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Making Tax Digital (MTD)

Exploring Business Income Tax Errors and how these can be addressed within software design

Prepared by Jigsaw Research for Her Majesty's Revenue and Customs

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Behaviour, Insight & Research Team

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Research requirement (background to the project)

Making Tax Digital (MTD) was announced at Budget 2015, with more detailed business specific commitments (MTD) announced at Autumn Statement 2015 and in the Roadmap[1], published in December 2015. MTD will make it easier for businesses to get their tax right the first time, reducing the £9.4bn tax gap resulting from avoidable mistakes. It will also reduce the cost, uncertainty and worry that businesses face when HMRC is forced to intervene to put things right.

The Government announced on 13 July 2017 that only businesses with a turnover above the VAT threshold will be mandated to use MTD from April 2019, and then only to meet their VAT obligations. Businesses with a turnover below the VAT threshold will not be required to use MTD but can choose to do so. Businesses will also be able to opt in for other taxes.
MTD will not be widened beyond VAT before 2020 at the earliest. These changes will be included in the second 2017 Finance Bill.

The smallest businesses and landlords will be able to choose when to move to the new digital system, adding to the millions of businesses who are already banking, paying bills, and interacting online. Delivering a modern digital tax system and digitising routine business tasks such as record keeping is the next step.

MTD will change the way businesses interact with HMRC, moving customers away from a paper based or telephone first approach to increasingly digital services. Through the use of third-party developed software and apps, businesses will be able to automate and integrate their record keeping into the day-to-day running of their business. In doing so, businesses will be able to update HMRC on a quarterly basis, getting a more up to date view of the tax they owe, increasing certainty, providing the foundations for businesses to grow. The processes for updating HMRC will be light touch, with the software doing much of the work. This will also enable businesses to keep track of their financial and tax position much closer to real time.

The software used for digital record keeping will over time incorporate nudges and prompts that directly address common reporting errors at source, allowing customers to minimise mistakes. Nudges and prompts are messages that appear at the point of data entry, or shortly after updates have been sent to HMRC. For instance, messages may appear in third party software as customers enter data to highlight common errors that are made and provide guidance, including links and tailored content, on avoiding these. This will also provide increased certainty that they have got their tax liabilities right.

The incorporation of nudges and prompts into third party software has the potential to address two broad categories of error:

- Simple errors such as transposition, mistakes in addition/subtraction and omission which the third party software will address at source; and
- ‘Technical’ errors resulting from lack of tax knowledge, lack of confidence with tax rules (e.g. allowable expenses and capital costs).

[1] HMRC Making Tax Digital (https://www.gov.uk/government/publications/making-tax-digital)

Qualitative research with small businesses was used to develop HMRC's understanding of the reasons for common, simple and technical errors in Income Tax Self-Assessment, and how they might be most effectively addressed within MTD design.

Aims and Objectives

This research had two primary aims. The first was to inform HMRC's understanding of the reasons common errors are made by business customers. The second was to inform the development of design principles.

More specifically the project set out to answer the following questions:

- What are the current business reporting behaviours that lie behind common, simple and technical errors, particularly in completing the Self-Assessment (SA) tax return? This includes business customers' record keeping practices, use of accounting software, level of expertise in accounting and tax, current reporting methods, and use of tax agents.
- What are current business customer behaviours and decisions that result in errors? How do these vary by customer type and sector?
- At what point of data entry is upstream intervention needed, and how could software nudges and prompts address behaviours and decisions?
- What types of nudges and prompts would help to minimise errors and produce a positive overall customer experience in using the Making Tax Digital software?
- How and when could signposted HMRC guidance be amended to maximise the effectiveness of the potential nudges and prompts?

When the research took place

The fieldwork for this research took place between 9th and 25th August 2016.

Who did the work (research agency)

The research was undertaken by Jigsaw Research Ltd. The team for the project comprised Hazel Fletcher, Ann Morgan and Natalie Bursk.

Method, Data and Tools used, Sample

The research undertaken was qualitative in nature. Qualitative research aims to understand the range of views and factors underpinning these. It does not seek to provide statistical or numeric information.

The study consisted of 36 face-to-face depth interviews, carried out in London, Manchester, Glasgow and Bristol. The research focused on taxpayer groups that, through analysis of data held by the Department, HMRC had identified as being potentially more likely to make errors in their record keeping and reporting for SA. Interviews were conducted with a mix of customers with secondary self-employment income and Sole Traders in SA (see table below).

Participants were recruited with varying levels of digital confidence, defined as confidence in 'using computers and the internet for your business needs', and varying levels of confidence in tax. They were also recruited from a range of sectors including:

- Construction;
- Transportation;
- Professional, Scientific & Technical; and
- Arts, Entertainment & Leisure.

The Sole Traders were purposely sampled to include a range of business size (half below the VAT threshold and half above) and business age.

	Individuals in PAYE with secondary business income 7 depth interviews	**Self Employed in SA 29 depth interviews**
Confidence in tax[2]	2 x Low 3 x Medium 2 x High	7 x Low 14 x Medium 8 x High
Tax Agent Representation	None to be represented	Maximum of 10 represented and only to use an agent for final check of SA tax return

The research team was briefed extensively by HMRC about the rules pertaining to allowable and non-allowable expenses, so that they could identify potential areas in which participants may have made errors.

[2] Respondents were asked to rate their confidence around business and employment tax issues and liabilities on a 10 point scale, where '1' meant 'Not very good at all' and '10' meant 'Extremely confident'.

Main Findings

The main research findings are outlined below.

Tax Knowledge

Participants generally felt that they knew enough about tax to meet their obligations. Most of their knowledge was acquired when they first set up in business. At this time, they asked around for help and advice, consulting with colleagues, peers and family members. They may also have consulted an accountant and looked online for basic advice, for instance from the HMRC webpages on gov.uk. This was usually quite an informal and unstructured process.

As a result of some of the information and advice sources being unofficial, some of the information that was picked up at this stage was incorrect. An example of this would be a friend or family member incorrectly telling the participant that a certain category of expense is allowable against tax.

Based on the information customers gathered at this initial stage, they set up their record keeping system and, at the appropriate time, completed their first SA tax return. None of the participants had ever been contacted by HMRC about this return, so they assumed their systems of record keeping and tax return completion were working well, and that their tax return was correct.

Almost without exception, their processes, both in terms of record keeping and the transposition of their records into the tax return, tended to be quite fixed from that point onwards. Their tax knowledge level had also plateaued relatively early on in the life of their business. From then on they had not looked out for changes to the tax rules that might affect them and instead assumed that HMRC would inform them directly of any changes. As a result of all of these factors, errors could be repeated from year to year.

Record Keeping

Participants from all sample groups tended to understand that record keeping is critical, both from the point of view of ensuring money is coming in and cash flow issues do not arise, but also to fulfil their tax obligations.

The need for record keeping appeared to be ingrained in the self-employed mentality and participants reported that the system they used was embedded into their routine. They admitted that occasionally they could ‘get behind’ but they tried hard to avoid this. Participants were generally keen to comply and saw well-managed record keeping as a key aspect of this. Many also saw good record keeping as part of being a professional business owner/person.

Each participant had developed their own record keeping system which they had then stuck to. Paper based record keeping tended to be the norm. All started with paper records in the form of receipts, and developed a routine of storing them in folders, boxes or plastic wallets. Some participants reported that these were then transferred into spreadsheet format, using Excel. However, in the majority of cases, the information from receipts was transferred into a book. This transfer of data into a book or a spreadsheet varied in frequency from daily to monthly or quarterly.

Participants generally categorised their expenses according to date, regardless of whether transferring into a book or a spreadsheet. A minority also categorised by expense type using categories and language that made intuitive sense to them, for example, materials, petrol, or stationery.

The majority of participants, including those not using spreadsheets, were using a computer to generate invoices, which they often printed and stored in a paper filing system. In all cases bank and credit card statements completed the records, although these were not integrated into one system.

In a small number of cases, digital record keeping was starting to replace paper receipts, for example, parking fees recorded on smart phones. However, these digital records still need to be transferred into the participant's system – either paper or Excel based.

Where Excel was used as part of the record keeping process, it tended to be by participants in the Arts, Entertainment & Leisure, and Professional sectors. Many participants in these sectors entered the records of their income and expenditure on to a spreadsheet and on a regular basis so that they did not fall behind. The methods used here, including the content, layout and sophistication of spreadsheets, varied considerably. The most sophisticated used separate tabs for income and expenses, the addition and subtraction functionality, and entered expenses into different categories. The least sophisticated used Excel simply as an electronic storage tool, digitally replicating the paper book that they had used to use. They did not use any of the spreadsheet functionality Excel provides, including use of calculator tools embedded into the spreadsheet to sum cells, choosing instead to manually sum totals when needed.

Accounting software

Only a very small number of participants who used accounting software were interviewed during this research. Participants not currently using software tended to have no perception that accounting software would be relevant to them or could help them. They believed that their affairs were relatively straightforward and that their current methods were fit for purpose. They therefore saw accounting software as representing a cost that would provide no real benefit.

Approach to Reporting

The annual SA tax return is the reporting mechanism for this audience. Annual completion is not sufficient for the process to have become intuitive, but they nevertheless tried to repeat the process they had used in previous years. This tended to involve:

- adding up all their income for the year;
- putting their expenses into categories and adding them up;
- checking income and expense figures against bank statements and credit card bills;
- trying to match their own categories with HMRC's categories; and
- finding the correct box for each element on the tax return.

In some cases, participants reported leaving tax return completion to the last minute, which meant that they did not have time to check it fully before submission.

Participants reported that they found the subject of how to handle expenses confusing. They were generally aware that some expenses are allowable for tax and some are not, but the specifics of how this relates to their particular expenses was not well understood. In the same way as general tax knowledge had become fixed early on, knowledge about which expenses were allowable and which were not also tended to be fixed fairly early on, and on the basis of inconsistent information sources and advice. It was common for participants to report that they had received informal advice in this area, and it appeared that this advice had sometimes been incorrect, but it had been accepted as it had come from a source they trusted and their tax returns had never been challenged by HMRC. Others had received good informal advice or had used more formal sources such as the HMRC webpages, and were treating expenses as allowable or not allowable correctly.

The process of adding up figures, for example individual expense and income items, was often done manually using a calculator, and many of those who used Excel did not use the addition functionality but used a calculator instead. Others used a calculator because their spreadsheet was not set up to group expenses by category or because the categories they had devised in their spreadsheet did not match HMRC's categories.

Participants generally reported that they tried very hard to get the figures right at an overall level and worried less about whether or not they had put individual figures in the correct expense boxes on the tax return. They kept their records as an insurance policy, thinking that if HMRC wanted to check their calculations they would be able to show their paper trail.
They also tended to use the previous year's return as a guide and a check – both in terms of which box on the tax return to put things in and to see if the totals looked similar year on year.

Behaviours and decisions causing errors[3]

On the whole, participants believed they were not making errors in their SA tax return. This was largely based on the fact that they had never been contacted by HMRC about their tax return to question their tax return or audit them more broadly. It also stemmed from the fact that participants generally had a compliant mind set; their intention was to comply. These factors combined to mean that although all could identify aspects of their process that could result in error, they largely assumed they were in fact doing everything correctly[4]. The rest of this section therefore assesses where **potential risks of errors** existed, identified either by participants or by the research team.

Poor record keeping and other complications with record keeping

Businesses reported several risks of error in this area, mostly relating to expense items:

- **Lost receipts** was the risk most commonly identified by sole traders. It was not considered to cause serious errors but it was felt to cause inaccuracy and inconsistency. If a paper receipt was lost it may not have been transferred into their record keeping system. In this situation, some wrote a note in their book or added the item into their spreadsheet. Others left the item out and did not claim for it. Paper receipts are becoming less common as the world becomes more digital, but the loss of paper receipts was still felt to be a considerable risk in terms of inaccuracy, especially for sole traders in Construction and Transport.

[3] Potential errors were identified by the research moderators, based on extensive briefing by HMRC as to the rules and guidance on allowable and non-allowable expenses.
[4] Participants' SA returns were not reviewed during this research. As such, from this research it is not possible to understand the relationship between potential errors and actual errors.

- The occasional inability to **obtain a receipt** was another example where participants considered there to be the risk of inaccuracy of record keeping and reporting. This was perceived to be an issue mainly in relation to the payment of other people. For example, if someone paid a teenager to do a leaflet drop in the local area, there would typically be no record of this, but it would still be considered by most to be an allowable expense. Another example would be giving a partner a 'salary' for a couple of hours' book keeping/admin per day.
- The amount of **time** between obtaining a receipt and including it in their business records also increased the risk of error. Sometimes participants reported that between storing the receipt and logging it in their system, they forgot what it was for and whether it was a business or personal expense. They also reported that if a considerable amount of time had lapsed, the receipt may have faded and become difficult to read.
- Participants often reported that the **expense categories** they used in their record keeping system did not match the categories on the tax return. This could cause items to be entered into the incorrect box.
- A few participants reported that they had had difficulty in situations where expense **items and totals did not match up** with bank statements and credit card bills. In this case, some worked hard to find the error and to reconcile the figures. Others allowed there to be inconsistency.
- Finally, participants reported risks associated with expense items where they needed to **extract the business element from a general household bill**, such as a telephone bill, utility bill or petrol. These caused considerable confusion with participants using different approaches, and some not claiming at all.

Inadvertent errors

Calculators were commonly used, not only by those with paper based record keeping systems, but occasionally by those using Excel as well. The use of calculators and the relative lack of skill in Excel could potentially increase the risk of error. Participants were conscious that they could make mistakes in manual addition using a calculator, whether transposing figures from a paper based or spreadsheet based record keeping system, and many of those using Excel admitted that they may have made errors because they lacked skill and confidence in using the software package.

Technical errors

On the whole businesses understood that not all business expenses are allowable, but there was considerable confusion around knowing which expenses are allowable and which are not. This confusion pertained both to entire categories, for example clothing, as well as expense categories where some elements are allowable and some are not, and appeared to result in both over and under claiming. The risk of error was increased as generally participants had only received informal advice about which expenses were allowable and had not read the official guidance available.

In general, customers had attempted to understand the rules that they believed were most relevant to them, but not those that they felt were irrelevant. For example, taxi drivers reported that they focused on the rules relating to fuel and vehicle maintenance, but did not know about tools and materials.

However, even within the expense areas most relevant to them, individuals in PAYE but with secondary business income admitted that they did not know the rules in detail. They felt that it was acceptable to use a ‘common sense’ approach and to achieve a ‘good enough’ result. As a result, there was evidence of many errors being made that were caused by an incomplete understanding of the rules. These were not generally reported by participants spontaneously, but emerged during detailed discussions with individual participants about how they treated individual expense items. The research team concluded (based on the technical briefing supplied by HMRC) that misunderstandings in the following areas were likely to have caused reporting errors:

- **Clothes and cleaning of clothes:** businesses reported a lot of confusion as to whether these were allowable. There were examples of both under and over claiming in this area.
- **Charity donations, staff and customer entertainment and gifts:** there was considerable confusion in this area and practices varied widely.
- **Insurance:** many were unclear about which types of insurance were allowable, such as vehicle insurance, home contents insurance. Again, practices varied widely.
- **Car, van and travel:** there were many different approaches to claiming in this area and a lot of confusion as to what was and was not allowable.
- **Tools:** many in the Construction sector were confused about the difference between tools and materials.
- **Phone, fax, stationery and other office costs:** practice was varied and confusion was common.
- **General costs of an office at home:** there was also a lot of confusion in this area, mainly related to whether and how to extract the business element of domestic bills. It was reasonably common for customers to claim nothing as a result of not knowing how to do this correctly.

- **‘Other business expenses’:** none of the participants interviewed had a thorough understanding of this category. It was commonly used it as a ‘catch all’ for any expense that they believed was allowable but for which they could not find another box on the tax return.
- **Interest on bank and other loans and depreciation costs**: generally customers were not claiming, although it was difficult to know whether this was because these were not relevant or because they did not fully understand these elements.

Separating business expenses from personal expenses was an area in which businesses reported widespread confusion. This research suggested that there is a relatively low level of understanding of the principle that only expenses directly related to the business are allowable across all expense categories. Some believed it is acceptable to claim 100% of fuel and phone expenses, for example. Others claimed 100% for fuel, often incorrectly, but only a proportion of their phone costs, or vice versa. As with several other errors, this confusion can lead to both over and under claiming, although it was difficult to be definitive about which was the case in each instance

Those who do separate out business from personal expenses use a variety of methods for doing so, including:

- For fuel expenses, some use a proportional ‘1 in n’ approach to receipts (so choosing to claim for one in four or one in five receipts, for example), others use a mileage or percentage basis.
- For phone expenses, some go through bills and try to separate personal from business calls. Others use a rough percentage basis.
- For office costs at home, some use a percentage basis, others just make a rough estimate. It was common for customers not to claim anything at all in this area.

Businesses reported confusion around the boxes on the SA form due to terminology that they found confusing, and disparity between the categories on the form compared with the categories they use or regard as being ‘sensible’. However, generally they are not too concerned by this, as long as the amount is allowable.

Conclusions

This research indicated that there are risks of businesses making errors in their SA returns both as a result of poor record keeping, and poor knowledge and understanding of the rules.

These findings will be brought together with wider evidence and user testing to inform the development of design principles for nudges and prompts to minimise the risk of errors and address errors at source in line with the objectives of MTD. These principles will be shared with the software industry through ongoing engagement in the delivery of MTD.