Low Incomes Tax Reform Group.

A voice for the unrepresented.

Consultation on Tertiary Legislation for Making Tax Digital for Income Tax
Response from the Low Incomes Tax Reform Group (LITRG)

1. Executive Summary

1.1. We welcome the opportunity to comment on the draft Notices required under the Income Tax (Digital Requirements) Regulations 2021 (SI 2021 No 1076).

1.2. Before doing so, we would like to express our continued concern as to the readiness of the MTD for ITSA programme for a 'go live' date of 6 April 2024. Due to the very low numbers in the pilot, which are constrained by things like type of software used, accounting period and sources of income among other things, there is very little testing of the potential pinch points that will inevitably arise with escalating numbers and less straightforward circumstances. Although the hope is to scale up the numbers in the next few months this does not allow time to fully test the end-to-end process in all the various circumstances. We are also concerned that even if unrepresented taxpayers are recruited into the pilot, they are likely to those who are most engaged and comfortable dealing with their self-employment.

1.3. We are particularly concerned that when considering the various stages of the whole MTD process, there is a presumption that all taxpayers will be using sophisticated software that will be able to deal with many of the 'wrinkles' that might arise during the end-to-end MTD journey. However in our view, unrepresented and/or low income taxpayers may not be able to afford this kind of software or be unable to use it properly and are more likely to use combinations of software, for example, spreadsheets together with a bridging product perhaps. For these taxpayers, their end-to-end journey is still unclear, even at this stage.

1.4. In view of the above, and also the many points mentioned below which suggest there are still many outstanding design issues to be addressed, we think it is time for HMRC to consider ways in which the MTD ITSA rollout could be staggered. The launch of MTD for VAT was staggered by only bringing in traders who were over the VAT threshold first and then bringing in other VAT registered businesses a few years later. Serious consideration should be given now to this kind of approach for MTD for ITSA otherwise we are concerned that the roll out in April 2024 will fail.

1.5. We are aware that the intention is to produce detailed guidance to support this tertiary legislation. It appears that much of the detail that we would expect to see in the notices will be left to be covered in guidance. We are not supportive of this approach and think that key details and definitions must be included in these notices, as they were in the VAT notice 700/22. For example:

- We would like to see specific definitions of the many technical terms used in paragraph 2, such as' recapture', 'digital action' and 'manual action' to provide clarity (see section 3 below)
- It should be a requirement under the Notice to declare whether the quarterly updates have been prepared on a cash basis or an accruals basis.
- As different expense categories will be relevant depending on whether a taxpayer is using cash basis or accruals basis accounting, we think the Notice should have two tables at paragraph 4, one to specify the requirements if using accruals accounting and one to specify the requirements if using cash basis accounting (see 4.1.1 below).
- We recommend further consideration is given to what information is reported in the quarterly update where income tax or other charges/commissions are withheld from either expenses or income when cash accounting is being used (see 4.1.5-4.1.8 and 4.2.1 below)
- With regard to furnished holiday lettings (FHL) a taxpayer may not know until the end of the tax year whether their letting has met the criteria to qualify as a FHL for that tax year. It is not clear to us how the quarterly updates would be completed in these circumstances and we think this should be addressed in the Notice. (see 4.2.5 below)

1.6. Even with more detail added to the notices, guidance will still be needed. We urge HMRC to provide comprehensive and thorough guidance in a timely manner. People are already joining/being asked to join the MTD for ITSA pilots without this guidance being available. Those using spreadsheets or simple software packages will need clear instructions as to what falls into the categories specified in the Notice to enable them to have confidence their quarterly updates are accurate.

1.7. We are pleased that the Notice provides for a taxpayer to opt for '3 line accounts' reporting when completing their quarterly updates (see 4.1.9 below)

1.8. We are very concerned that the MTD process is imposing obligations on some taxpayers which will be significantly more onerous than current legislation requires for establishing their income tax liability. This would include taxpayers who are claiming trading or property allowances, qualifying care relief, and rent a room relief for example. We urge the government to exempt these taxpayers from quarterly reporting (see 4.1.10 and 4.2.6 below).

1.9. The interaction between what is required under quarterly reporting and what can be claimed under the simplified expenses rules will be very confusing for the many small businesses who utilise this regime. Many are likely to be doing their quarterly updates themselves to minimise additional compliance costs, even if they have an agent to deal with their annual accounts. (see 4.1.11 below)

1.10. We note residential property finance costs is an expense category for property updates. As the tax relief for residential finance costs is complicated (as the tax relief is given as a tax reducer) we suggest this category of expense is excluded from the quarterly update and included in the EOPS with other adjustments once the accounting period is completed.

1.11. We are very concerned that there is an expectation Quarterly Updates will be reconciled to taxable profits by the EOPS. This could make the EOPS very confusing for unrepresented taxpayers. We think it is a step too far to expect this to be done (see 5.2 below).

1.12. If quarterly updates are prepared on a cash basis but end of year accounts are prepared on an accruals basis will this need to be noted in the EOPS? We assume quarterly updates will not need to be retrospectively adjusted for this.

2. About Us

2.1. The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998, LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low-income workers, pensioners, migrants, students, disabled people and carers.

2.2. LITRG works extensively with HM Revenue & Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

2.3. The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3. Software Notice (as required by regulation 3)

3.1. Paragraph 2 states that the transfer, recapture or modification of a digital record must be done digitally and not manually. As identifying what is a digital action and what is a manual action could be quite a grey area, particularly if using spreadsheets for record keeping, these terms should be specifically defined in the Notice to provide clarity around this.

3.2. For example, by typing a figure in a cell in an Excel spreadsheet, data is being entered manually, even though digital equipment and software is being used to do it. But what if it is linked across to a different tab – is that manual (given that the cell to transfer it to is manually selected)? Or what if a sum (or SUMIF function) is done – are these manual or digital operations?

4. Update Notice (as required by regulation 8)

4.1. *Businesses with Trade Profits*

4.1.1. We think it should be a requirement under the Notice to declare whether the quarterly update has been prepared on a cash basis or an accruals basis. This is important as some of the expense categories under the heading 'Transactions that lead to Business Expenses' will NOT be relevant if using cash basis accounting. For example, a business will never have debts written off if they are using cash basis accounting. Therefore, we think the Notice should have two tables at paragraph 4, one to specify the requirements if using accruals accounting and one to specify the requirements if using cash basis accounting.

4.1.2. The expense category 'depreciation and loss or profit on sale of assets' is not a transaction based category but an accounting category. Therefore we question whether this should be included as a category for the quarterly update. A trader does not have an actual depreciation expense per se, although we acknowledge that more sophisticated software which uses the accruals basis could calculate a depreciation charge on a quarterly basis. Those using simple software or spreadsheets for their digital recordkeeping may find this confusing, as will those on cash basis accounting.

4.1.3. Any unrepresented taxpayers who will be dealing with their quarterly updates themselves will find it difficult to extract some of the transaction data required. For example, how will they know what the interest element is to enter in the 'interest on bank and other loans' category when they make a bank loan repayment? How will they identify the financial charges element of credit card repayments for the 'Bank, credit card and other financial charges' category? We do not think this is what taxpayers will understand transactional data to be – in our view they will expect to record the actual amount of their business credit card payments and their loan repayments that they make, not the various constituent parts that make up the total amount paid. We cannot see how software will solve this easily, and if a taxpayer is recording their transactions on a spreadsheet, very few are likely to record the interest and loan/credit card repayment elements separately. It may be difficult to rely on statements to provide the split between interest and capital as they may only be issued annually.

4.1.4. For those businesses which carry stock, does the category 'cost of goods bought for resale or goods used' refer to actual stock purchases? If so, we would expect most people to regard these as a transaction and so it should be relatively straightforward to identify. However, if you are using accruals basis accounting, will this be the cost of sales amount, which is not a transaction but an accounting calculation requiring a stock-take and valuation of stock on hand to be made every quarter.

4.1.5. We note payments to subcontractors in the construction industry is also a category under the 'Transactions that lead to Business Expenses' heading. You will be aware that often , payments to subcontractors will be made net of an income tax deduction under the Construction Industry Scheme (CIS). As the quarterly updates are supposed to contain transaction-based data, it is likely that the actual payment to the subcontractor will be regarded as the transaction by most contractors , and so will be the net amount where tax is deducted at source, particularly where cash accounting is being used. But presumably the income tax withheld and subsequently paid over to HMRC (which is another separate transaction, probably at a later date) should also be reported in an update. If so, where should it be reported – in the 'other business expenses' category? It might be more helpful to have an additional box covering tax withheld under CIS.

4.1.6. There is also the position of the subcontractor who **receives** income net of tax deducted at source to be considered. As they do not receive the tax element of their income at all, if they are on cash basis accounting it is very likely their turnover/sales/income figure will only include the amounts they have actually been paid, and the tax element will not be reported in an update at all. Also, it is not unusual for there to be a delay by contractors when issuing CIS information to subcontractors, which can add to problems. We recommend further thought is given as to how the whole MTD journey will work for these taxpayers, for example, should the tax deducted be included at the EOPS stage if not as part of the quarterly updates? Or as part of the final declaration?

4.1.7. Of course, there are other circumstances where the amount actually received by a taxpayer does not reflect the income earned, for example, where someone works via a platform and the platform withholds its fees, commissions, charges etc before paying the earnings to the taxpayer, which is very common in the gig economy. Another example might be self-employed taxi drivers where the amount they receive is often after charges from the taxi company are deducted. As the gig economy is a growing sector we urge HMRC to consider the MTD journey/ design for these types of workers now before MTD is implemented.

4.1.8. This will also potentially be a consideration where wages and salaries are paid and PAYE deductions are made and subsequently paid over to HMRC, together with employers NIC. Again, this is likely to be most relevant to those using cash accounting.

4.1.9. We are pleased that the Notice provides for a taxpayer to opt for ‘3 line accounts’ reporting when completing their quarterly updates. This is welcome as this simplification measure is currently used by many small businesses and as they will be familiar with this, we expect it to continue to be well used under MTD.

4.1.10. There may be times when a quarterly update is required in relation to an activity which does not require the taxpayer to retain details of their expenses, for example where someone is claiming trading allowance or qualifying care relief or the 10% wear and tear allowance for childminders. We are very concerned that the MTD process is imposing obligations on some taxpayers which will be significantly more onerous than current legislation requires for establishing their income tax liability. We urge the government to exempt taxpayers who are claiming trading allowance or qualifying care relief from quarterly reporting for these sources of income.

4.1.11. Some taxpayers may claim simplified expenses rather than actual expenses, for example when considering ‘use of home as office’ expenses or business motoring expenses. Some may not make this decision until after their accounting year end so they can decide which is most beneficial for them to claim. As car expenses are included within an expense category, it seems that quarterly updates will be required to include costs which may ultimately be disallowed and replaced by a mileage allowance. On the other hand, home running costs do not seem to be required as part of an update, unless perhaps they are included under ‘other business expenses’. This will be very confusing for the many small businesses who utilise the simplified expenses regime, many of whom are likely to be doing their quarterly updates themselves to minimise additional compliance costs, even if they have an agent to deal with their annual accounts.

4.1.12. Also, it is not clear from the Notice when any adjustments for simplified expenses are to be made. We would expect it to be required as part of the EOPS and so perhaps it should be taken account of under ‘m’ in the list at paragraph 10 of the notice? We should be grateful of clarification of this or recommend an amendment to the Notice to deal with this point if our assumption is incorrect.

4.1.13. We note there is an expense heading which refers to fax expenditure. This might be an opportunity to change this to reflect 21st century technology and include broadband costs instead.

4.2. ***Businesses with Property Income***

4.2.1. In a similar way to the self-employed receiving expenses after deductions have been made by the payee (as discussed above) some people will receive rental income after letting agents have deducted their commission and any expenses they have paid on behalf of the landlord. Therefore if individuals are reporting transactions we believe many people will inadvertently declare the net amount they receive as their income. Unfortunately, many of the statements issued by letting agents are confusing and inconsistent, and identifying gross income and expenses deducted can be tricky, especially to those who are less numerate. Also, some agents issue statements monthly, some annually and some irregularly and so taxpayers may not always have the paperwork to hand to assist when they prepare their updates. Some agents charge landlords for these statements so this will be an additional cost compliant taxpayers will need to bear.

4.2.2. Experience suggests that taxpayers may also inadvertently double count expenses by including any agents deductions as professional fees too, especially if the agent issues an invoice for their fees.

4.2.3. As a minimum, detailed guidance will be necessary to explain what is actually required by taxpayers, if the Notice is not to be amended to cover these issues.

4.2.4. We note residential property finance costs is an expense category for property updates. We question whether this is sensible as some unrepresented taxpayers will inevitably include the full amount of their mortgage payments, even if the repayments include a capital element as they will be unlikely to be able to distinguish what the components of their payments are. Most mortgage statements showing a breakdown of capital and interest are only sent to the borrower on an annual basis (which does not necessarily tie in with tax year) or when changing mortgage product, so obtaining this information on a quarterly basis may prove an additional administrative burden. As the tax relief for residential finance costs is complicated (as the tax relief is given as a tax reducer) we suggest this category of expense is excluded from the quarterly update and included in the EOPS with other adjustments once the accounting period is completed.

4.2.5. We note the requirement to do separate updates for furnished holiday lettings (FHL) and long term lettings. This could be problematic as a taxpayer may not know until the **end** of the tax year whether their letting has met the criteria to qualify as an FHL for that tax year. It is not clear to us how the quarterly updates would be completed in these circumstances and we think this should be addressed in the Notice.

4.2.6. There may be times when a quarterly update is required in relation to an activity which does not require the taxpayer to retain details of their expenses, for example where someone is claiming the property allowance or rent a room relief. We are very concerned that the MTD process is imposing obligations on some taxpayers which will be significantly more onerous than current legislation requires for establishing their income tax liability. We urge the government to exempt taxpayers who are claiming property allowance or rent a room relief from quarterly reporting.

5. End of period notice (as required by regulation 12)

5.1. The end of period information relates to the accounting period for the business, and its purpose is 'to provide information relevant to the calculation of profits, losses or income of the business'. As we understand it, the intention is that the EOPS is the mechanism to reconcile the quarterly updates to taxable profit. We strongly believe this will be a step too far for many unrepresented taxpayers, particularly if lots of adjustments are required to arrive at taxable profits. It will make it very complicated and could mean they incur costs in order to comply.

5.2. For businesses with trade profits, we cannot identify which of the categories listed at para 10a-10r inclusive the following information, which we consider to be relevant to the calculation of taxable profits for an accounting period, would be reported under*:*

- Accounting adjustments such as stock valuations, prepayments, debtors and creditors, etc when on accruals accounting
- Loss relief claim relevant to the tax year
- Tax deducted at source from income (eg CIS tax)
- Claims for expenses allowances such as simplified expenses (mentioned at paras X – X above), qualifying care relief, childminder expenses, trading allowance (perhaps these fall under 10m, adjusted profit or loss for the year

Other claims and elections relevant to the tax year for example, electing for cash accounting

5.3. Should there be a way of indicating that a taxpayer wants to pay voluntary class 2 National Insurance contributions on the EOPS? If not, how will this be done to ensure the class 2 NI liability is included in the overall liability for the tax year?

5.4. For businesses with property income, should the claim for tax relief for residential property finance costs be included in the EOPS? If not, where will this be quantified to ensure the appropriate tax reducer is reflected in the overall liability for the tax year?

5.5. If quarterly updates are prepared on a cash basis but end of year accounts are prepared on an accruals basis will this need to be noted in the EOPS? We assume quarterly updates will not need to be retrospectively adjusted for this.

5.6. We are very happy to meet to discuss the points raised in this response in more detail if that would be helpful.

LITRG
28 July 2022