HMRC needs to be told that the business has started, depending on specific circumstances and relevant tax regimes.

During this initial stage, referred to in this report as pre-formalisation, decisions may be made that have unintended negative consequences for the business. These include taking on staff without realising they may be employees, or establishing a company in circumstances where this was not helpful or the implications were not fully appreciated. In some cases, the focus on day-to-day business may mean that there is an almost complete absence of records. Advisers, when they are eventually consulted, frequently find themselves needing to resolve such issues much later on, adding to inefficiency and cost.

The OTS has looked at options to support businesses during this pre-formalisation stage, noting that it is essential that such support is not viewed as an additional burden at such a challenging time. The OTS also notes that this is not a new issue: a range of initiatives to support start-up businesses have existed in the past and continue to be developed. However there are more very small businesses now than there were in the past and work trends suggest that this pattern will continue in years to come.

Effective support should help smooth the path into routine tax compliance, with benefits and cost savings both for the business and HMRC – with fewer problems to sort out or queries to answer, there should be more time for the business owner to focus on running and growing the business.

Recommendation 1: The government should develop and offer small businesses a package of start-up guidance taking them step-by-step through the things they need to do at key stages in the business, with tax as a major (although not the only) focus.

The package should be extremely accessible and take businesses through what they need to know at each point. It should reflect the needs of different types of businesses, from freelancers through to retailers and small manufacturers. To ensure widespread coverage, a range of delivery channels should be adopted (online, paper, visual displays), and third parties who interact with start-up businesses (including Job Centres, Growth Hubs, banks, charities and bodies such as Enterprise Nation and the Prince's Trust) could help to share it.

The guidance should be designed from the perspective of someone with no tax or regulatory experience and divided into easily-grasped sections (such as 'Five things to consider in your first month', 'Three simple ways to keep a record of sales and purchases' or 'The key deadlines in your first year'). It would complement the more detailed guidance already available on GOV.UK and signpost users to that guidance if they want more information.

2. Pay As You Earn (PAYE)

The PAYE system, under which tax is collected from employment and pension income before it is paid to employees, means that most UK taxpayers never have to think about tax or do a tax return. This significantly simplifies the taxpayer experience and enables large amounts of tax to be collected efficiently (£154 billion in the year 2017 to 2018, almost 28% of all tax collected by HMRC).

The OTS has seen evidence of HMRC's commitment to, and careful management of, key elements of the system (such as policy, processes and communications). However, currently, there is no one person with overall strategic ownership or oversight of PAYE. This is a significant gap, making it harder to prioritise and implement cross-cutting changes and sustain development of a future vision for PAYE.

The OTS understands that HMRC is taking steps to strengthen its oversight of its core processes, and welcomes this.

The OTS has heard significant criticism concerning Real Time Information (RTI) for PAYE, the process by which employers update HMRC about tax and other deductions from employees' salaries. Since RTI was introduced it has achieved many of its goals, giving HMRC faster access to information which can be used to increase the accuracy of tax codes, tax credit and universal credit payments, and significantly reducing the number of cases where incorrect tax positions carry over from one year to the next. However, the promised additional benefits – transparency and accessibility – have been slower in materialising.

Information collected through RTI or from third-party data-feeds does not always flow through to personal tax accounts quickly, and resulting calculations are not always accurate. The outcome can be stress for taxpayers: for example, if universal credit payments are delayed, or wrong amounts of tax deducted. It can also lead to incorrect tax codes and a lack of faith in HMRC's systems.

If better quality information fed more quickly (and accurately) into the system, this would be helpful for taxpayers and could reduce queries to HMRC. In particular:

- the current system does not handle the fluidity of the modern workplace very well, for example in relation to changes of job mid-month or individuals holding multiple jobs or concurrent employment and self-employment
- system problems lead to significant costs for businesses, agents, employees, and HMRC itself. For example, there are around 350,000 duplicate employment records, and around 5% of returns are received late

System change would have upfront costs but should soon pay for itself, improving employer and taxpayer experience, and efficient tax collection.

Recommendation 2: A strategic focus on the PAYE system should be an HMRC priority to ensure effective implementation of improvements and system changes.

In addition to ensuring that there is appropriate oversight of the system, the strategic focus should include

- ensuring that the commitments made by HMRC in the 2017 Post-Implementation Review of Real Time Information are prioritised and addressed[3]
- working with employers and their agents, to identify areas where the system is not working efficiently and to design and agree solutions

A roadmap should be drawn up to show the stages of progression and planned changes over the next 5 years.

Recommendation 3: A fresh review of areas where the PAYE/RTI system should be improved should be carried out, possibly by the OTS.

The focus of this review would be to

- consider the fit between the PAYE/RTI processes and modern work patterns
- identify options to simplify and streamline the PAYE and RTI system
- consider options to ensure that PAYE and RTI processes are ready to support future streamlining of the tax system

3. The role of agents

Agents who are engaged to help people with their tax affairs play a major role in supporting compliance. Various aspects of running a business are inherently complex: although some business owners choose to manage these themselves, many value support from agents.

HMRC recognises the valuable role tax agents play and seeks to support them. A regular Agent Update bulletin covers key topics and relevant reminders, and webinars are produced on areas of significant interest.

Agents are able to complete some tax transactions on behalf of clients. However, the approach to this, and its coverage, is inconsistent. Agents are unable to access a number of key services and sometimes have to ask their clients to do things that the client would much prefer the agent to do.

If tax agents were able to see relevant client information and carry out such tasks routinely, they would be completed more quickly and with fewer mistakes, which on its own would be a major improvement. This change would reduce costs for taxpayers and for HMRC, as there would be fewer calls and queries to resolve.

Experienced tax agents can also add value by being consistently consulted when changes are being implemented or communications developed.

Agent feedback in HMRC surveys is persistently less favourable than feedback from individuals and businesses. There have been some improvements in recent years but there is a good deal further to go.

Agents' role in supporting compliance with the tax system is recognised in HMRC's 2014 Agent Strategy, which commits HMRC to a number of initiatives to help

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3 https://www.gov.uk/government/publications/real-time-information-programme-post-implementation-review

agents.[4] Some of these have been completed, but HMRC has struggled to prioritise implementation of this strategy in the face of other demands.

The principles set out in the Agent Strategy seem sound and reasonable: they include enabling agents to see the same information as their clients and carry out any tax transaction their client wishes them to do. The challenge lies in implementation.

The OTS's recommendations are intended to encourage consistent implementation of the strategy, to ensure that agents are able to support clients in complying with tax at minimum cost.

Recommendation 4: HMRC should appoint a senior official to oversee and prioritise implementation of the Agent Strategy.

The focus of this role should include ensuring that agent needs are built into new systems (see recommendation 5); developing constructive engagement with the profession, to ensure that agents feel listened to and understood; as well as working with HMRC officials to increase their understanding of the role of agents.

Recommendation 5: HMRC should routinely build agent awareness and needs into system design and improvement and its related guidance.

The government should produce a roadmap setting out dates for implementation of the key improvements, such as the ability of agents to see data relating to their clients and ensuring that consideration of agents is a mandatory part of all new system redesign. Improving agent engagement feedback scores would be one way to monitor the impact of improvements.

This recommendation includes ensuring that agents are copied into key exchanges with clients, a longstanding practice that seems to have been missed in some recent process redesigns.

4. Corporation tax and small companies

Corporation Tax is one of the tax regimes where businesses are least likely to attempt to deal with the tax themselves. Most use agents because of the complexity of the task, in particular the need to prepare a set of accounts. Accounts are required for Companies House, but the company law requirements for filing small business accounts are relatively minimal and additional work is needed to prepare accounts for tax purposes.

The government has made a number of changes in recent years to simplify tax for small businesses, including the trading and property allowances, cash basis and simplified expenses rules for income tax.

The OTS considers there is also scope to simplify the corporation tax process. One particular concern is that almost 60% of companies formed since 2010 have needed to do two tax returns to cover their first accounting period: one for 12 months and one for a few days or weeks.

Recommendation 6: HMRC should work with partners such as Companies House to develop digital options to help small companies prepare accounts and tax returns,

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4 https://www.gov.uk/government/publications/agents-strategy-an-overview/agents-strategy-an-overview

including use of an optional accounts template that is simple to use and acceptable to HMRC and other departments.

The template would incorporate standard iXBRL tags, applied automatically to relevant entries, to ensure consistency and simplicity in their application.[5]

Recommendation 7: HMRC should simplify the corporation tax online return process as part of any future extension of Making Tax Digital to corporation tax, so that, as with the online income tax process, taxpayers only see the pages and information relevant to them and have pop-up information and help screens at key points.

Recommendation 8: HMRC should explore ways to reduce the number of companies having to file two tax returns to cover first accounting periods that are very slightly longer than 12 months.

5. A more strategic approach to tax administration and system change

The administration of the tax system is undergoing significant transformation. Changes in recent years include the introduction of Real Time Information for PAYE (RTI), Simple Assessment for income tax, the Personal and Business Tax Accounts and Making Tax Digital (MTD) for income tax (pilot) and MTD for VAT. There is an expectation that, in some form, MTD will ultimately extend to cover CT.

Looking across this landscape, the OTS has not found evidence of consistent cross-tax strategic oversight focusing on the end-to-end process for key customer groups such as small businesses.

There are some encouraging signs of progress: for example HMRC's Customer Journey team has looked at a range of customer journeys including the experience of someone taking on an employee for the first time. The goal of this work is to ensure that systems are built around customer needs and with an accurate understanding of the customer perspective. At this time, customer understanding is not consistently embedded in process developments, which can result in complexity and cause practical difficulties for taxpayers.

For example, it can be surprisingly difficult to pay tax to HMRC in non-standard cases. In addition, each regime has its own payment processes, some more effective than others: it is not always possible to pay by direct debit when a return is filed (as can be done with VAT), or to pay in advance if that is desired.

More widely, it would be valuable to map the customer journeys of small businesses across tax regimes; for example considering businesses as they progress towards formalisation, those that form a company or operate through partnerships as well as sole traders, businesses that register for VAT or start to make overseas sales. Such mapping could then be used in consideration of policy matters across different tax regimes.

Recommendation 9: HMRC should map major customer journeys for small businesses across tax regimes, to develop a programme of change to streamline the small business experience of the tax system.

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5 iXBRL stands for Inline eXtensible Business Reporting Language, XBRL involves the application of computer-readable tags to business data. This enables the data to be processed automatically by software. Since 2010, accounts submitted to Companies Hosue must have iXBRL tags. They are required by HMRC and other official bodies also, including Companies House.

Recommendation 10: HMRC should review tax payment processes across core taxes and regimes, with a view to aligning and streamlining them.

A PAYE-like experience for self-employed people?

Tax can be a source of stress for the very smallest one-person businesses, and the need to set money aside for long periods to pay future tax liabilities can be difficult to manage financially. The OTS considers that there would be merit in exploring an optional PAYE-like experience for self-employed people.

Quite a number of the smaller businesses the OTS consulted in this review said they would welcome an optional process under which they could have an appropriate amount of tax deducted from their income each month. Technology is advancing rapidly and functionality that supports this could be available within a few years. The OTS has given initial consideration to how such a system could work for people who work for online platforms.[6] The OTS envisages developing this thinking further and extending it to include self-employed people more widely.

6 https://www.gov.uk/government/publications/ots-suggests-paye-equivalent-for-online-platform-workers

Box 1.A: Summary of core recommendations:

1 The government should develop and offer small businesses a package of start-up guidance taking them step-by-step through the things they need to do at key stages in the business, with tax as a major (although not the only) focus.

2 A strategic focus on the PAYE system should be an HMRC priority to ensure effective implementation of improvements and system changes.

3 A fresh review of areas where the PAYE/RTI system should be improved should be carried out, possibly by the OTS.

4 HMRC should appoint a senior official to oversee and prioritse implementation of the Agent Strategy.

5 HMRC should routinely build agent awareness and needs into system design and improvement and its related guidance.

6 HMRC should work with partners such as Companies House to develop digital options to help small companies prepare accounts and tax returns, including use of an optional accounts template that is simple to use and acceptable to HMRC and other departments.

7 HMRC should simplify the corporation tax online return process as part of any future extension of Making Tax Digital to corporation tax, so that, as with the online income tax process, taxpayers only see the pages and information relevant to them and have pop-up information and help screens at key points.

8 HMRC should explore ways to reduce the number of companies having to file two tax returns to cover first accounting periods that are very slightly longer than 12 months.

9 HMRC should map major customer journeys for small businesses across tax regimes, to develop a programme of change to streamline the small business experience of the tax system.

10 HMRC should review tax payment processes across core taxes and regimes, with a view to aligning and streamlining them.

Box 1.B: Additional Recommendations

As well as the core recommendations, our research and discussions have identified a number of smaller matters, each of which could help improve the process of tax filing for taxpayers and HMRC. Most of these recommendations could be adopted by HMRC without any legislative requirement.

Starting up in business

11 The OTS suggests that HMRC commission research into the pre-formalisation period of start-up businesses.

12 The OTS considers that it may be helpful if the company registration process offered people targeted information and guidance about the key features of a company, together with a nudge to stop and think before they push the button to set up the company.

13 The OTS suggests that HMRC look further at the online process for registering for income tax self-assessment. Is a two-track process (self-employed vs not self-employed) necessary? If it is necessary, consider an optional explanation box to help customers understand why they are being asked this question and how to answer it.

14 The OTS understands the need for a secure tax registration process. However, the two-stage postal process is too lengthy. Could this not be reduced to one stage, assuming a postal process is necessary?

15 The OTS suggests that the government consider options to copy company registration information to a tax agent, when that agent has made the application on behalf of their client and has a continuing relationship with them.

Calculating and paying tax

16 The OTS recommends that HMRC looks again at the pages of the income tax return with the user's perspective in view, to increase consistency of approach and more clearly signal what is needed.

17 The OTS recommends that HMRC consider further the reasons for having two separate tax accounts for self-employed people and small unincorporated businesses. The most obvious way to do this would be for the business tax account to be a 'pane' in the personal tax account.

18 The OTS recommends that HMRC consider ways to give businesses personalised reminders, for example around payment dates, or that their declared turnover is nearing the VAT registration threshold.

Taking on an employee

19 The OTS recommends that, as is common in other regimes, HMRC consider accepting any RTI data subject to manual processing as provisionally correct for the purpose of the employer's ledger and account balance, until such time as the verification is completed.

20 The OTS recommends that HMRC consider the process and terminology used for pensions under PAYE/RTI from an employer's perspective, to identify ways to simplify the regime and reduce the potential for errors.

Small company taxation

21 The OTS recommends that HMRC and Companies House work towards sharing dormancy information automatically and in real time, to reduce the number of penalties issued to dormant companies by HMRC.

22 The OTS recommends that HMRC consider reform of the schedular system for companies (under which different types of income are taxed differently).

23 The OTS considers that a basic guide for new companies should explain the purpose of the rules on directors' loans and how they work in practice.

24 The OTS suggests that HMRC look closely at the application of the loan relationship rules to the smallest companies.

Issues faced as businesses grow

25 The OTS recommends that HMRC consider incorporating R&D claims fully into the CT return, perhaps as part of any extension of Making Tax Digital to corporation tax.

26 The OTS suggest that, in any future review of R&D relief, consideration is given to:

- The most appropriate ways to differentiate between large and small companies in a supply chain, including how the rules apply differently to them (such as the treatment of subcontracted research)
- Revisiting the policy rationale for excluding non-corporate businesses from the relief

27 The OTS recommends that HMRC look at its guidance to see if capital allowances can be explained more simply and clearly, perhaps giving illustrations and case studies as in the R&D leaflet.

28 The OTS recommends that HMRC review the process of closing a business, to simplify and streamline it so that the business need only tell HMRC once that it is closing and that this notification will cover all HMRC regimes. The review should include consideration of a shorter repayment period for directors' loan repayments for insolvent companies.

Chapter 1

Introduction - small businesses in the UK

Source: Shutterstock

Background: small businesses now

1.1 This review focuses on the most significant everyday tax issues that arise in the course of the lifecycle of a small business. The aim is to highlight those areas where complexity adds cost and inefficiency, with a particular focus on the smallest micro businesses – that is, businesses with 9 or fewer employees and turnover of less than £2 million.

1.2 To provide context, this Chapter briefly summarises some key facts about small businesses in the UK:

- There were 5.7 million businesses in the UK at the start of 2018
- Of these, 99.3% were small businesses [1]

[1] https://www.gov.uk/government/statistics/business-population-estimates-2018 In this statistical release, a small business is defined as a business with 0 to 49 employees. This OTS review is focused on the smallest businesses in this population – those with 0 to 9 employees and less than 2m turnover.

- 12.9 million people were employed by small businesses - 48% of all private sector employment in the UK
- the combined annual turnover of small businesses was £1.4 trillion, 52% of all private sector turnover
- small businesses paid around £205bn in taxes in 2017-18, which included PAYE income tax and National Insurance of £95 billion from their employees (in total 33.5% of all tax paid that year) [2]
- HMRC estimate that they spent £525m on compliance activities with small businesses in 2017-18
- At the start of 2018, 75% of businesses did not employ anyone aside from the owner(s), comprising 3.1 million sole proprietorships, 883,000 companies and 291,000 partnerships[3]
- Small VAT-registered businesses spend an average of three days per year completing their quarterly VAT returns[4]
- Small companies spend an average of 2 days per year on their annual corporation tax return[4]

1.3 Small businesses occur in every sector of the economy, but a few sectors (construction; professional, scientific and technical services; wholesale and retail trade and repair of motor vehicles) represent a large proportion of the total number (41%).

Prosperity

1.4 Using HMRC data, the Institute for Fiscal Studies (IFS) found that, despite growing in numbers by 25%, the self-employed population accounts overall for lower turnover now than it did in 2007-08.[5] The proportion of self-employed people who also have some employment income – almost 25% - has been stable over the last decade. The proportion investing in the business (for example, buying capital items for use in the business) or employing others has fallen significantly. Average profits have also fallen substantially since the financial crisis. The IFS notes that this fall in prosperity is not driven by an increase in numbers of new businesses, who might be expected to have smaller profits in the early stages of business development, but reflects a fall in the profits of existing businesses.

1.5 In short, there are a substantial number of very small businesses with limited financial means. To help these businesses prosper it is important that the tax system, as it applies to them, is as simple and streamlined as possible.

2 HMRC Annual Report and Accounts, 2017-18 https://www.gov.uk/government/publications/hmrc-annual-report-and-accounts-2017-to-2018: See page 36: note that this figure includes an estimated £28bn of small and medium business taxes where the split cannot be broken down exactly.

3 https://www.gov.uk/government/statistics/business-population-estimates-2018

4 HMRC Research: Understanding Tax Administration for Businesses https://www.gov.uk/government/publications/understanding-tax-administration-for-businesses

5 https://www.ifs.org.uk/events/1602

It's not just tax: regulatory burdens

1.6 The most recent World Bank 'Ease of Doing Business' rankings place the UK in 9th position overall, and 23rd in the tax component.[6] While the overall ranking is high and there are many economies ranked lower, there is clearly some room for improvement to make the UK more competitive. The OTS notes that these rankings have slipped from previous years – the overall ranking was 7th in the last report, and the UK tax system was ranked as 14th in 2014. The OTS carried out a review of the competitiveness of the UK tax system and published its findings in December 2014: the purpose of the review was to identify ways to increase competitiveness. Although the OTS review and its findings were welcomed, a number of key recommendations remain outstanding and some will be revisited in this paper.

1.7 Business owners in the UK face a range of regulatory requirements.

1.8 Some regulatory requirements are business-specific: the dry cleaner who has to tell the local authority what chemicals have been used in their business; the taxi and delivery firms that need to ensure drivers hold clean UK-valid driving licences, are able to work in the UK and have passed any DBS checks; the local baker or restaurant that needs to ensure its premises and practices comply with relevant cleanliness and food safety guidelines.

1.9 In addition to the business-specific requirements, anyone employing staff is required to comply with minimum wage rules, to offer holiday and sick pay and other mandatory benefits, and to enroll relevant staff into a workplace pension scheme.

1.10 Other significant business life events bring with them their own regulatory issues: for example, buying or selling a business; construction of premises; setting up and maintaining a company; entering into and enforcing contracts.

1.11 These requirements ensure that the UK is a safe and predictable place to do business and that customers and employees are protected from unsafe and unfair practices. That said, they can represent a significant burden for small businesses. It is neither likely nor desirable that this kind of regulation will significantly reduce: given this, it is vital that the smallest businesses, in particular, are supported to help them comply as easily as possible.

Small business contribution to economy – macro, micro, local

1.12 Small businesses employed 12.9 million people, generated £1.4 trillion in turnover and paid £110bn in tax in 2017-18: these businesses make a significant contribution to the UK economy. However, their contribution to the UK goes beyond the purely financial.

1.13 Most small businesses are located near to their owner's residence (many indeed are based in the owner's home). This means that they play a role in

[6] This is a fall of 2 places from the previous review, where the UK was ranked 7th: in 2014, the UK tax system was ranked 14th

their local communities, buying from other local businesses, supporting schools and other local services.[7]

1.14 One-person businesses, in particular, may be a key source of income in areas where paid employment is in relatively scarce supply. Freelance and self-employment activity enable people to supplement their income or contribute to the economy in cases where flexible hours are essential.

How do small business owners feel about tax?

1.15 HMRC's research shows that 74% of small businesses reported a positive overall experience of dealing with HMRC. This is lower than the equivalent results for large business. New and growing businesses and those experiencing tax life events were generally less positive (tax life events include registering for VAT, PAYE or NICs, submitting a first income tax self-assessment return, asking for a deferment or laying-off staff).[8]

1.16 The most important driver of customer satisfaction for small businesses was the quality of information available to them: HMRC getting tax transactions right, resolving queries, systems preventing mistakes, and being timely and professional were also key. 78% of small businesses felt HMRC treated them fairly and 83% felt they were treated as honest taxpayers and 70% felt that HMRC ensured they paid the right amount of tax and that it was easy to deal with tax issues. However, a smaller proportion felt that HMRC minimised the time, cost and effort of dealing with their tax affairs (58%) or that HMRC services were personalised to them (50%).

1.17 71% of small businesses used multiple channels to consult HMRC (69% used HMRC online services; 32% used the phone). Online services were rated more positively than telephone helplines (79% vs 55%).

1.18 HMRC recently published research looking at factors that cause complaints and contribute to delays in resolving those that have arisen. HMRC wants to understand how best to prevent complaints arising and to resolve any that do arise quickly. They know that customers have a range of wants and needs from their engagement with HMRC, and have accordingly categorised the complainants to help them identify how best to support people who fall within the different categories. The OTS notes that the small business owners who took part in this research were in general characterised by pragmatism, wanting to understand what had gone wrong and quickly resolve it.

1.19 The evidence gathered by OTS from its survey and call for evidence is broadly consistent with HMRC's research.

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[7] The Federation of Small Businesses found that 80% of their members had volunteered or contributed to a local charitable cause in the last three years. This level of engagement was consistent across the UK areas surveyed, showing the role that small businesses have to play in contributing to areas away from the major population centres

[8] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/721604/488_HMRC_Individuals__Small_Business_and_Agents_Customer_Survey_2017_Report.pdf; https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/769464/Drivers_of_Customer_Complaints_Reserach_Report_Jan19.pdf

1.20 Most respondents felt that online services were relatively easy to use. Businesses liked to resolve queries quickly where possible. 85% of respondents said they had used HMRC's guidance for help with their tax: of these, 63% found it helpful.

1.21 The most common reason for not using guidance was reliance on a tax agent, followed by distrust of HMRC and finding the guidance too hard to understand. Respondents found the guidance swung between very simple (sometimes too simple) explanations and the technical complexity of the HMRC manuals. Common complaints were that it was hard to find the relevant pages, and it could then be hard to follow what was said. The guidance doesn't generally take people step-by-step through the process of answering their query: a more intuitive guidance process would help many. The recent OTS review of tax guidance made a number of recommendations to improve the position: HMRC have accepted the recommendations and are working to improve their guidance.[9]

1.22 In common with any other group within society, some small business owners will be vulnerable or need additional support. This may be because of the impact of major life events (illness, accident, family or other problems), or because of literacy or numeracy challenges. It is notable that in a range of circumstances, people who find it difficult to get paid employment are encouraged to set up small businesses.

1.23 HMRC is conscious of the needs of these customers and offers a range of support to help people with additional needs to comply with their obligations.[10] In addition to the support that HMRC provides directly, a range of charities assist fledgling businesses and people who need help in dealing with HMRC.[11] [12] There will always be some people who need additional support when dealing with HMRC: some may also need an advocate, and the government cannot advocate against itself. The government recognises this need, and provides some financial and practical support to such organisations.

Conclusion

1.24 In summary, there are large numbers of small businesses, which make a significant contribution to the UK. Business owners value accuracy, speed and simplicity in their tax affairs, and like the convenience of online systems and guidance where these are well-designed.

1.25 A complex tax and regulatory environment will be challenging for many of the smallest businesses, and this can lead to stress, wasteful use of the resources of both the business and HMRC, and error. This report identifies a range of places where there is room to streamline tax for these businesses, increasing productivity across the piece.

9 https://www.gov.uk/government/publications/guidance-for-taxpayers

10 https://www.gov.uk/dealing-hmrc-additional-needs

11 https://www.princes-trust.org.uk/

12 https://taxaid.org.uk/

Chapter 2
Pre-formalisation

Pre-formalisation

2.1 Start-up businesses in the UK are very diverse, ranging from freelance individuals supplying their own services through to high-tech entrepreneurs with significant capital backing. Many are started by someone who was previously an employee or in education, and by definition they are likely to have had limited engagement with tax or regulatory requirements. Starting up in business is a challenging process in its own right, and most businesses in their early stages are preoccupied with survival – finding clients or customers and servicing them, establishing supplier relationships and getting paid and managing cash flow.

2.2 A business does not necessarily need to register for tax with HMRC at the time when trading starts. Depending on circumstances, it can be as much as 18 months before HMRC must be notified (the timeline will be shorter if, for example, the business goes over the VAT threshold, forms a company or takes on an employee during this period).

2.3 During this initial stage, referred to in this report as pre-formalisation, decisions may be made that have significant (and potentially negative) unintended consequences for the business. Agents and bodies supporting small businesses told the OTS that often they need to spend time with new clients helping them resolve tax problems that have arisen in their start-up period. Some small businesses start and end without ever completing a tax return.

Case study 1.A: Joseph

Joseph was made redundant in February 2018 after 29 years as a delivery driver for a large business. Aware that the job market in his area was limited, Joseph used some of his redundancy money to buy a second-hand van, costing £3,000. He already had a relatively new car, bought before the possibility of redundancy emerged. His former company offered some work delivering for them, as and when needed. Joseph put notices up in local retail premises offering his services as 'a man with a van'. He also signed up with a taxi firm and works for them in the evenings and weekends, when his van is not otherwise in demand.

Demand for his services varies significantly. Some weeks he will do four or five full days' work in the van: other weeks may have only one half-day booking. The flexibility of the taxi activity is helpful in smoothing his income during this period. Joseph found it hard at first to get used to this unpredictability. Stress caused some health issues: Joseph did not feel able to take time off and soldiered through.

Friends told him that it's a good idea to set aside about 30% of your income to pay tax. Joseph set up an account and puts money into it, but is tempted sometimes to dip into this fund.

Towards the end of the first calendar year of self-employment, Joseph starts to see advertisements reminding him that the deadline for submitting his income tax return is 31 January. He searches online to find out what he needs to do. The search 'I am self-employed and need to pay tax – what do I do?' brings up a lot of results. Some talk about his needing to have accounts and software, which feels very complicated.

Joseph likes the Money Advice Service site as this seems very clearly written and talks him through the process. It doesn't mention accounts, but just says that he needs to know what his business income and expenses are.[1] It explains that tax is paid in financial years, so for the 2017-18 year Joseph only needs to pay tax on income from February to early April.

It is now November and the site tells him that he should have registered with HMRC by 31 October and may get a penalty. It adds that he will get a penalty if he doesn't file and pay tax by 31 January. Joseph is worried that he may already owe a penalty and that despite searching online he can't find out how much it will be, but decides to concentrate on getting registered and filing his return to avoid what may be a bigger penalty.[2]

Joseph reflects that if he had started his business on 14 April instead of 14 February he would not have needed to register until October 2019 or pay any tax until 31 January 2020.

In the course of his driving work, Joseph has incurred some parking fines. These are irritating and expensive, but not a great source of anxiety. However Joseph feels that getting into trouble with HMRC would be a much bigger problem, and is concerned that a black mark on his record might impact on future work or benefit claims, should he need these. His ulcer starts to trouble him again: he decides that the best thing to do is concentrate on getting things right for the future so they will see he is doing his best if they do look into his record.

Later chapters will follow the experience of Joseph and others as they engage with the tax system.

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1 https://www.moneyadviceservice.org.uk/en/articles/tax-and-national-insurance-when-youre-self-employed

2 Neither the Money Advice Service nor gov.uk explain the penalty position clearly. The OTS understands that, if no tax is due at 31 October, no penalty will be due. There is also a twelve month grace period after the due and payable date after which an unprompted disclosure can attract a 0% penalty (10% if after 12 months). So if Joseph made an umprompted disclosure at any point up to 30 January in year 2 (30 January 2020 in this example) he would not have to pay a penalty.

2.4 In its work on this review, the OTS has met seasoned entrepreneurs setting up new businesses with a wealth of background knowledge and a clear understanding of tax and regulatory rules and how to manage those. However, the OTS has also learned that businesses like Joseph's are very common.

2.5 The OTS has heard from tax agents that many of their new clients come to them having traded for some time. They may be prompted to come to the agent because they have penalties for not having filed a return or for help to meet an upcoming deadline or for other reasons.

2.6 Tax agents said that such clients may have engaged the services of another person during this period without considering whether they were an employee, or might have set up a company without understanding the compliance requirements, such as the need to file accounts with Companies House. Companies House sends a letter to all new company directors reminding them of the obligations of a director. While many will comply fully, some do not, for a range of reasons.

2.7 Often the tax agent will spend time and resources sorting out problems and getting the new business into a position of basic compliance. Agents told OTS that time spent sorting out problems that could have been prevented is wasteful for both them and their client. They report widespread confusion about employment status, and many also reported that it was now so easy to set up a company in the UK that many clients had gone online, paid their £12, clicked a few buttons and set up a company, without really understanding the consequences.[3]

2.8 The OTS understands that the Set up a limited company and register for Corporation Tax service (SCRS) will soon include the ability to sign up to receive email reminders: this will inform the user during the set-up process that their company will have filing obligations to Companies House. This could usefully be complemented by additional signposting to guidance about obligations and running a limited company – perhaps in the email that is sent containing the incorporation certificate of the newly formed company.

2.9 People sometimes start in business without appreciating that they have done so. For example, a student taking on work at weekends to help fund their studies, or a pensioner supplementing their income by providing occasional administrative support to a range of local businesses. In such cases the income from the business may be small: if the individual has no other income then they may fall beneath the income tax and national insurance annual exemptions and not be required to register for tax. But if the individual has sufficient income from the business in its own right or in combination with other sources to be above the thresholds (and the new trading and property allowances, under which up to £1,000 of income from

3 https://www.gov.uk/limited-company-formation

either source can be disregarded for tax purposes) then they will be required to register and pay tax.[4]

2.10 Businesses in these early stages might be considered a subset of the informal sector. In this report they are referred to as pre-formal, on the understanding that most such businesses plan to formalise in time. The informal sector has been and continues to be much researched.[5] However the OTS has not found any research focusing specifically on the crucial start-up period.

2.11 The government recognises that start-up businesses need some time to establish themselves and that during this period, tax is not their first concern: that is one reason there is no need to register on the first day of trading. There is a recognition that fledgling businesses need guidance and support to formalise, and guidance is offered.[6]

2.12 The OTS is also aware of cross-government work that is looking at ways to streamline some of the regulatory interactions a business faces in the future – for example, by sharing information across government departments so that the business only needs to give it once (particularly financial information that could meet the needs of all government departments) or by providing guidance that covers business interactions with all relevant government departments in a unified way. Sharing information once might mean that, for example, when a food service business notifies a new address to the regulator, that new address is shared with HMRC and other relevant bodies: similarly, relevant updates about a company and its status should flow freely between Companies House and HMRC.

2.13 This cross-government work is at an early stage and is a welcome initiative: anything that makes it easier for new businesses to fulfil their regulatory requirements is to be welcomed and is highly likely to facilitate voluntary compliance.

2.14 An early example of cross-cutting guidance is the GOV.UK page on setting up as a sole trader in business.[7] As well as core information on tax, this page discusses matters such as employment status, naming the business and trade marks. Information is presented in a step-by-step way, with a side bar to show that any page is part of a wider set of guidance.

2.15 The lack of in-depth research on pre-formalised businesses seems like a significant gap. The fact that decisions taken during this period have an impact on future costs and compliance has already been noted: in addition, smoothing the path into compliance for such businesses has potential to reduce the shadow economy. Any action taken to facilitate the entry of these businesses into tax processes should be informed by good knowledge of this customer group, and so the OTS considers that this gap should be addressed. Targeted research, informed by the learning from behavioural

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4 https://www.gov.uk/guidance/tax-free-allowances-on-property-and-trading-income

5 See this current cross-EU work and reference library for examples of good practice - https://ec.europa.eu/social/main.jsp?catId=1299&langId=en; https://ec.europa.eu/social/main.jsp?catId=1299&intPageId=4875&langId=en

6 https://www.gov.uk/set-up-sole-trader

7 https://www.gov.uk/set-up-sole-trader

insights, could provide evidence to help shape a programme to support businesses in this period and reduce the risk of non-compliance or delayed compliance.

2.16 The OTS makes the following recommendations to support businesses during this period, without adding to their burden:

Core Recommendation 1: The government should develop and offer small businesses a package of start-up guidance taking them step-by-step through the things they need to do at key stages in the business, with tax as a major (although not the only) focus.

2.17 HMRC should lead on the development of this package aimed at start-up businesses, liaising with others such as BEIS and Companies House.

2.18 The package should be readily and easily accessible and take businesses through what they need to know in a step-by-step approach. To ensure widespread coverage, a range of delivery channels should be adopted (online, paper, posters), and the material should be available or signposted consistently in places where start-up businesses may see it.

2.19 Central and local government and other bodies who engage with small businesses should help to share it: examples of relevant parties include Job Centres, Growth Hubs, local council trading licence centres, banks, charities and bodies such as Enterprise Nation and the Princes Trust. In addition, information might be given to school leavers and students about to graduate from college or university, and included with the letters sent to 16 year olds with their National Insurance Number. Posters signposting the advice might be displayed in health and community centres. Online platforms and others engaging self-employed people could be asked/required to give the package to those working with them.

2.20 The guidance should be designed from the perspective of someone with no tax or regulatory experience and divided into easily-grasped sections (such as 'Five things to consider in your first month', 'Three simple ways to keep a record of sales and purchases' or 'The key deadlines in your first year'). It would complement the more detailed guidance mentioned in paragraphs 2.11 to 2.15 above and signpost users to that guidance if they want more information.

Additional Recommendation 11: The OTS suggests that HMRC commission research into the pre-formalisation period of start-up businesses.

2.21 The research should scope the population and identify key categories and sub-groups that might be prioritised. It should seek to understand the behaviour of these groups – their attitudes to tax and regulation, their preferred modes of engagement and communication and their ability to navigate existing guidance and systems. It should identify conditions that encourage businesses to formalise and those that discourage them.

2.22 Some of those running these fledgling businesses will be particularly vulnerable, for a range of reasons, and may need additional support to deal with any tax issues that arise. This category will include people who are unable to find employment because of their location, health or other reasons. It includes people with limited literacy or numeracy skills who are able to work in activities that do not require those skills. People sometimes become temporarily vulnerable because of major life events such an illness, accident or bereavement.

2.23 HMRC, Job centre advisers and a number of charities and NGOs already provide support to help a range of vulnerable individuals in their engagement with the tax system. One focus of the research could be to look at how people with additional needs could best be consistently supported.

Chapter 3
Choice of business form

Introduction

3.1 Chapter 1 outlined the growth in businesses in the UK. The term business includes both companies and people working outside a corporate structure, often referred to as self-employed. The structures that can be used are known as the business form, and each will have different tax consequences.

3.2 The OTS Small Company Report noted that there is no definition of self-employment, although there have been calls for a single definition to cover both tax and employment law.[1] [2] The OTS notes that the government's Good Work Plan includes a programme of work to look at closer alignment between the definitions of employment and self-employment for tax and employment law purposes.[3] In the absence of a current definition, the term self-employment is used in this report to cover those working for themselves (a sole trader) and those in a working relationship with others (a partnership, which can take a number of different forms).

Practicalities of different business forms

3.3 From an administrative point of view, the simplest business form is that of a sole trader – a single person working in business. A sole trader will need to register with HMRC for income tax and National Insurance Contributions (NICs), also for VAT if above the threshold and PAYE if employing someone. Sole traders directly own the assets of their business, and are entitled to the income of the business. Similarly, the sole trader will be responsible for the liabilities of the business, meaning that their personal assets, including their home, are at risk.

Case study 2: Poll's preserves

Polly is a mother of two and an excellent cook. She took time off from employment to look after her children. During this time she began making jams and chutneys. Initially these were gifts for friends and then sold at charity fairs for the children's nursery and local organisations, but there was so much demand that she began to sell through local shops and tearooms. A buyer for

1 https://www.gov.uk/government/publications/small-company-taxation-review

2 https://www.gov.uk/government/publications/good-work-the-taylor-review-of-modern-working-practices

3 https://www.gov.uk/government/publications/good-work-plan

a major supermarket bought some of Polly's products while visiting family in the area. The supermarket subsequently approached Polly to ask if she could produce this quality at scale.

Polly already has someone helping her keep up with demand for her products. Scaling up to this extent would need new premises but she thinks she could organise that. However, she has been very worried by recent press coverage of a case where a person with an allergy died after eating food that was not clearly labelled. Polly is scrupulous about hygiene and labelling but is concerned to protect her family home from any unforeseen problem caused by the business. She already has appropriate insurance, but is advised that putting the business into a company would separate the business assets and liabilities from her and her family's personal assets.

Her accountant helps her set up the company and they agree that the accountant will do accounts and tax preparation going forward. Polly and her current helper as well as any future staff will become company employees and the accountant's payroll team will manage their PAYE returns.

3.4 If an individual decides to operate a business through a limited company, they must incorporate and register the company at Companies House. Companies set up using the Set up a limited company and register for Corporation Tax service will be registered with Companies House and HMRC for corporation tax in a single submission, with the option of registering for PAYE with HMRC, as well. The company is a separate legal entity from its shareholders and directors. The personal liability of a shareholder of a limited company is limited to their share capital[4]. However, the directors of a company (as opposed to its shareholders) have specific legal duties and responsibilities laid out in company law.

3.5 Administrative burdens will increase, as the company needs to be registered and file accounts with Companies House (CH) as well as HMRC, with both the company and the individual paying taxes. Accounts filed with Companies House are published online and available for any interested party to view.

3.6 As well as limited liability, the tax payable, perceived status and credibility that comes with a company, and the desire for a formal structure or the demands of the customer are all considerations in choosing a company as the business form.[5]

3.7 The taxation and legal implications of a partnership were looked at in the OTS partnership review.[6] Essentially, the profits are divided between the partners (in line with their partnership agreement), and each individual partner will be taxed as if a sole trader on their own profit share.

3.8 It is possible for a limited company to be a partner in a partnership, when the profits will be allocated according to the profit share agreement, with

4 Some shareholders may take on additional liabilities through guarantees e.g. of bank loans

5 https://www.gov.uk/government/publications/reasons-behind-incorporation

6 https://www.gov.uk/government/publications/partnerships-review

the individual partners assessed to income tax as a sole trader, and the corporate partner assessed on its share to corporation tax as a limited company. A partnership can incorporate, forming a limited liability partnership (LLP), giving limited liability to the members in a similar way to that of a company: partners are still taxed on their own profit share as set out for a partnership above.

3.9 While it is for a business owner to choose whether to operate as a sole trader or through a limited company, the matter of whether an individual is self-employed or employed is not one of choice, but depends on the facts and the terms of the contract in place with the customer. This subject of employment status in the context of changing work practices has been widely discussed recently, including two OTS reports (Employment Status and the Gig Economy focus paper)[7] and Good Work: the Taylor review of Modern Working Practices.[8]

Taxation of different business forms

3.10 Different tax consequences follow from the decision to use a particular business form. Chart 3.A below shows a significant difference between the tax and NICs cost of employment income versus self-employment/company income. Chapter 6 will show the additional financial and regulatory costs that arise when a business takes on employees.

3.11 The OTS notes that the differential could influence attempts to fall within the self-employed category.[9] This behaviour has in turn given rise to a range of anti-avoidance provisions, including recent changes for both public and private sector engagers, requiring them to determine whether or not the relationship is one of quasi-employment (which would require the operation of PAYE).

3.12 The Taylor Review and recent Institute for Fiscal Studies (IFS) analysis have found that the different rights and obligations between self-employed and employed people are not sufficient to justify the tax and national insurance differential.[10] As long as the significant differential continues, there will be a desire to obtain the more economically favourable treatment and a need for complex anti-avoidance rules and compliance interventions.

Tax and NIC costs of employment, self-employment and a single-person company

3.13 Chart 3.A compares the 2018 to 2019 tax cost of income at levels of £10,000, £25,000, £50,000, £75,000 and £100,000, for a director/shareholder of a limited company, a self-employed individual, or an employee. The table starts with the assumption that a business has a set sum

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7 https://www.gov.uk/government/publications/employment-status-review;
https://www.gov.uk/government/publications/the-gig-economy-an-updated-ots-focus-paper

8 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/627671/good-work-taylor-review-modern-working-practices-rg.pdf The Government's response to the review is here:
https://www.gov.uk/government/publications/government-response-to-the-taylor-review-of-modern-working-practices

9 Taylor Review Chapter 9 – Incentives in the system

10 https://www.ifs.org.uk/publications/13079

to spend in return for the services of its employee, owner or director/shareholder: relevant deductions are then shown, to arrive at a net amount in the hands of the recipient. In practice, a company might decide to spend additional sums to ensure that the employee receives more money: however the Chart shows the net tax cost of different arrangements. Full workings are shown at Annex D.

3.14 The limited company figures assume a single shareholder, salary equal to the primary national insurance contributions (NICs) threshold, with the balance of profits distributed as dividend: this is the approach which minimises the tax and NIC paid in the case of a limited company.

3.15 The tables set out the amount left in the hands of the employee/self-employed individual/shareholder after deduction of:

- limited company – corporation tax, income tax on dividends drawn (as the payment above the primary NICs threshold is taken as a dividend, no tax or NICs on salary are relevant). Dividends do not attract NICs
- sole trader – income tax on profits, class 2 and 4
- employee – Class 1 NICs, employers' NICs, income tax on salary. Further employment costs can apply in respect of auto-enrolment, holiday, sickness, maternity/paternity pay and so on

Chart 3.A: Tax and NICs differences between employment, self-employment and a single-person company 2019-20[11]

Profit[11]	£10,000	£25,000	£50,000	£75,000	£100,000
Limited Company	£9,740	£21,336	£40,067	£55,701	£69,369
Sole Trader	£9,721	£20,871	£38,621	£53,121	£67,261
Employee[12]	£9,690	£19,186	£34,125	£47,365	£60,107
Differences[13]					
Tax difference between limited company and sole trader	£19	£465	£1,446	£2,580	£2,108
Tax difference between limited company and employee	£50	£2,150	£5,942	£8,336	£9,262

Source: OTS

[11] The figures shown for a limited company, sole trader and employee below each column heading are the amount of net income after tax.

[12] Assumes employee's salary paid after deduction of employer NIC

[13] The figures below show in each case that less tax and NICs are payable in the case of a limited company.

Tax differentials

3.16 Chart 3.A shows that the biggest difference in cost occurs between a limited company and employment. This is largely due to the impact of employer NICs. The further costs associated with employment, including auto-enrolment pension contributions, sickness and maternity/paternity pay will be explored in Chapter 6.

3.17 The tax costs for a limited company director/shareholder as compared with a self-employed individual are not too far apart. The slight advantage for companies at most income bands would be outweighed by the additional administration costs of running a company: research carried out in 2015 for HMRC into tax administration for businesses reported that surveyed micro companies paid an average agent's fee of £1,853, while the average agent's fee across all businesses for the self-employment return was £426.[14]

3.18 The company owner also has the flexibility to retain profits within the company, to reinvest in the business, or simply to wait until lower tax rates apply, for example on winding up the company when, if Entrepreneurs Relief conditions are met, a rate of Capital Gains Tax of 10% on distributions may apply (subject to anti-avoidance rules).

3.19 There is evidence that tax impacts on behaviours. In the IFS's June 2018 presentation: *How do small business owners respond to the tax system?* they found that small businesses are highly responsive to the tax system, with notable peaks at VAT and higher income tax thresholds.[15]

3.20 The IFS also found that corporate business owners use flexibility on income recognition to respond to tax rate changes.[16]

3.21 Historically, the tax position significantly favoured incorporation. Changes to the tax treatment of dividends in April 2016 somewhat reduce that advantage.[17] However, other tax changes, such as the reduction in the ability of landlords to offset mortgage interest against income tax may have encouraged small landlords to incorporate (companies are not affected by this measure).[18] There is no evidence that the number of company registrations is reducing significantly.

Self-employment or employment

3.22 To help determine whether a contract of employment exists, the OTS previously recommended[19] that HMRC enhanced their online employment

14 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/443746/HMRC_Report_375_Tax_Administration.pdf

15 https://www.ifs.org.uk/publications/13027

16 https://www.ifs.org.uk/publications/13027; https://www.gov.uk/government/publications/profit-distribution-and-investment-patterns-of-unlisted-companies

17 Initially there was a £5,000 allowance to protect passive savers: this was reduced to £2,000 from April 2018

18 Bringing a property business into a company is not a straightforward matter and should not be undertaken without appropriate advice. The transfer will involve legal costs and potentially additional stamp duty land tax and capital gains tax. There are inheritance tax implications.

19 Employment status report March 2015

status tool. This work has been carried out, and the revised tool is known as the Check Employment Status for Tax (CEST).

3.23 In meetings with stakeholders, the OTS have met businesses that are unaware of the existence of the CEST tool. Some advisers had the perception that the tool was weighted towards employment.

3.24 The tool does not give an answer in every case. HMRC's analysis of the tool since implementation shows that it has been used 800,000 times and reaches a decision in about 85% of cases. Of the decisions made, approximately 60% of cases were found to be self-employed and 40% employed. Similar tools are available commercially and HMRC's benchmarking showed that the 85% decision rate and other markers were in line with those tools.

3.25 HMRC have advised that in cases where correct information is provided in accordance with their guidance, HMRC will stand behind the result of CEST. HMRC also advised that it is not mandatory for customers to use CEST to determine employment status.

3.26 HMRC plan a number of updates to CEST, which will be introduced before planned tax changes come into effect that will make businesses responsible for deciding whether a sub-contracted one person company which they are engaging is an employee for tax purposes. These updates are things that businesses and representative bodies have said would be helpful. Among other things, some of the language used will be in plainer English to reflect wider target audiences. HMRC are also looking at having more embedded data in the tool (info boxes and pop-ups at points where people may need further explanation) as well as more in-depth updated customer guidance.

3.27 The Government's Good Work Plan published 17 December 2018[20] takes on board recommendations from the Taylor report, and undertakes to legislate to improve the clarity of the employment status tests, together with further improvements to guidance and the online tool.

Reasons for incorporating and consequences

3.28 As noted above, there is a good body of evidence showing that tax is not the only motivating factor that may be behind a business's decision to incorporate, though it may be a factor. The OTS has heard from businesses, agents and representative bodies that factors such as limited liability, increased perception of credibility and a desire for a more formalised business structure are important considerations. Many businesses have also been encouraged to incorporate in order to do business with their customers.

Case study 3: John

John is an experienced and specialist scientist working in the pharmaceutical sector. Made redundant following a restructuring, John was offered work by a different company (company A). Company A required John to form his own

20 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/765128/good-work-plan.pdf

company, which they would then engage as a contractor. John formed a company and took on the work on those terms. Unfortunately, the work ended after six months and John was forced to seek employment elsewhere.

Some months later John was required to complete accounts and a tax return for his company. Given his scientific and analytical background he felt that he should be able to do this himself. However, he found that he could not understand what the system required of him. His engagement had not earned him sufficient money for him to feel that he could afford paid advice. In desperation he contacted an old university friend, who happened to be an accountant. She successfully talked him through the filing process and advised him to deregister the company.

Throughout this process John assumed that he was doing the right thing by acting as company A asked: he never considered the possibility that he might in fact be an employee, even though every aspect of the day-to-day work he did was similar to the basis on which he had been employed by his previous company. (He carried out the work he was asked to do, using the scientific protocols requested, working in the company building during specified hours and reporting to a direct manager. If asked, he would have described himself as someone working for company A and not as a consultant providing services to the company.) Under IR35, John should have asked himself whether he was in fact an employee, in which case a payment for income tax and NICs should have been made on his earnings.

3.29 As noted earlier, the distinction between employment and self-employment is not one of choice, but one of fact. However, engaging a limited company is outside of a contract of employment and a limited company cannot legally be an employee. There is evidence that pressure from engagers seeking to avoid the cost and complication of having employees has been one of the drivers for people to form a limited company. Equally, there is also evidence that some employment agencies have marketed the tax/NIC savings from using an intermediate company to those they place with engagers.

3.30 Legislation introduced in 2000, known as IR35, has the effect that where limited companies are engaged on terms that would have been employment if applying to the director personally, then tax and NICs are due as if an employment existed (but without making the person an employee for employment law purposes). The obligation to decide on status, and to report and pay the right amount of tax, fell on the engaged company rather than the engager. HMRC consider that there is a wide level of non-compliance for a range of reasons including lack of understanding, as in the example above. HMRC continues to litigate a range of cases in this area, with a mixed record.

3.31 Changes were introduced to off-payroll working in the public sector from April 2017, resulting in the engager having to decide and act on the status decision rather than the engaged business. At Budget 2018, it was announced that this will be extended to the private sector for medium and large engagers from April 2020 following a further consultation.

3.32 The OTS notes that this and other anti-avoidance legislation is dealing with the symptom rather than the underlying issue, which is the differential tax/NICs treatment and other regulatory burdens that make an employee significantly more costly to a business than a contractor.

Additional Recommendation 12: The OTS considers that it may be helpful if the company registration process offered people targeted information and guidance about the key features of a company, together with a nudge to stop and think before they push the button to set up the company.

3.33 The OTS suggests that HMRC work with BEIS and Companies House to develop a package of material intended to support people in making the right decision about forming a company at the right time. Elements of this package could sit alongside the material aimed at start-up businesses (See core recommendation 1 on page 23).

3.34 Companies House have produced an interactive learning tool for flat management companies. This is a good example of the sort of material that might be helpful for a wider category of small company.

3.35 HM Treasury and BEIS have announced they are working to improve the clarity of legislation determining employment status, as set out in the recent 'Good Work Plan'. The OTS would be happy to offer support, if requested.

3.36 Before the 2020 off-payroll legislation is introduced, the OTS would like to see HMRC continue to make its planned improvements in the Check Employment Status for Tax (CEST) online tool. These improvements are proposed alongside better guidance in the Good Work Plan. The OTS also suggest signposting to the guidance and the employment status helpline, where the tool does not produce an answer, or the taxpayer does not agree with the finding. The OTS acknowledge that it is very useful that, where correct information is provided, and a result is given by CEST, HMRC agree the result can be relied upon, providing certainty to the service provider and the engager.

3.37 The OTS notes that there is no easy route for a service provider to appeal against a ruling by the engager that the services are provided under a quasi-employment.

Chapter 4

Initial engagement with HMRC

Registering for tax

4.1 Registering for a particular tax generally begins and ends online, supported by some postal stages the first time someone registers with HMRC.[1] For most people, registering for the first time is relatively painless but is a lengthy undertaking, lasting around four to five weeks – see the summary of the process for income tax below. The OTS notes that the GOV.UK page for tax registration is clean and uncluttered and has clearly identified links for all the key taxes, with an additional link for agents.[2]

Registration process

1 Go into GOV.UK website

2 Open "HMRC services: sign in or register"

3 Click "Register for HMRC on-line services"

4 Click "Register if you are self-employed "

5 Enter name, email address and create an 8-12 character password

6 A 12 number-character User ID is created on line for you which you are advised to record

7 Then fill in a form online with name, address, and business details

8 10 working days later, receive a letter (hard copy) containing your Unique Taxpayer Reference (UTR)

9 Create a new account and use the UTR to register for Self-Assessment online services

10 Receive an activation code in the post within 10 working days (hard copy again)

11 When you have your activation code, you can sign in to your online account

12 You can then file an online self-assessment tax return

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1 Once an individual is registered on the Government Gateway, any subsequent registrations by the same person – for example for a particular tax such as VAT – do not require the additional postal identity verification stages

2 https://www.gov.uk/log-in-register-hmrc-online-services/register

Assuming you do all the online tasks instantaneously, in the right order and without error, the whole process will take around 4-5 weeks (steps 8 and 10 above).

Case study 1.B: Joseph

Joseph finds the GOV.UK page for tax registration quite easily.[3] He completes the initial process (see above), and receives his Unique Taxpayer Reference number in the post some weeks later. He uses this to set up a new account and then is sent an activation code, again through the post. The whole process takes five weeks and he is registered by late December. He is thankful that he did not wait any longer to start as he might not have got the code on time to complete his registration and file online by 31 January.

Joseph's daughter Anna is a student. Her course began in October 2017. She is also a keen gardener, and has been helping to finance her studies by tending neighbours' gardens. Her customers pay her in cash or directly into her bank account. Anna is not registered for tax. Anna and Joseph discuss her position, and agree that it is time for her to register and pay tax on her earnings, as these are above the income tax threshold.

Anna goes online and tries to register. The system asks her if she is self-employed or not self-employed. She doesn't know how to answer. She is a student, who earns some money to subsidise her studies. She doesn't know why it matters. She decides to register as not self-employed and starts the process. However the system tells her that it cannot validate her. Anna does not have a credit card or loan other than her student loan, and thus the automatic cross-check with credit reference agencies fails.[4]

She is tempted to give up, but her father encourages her to call HMRC. They tell her to print off an online form and post it to them for processing. Anna wonders why this isn't an online service; she can't remember the last time she sent a letter.

4.2 The OTS is aware that HMRC is working on improvements to the identity assurance process, so that fewer people fail because of a lack of credit history.

4.3 For income tax registrations, it is not clear why there is a need for taxpayers (such as Anna in the case study above) to decide if they are self-employed or not, and why there are two paths to register, depending on whether one ticks the box for self-employment. If this two-track process is necessary, the OTS recommends consideration of a pop-up box explaining what the terms mean in this context, to help people understand which box they should tick.

3 https://www.gov.uk/log-in-file-self-assessment-tax-return/register-if-youre-self-employed

4 This is a not uncommon experience. https://twitter.com/Peston/status/1009911820394561536?s=09

4.4 In the course of registering for income tax, the taxpayer gets two identification numbers, the UTR and the Gateway number, that they need to track. Individuals already have a National Insurance number, so there are at this stage three tax-relevant identify numbers for one person.

Additional Recommendation 13: The OTS suggests that HMRC look further at the online process for registering for income tax self-assessment. Is a two-track process (self-employed vs not self-employed) necessary? If it is necessary, consider an optional explanation box to help customers understand why they are being asked this question and how to answer it.

Additional Recommendation 14: The OTS understands the need for a secure tax registration process. However, the two-stage postal process is too lengthy. Could this not be reduced to one stage, assuming a postal process is necessary?

Registering a company

4.5 The process for registering a company begins with registering with Companies House. Registration can be done online via the GOV.UK website.[5] A fee of £12 is charged to register a UK company. Other options for registration include printing off and sending a paper form (the fee for a paper application is £40), or using an agent or third-party software.

4.6 Around half of all new company registration applications are made by agents. Some agents specialise in in company registration and related processes: others will be tax agents, setting up the company as part of their tax-related services. The application process identifies whether the application is made by a director of the company or an agent. Agent details are kept on record: they are not routinely passed to HMRC with other information about the registration. It is not possible for the agent to signal whether they expect to have a continuing relationship with the client. It may help with future compliance if the communications about the new company reinforced the need for directors to either act on the letter or inform their agent.

4.7 Agents note that if they act on behalf of a client they are required to have carried out anti-money laundering and other due diligence checks, while a person acting on their own behalf is not subject to any such checks. Assuming that such checks are in principle important, there seems to be a gap in coverage.

4.8 Agents also note that even in cases where they have registered a company on behalf of a client, they will only receive the registration papers from Companies House if the company is registered at their premises. If the company is not registered at the agent's address, the papers will be sent to the client and will not be copied to the agent. The agent can find out if the registration has been completed by checking online, but is not routinely informed (clients in such cases tend to assume that the agent will have their own copy of the material and may not think to share the information with them, even when agents tell them in advance that this will not happen).

5 https://www.gov.uk/limited-company-formation/register-your-company

4.9 Tax agents need to show that they have consent from a business before HMRC will allow them to act: the challenge with a company is that HMRC do not accept the forms until the company is registered. Companies House does not require authorisation of company formation agents.

4.10 Guidance on registering for corporation tax says that a company is required to notify HMRC that they have formed and to register for corporation tax within three months of formation.[6] However what happens in practice is that Companies House sends HMRC details of all new registrations and HMRC follow this up by registering the company for corporation tax and sending the registration details to the address they have together with requests for any additional information they need. The guidance therefore does not seem to fully reflect current practice.

4.11 Companies House does not tell HMRC that an agent made the registration. Businesses with tax agents acting may send this material to their agent, but the OTS has heard that the businesses often neglect to do this and so the agent needs to spend time following up.

4.12 Registering a company will start the clock for the purpose of sending a first corporation tax return unless the company has been flagged as dormant. (See Chapter 7, which looks in depth at company tax, for more on first return timing.)

4.13 The OTS heard from many tax agents that new clients may come to them having already incorporated, without advice and without fully understanding the effect of incorporation.

Case study 4: The Miller family

Helen and Jamie Miller own their family home jointly and have also invested in two buy-to-let properties as part of their retirement planning. Concerned by recent changes to the taxation of rental properties, which mean that their mortgage costs can no longer be fully offset against the income from the property for tax purposes, they decided to set up a company (they have heard that the interest restrictions don't apply to companies). It was very easy to set up the company online and they did not consult their tax adviser at that time, but brought the company details and all other financial data to their adviser as they approached the tax year end, as normal.

The adviser quickly realised that Helen and Jamie had not transferred the properties into the company and had continued to invoice the rent in their own names: this means that the property income was still their income for income tax purposes. If the family were to transfer the properties into the company, legal fees, capital gains tax and stamp duty land tax charges may apply, potentially cancelling out any income tax advantages. Helen and Jamie had not anticipated any additional legal or accounting costs in relation to the company: it had been so easy to set it up, and their expectation was that administration would continue to be minimal.

[6] https://www.gov.uk/limited-company-formation/set-up-your-company-for-corporation-tax

4.14 The OTS's small company report included an observation that it is almost too easy for a business to set up a limited company without understanding the legal, accounting and admin implications.[7] The OTS has continued to hear this message, and understands that significant numbers of companies have been set up and closed in recent years: HMRC's records show that 2 million companies formed since 2010 have since been struck off the company tax register. Of these, 1 million were struck off before their first tax filing date.

4.15 It is a good thing when government processes are streamlined and simple to operate. The OTS welcomes the fact that the process of setting up a company and registering it for tax is easy and efficient.

4.16 However, registering a company has implications that are not well understood by a reasonable proportion of those setting them up. This can result in unnecessary administrative costs, or fines and penalties. It is important that people are provided with information to help them understand the impact of decisions they make.

4.17 Although in principle a matter for Companies House, company registration issues have significant impact for tax and for HMRC's relationships with businesses. So this is an area where cross-government working is particularly appropriate, and the OTS is pleased to note that HMRC, BEIS and Companies House engage regularly on matters of common interest.

4.18 The OTS considers that it may be helpful to offer customers a nudge to stop and think before the push the button to set up a company.

4.19 That said, by the time someone gets to that stage they may already have made up their mind, and clear and accessible information at earlier stages in a business's lifecycle may be more influential. The OTS considers that any start-up information package should include a summary of the pros and cons of forming a company and of the differences between a company and its owner.

Registering for VAT

4.20 Most VAT registration applications can be completed online.[8] The feedback received by the OTS showed that businesses and agents consider this a smooth and effective process. No suggestions for areas that should be simplified were received.

4.21 A number of comments were received about the VAT registration threshold, and its impact on businesses. The UK has the highest VAT threshold in both the EU and OECD. This has the benefit of ensuring that the smallest business have one less tax to deal with. On the other hand, it can cause competitive pressures, and the cliff-edge impact of suddenly needing to pay 20% more tax on business supplies is a challenge for businesses dealing with retail (non-business) customers when they cross the threshold.

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7 Chapter 6: https://www.gov.uk/government/publications/small-company-taxation-review

8 https://www.gov.uk/vat-registration/how-to-register

4.22 The VAT registration threshold was explored in the 2017 OTS review of VAT.[9] The government subsequently issued a call for evidence on whether the design of the threshold could better incentivise growth. A response was published on 29 October 2018. The government noted that no clear solution had been identified to the concerns around the threshold, and stated that it will continue to monitor the position and consider smoothing mechanisms following the UK's departure from the EU. In the short term, the current thresholds have been frozen until 31 March 2022.[10]

Identification numbers

4.23 One of the challenges in tax administration is that individuals and companies are given multiple reference numbers.

4.24 Individuals will almost certainly have a National Insurance number, if they are UK resident. This is typically issued to individuals when they reach 16. Individuals coming to the UK to work need to apply for a National Insurance (NI) number. Many individuals will also be allocated a Unique Tax Reference (UTR) by HMRC.

4.25 Companies and UK Limited Liability Partnerships (LLPs) will be allocated a reference number by Companies House, which is used to identify the company or LLP. This is used in a wide range of business transactions. Yet HMRC will also allocate a UTR to companies and LLPs.

4.26 HMRC record the NI numbers and company numbers of individuals, companies and LLPs.

4.27 NI numbers are used by employers; those operating the Construction Industry Scheme; pension savings companies; and financial institutions issuing Individual Savings Accounts (ISAs). They may also be sought by financial institutions in relation to the US FATCA rules and the Common Reporting Standard.

4.28 The OTS considers that there would be a real advantage in using a single reference number for all purposes, where possible. The 'OTS Technology Review: A vision for tax simplicity' considered the option of combining tax and National Insurance numbers, including potential risks to be managed.[11]

4.29 Additional tax reference numbers would still be needed for a number of cases. For example, VAT numbers follow a common EU standard for a range of reasons: in addition, VAT registrations can encompass a group of companies all within a single registration and making one return, while for corporation tax, each company is registered in its own right. Other examples include non-resident taxpayers who would not have NI numbers, and entities which are not required to register at Companies House.

4.30 Moving to a single reference number for all purposes other than VAT would not be a quick process, given the millions of individuals and companies

9 https://www.gov.uk/government/publications/ots-report-on-routes-to-simplification-for-vat-is-published

10 https://www.gov.uk/government/consultations/vat-registration-threshold-call-for-evidence

11 See paras 1.48 to 1.53.

involved. Yet starting such a project now would ultimately produce benefits for everyone.

4.31 At the same time, those likely to provide data to HMRC should be required to start gathering that information. For example, banks and building societies could be required to obtain NI numbers in relation to all bank accounts – not just ISAs. Charities could be required to gather the data in relation to Gift Aid claims. Given the systems changes that would be needed, a notice period of several years would be required to allow for this.

Strategy for agents

4.32 Paid tax agents play a major role in supporting compliance, and their input usually starts at or around registration.

4.33 Various aspects of running a business are inherently complex: some business owners choose to manage the complexities themselves, but many need or value support from agents. 33% of the businesses who responded to the OTS survey said they dealt with no taxes themselves. Those who dealt with tax themselves mostly completed the income tax return: the use of tax agents was highest for corporation tax.

4.34 Complexity and the fear of making mistakes were the most common reasons cited for using agents, followed by a desire to focus on core business activities. A number of company respondents noted that they could not prepare accounts themselves.

4.35 HMRC recognises the valuable role tax agents play and seeks to support them. An Agent Update bulletin is produced regularly, covering key topics and relevant reminders, and regular webinars are produced on areas of significant interest. Agents are able to complete some transactions on behalf of clients. However, the approach is inconsistent, with agents unable to access a number of key services and sometimes compelled to ask their clients to do things that the client would much prefer the agent to do.

4.36 If agents were able to see relevant client information and carry out such tasks routinely, they would be completed more quickly and with fewer mistakes. This would reduce costs for clients and for HMRC, who would have fewer calls and queries to resolve.

4.37 Experienced tax agents can also add value by being consistently consulted when changes are being implemented or communications developed.

4.38 Agent feedback in HMRC surveys is consistently less favourable than feedback from individuals and businesses. There have been some improvements in recent years but there is a good deal further to go. The OTS has been concerned to see evidence of considerable gaps in mutual understanding between the agents and HMRC officials it has met in researching this subject.

4.39 Agents' role in supporting compliance with the tax system is recognised in HMRC's 2014 Agent Strategy, which commits HMRC to a number of initiatives to help agents.[12] Some of these have been completed, but HMRC

12 https://www.gov.uk/government/publications/agents-strategy-an-overview/agents-strategy-an-overview

has struggled to prioritise implementation of this strategy in the face of other demands.

4.40 The principles set out in the Agent Strategy seem sound and reasonable: they include enabling agents to see the same information as their clients and carry out any transaction their client wishes them to do. The challenge lies in implementation. At present, there is very limited agent visibility of taxpayer information. The OTS's recommendations are intended to ensure consistent implementation of the strategy, to ensure that agents are able to support clients in complying with tax at minimum cost.

4.41 HMRC should appoint a senior official to oversee implementation of the Agent Strategy.

4.42 The focus of this role should include ensuring that agent needs are built into new systems and also a constructive engagement with the profession, to ensure that agents feel listened to and understood, and work with HMRC officials to increase understanding of the role of agents.

4.43 This also includes ensuring that agents are copied into key exchanges with their clients (a longstanding practice that seems to have been missed in some recent process redesigns).

4.44 There should also be consideration of the role employers pay. Employers effectively act as the PAYE agent for all their employees, the majority of whom will be unrepresented. Tax agents get a priority helpline: there is an employer helpline also, but the OTS understands that this is not a priority line. Employers, particularly those with larger numbers of staff, should also be considered for prioritisation.

4.45 The government should produce a roadmap setting out dates for implementation of the key improvements, such as the ability of agents to see data relating to their clients and ensuring that consideration of agents is a mandatory part of all new system redesign. Increasing agent engagement feedback scores would be one way to monitor the impact of improvements.

4.46 The OTS has been concerned to see evidence of considerable gaps in mutual understanding between the agents and HMRC officials it has met in researching this subject. For example, agents don't always appreciate the complexity and challenge of making change for an organisation that deals with more than 31 million income tax payers annually. On the other hand, the OTS has encountered tax officials who do not understand the extent to which compliance (as opposed to tax planning) is at the heart of the agent's role.

Core recommendation 4: HMRC should appoint a senior official to oversee and prioritise implementation of the Agent Strategy

Core recommendation 5: HMRC should routinely build agent awareness and needs into system design and improvement and its related guidance.

Additional Recommendation 15: The OTS suggests that the government consider options to copy company registration information to a tax agent, when that agent has made the application on behalf of their client and has a continuing relationship with them.

Chapter 5

Calculating and paying tax

Case study 1.C: Joseph completes his income tax return

Joseph has kept track of his earnings and outgoings to an extent, but needs to do some work before he can file his return. He has saved all his receipts and invoices and employment information in a box. He sorts these into months, and checks his bank account so he can see any payments he may have missed. He then adds up a monthly figure of purchases and sales.

Joseph has heard that there are special tax rules for cars and vans. He searches online to see what he needs to do for these expenses. This is frustrating, as the searches keep producing results about company cars and vans being used by employees. However, he eventually manages to find some guidance that seems to relate to his situation. It is quite complicated, and he needs to read it a few times before he feels he has understood.

For the car, which he owned before starting the business, he finds that he has an option to claim simplified expenses or to work out the actual cost, and that there is a calculator that helps him to see which will be most advantageous for him.[1] For the van that he bought with his redundancy money, he thinks that he can claim what it cost.[2] (This rule applies for people on cash accounting, and he has already decided he will say he is doing accounts on a cash basis as cash is easy for him to understand.)

With this information ready, Joseph logs into the system and starts to work through the return. The return asks him about his employments, and he uses his P45 to fill in the relevant information about his employer. He sees that the boxes with numerical data (earnings from the employments) are shown as optional. He wonders if that means he shouldn't fill them in because HMRC already has this data. But if that's the case, why have the boxes? He is uncertain, but puts the numbers from the P45 into the return as he has it to hand.

The form asks him if he makes up his accounts to 5 April, the tax year end. Joseph isn't sure if his summary of purchases and receipts are accounts, but

1 https://www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age

2 https://www.gov.uk/simpler-income-tax-cash-basis/income-and-expenses-under-cash-basis

decides to say yes, as that seems the simplest option and the system seems to be nudging him to say yes at this point.

When Joseph enters his income and expenses, a note tells him that he has the option to use a £1000 trading allowance instead of claiming actual expenses. As he was just trading for 7 weeks, this allowance is more than the day-to-day expenses he incurred. He is not sure if the allowance is for the whole year and so should be adjusted for part years. He can't find anything telling him to make a part-year adjustment, but in any event the cost of the van means that his expenses for that period were more than £1000, and so he decides to go ahead on the basis of his original calculation, hoping that is the right thing to do.

As he works through the return he finds himself stopped at a number of points. In some pages, he has to put in a zero or number in a box in order to go to the next question. At other times if he puts in a zero he gets a message telling him that he must not do this, and he cannot move on until he deletes the zero. This is irritating, but he manages in time to work his way through the return.

The system offers him the chance to see the calculation in full and check it before he finishes. He likes this, and the fact that he can take a break and come back to the form when he needs to. He checks the return a few times before pushing the button to submit it.

He is happy that he understands the figures and they make sense to him. However, he is shocked by the tax bill. The purchase of the van for £3,000 meant that he had a loss in the first year and some offset available for the second year, but he finds he has to pay an extra amount which is around half of a full-year's profits. This is his first of two payments on account of the tax due for next year: it's an estimate calculated on the basis of the information he has given.

Joseph does not have enough money to pay this by the end of January. Because he expected to have no tax to pay, he used some of the money he had set aside for Christmas presents and expenses. He finds that HMRC won't accept credit cards so he can't spread the payment that way. He sees that people who can't pay the bill are encouraged to call HMRC to talk about options, but he doesn't want to pay late and have a debt hanging over him. He also doesn't want to take out a bank loan. Joseph had used his surplus redundancy money to overpay his mortgage, and he decides to draw down some of this money to pay his tax bill.

He is determined that next year he will have all the money ready. He notes that HMRC offer a budget payment plan as a way to set money aside for next year's tax and decides to explore this.

5.1 In relation to the substance of the return calculation, the OTS notes and welcomes key simplifications including the £1000 trading and property allowances, rent-a-room relief, and cash accounting. The allowances and rent-a-room relief have the effect that those with very low amounts of trading income are not required to register and pay tax. For those with higher incomes, they can simplify the calculation of expenses.

5.2 OTS research has found that the income tax return process works well, if not perfectly. Key positive features include customers seeing only the pages that matter to them, being able to save and return to the form later, being able to see and check the calculation and information before submitting, all adding up to a good customer experience.

5.3 As noted in the case study, there are some aspects of the return that are not intuitive and warrant further work – such as showing figures as optional that are not, requiring zeros in some cases and rejecting them in others.[3]

5.4 The OTS has heard also that some people find the appearance of the return pages very formal and off-putting: it has been said to look more like a database entry screen than an online portal for customers. Although this may sound like a trivial point, in practice peoples' responses are affected by such matters. See, for example, the recent analysis from the Financial Conduct Authority (FCA) of how people see, interpret and act upon information in financial advertisements (FCA occasional paper number 26 'From advert to action: behavioural insights into the advertising of financial products').[4] The tax return is of course not an advertisement, but this report helpfully summarises what people are drawn to and what they may not see or notice, when looking at financial information.

5.5 The return might also more clearly signpost cases where it may not need to be completed. The OTS has heard of people completing the return only to find at the end that they had no tax to pay because of the trading allowance and so did not in fact need to complete the return.

5.6 On the employment pages, given that HMRC has already received information from employers on income paid to their employees, it is to be hoped that these boxes will soon be consistently pre-populated.

Additional recommendation 16: The OTS recommends that HMRC look again at the pages of the income tax return with the user's perspective in view, to increase consistency of approach and more clearly signal what is needed.

5.7 The OTS asked what aspects of calculating tax are found challenging. Understanding what expenses can be claimed and what cannot has been highlighted as a particular problem area: the OTS understands that errors in expenses are a significant component of the small business tax gap.[5] Good guidance would play a role alongside compliance interventions in addressing that gap.

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3 The OTS tested the 'optional' employment figures on a real return, and established that leaving the boxes blank shows up in the final calculation as no income for the relevant employment.

4 https://www.fca.org.uk/publications/occasional-papers/no-26-behavioural-insights-advertising-financial-products

5 https://www.gov.uk/government/statistics/measuring-tax-gaps

5.8 What might good guidance look like? A body that advises young people starting up in business said that they point them to the GOV.UK website guidance on matters such as expenses, but their clients struggle to understand the relatively abstract words and translate them into real life. A guidance package for small businesses should consider ways to make the examples more concrete and relatable for people without an accounting or business background.

5.9 Ideally information should be presented in a visually engaging way, using graphics and interactive options to help viewers navigate through the material. See the FCA research mentioned in paragraph 5.4 above for information on the importance of visual cues and pictures in conveying information. The need for simplicity in presentation is also borne out by HMRC's own 2015 research into small business communication preferences.[6]

5.10 The material on GOV.UK tends to be largely in the form of words and numbers. However well and carefully-drafted, material presented in this way is not always easy for people to grasp. HMRC can produce very engaging animations and visual products: ideally the guidance would use some of the skills shown in videos such as Tax Facts to produce targeted guidance products.[7]

Other returns and forms

5.11 Inconsistent practice on iforms (electronic forms that are needed to file returns, make claims or other declarations) was mentioned frequently during the review as a major source of frustration. Some work well – the online income tax return, for example, can be completed over time, saved and revisited as necessary before final submission. Others must be completed in one sitting and don't allow one to skip forward to see what information is needed, which can mean that a number of attempts are required before the form can be completed, with the same information needing to be re-entered frequently. Some forms must be completed online and then printed and posted.

5.12 The OTS has learned that HMRC is currently working on a programme to bring all their iforms into line with the recommendations of The Public Sector Bodies (Websites and Mobile Applications) (No.2) Accessibility Regulations 2018. The regulations require, among other things, that all iforms are designed to be easily accessible. This includes features such as the ability to save partly-completed forms and return to finish them. This work is to be completed by September 2020 and the new forms will be called GForms, to distinguish them.

5.13 The OTS welcomes this programme of improvement, and recommends that key forms are tested with potential users to ensure that they are easily understood and completed.

[6] https://www.gov.uk/government/publications/small-business-and-choice

[7] https://youtu.be/O3dDaEkykto

Corporation tax returns

5.14 The process of completing and filing a corporation tax return is considered alongside other issues relating to corporation tax calculations in Chapter 7.

VAT returns

5.15 Filing the 9-box VAT return was considered to be a comparatively straightforward process. A business with taxable turnover above the VAT registration threshold will be required to keep digital records and submit returns digitally using appropriate software under Making Tax Digital for VAT: this applies to VAT returns starting on or after 1 April 2019, although for some businesses this date has been deferred to 1 October 2019.[8] Businesses voluntarily registered below the threshold or exempted from MTD will continue to file as now. Given these prospective changes the OTS has not looked at the VAT return process in this review, but may consider such a review in the future.

Personal and business tax accounts

5.16 Anyone who is registered for income tax, corporation tax or VAT will have either a Personal Tax Account (PTA) or a Business Tax Account (BTA), or both.[9] In addition, anyone who wishes to view their PTA is able to do so by registering on GOV.UK.[10] The process of registering was explored in Chapter 4 above, and is not straightforward. The PTA enables individuals to

- check their tax code and request a change
- notify a change of address
- check their National Insurance contribution record and State Pension estimate
- check their Child Benefit and Tax Credit position

5.17 The BTA enables businesses to check their tax position and notify some changes, but functionality is limited.

5.18 Both the PTA and BTA have links that enable people to access and complete relevant tax returns.

5.19 Agent access to the BTA is patchy: they often can't see key information that would enable them to support their clients.

5.20 61% of the smallest businesses who responded to the OTS survey do not use their PTA. Awareness and use of the BTA was low across all businesses.

5.21 The purpose and rationale for having two separate tax accounts for self-employed people, landlords and small unincorporated businesses is unclear.

8 https://www.gov.uk/government/publications/making-tax-digital/overview-of-making-tax-digital#making-tax-digital-for-vat

9 https://www.gov.uk/personal-tax-account; no online overview information was found for the Business Tax Account other than a performance dashboard

10 https://www.gov.uk/log-in-register-hmrc-online-services

5.22 The OTS recommends consideration of a single tax account for any case where a business owner and individual taxpayer are the same person.

5.23 There is no obvious value to HMRC or the taxpayer in having some tax matters on two different tax account pages.

Additional recommendation 17: The OTS recommends that HMRC consider further the reasons for having two separate tax accounts for self-employed people and small unincorporated businesses. The most obvious way to do this would be for the business tax account to be a 'pane' in the personal tax account.

Help to comply

5.24 Small businesses have a number of tax deadlines to remember. There are annual reminders for those who are registered for self-assessment, but there is scope to offer more personalised reminders, for example around payment dates, or when businesses are nearing the VAT registration threshold, and the OTS suggests that HMRC consider ways to give personalised reminders.

5.25 Such messages about individual deadlines could be given by text, but a consolidated schedule of key dates that people could check would be a useful additional feature for the PTA and BTA.

Additional recommendation 18: The OTS recommends that HMRC consider ways to give businesses personalised reminders, for example around payment dates, or that their declared turnover is nearing the VAT registration threshold.

Paying tax

5.26 The OTS has been surprised to find that HMRC does not consistently make it easy to pay tax that is due, and by the number of different options that exist across and within taxes. These points are briefly summarised below.

Income Tax

5.27 Under Pay as you Earn (PAYE), deducted by employers and pension providers before wages and pensions are paid and this is then reported to HMRC each pay period. If an employee/pensioner is likely to overpay or underpay tax, the tax code is adjusted by HMRC during the year, this is called 'dynamic coding'. The aim is that by the end of the year, most people will have paid the right amount of tax for that year.

5.28 If some tax is due that can't be collected by the code, the taxpayer cannot simply call HMRC and pay it.[11] Until the introduction of Simple Assessment, people in this position were sent a voluntary payment letter. People could make payments in response to this and many did, but not all. Alternatively, HMRC could issue a self assessment income tax return.

5.29 HMRC call centre advisers told us that they quite often found that pensioners were uncomfortable with requests to make a voluntary payment, preferring instead to receive something that they could recognise as a bill, like with gas

[11] Tax made not be able to be collected by a code if there isn't sufficient taxable income to cover it, or if it increases the tax due by more than 50%

and electricity and council tax. In cases where people did not pay in response to the letter, they were required to complete income tax self-assessment returns to make the payment.[12]

5.30 Where Simple Assessment is available, it enables a taxpayer to agree the amount due with HMRC and then pay it. [13] [14] However it is worth noting that until recently, the agreement of the amount and the payment were two separate transactions. HMRC advisers told OTS of the frustration of having to tell customers with whom they had agreed an amount that the customer would need to make a separate call to pay the sum. HMRC have improved the system so that advisers can now pass the calls through to a secure payment line: the previous difficulty is mentioned to illustrate the underlying issue of a lack of flexibility in payment processes.

5.31 Under income tax self-assessment, payments can be made electronically through bank settlement systems (BACS for smaller payments: CHAPS for quicker payment of larger sums). In addition, there is an option to make a phone payment using a debit card (but not a credit card), or to send a cheque.

5.32 The OTS notes that, although there are a good number of options available for those required to complete an income tax return, it is not always easy to work out what needs to be paid, and there is no simple mechanism to pick up the amount due and push that through to payment, as would normally happen when one makes an online payment of an invoice.

5.33 With regard to identifying the amount payable when an income tax return is submitted, a person completing their income tax return and who is required to make payments on account will be presented with a figure showing the amount due in respect of the last tax year and both payments on account (only one of which is payable before 31 January). There is no single figure showing the amount payable by 31 January.

5.34 HMRC also has a budget payment plan, under which people can make regular payments towards their future self-assessed income tax. There is also an option to make one-off payments on account.[15] Features such as the Budget Payment Plan were not widely publicised, but HMRC is increasingly flagging these up to customers.

5.35 When payments are made under the Budget Payment Plan, these will appear in the Business Tax Account. However there is no simple summary of the net position at the point at which the viewer looks at the account (one sees payments in and payments due, but not the current balance). Completing the income tax self-assessment return does not immediately link to the amounts already paid on account; it simply shows the gross amount due before payments. The return does not help the taxpayer by mentioning that this is a gross figure. After a couple of days for processing, the online

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12 https://www.gov.uk/government/publications/income-tax-simple-assessment/income-tax-simple-assessment

13 HMRC told the Public Accounts Committee in May 2018 that they have paused the rollout of simple assessment.

14 https://www.gov.uk/simple-assessment

15 https://www.gov.uk/pay-self-assessment-tax-bill

account shows the total tax due after payments but does not make it easy to see what is due on 31 January and 31 July (the payments are summed).

5.36 The self-assessment return tells taxpayers to make payments to one of two HMRC payment centres. It doesn't make it easy for the taxpayer to know which HMRC payment centre to use. Taxpayers should not need to struggle with this information. It is surely questionable why there are two centres made visible to taxpayers, with different bank details. If this is indeed essential, HMRC's online systems should made it completely clear to taxpayers which should be used.

5.37 HMRC should consider offering a direct debit mechanism for taxpayers.

PAYE for employers

5.38 Under PAYE, the employers' return and payment processes are separated. Payment is due by the 19th or 22nd of the month following the month for which it is owed, depending on whether payment is made by cheque (19th) or online (22nd). The sum due does not carry forward automatically from the return: it must be keyed in separately when the employer is on the payments page. The OTS has heard of many cases where PAYE payments are not linked to the correct month – which is costly for HMRC and for taxpayers to resolve. Introducing a direct debit system for smaller businesses, as with VAT, would help solve this issue.

VAT

5.39 When a VAT return is submitted, the sum due will normally be collected automatically by direct debit set up by the taxpayer.[16] However a range of other options exist.

Corporation Tax

5.40 The options to pay corporation tax are broadly the same as those for income tax and VAT.[17]

Simplifying the payment rules

5.41 With the exception of PAYE, all of the taxes mentioned above have payment on account rules, which require interim payments between return dates in specified circumstances.

5.42 The rules on dates and methods for payments set out above have grown up over time. Each tax has developed its own rules, and these have not been systematically revisited to make a more coherent process.

5.43 The OTS recommends that HMRC look at the rules for paying tax across its core taxes and regimes, with a view to ensuring that tax can be paid in the most effective way, including in advance of a finalised assessment when the customer wishes to do that.

5.44 The advantage for HMRC of a streamlined cross-tax approach would be earlier and more effective collection of tax. The advantage for the business

[16] https://www.gov.uk/pay-vat

[17] https://www.gov.uk/pay-corporation-tax

taxpayer would be a reduction in the effort needed to keep track of and make all the relevant payments.

Core recommendation 10: HMRC should review tax payment processes across core taxes and regimes, with a view to aligning and streamlining them.

An optional PAYE-like experience for self-employed people?

5.45 Tax can be a source of stress for the very smallest one-person businesses, and the need to set money aside for long periods can be difficult to manage financially. The OTS thinks there is merit in exploring an optional PAYE-like experience for self-employed people.

5.46 As noted earlier, the self-employed population is very diverse. People may enter self-employment through conscious choice or because of the nature of the work they do, or because it is difficult for them to find employment. In contrast to employment, the income of the self-employed can vary significantly from week to week or at different times of the year. Some self-employed individuals are very well-paid: many struggle to make ends meet.

5.47 Quite a number of the smaller businesses the OTS consulted indicated that they would welcome an optional process under which they could have an appropriate amount of tax deducted from their income each month. Technology is advancing rapidly and functionality that supports this could be available within a few years. The OTS has given initial consideration to how such a system could work for people who work for online platforms.[18] A future paper will develop this thinking further and consider the potential for extending it to include self-employed people more widely.

5.48 One consideration the paper will explore is the option to manage the payment flexibly – for example, if someone earns a lot one month, and pays a good sum to HMRC towards their final bill while they can afford to, but then earnings dip and as the year progresses it appears they have set aside excess, the person might have the option to access this money before year end to help them manage cash flow when things get tough.

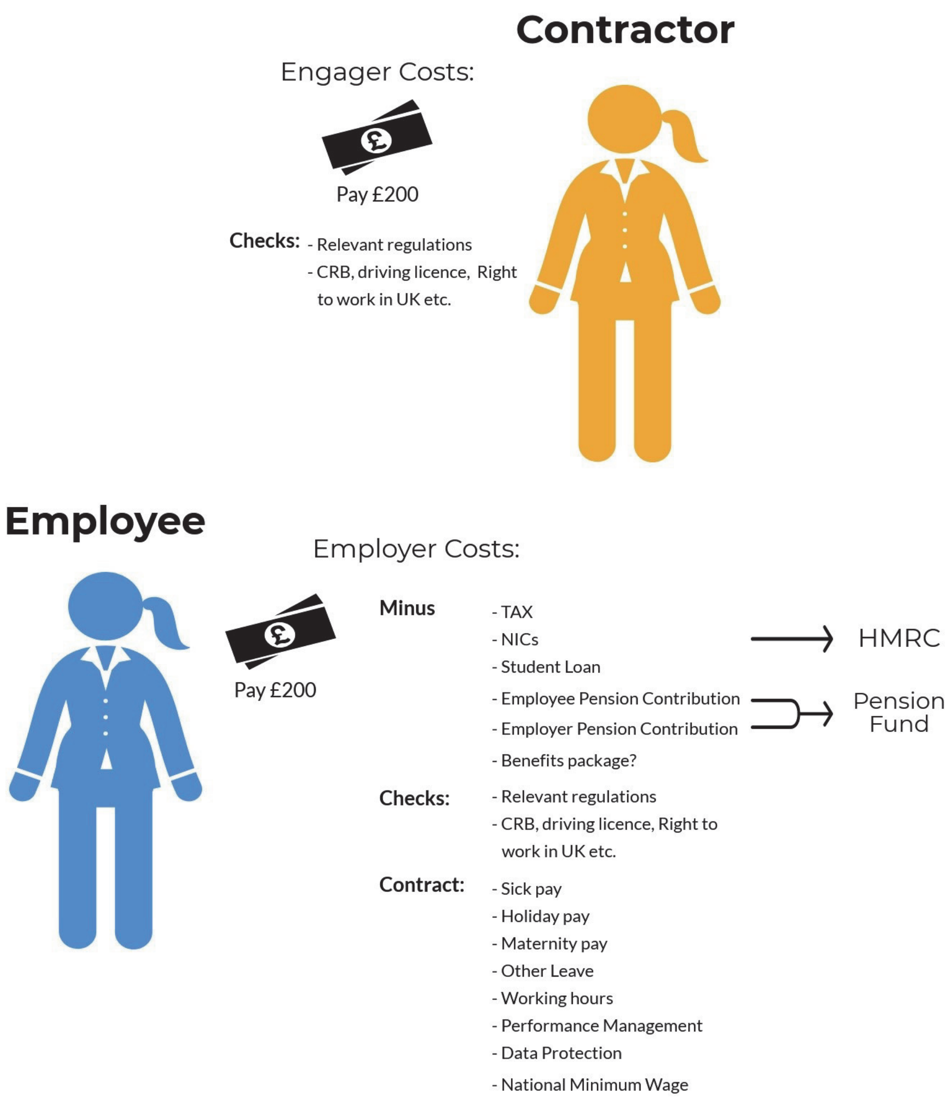
[18] https://www.gov.uk/government/publications/ots-suggests-paye-equivalent-for-online-platform-workers

Chapter 6

Taking on an employee: PAYE and RTI

6.1 Taking on a first employee is a very significant step for any new business. Chapter 3 compared the tax costs of taking on an employee relative to a self-employed contractor. This diagram completes the picture with an overview of the key regulatory and financial burdens that flow from taking on an employee as compared with engaging a self-employed contractor.

Chart 6.A: Employer Burdens: Contractor vs. Employee



Source: OTS

6.2 Payroll-related matters generated significantly more responses than other areas both in the online survey and in meetings. 39% of the businesses who responded to the OTS survey reported a significant increase in administrative burdens resulting from taking on a first employee: a further 22% reported a modest increase. Many use their accountants or other payroll professionals for payroll matters.

6.3 One theme in the comments was that it would be helpful if payments flowed automatically following the filing of an RTI submission. The RTI system was also said to deal poorly with non-standard circumstances.

6.4 Overall, it was felt that payroll was too complicated and risky for small businesses to do themselves, with a high likelihood of inadvertent mistakes and penalties. Some commentators noted that payroll alone would be manageable, but auto-enrolment adds significant burdens.

6.5 Since RTI was introduced, it has achieved many of its goals in terms of ensuring that HMRC have quicker access to information about payments, which can then be used to increase the accuracy of tax codes, tax credit and universal credit payments. However, the additional benefits for users of the system – transparency and accessibility – have been noticeably slower in materialising. For some taxpayers the calculation algorithms used do not update the tax code correctly.

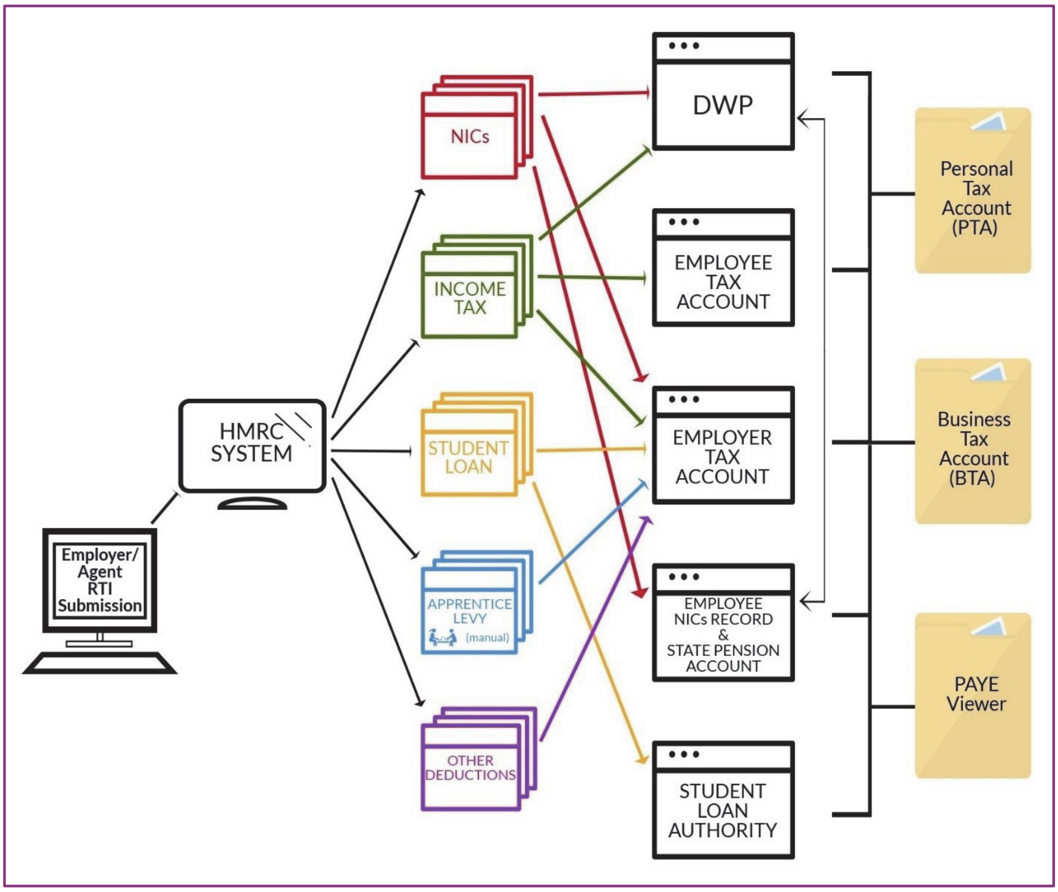
6.6 A number of points raised as persistent challenges in this respect were:

- data on submissions taking a long time to feed through into employee accounts
- the system generating automatic repayments of tax that is in fact due, meaning that it has to be paid to HMRC again
- employers not being able to tell HMRC mid-month if an employee leaves, with the consequence that duplicate employments may be recorded when the new employer sends in their submission at the end of the month
- duplicated employment records: there were there were around 350,000 duplicate employment records in the system in 2017 to 2018 and 2018 to 2019. These numbers represent a significant fall since 2015 but in recent years progress has slowed

6.7 Although the term 'Real Time Information' refers to the receipt by HMRC of timely information, it is inevitable that this title causes an expectation that the information will feed through into taxpayer records in a similarly timely manner. In considering the reason for the delays that are sometimes experienced, it may be helpful to look at this very simplified illustration of the RTI/PAYE process.[1]

[1] This is purely an illustration – it is not intended as a precise schematic of the system

Chart 6.B: Illustration of the PAYE/RTI process



Source: OTS

6.8 Many of the data items supplied by employers feed through into HMRC computer systems, and are processed very quickly – no later than the next day. However, some information is subject to manual processing and checking. This manual process can take some weeks, and the timetable can be affected by staff resourcing pressures. When information takes some weeks to be shown on the business account it is hard for the business or their agent to reconcile payments and be sure they are up to date: delays can also cause the system to pay the money back in error.

Additional recommendation 19: The OTS recommends that, as is common in other regimes, HMRC consider accepting any RTI data subject to manual processing as provisionally correct for the purpose of the employer's ledger and account balance, until such time as the verification is completed.

6.9 On the right hand side of the diagram three output channels are shown. Each will show different information: the personal tax account will show an individual their tax code, total tax paid and NICs contributions; the business tax account will show a net balance for employers; while the payroll viewer gives employers information on new tax codes. Data such as tax codes from HMRC feeds into employers' own in-house PAYE software.

Pensions – gross and net pay

6.10 The OTS has heard that businesses make frequent errors in tax relief entries for pensions. Payroll agents reported widespread confusion between relief at source and net pay, even among professionals. This confusion partly results from the fact that the terms 'relief at source' and 'net pay arrangements' suggest the opposite of what they mean ('net pay' pension deductions are taken at source from the employee's gross pay - the take home pay being 'net' of the deduction; 'relief at source' is given by the pension fund after they have received the payment from the employer or employee – this having been deducted from net pay). Confusion is understandable, given sections like this in HMRC's RTI guidance for RTI software providers:

Table 6.A: HMRC guidance: data items for RTI

58B	Value of deductions from net pay in pay period	Enter value of deductions made from your employee's net pay after deductions for tax, National Insurance and all types of Student Loans. For example, pension contributions that are not paid under a net pay arrangement, trade union subscriptions, subscriptions for health cover and attachment of earnings orders[2]

Source: HMRC

6.11 The general consensus of opinion among those consulted by the OTS was that there is no inherent problem with having two different types of pension scheme, as long as they are clearly named and identified. HMRC reviewed terminology around pensions last year. They found evidence of some confusion among employers, particularly on the net/gross pay point. However, they also found that the pensions industry and many employer payroll functions have been using this language for decades and understand the terms well. There were few reported problems before auto-enrolment brought a large number of smaller businesses into pensions regimes.

6.12 While recognising that those businesses may struggle with the language, the cost of making a wholesale change was deemed likely to outweigh the benefits. HMRC's Employer Bulletin for February 2019 explained the terms at page 6, recognising the potential for confusion.[3]

6.13 The OTS notes that the use of these terms is long standing and they were widely used and understood before auto-enrolment. However, the use of terms that are likely to mislead those who do not already understand them is a recipe for confusion. Some millions of additional businesses were required to engage with pensions and tax following auto-enrolment. Given the evidence that mistakes are being made, the OTS recommends that HMRC reconsider the process and terminology used for pensions under PAYE/RTI from an employers' perspective, to identify ways to simplify the regime and reduce the potential for errors.

2 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/775920/Data_items_guide_2019_to_2020_v1.1.pdf

3 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/778061/Employer_Bulletin_February_2019.pdf

Additional recommendation 20: The OTS recommends that HMRC consider the process and terminology used for pensions under PAYE/RTI from an employer's perspective, to identify ways to simplify the regime and reduce the potential for errors.

Strategic oversight of the PAYE/RTI system

6.14 PAYE means that most UK taxpayers never have to think about tax or do a tax return. This significantly simplifies the taxpayer experience and the process enables large amounts of tax to be collected efficiently (£154 billion in 2017 to 2018, almost 28% of all tax collected by HMRC).[4]

6.15 However the current system does not handle the fluidity of the modern workplace very well, for example in relation to changes of job mid-month or individuals holding multiple jobs or concurrent employment and self-employment.

6.16 Information collected through RTI or from third-party data-feeds does not always flow through to personal tax accounts quickly, and resulting calculations are not always accurate. The outcome can be stress for taxpayers: for example, if universal credit payments are delayed, or wrong amounts of tax deducted.

6.17 If better quality information fed more quickly into the personal tax account (PTA), this would be helpful for taxpayers and could reduce queries to HMRC. In particular:

- The current system does not handle the fluidity of the modern workplace very well, for example in relation to changes of job mid-month or individuals holding multiple jobs or concurrent employment and self-employment.
- For many taxpayers, the estimates in their personal tax accounts of annual income are incorrect, potentially leading to incorrect tax codes and certainly undermining trust in the system
- System problems lead to significant costs for businesses, agents, employees, and HMRC itself. For example, there are around 400,000 duplicate employment records, and around 5% of returns are received late.

6.18 In the course of its work the OTS has seen evidence of HMRC's commitment to, and careful management of, key elements of the system (such as policy, processes, and communications). However, currently, there is no one person with overall strategic ownership or oversight of PAYE. This is a significant gap, impacting making it harder to prioritise and implement cross-cutting changes and sustain development of a future vision for PAYE. The OTS understand that HMRC is conscious of the need to strengthen its oversight of key processes and is working to address this.

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[4] See page 8 - https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/780013/Jan19_Receipts_NS_Bulletin_Final.pdf

Core Recommendation 2: A strategic focus on the PAYE system should be an HMRC priority to ensure effective implementation of improvements and system changes.

Core Recommendation 3: A fresh review of areas where the PAYE/RTI process should be improved should be carried out, possibly by the OTS.

Benefits In Kind and P11Ds – a lesson in policy-making

6.19 Following the OTS review into employee benefits and expenses HMRC introduced the option for employers to payroll benefits in kind – that is, to include such payments in employees' PAYE calculations, as opposed to on a separate form after the end of the tax year.[5] This was intended to significantly reduce the number of year-end forms (called P11D) and simplify the administration of such benefits.

6.20 However, in practice relatively few employers payroll their benefits and the number of P11D forms has not reduced as much as initially hoped: HMRC figures show a reduction of around 350,000 P11Ds as a result of the overall OTS simplification package, with voluntary payrolling contributing the most to this reduction.

6.21 Discussions with payroll professionals revealed a number of reasons for the slow uptake of payrolling by small and medium businesses:

- Some benefits can't be payrolled
- The process of calculating the benefit and including on the payroll can be complex
- Most significantly perhaps, a key driver for the forms is that employees may need a breakdown of these expenses for their personal tax returns. The law requires employers to give this information to their employees

6.22 In short, whether they payroll benefits or not, an employer will have to

- give employees a description of the benefits that have been payrolled in the tax year, for example car fuel
- include in this description the cash equivalent of each benefit that has been payrolled in the tax year
- still submit a P11D to HMRC for any benefits that aren't payrolled and provide the employee with the details of these
- submit a signed P11D(b) return for class 1A national insurance contributions on benefits (a return is required even in cases where there is no class 1A due)

6.23 In the circumstances it is not surprising that smaller employers who offer benefits in kind have not seen added value in bringing in a system to payroll these benefits.

6.24 HMRC are conscious of this and are exploring options for improvement. The OTS will follow progress with interest.

[5] https://www.gov.uk/government/publications/review-of-employee-benefits-and-expenses-interim-report

6.25 This example illustrates particularly well a point that has arisen in other parts of this paper and in previous OTS reports: the need to be sure that any policy change fully understands the wider context in which it sits, including an end-to-end exploration of the process the customer (both employers and employees in this case) will follow. If this had been undertaken, the option to payroll benefits in kind might have been more widely adopted; Simple Assessment could have had an integrated approach to paying the assessed tax at the start; and the income tax calculation would have correctly dealt with the allocation of allowances following the recent changes in relief for savings and dividends.[6]

6.26 The OTS is aware that HMRC is working to include the customer perspective throughout its thinking. For example, policy officials are receiving training on considering change from the customer perspective, IT professionals stress-test planned changes before they go live using customers and those who deal with customer queries, and HRMC's Customer Journey Team and Customer Insight Unit proactively examine key processes from the customer perspective. These initiatives are welcome but are not yet, as far as the OTS has been able to establish, part of a consistently integrated and joined-up approach to change.

6.27 The OTS suggests that HMRC consider ways to ensure that changes to the tax system are consistently stress-tested from the customer perspective.

Core recommendation 9: HMRC should map major customer journeys for small businesses across tax regimes, to develop a programme of change to streamline the small business experience of the tax system.

6.28 The OTS understands that HMRC's Customer Journey team have mapped some journeys that are relevant to business, to identify opportunities for improvement: the experience of a person who is seeking to pay off a tax debt has been explored, and work is in train to explore the experience of someone taking on an employee for the first time. Other key journeys that should be explored include: the experience of people starting up in business for the first time, and their progress towards registering for tax; the experience of a business preparing and filing a return and paying tax for each of income tax, corporation tax, VAT and PAYE; a payroll agent supporting a range of businesses to make RTI returns; a bookkeeper helping small businesses with tax matters.

6 https://www.gov.uk/government/publications/simplifying-the-taxation-of-savings-income

Chapter 7
Small company taxation

Introduction

7.1 As noted in Chapter 1, there are a significant number of small companies in the UK: 1.9 million at the start of 2018, of which 883,300 (46.2%) did not employ anyone other than the owner(s).[1]

7.2 Setting up a company is an easy, quick and cheap process, completed online for a payment of £12 (UK companies).[2] All companies are required to register, and once registered to file accounts annually annually by a set date after the end of its accounting period (6 months for a public company, 9 months for a private one). A company can change its accounting period, to either extend or shorten it: however if it is extended it cannot cover a period of more than 18 months, and the number of times an extension can be made is limited to once in any 5-year period.

7.3 All new company registrations are notified to HMRC, who register them on their company tax system. This generates a notice to file a return unless the company is identified as dormant at the time of registration.

7.4 The ease of registration, combined with the benefits (including tax related) of having a company have contributed to the increase in the number of companies in recent years.[3]

7.5 The OTS has heard that agents and other bodies supporting small businesses often see cases where a client has formed a company without understanding that this will create additional compliance requirements, often in circumstances where having a company is of limited value. HMRC's records show that 1 million (50%) of the 2 million companies formed since 2010 and subsequently deregistered, were removed from their company tax

1 There was a small drop in the percentage of one person companies between 2017 and 2018. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/746599/OFFICIAL_SENSITIVE_-_BPE_2018_-_statistical_release_FINAL_FINAL.pdf Details may be found in table 27 of the detailed tables.

2 The government has opened a consultation on options to tackle misuse of the company register, ensure its accuracy and enhance protection of business owners against fraud. https://www.gov.uk/government/consultations/corporate-transparency-and-register-reform Options discussed in the consultation include verification of directors' identities at the time of registration.

3 The BEIS statistical release shows that there were 2.2 million (63%) more businesses in 2018 than in 2000.

system before the time at which they were required to file their first tax return.[4]

7.6 In general, corporation tax is one of the taxes where businesses are least likely to try to complete the return themselves. Businesses which responded to the OTS survey cited complexity and the fear of making mistakes as the most common reasons for using agents. A number of company respondents also noted that they could not prepare accounts themselves.

Company tax returns and accounts

7.7 The company tax return process is tied into the accounts, the tax calculation being based on the profit calculated in the accounts and a number of specific tax adjustments. For small companies there are simplified accounts standards. A template for accounts preparation exists under accounting standard FRS 105 but it is not configured to be sufficient for tax purposes.

7.8 This lack of a template creates a barrier for the smallest businesses. Without a background in accounts it can be challenging to produce a balanced set of accounts, and this, quite apart from the need for iXBRL tagging, is a major reason why agents are often used for corporation tax. HMRC officials told OTS that a significant proportion of the calls from businesses struggling to complete their company tax return resulted from the fact that the accounts are not balanced and so are rejected by the system.

7.9 The current system is flexible as it needs to cover a significant variety of different types of business. However, an optional template that the very simplest businesses could use for both tax and company reporting may be a helpful simplification, while preserving flexibility for those who will benefit from that. The rules and standards on preparation of accounts are a matter for the financial reporting authorities, but the OTS considers that it may be possible and helpful to draw up an optional template that would comply with relevant standards and could help the smallest companies complete their returns.

7.10 A standardised accounts format would support automated calculations for small businesses and could usefully be considered as part of any future extension of Making Tax Digital to corporation tax (CT).

Core recommendation 6: HMRC should work with partners such as Companies House to develop digital options to help small companies prepare accounts and tax returns, including use of an optional accounts template that is simple to use and acceptable to HMRC and other departments.

7.11 The template should incorporate standard iXBRL tags, applied automatically to relevant entries, to ensure consistency and simplicity in their application.

[4] The OTS notes that there have been quite a few articles in recent years on the cost savings that can come from using a corporate structure and receiving remuneration by way of dividends rather than salary, and wonders about the extent to which these (from google searches) are driving the use of corporates

CT return process

7.12 A short form of the CT600 (part of the Company Tax return) used to be available for small businesses, clubs and companies with straightforward tax affairs. This was withdrawn for any accounting period starting after 1 April 2015.[5] Agents report that the loss of the short form return means they need to send clients multiple pages of returns with zeros on them to check before the return can be filed, adding complexity and cost to the return preparation process.

7.13 A simple tax return process should be available for the simplest CT calculations. Challenges in compiling returns could be mitigated if the CT filing process were more like the income tax return, with businesses only seeing the relevant pages.

7.14 The OTS recommends that the CT return process should be revisited as part of any future extension of Making Tax Digital to CT, to ensure that businesses only see the pages that are relevant to them.

Core recommendation 7: HMRC should simplify the company tax online return process as part of any future extension of Making Tax Digital to corporation tax, so that, as with the online income tax process, taxpayers only see the pages and information relevant to them and have pop-up information and help screens at key points.

Registration and first filing dates

7.15 When a company is registered, its first accounting period is very commonly more than 12 months. This is because the accounting period starts on the day on which the company was formed and ends on the anniversary of the last day of the month in which formation happened (for example: if a company registers on 13 March 2018, its accounts will cover the period from 13 March 2018 to 31 March 2019).

7.16 Tax law requires company tax returns to cover no more than 12 months. This means that many companies may be required to complete two tax returns in respect of their initial registration period – using the example above, a company registered on 13 March 2018 will need to file one return for 13 March 2018 to 12 March 2019, and a second return for the period from 13 March 2019 to 31 March 2019. There will additionally be separate payment dates for each of these returns.[6] However, if the company does not start trading straight away or otherwise "come within the charge to corporation tax" and is dormant for a period, it may not be required to make two filings (see below in relation to dormant companies).

7.17 This has been raised as a problem area by advisers and by HMRC process teams. The OTS has established that at least 58% of new CT registrations

5 https://www.gov.uk/government/publications/corporation-tax-short-company-tax-return-ct600-short-2008-version-2

6 https://www.gov.uk/first-company-accounts-and-return If a company is initially dormant and is registered for CT before the accounting reference date the problem may not arise: in these circumstances the first AP from the date trading starts is likely to be less than 12 months. https://www.gov.uk/first-company-accounts-and-return/trading-after-set-up

since 2010 may have had to do two returns for their first AP – one for 12 months and one for a much shorter period.

7.18 The guidance on GOV.UK sets out the position, but although carefully drafted in generally plain English, the format requires some concentration and may not be accessible to a significant proportion of the population, including many small company owners.

7.19 The OTS notes that the language used on this page, although mostly clear, includes some terms that may not be widely understood – such as the term 'dormant' (again there is guidance on this, but the answer is not straightforward, and it appears that the term may mean different things to HMRC and Companies House – see the section headed 'What does dormant mean for corporation tax').[7] This instance exemplifies some of the challenges facing those writing guidance. User research has shown that it is important to include common terms in guidance, as people will use those terms in searches as they are used elsewhere: calling 'dormant' something different might mean that users don't find the term.

7.20 The requirement to file a return for a period of a few days or weeks seems unnecessarily burdensome. The OTS recommends that HMRC consider options to reduce the number of companies who have to file two tax returns for their first accounting period. Possible solutions include allowing a first return period of up to 13 months, or prompting businesses to enter different accounting dates on the system.

Core recommendation 8: HMRC should explore ways to reduce the number of companies having to file two tax returns to cover first accounting periods that are very slightly longer than 12 months.

Dormant companies

7.21 The OTS has heard that penalties are frequently issued for non-filing in cases where the business is dormant but HMRC has not been notified of the dormancy. There are software issues that can lead to this problem, and it may also arise if the business has not realised that they need to flag the dormancy with HMRC as well as with Companies House.[8] Penalties cause stress for businesses and have a resource cost both for the business and HMRC.

7.22 The OTS is aware that HMRC aim to take a pragmatic approach to ward off potential problems – for example by scanning records to identify new companies that have not traded for some months to establish, before a notice to file is issued, if they are active in relation to any other tax or should be flagged as dormant.

7.23 Effective two-way communication between HMRC and Companies House is important to the efficient management of companies, both from the perspective of identifying potentially bogus dormancies and ensuring that resource is not wasted pursuing those which are genuinely dormant.

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[7] https://www.gov.uk/guidance/corporation-tax-trading-and-non-trading

Additional recommendation 21: The OTS recommends that HMRC and Companies House work towards sharing dormancy information automatically and in real time, to reduce the number of penalties issued to dormant companies by HMRC.

Schedular reform

7.24 The UK tax system, both for companies and individuals, has long provided for different types of income (such as employment income, trading income, property income and so on) to be calculated separately and to be subject to different rules. This is still known as the schedular system, even though the legislation no longer uses that specific term.[9]

7.25 Within the income tax return different types of income are recorded on separate pages: however, this approach is not available for the company tax return. For smaller companies in many cases the separate calculations do not alter the total taxable profit.

7.26 The 2017 OTS review of the CT computation recommended that the Government develop a roadmap for progressing towards schedular reform for all businesses.[10] In his response the Chancellor said that he wanted to better understand the challenges involved, with work by officials to gauge the Exchequer costs, risks and impacts on different customer groups.

7.27 The OTS understands that the government continues to consider options for some micro companies: this work is welcomed and the OTS looks forward to the outcome.

7.28 To some degree the schedular system is already finessed, as modest rental income on property partly used by the business and partly used by a tenant can be included with the trading income[11] and similarly some interest is arguable as a trade receipt.[12]

7.29 However, the schedular system causes the following issues:

1. work is needed to separately identify interest and property income where this is included in turnover, and yet generally this has little impact on the tax calculation
2. CTSA interest (that is, interest received when companies have made payments under payment on account rules that turn out to have been excessive) is often hard to identify within the accounts and taxpayers may be unaware of their annual amount.[13] These amounts should be visible in the company's Business Tax Account: however businesses may not be aware of this
3. allocating costs properly between trade and property income, and between trading activity and the management of investments,

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9 The term 'Schedule' was removed in the course of the Tax Law Rewrite Project's work

10 https://www.gov.uk/government/publications/ots-review-on-simplifying-the-ct-computation

11 https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim41015

12 https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim40805

13 https://www.gov.uk/hmrc-internal-manuals/company-taxation-manual/ctm92670

requires both data and judgement and so allocating costs properly can be time-consuming

4. in many cases it is likely that micro and small business don't realise they need to do the calculation, thus leading to errors in tax calculations

7.30 A legacy of the schedular system is to restrict the use of carried-forward losses. The significance of this is more limited following the recent reform of corporation tax loss relief, which means that losses incurred post-April 2017 can generally be offset against total profits. However, some restrictions remain including loss streaming for pre-2017 losses, and limitations on losses when a trade ceases. Whilst relaxing the restrictions on losses carried forward and the rules on the categories of income for smaller businesses may reduce the burden on these businesses, it would present implementation challenges and result in difficult transitional issues as businesses grow.[14]

Additional recommendation 22: The OTS recommends that HMRC consider reform of the schedular system for companies (under which different types of income are taxed differently).

Directors' loans

7.31 Where a company is owned by one person or is a small family or close company, it is quite common for a director to borrow money from the company or lend money to the company.[15] In some cases this is done quite informally, as people don't always understand that the company's money is not theirs. Unless the sum is repaid quickly (within nine months of the end of the accounting period in which the loan was made) or if that repayment is temporary, the company will be required to pay tax of 32.5% on the balance of the loan. This is to prevent people taking a permanent tax-free loan from their company.

7.32 When the loan has been repaid, any tax paid by the company can be reclaimed. If the loan is written off and not repaid, the director will pay national insurance and income tax on this amount.

7.33 If the director owes the company £10,000 or more at any time in a tax year and interest is charged at less than the official HMRC interest rate for the year, or not paid at all by the director, the company must declare the unpaid interest on the loan on the director's P11D and company will pay Class 1A national insurance on the same amount.

7.34 The OTS recognises this is an area with significant potential for tax loss through avoidance, so a relaxation or simplification of the rules could only be considered if the risks were low. No potential substantive change has been identified as yet.

14 After some years the relaxation could be contemplated for larger businesses, when losses had been significantly used. HMRC should be able to track tax losses through the iXBRL tags that businesses are required to apply to their tax entries

15 Broadly, a close company is one that is under the control of 5 or fewer people. A full definition is set out in the Corporation Tax Act 2010, sections 439 et seq.

7.35 However, the OTS has heard that there is confusion among some taxpayers about these loans. HMRC teams told OTS that they get lots of challenges to the rules on director's loans. People expect relief from tax once paid back, but companies have to wait until 9 months after the end of the relevant accounting period in which the repayment is made (though see earlier where it is repaid quickly). Some make claims too late through lack of understanding of the guidance.

7.36 The OTS has reviewed the guidance on GOV.UK.[16] The language is generally clear and the rules are set out quite straightforwardly. But there is limited practical guidance on matters such as how to evidence repayment, and the guidance is entirely in text and relatively formal to look at.

Additional recommendation 23: The OTS considers that a basic guide for new companies should explain the purpose of the rules on directors' loans and how the rules should work in practice.

7.37 This should contain practical examples and use diagrams and other visual aids to make the material easier to understand and more accessible.

Loan relationships

7.38 The term loan relationships refers to a tax regime for companies that applies to a wide range of financial arrangements, including simple loans such as an overdraft as well as complex financial instruments. In essence, interest or other income gained from loans or other more complex arrangements, and relevant costs, are separated out from other sources of income (unless the interest or income is classed as trading income – for example, because the business is a finance business). Any net loss (known as a loan relationship deficit) may be offset against only some types of income.[17]

7.39 The rules contain anti-avoidance provisions aimed at preventing the use of financial instruments to artificially reduce company trading profits or increase trading losses. It is understandable that such safeguards will be needed for medium and large companies capable of engaging in transactions involving complex financial instruments. However, the loan relationship system applies to all companies, including the smallest single-person businesses, and may be an additional category of income within the schedular system.

7.40 Tax advisers and accountants completing CT accounts and returns for their clients are aware of these rules, but the extent to which the smallest unadvised companies understand and follow them is doubtful. Advisers have told OTS that the work required to ensure that relevant loan relationship rules are met is rarely productive – it is a process that commonly makes no

16 https://www.gov.uk/directors-loans

17 If the business borrows money for its trading activity – for example, to buy equipment or premises – that will be a trading loan and interest is included in the calculation of trading profits. However it is unlikely that cases where the business lends money will be treated as part of the trading business unless the company is a finance business. https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm32020

difference to the amount of tax due - and they do not feel it adds value to the service they offer to their smaller clients.

7.41 The OTS has not found any simple guide to loan relationships on GOV.UK. Guidance instead is contained in the relevant sections of the HMRC corporate finance manual.[18] [19] This guidance is well written but is clearly intended for people with some tax expertise and is unlikely to be accessible to small businesses. The OTS has not found any more general guide to calculating profits for corporation tax that obviously covers this subject.[20]

7.42 The OTS suggests that HMRC look at the application of the loan relationship rules to the smallest companies. Could the requirements be streamlined so they are easy to comply with while protecting against abuse? As a minimum, the OTS suggests that some simple guidance be prepared to help small businesses understand and comply with the rules.

Additional recommendation 24: The OTS suggests that HMRC look closely at the application of the loan relationship rules to the smallest companies.

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18 https://www.gov.uk/browse/business/business-tax; https://www.gov.uk/topic/business-tax

19 https://www.gov.uk/hmrc-internal-manuals/corporate-finance-manual/cfm30000

20 https://www.gov.uk/topic/business-tax/corporation-tax

Chapter 8

Issues faced as businesses grow

8.1 As a business grows and develops and its activities become more varied and sophisticated, it may come into contact with a number of specialist areas of the tax system. For example, it may move into new premises or refurbish existing premises, it may invest in research and development, or borrow or lend money.

8.2 The OTS received comparatively few comments on these matters, relative to the number of comments received on the day-to-day administration of tax. This will be due in part to the focus of this review on the smallest businesses. This chapter will briefly consider some matters that were raised.

8.3 In the future the OTS considers there would be value in looking at taxation issues affecting slightly larger, medium-sized businesses to identify areas for simplification there, where a number of the points briefly discussed below are much more significant.

8.4 The OTS recognises that such businesses may generally be more able to navigate the complexities and pay for relevant advice, but the costs of doing so inevitably fall on UK residents, in so far as they are either users of the company services, or shareholders, or both. An over-complex tax system acts as a drag on UK competitiveness and economic growth. Complexity and consequent lack of transparency can also contribute to avoidance.

Research and development

8.5 Research and development (R&D) tax reliefs are available to companies to support work on innovative science and technology projects. The tax reliefs are available to companies within the UK's corporation tax regime and are not available to unincorporated businesses. There are two schemes for claiming R&D tax reliefs: The Research & Development Expenditure Credits (RDEC) and the more generous Small or Medium sized Enterprise (SME) scheme.

8.6 Both schemes offer generous allowances against taxable profits and can result in payable tax credits: under the SME scheme, companies can:

- deduct an extra 130% of their qualifying costs from their yearly profit, as well as the normal 100% deduction, to make a total 230% deduction
- claim a tax credit if the company is loss-making, worth up to 14.5% of the surrenderable loss

8.7 All other companies (including SMEs) can claim RDEC, these companies can receive a tax credit at a rate of 12% of their qualifying expenditure. The credit can result in a net payment of tax to the taxpayer.

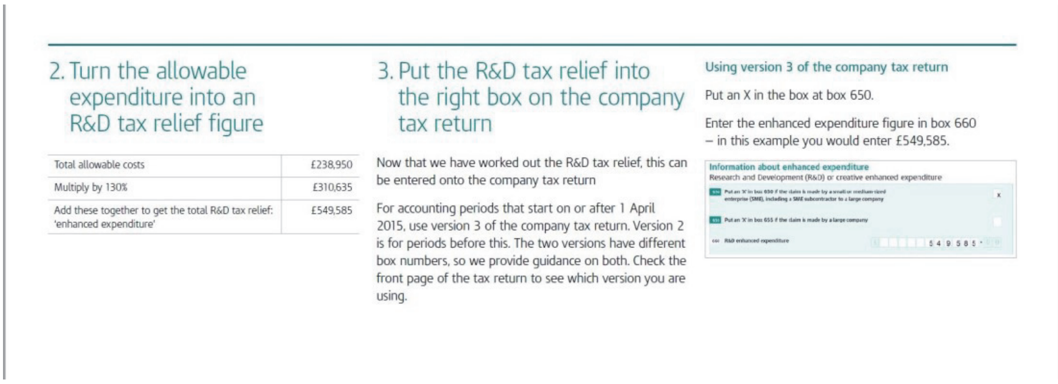
8.8 Both schemes apply the same definition of R&D and most of the same cost exclusions. Both allow some recovery of sub-contracted costs but in RDEC there are greater restrictions on the recovery of sub-contractor costs.

8.9 The process for claiming is to make an entry on the CT return and then provide any additional evidence in support of the claim via an online system.

8.10 Two previous OTS reports looked at R&D tax credits. Their main recommendations were that HMRC should provide clearer guidance, including case studies of successful and unsuccessful claims.[1] HMRC have produced an illustrated booklet called '*Research and Development Relief: Making R&D easier for small companies*'. This is clearly signposted on the GOV.UK page covering research and development reliefs for SME businesses.[2]

8.11 The guidance covers the process of making the claim, with stage-by-stage examples showing the process of putting the claim on the CT return:

Chart 8.A: Example section from HMRC's Research and Development Relief: Making R&D easier for small companies



2. Turn the allowable expenditure into an R&D tax relief figure

Total allowable costs	£238,950
Multiply by 130%	£310,635
Add these together to get the total R&D tax relief: 'enhanced expenditure'	£549,585

3. Put the R&D tax relief into the right box on the company tax return

Now that we have worked out the R&D tax relief, this can be entered onto the company tax return

For accounting periods that start on or after 1 April 2015, use version 3 of the company tax return. Version 2 is for periods before this. The two versions have different box numbers, so we provide guidance on both. Check the front page of the tax return to see which version you are using.

Using version 3 of the company tax return

Put an X in the box at box 650.

Enter the enhanced expenditure figure in box 660 – in this example you would enter £549,585.

Information about enhanced expenditure

Research and Development (R&D) or creative enhanced expenditure

650 Put an 'X' in box 650 if the claim is made by a small or medium-sized enterprise (SME), including a SME subcontractor to a large company X

655 Put an 'X' in box 655 if the claim is made by a large company

660 R&D enhanced expenditure 549585

Source: HMRC

8.12 There are a range of case studies covering particular sectors such as agriculture, health and information technology. The OTS understands that HMRC will shortly introduce an updated form to help SME businesses make claims for relief.

8.13 The 2016 OTS Small Companies Review noted the existence of a proliferation of "specialists" charging up-front fees of up to 30% to make R&D claims on behalf of owners. As part of the evidence-gathering process for this review, the OTS again asked businesses and advisers about the schemes. The OTS

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[1] These were the Review of the Competitiveness of the UK tax system and the Small Companies Report: https://www.gov.uk/government/publications/small-company-taxation-review; https://www.gov.uk/government/publications/competitiveness-of-uk-tax-administration-review

[2] https://www.gov.uk/guidance/corporation-tax-research-and-development-tax-relief-for-small-and-medium-sized-enterprises; http://www.hmrc.gov.uk/gds/cird/attachments/rdsimpleguide.pdf

was pleased to hear that many advisers considered that the process was not so difficult and that they were planning to offer to help clients with this work, using specialists only for the most complex claims. The OTS also notes that the number and value of claims has been steadily increasing in recent years, including notable increases in SME claims.[3]

8.14 6% of the businesses who responded to the OTS survey had made an R&D claim – of those, two thirds of claims were made by specialist R&D firms. One respondent noted that the process of making the claim was difficult as they had to keep timesheets for staff activity, and suggested a more pragmatic approach would be sensible. Others noted the prohibitive cost of employing a specialist or using the specialist software that is available for R&D claims, asking for it to be included on CT online so that it could be a seamless part of the return.

8.15 Around 50% of the agents who responded had been involved in making claims. Generally the process was considered complex. Agents also wanted to see the process incorporated fully into the CT return and to see some simplification of the tests on what qualifies.

8.16 The OTS welcomes HMRC's process improvements and the fact that non-specialist agents increasingly feel that they can help clients with R&D claims.

Additional recommendation 25: The OTS recommends that HMRC consider incorporating R&D claims fully into the CT return, perhaps as part of any extension of Making Tax Digital to corporation tax.

Additional recommendation 26: The OTS suggest that, in any future review of R&D relief, consideration is given to:

- The most appropriate ways to differentiate between large and small companies in a supply chain, including how the rules apply differently to them (such as the treatment of subcontracted research)
- Revisiting the policy rationale for excluding non-corporate businesses from the relief

Moving and refurbishing premises – capital items

8.17 Capital allowances are one of the main tax deductions claimed by companies and partnerships/sole traders. They are a way in which the tax system gives tax relief for business costs on capital expenditure. For 2017 to 2018 it is forecast that, compared with the position if there were no relief for capital expenditure, CAs result in a considerable reduction (£21.5bn) in tax.

8.18 Capital allowances represent a long-running source of business complexity. The term is not generally understood beyond tax experts, yet these allowances are a highly valuable relief for businesses of all sizes. In summary, expenditure for the purchase of fixed assets is reflected on a business's balance sheet. An amount called 'depreciation' is included in the profit and loss account reflecting the wear and tear of assets. This figure is specifically

3 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/742661/Research_and_Development_Tax_Credits_Statistics_September_2018.pdf

disallowed for tax relief. Instead relief is given for the ownership of qualifying fixed assets but by a separate mechanism called 'capital allowances'.

8.19 Since April 2008 it has been possible to claim an immediate tax deduction for the full cost of purchases of qualifying plant and machinery subject to an overall monetary limit: this is known as the Annual Investment Allowance (AIA).[4] The AIA amount was temporarily increased from £200,000 to £1 million between 1 January 2019 and 31 December 2020. AIAs represent a considerable simplification for many businesses.

8.20 Allowances for plant and machinery form the main part of the capital allowances regime. The term 'plant' isn't defined by statute. Instead, tax cases define what it means, and there have been a great number of cases before the courts on the question of what qualifies for capital allowances as, unsurprisingly, businesses seek tax relief on their business costs.

8.21 There are a considerable number of boundaries in the capital allowance regime for plant and machinery – mainly over whether an asset is qualifying plant or machinery, whether it is a fixture in a building, or whether it forms part of the building.

8.22 The OTS completed in July 2018 a detailed review of how businesses receive tax relief on the purchase of fixed assets.[5]

8.23 The OTS report considered the proposition that accounting depreciation be directly deductible instead of via capital allowances: this would have simplified the calculation by removing the need to amend the accounts figures for tax purposes. The conclusion was that using depreciation as a basis for tax relief was viable, but the transitional arrangements to bring in such a system at this time would have been too complex and would not have been a simplification overall, particularly in the context of the current general annual investment allowance.

8.24 The report recommended widening the scope of the capital allowances regime as well as a number of system improvements. At Budget 2018 the government announced a new structures and buildings allowance, which is a welcome extension of the regime. The government is considering the scope for other capital allowance simplifications.[6]

Capital allowance pools

8.25 It has been noticeable from the OTS public consultation that capital allowances continue to be an issue for some businesses and agents, with taxpayer concerns mostly relating to uncertainty about which purchases qualify for relief and how the calculation of capital allowances is done.

8.26 The number of different types of capital allowance pools was commented on. Tax simplicity would certainly be advanced by taking a more general approach. The 'special rate pool' has evolved into a general pool of quite diverse assets. The short life asset pools are single asset pools of plant and

4 https://www.gov.uk/capital-allowances/annual-investment-allowance

5 https://www.gov.uk/government/publications/ots-review-on-simplifying-tax-relief-for-fixed-assets

6 https://www.gov.uk/government/publications/chancellor-responds-to-ots-review-on-tax-relief-for-fixed-assets

machinery that taxpayers claim may have a life of up to eight years. To ease administration, consideration perhaps should be given to a general 'Technology Pool' with a fast-track writing down allowance, letting current short life asset pools wither away with time.

Capital allowances: repairs and renewals

8.27 A common source of unintentional error is the treatment of 'repairs and renewals' (repair being the maintenance of existing assets and renewal being the replacement). The basic principle is straightforward; repairs are revenue in nature and therefore deductible while renewals are capital and are not deductible.

8.28 The challenge arises in categorising expenditure - analysis that requires consideration of several conflicting facts to arrive at the correct treatment. Sometimes decisions need to be made on quite subjective points. For example:

- replacing a part of an asset is a repair to that asset. However, replacing the whole asset is a renewal. At what point does the size of an item render it not part of an asset but an asset with individual identity?
- at what point does an alteration constitute a new asset?
- a certain amount of improvement can take place with new replacement parts due to the development of technology. At what stage does an improvement amount to an asset renewal?
- repairs to any asset to bring it into first use might be capital expenditure

8.29 All these factors could mean that there is some inconsistency in the application of the rules.

8.30 The OTS welcomes the government's continuing focus on finding ways to simplify the capital allowance regime.

Additional recommendation 27: The OTS recommends that HMRC look at its guidance to see if capital allowances can be explained more simply and clearly, perhaps giving illustrations and case studies as in the R&D leaflet.

Chapter 9

Closing down or transferring a business

Transfer, sale or succession

9.1 The first business lifecycle report looked in some detail at the issues arising when a business passes on to new owners. From an administrative point of view the main issues identified were the potential for confusion because of the number of reliefs available on disposal and succession, and the mismatch between the interests of the buyer and seller.

9.2 Where a business is sold, a sale of shares may qualify for Entrepreneurs Relief, but a sale of assets by the company and a subsequent winding up will result in an additional tax charge in the company. This means that sellers will often wish to sell the shares in the company.

9.3 However, purchasers will generally wish to buy assets from the company, rather than buy shares in it, to avoid inheriting the corporate history and to be able to claim tax reliefs (capital allowances, intangible assets allowances) on the consideration paid for plant and machinery and qualifying intangible assets.

9.4 The mismatch or tension this creates can cause difficult negotiations and distortions in sale prices to deal with the asymmetric tax impacts.

9.5 The OTS recommended consideration of how these difficulties and distortions could be reduced, to better facilitate commercial transactions.

Closure

9.6 The procedure for closing down a business and telling HMRC about it varies depending on the nature of the business and the tax regimes involved.

9.7 As a minimum a self-employed individual must complete a final income tax return, and a director of a solvent company must inform both Companies House and HMRC, and complete a final corporation tax return.

9.8 If the business had employees, the PAYE scheme will need to be closed. There is also a question of when and by whom the last P11D returns are done, which is sometimes overlooked in the sale. If this has happened, the purchaser (or their tax/payroll agent) will not have access to the historic information: this is a problem in cases where there are outstanding queries or liabilities.

9.9 If the company was registered for VAT or the Construction Industry Scheme these registrations must be ended and final returns completed.

9.10 If a company or business was unable to pay its debts, a range of options may apply.

9.11 Just under one fifth of the businesses who responded to the OTS's survey had been involved in a business closure at some point: in the vast majority of cases (93%) the closure was voluntary. 20% of these respondents found HMRC easy to deal with; 60% found engagement with Companies House easy. Most used agents to deal with the closure. 20% of the businesses had losses at the time of closure: none were offset for tax – in at least one case the business was unaware that this was a possibility.

9.12 Around 70% of agents have closed down a business: in contrast to the business respondents, the vast majority of these agents found dealing with HMRC and Companies House a relatively smooth process.

9.13 The OTS recommends that HMRC review the process of closing a business, to simplify and streamline it – for example so that a business need only tell HMRC once that it is closing, and that this notification will cover all HMRC regimes.

9.14 Two specific issues were raised with regards to insolvency.

9.15 Repayment of tax on director's loans: the time taken to make such repayments was noted in Chapter 7 above. Insolvency Practitioners also have concerns about the time taken to recover tax paid on director's loans. An enforced delay of around 9 months extends the period for finalising the insolvency, adding cost and delay to the process. The OTS suggests that HMRC consider a special rule for insolvent companies.

9.16 Requirement to file returns: A corporation tax liquidation may take up to three years to finalise. During this period the company will receive a notice to file every year. No tax is likely to be due. The OTS understand that HMRC are considering a process for marking insolvent companies as dormant so that they are not require to file during this time. The OTS welcomes this and hopes to see the change implemented shortly.

Additional recommendation 28: The OTS recommends that HMRC review the process of closing a business, to simplify and streamline it so that the business need only tell HMRC once that it is closing and that this notification will cover all HMRC regimes. The review should include consideration of a shorter repayment period for directors' loan repayments for insolvent companies.

Annex A
Scoping Document

The first business life cycle review by the OTS addressed the tax charges and reliefs applicable at key stages or events over the course of the life of a business (Start up, Incorporation, Finance, Succession and Disposal).

The primary focus was on external events such as the raising of capital or a change in ownership rather than on internal events such as registering for and paying tax, taking on the first employee or dealing with the tax consequences of unprofitable years. Neither was there space to do more than scratch the surface of the practical day to day issues facing businesses during their start-up phase.

These are the areas that will be at the heart of the present review, which will have a natural focus on the affairs of smaller businesses, especially those which struggle the most with tax on a day-to-day basis.

The review will consider the extent to which administrative complexity may contribute to errors or a failure to take reasonable care, as well as any other underlying factors which result in compliance-related practical difficulties and penalties and which contribute to the tax gap (tax not collected). In addition, the review will build on the Office's previous work on smaller businesses.

Scope of Review

The review will consider the direct and indirect tax issues facing unincorporated and incorporated businesses in the course of their ordinary operations. The review will be more focused on smaller businesses, particularly those with £2m turnover or less or fewer than 10 employees.

The review will consider issues such as

- the accessibility and clarity of guidance and support in relation to the process of setting up a business, including the information on GOV.UK (linking to the OTS's wider work on guidance), including issues arising from the interaction between an individual's personal and business affairs
- how a business works out and administers its taxes (taking into account matters such as Making Tax Digital, record-keeping, filing returns, understanding allowable deductions)
- sources of error and unnecessary complexity, and ways these could be eased or mitigated
- the way the tax system handles unprofitable years or shorter-term cash flow issues (for example through the loss rules and time to pay

arrangements) and the extent to which the tax system helps businesses manage the cash flow demands of paying tax more generally

- the impact of taking on the businesses' first employee and subsequent employees (with regard to payroll taxes, completing P11Ds in relation to benefits, employment allowance)
- the impact and any distortive effect of thresholds (recognising the significance of issues of this kind that the OTS drew attention to its 2017 VAT report)
- issues arising in relation to relevant tax reliefs such as R&D tax credits
- making overseas sales or purchasing goods or services from abroad for the first time
- issues arising as the business develops, for example moving to new premises

Further guidance for the review

In carrying out its review, the OTS will

- liaise with the Administrative Burdens Advisory Board
- consider the likely implications of recommendations on the Exchequer and on compliance with the tax system
- take account of relevant international experience
- establish a Consultative Committee to provide support and challenge

Annex B
Consultative Committee

We are very grateful for the time and support of our Consultative Committee members.

Individual	Organisation
Charlotte Barbour	The Institute of Chartered Accountants of Scotland
Chris Burns	Chris Burns Consulting Ltd
Chloe Evenson	HM Treasury
Andrew Jackson	Fiander Tovell LLP
Emma Jones	Enterprise Nation
Pete Miller	The Miller Partnership
Lorence Nye	Federation of Small Businesses
Nicki Ross-Martin	Ross Martin Tax Consultancy Ltd
Chas Roy-Chowdhury	Association of Chartered Certified Accountants UK
Kate Upcraft	Kate Upcraft Consultancy Ltd
Anna Longman/Stephen Tolfree	HM Revenue & Customs

Annex C
People and organisations consulted

Administrative Burdens Advisory Board of HMRC

Association of Chartered Certified Accountants

Association of Accounting Technicians

Association of Taxation Technicians

Steven Carey (Numbers UK Ltd)

Chartered Accountants Ireland

Chartered Institute of Taxation

Chartered Institute of Payroll Professionals

Companies House

CP Cook and Partners

CRW Accountants Limited

Department for Business, Energy and Industrial Strategy

DJM Consulting

Federation of Small Businesses

Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants of Scotland

James Ward

Low Income Tax Reform Group (CIOT)

The Prince’s Trust

TaxAid

UK 200 Group

Annex D

Income tax and NICs costs - detailed workings

Table 9.A: Profits available to be drawn of £10,000

	Limited company	Net	Self employed	Net		Employee	Net
Profits	10,000		10,000	10,000		10,000	
Salary = NI primary threshold	-8,632	8,632					
Profit after salary	1,368						
Corporation tax @19%	-260						
Employer NIC		0				-166	
Distributable profit	1,108	1,108			Salary	9,834	9,834
Less personal allowance	(12,500-8,632) -3,868		-12,500			-12,500	
	0		0			0	
Class 1 NIC primary							-144
Class 2 NIC				-156			
Class 4 NIC				-123			
		9,740		9,721			9,690

Source:OTS

Table 9.B: Profits available to be drawn of £25,000

	Limited company	Net	Self employed	Net		Employee	Net
Profits	25,000		25,000	25,000		25,000	
Salary = NI primary threshold	-8,632	8,632					
Profit after salary	16,368						
Corporation tax @19%	-3,110						
Employer NIC	0					-1,985	
Distributable profit	13,258	13,258			Salary	23,015	23,015
Less personal allowance	(12,500-8,632) -3,868		-12,500			-12,500	
	9,390		12,500			10,515	
Income tax on dividend 2,000 @ 0%		0					
Income tax on dividend 7,390 @ 7.5%		-554					
Income tax @ 20%				-2,500			-2,103
Class 1 NIC primary							-1,720
Class 2 NIC				-156			
Class 4 NIC				-1,473			
		21,336		20,871			19,186

Source: OTS

Table 9.C: Profits available to be drawn of £50,000

	Limited Company	Net	Self employe	Net		Employee	Net
Profits	50,000		50,000	50,000		50,000	
Salary = NI primary threshold	-8,632	8,632					
Profit after salary	41,368						
Corporation tax @19%	-7,860						
Employer NIC	0					-5,016	
Distributable profit	33,508	33,508			Salary	44,984	44,984
Less personal allowance	(12,500-8,632) -3,868		-12,500			-12,500	
	29,640		37,500			32,484	
Income tax on dividend 2,000 @ 0%		0					
Income tax on dividend 27,640 @ 7.5%		-2,073					
Income tax @ 20%				-7,500			-6,497
Class 1 NIC primary							-4,362
Class 2 NIC				-156			
Class 4 NIC				-3,723			
		40,067		38,621			34,125

Source: OTS

Table 9.D: Profits available to be drawn of 75,000

	Limited company	Net	Self employed	Net		Employee	Net
Profits	75,000		75,000	75,000		75,000	
Salary = NI primary threshold	-8,632	8,632					
Profit after salary	66,368						
Corporation tax @19%	-12,610						
Employer NIC		0				-8,048	
Distributable profit	53,758	53,758			Salary	66,952	66,952
Less personal allowance	(12,500-8,632) -3,868		-12,500			-12,500	
	49,890		62,500			54,452	
Income tax on dividend 2,000 @ 0%		0					
Income tax on dividend 35,500 @ 7.5%		-2,663					
Income tax on dividend 12,390 @ 32.5%		-4,026					
Income tax @ 20%				-7,500			-7,500
Income tax @ 40%				-10,000			-6,781
Class 1 NIC primary							-5,306
Class 2 NIC				-156			
Class 4 NIC				-4,223			
		55,701		53,121			47,365

Source: OTS

Table 9.E: Profits available to be drawn of £100,000

	Limited company	Net	Self employed	Net		Employee	Net
Profits	100,000		100,000	100,000		100,000	
Salary = NI primary threshold	-8,632	8,632					
Profit after salary	91,368						
Corporation tax @19%	-17,360						
Employer NIC		0				-11,080	
Distributable profit	74,008	74,008			Salary	88,920	88,920
Less personal allowance	(12,500-8,632) -3,868		-12,500			-12,500	
	70,140		87,500			76,420	
Income tax on dividend 2,000 @ 0%		0					
Income tax on dividend 35,500 @ 7.5%		-2,663					
Income tax on dividend 32,640 @ 32.5%		-10,608					
Income tax @ 20%				-7,500			-7,500
Income tax @ 40%				-20,000			-15,568
Class 1 NIC primary							-5,745
Class 2 NIC				-156			
Class 4 NIC				-4,723			
		69,369		67,621			60,107

Source: OTS