Low Incomes
Tax Reform
Group
A voice for the unrepresented

# Self-employed claimants of universal credit – lifting the burdens

A short report from the
Low Incomes Tax Reform Group of
The Chartered Institute of Taxation

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A large print version of this report is available from The Chartered Institute of Taxation upon request. Please write to the Low Incomes Tax Reform Group, The Chartered Institute of Taxation,1st Floor, Artillery House, 11-19 Artillery Row, London, SW1P 1RT.

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# Foreword

Over the next few years, universal credit will gradually take over from certain existing means-tested benefits and from tax credits as the primary welfare support for working-age people.

Under working tax credit, claimants who are genuinely self-employed have parity of treatment with employees and can, with very few exceptions, re-use their self-assessment tax data in making or renewing their claim for working tax credit. This saves them a lot of administration and bureaucracy, enabling them to get on with running their business, and it also makes it easier for HMRC to cross-check data when assessing the accuracy of the claim.

But universal credit, operated by the Department for Work and Pensions (DWP), is a different story. The universal credit assessment period is one month as against one year for tax; definitions of income and profit from self-employment differ for universal credit and tax; universal credit operates a cash basis which diverges from the cash basis option for tax; and the minimum income floor (MIF) in universal credit fails to account for fluctuating earnings or one-off large business expenses, often resulting in a self-employed claimant receiving substantially less benefit than an employed claimant on a similar overall income. From April 2018, the universal credit system will become far more complicated with the introduction of surplus earnings rules for both the self-employed and employed.

The Low Incomes Tax Reform Group (LITRG) has been raising concerns in both Parliament and Government about the proposed treatment of the self-employed under universal credit since the proposals were first mooted in the Bill which became the Welfare Reform Act 2012. This report sets out our own diagnosis of what is wrong with the current regulatory structure, and proposes what we believe to be a workable alternative for consideration. Our model preserves current incentives for entrepreneurial endeavour, brings more parity between the employed and self-employed and safeguards public finances.

In May 2017, the Work and Pensions Committee concluded that the MIF fails to get the balance right between supporting entrepreneurship and not subsidising long term, unprofitable self-employment. As a result there is a risk that viable new businesses will be stifled. The Committee recommended that an independent review be commissioned with a view to improving the MIF's sensitivity to the realities of self-employment. We believe our model restores this balance and addresses the flaws in the current rules.

In exploring the implications of the concept of parity between the employed and self-employed under universal credit, this report contributes to the wider debate, that is already underway but needs to be continued in earnest, about the need for greater coherence in policy making on how the tax and welfare systems should apply to the rewards from work, whether classified as employment or self-employment or any other category of work. As the Chartered Institute of Taxation, Institute for Fiscal Studies and Institute for Government observed in their report Better Budgets: making tax policy better,[1] tax policy-making in the UK has suffered from a lack of the same level of scrutiny, challenge and consultation that has characterised other policy areas. The recent Taylor Review ('Good Work') of modern working practices[2] cited evidence that:

> " ...employment status and payments of tax and NICs are often connected particularly when it comes to temporary work...[and] the number of cases in the Employment Tribunal and higher courts each year evidences that the lack of clarity in relation to definitions in the law itself is central to a growing problem. The lack of

1 16 January 2017 – see https://www.instituteforgovernment.org.uk/publications/better-budgets-making-tax-policy-better

2 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/627671/good-work-taylor-review-modern-working-practices-rg.pdf

consistency with tax law, which often uses variables adopted by the tax authorities based upon employment law principles, adds to this and together simply serves to create ambiguity and confusion."

It seems clear that tax, welfare and related policy aspects must be considered as a whole when making policy decisions in these areas. If such decisions are made by different departments in isolation from each other, the result is greater confusion, more burdensome administration and, in the area of self-employment, ultimately a strong disincentive deterring those who might otherwise be encouraged to set up their own business.

We hope that officials in the DWP, as well as wider Government, and politicians will carefully consider the proposals in this report and take up our recommendations. As always, we stand ready to work with officials to assist them in making the system work as well as it possibly can for all claimants.

Signed

Anne Fairpo
Chair, Low Incomes Tax Reform Group

# 1. Executive summary

Since the Welfare Reform Bill began its passage through Parliament, we have had significant concerns about the design of universal credit for the self-employed and have tried to engage with the DWP to identify ways to alleviate some of the unfairness in the current system.

This report proposes changes that could be made to the current universal credit system for the self-employed that would make the system fairer for self-employed claimants and also ensure more parity between the self-employed and employed.

Given that universal credit is already established and the full service is currently being rolled out across the UK we have not sought to start at the beginning and create a new model of support for the self-employed (either within the universal credit system or outside). Instead, we have worked within the existing structure and rules of universal credit and made suggestions for improvements and changes focusing on the areas where we have the most concerns. The issues we have focused on include:

- Aligning the cash basis for tax and universal credit
- Monthly reporting
- Measurement of income for businesses with irregular profits
- The Minimum Income Floor (MIF)
- Loss relief
- Surplus Earnings Policy
- The start-up period
- The unfairness between employed and self-employed claimants
- Support and guidance offered by Jobcentre Plus

We have devised a model which aims to treat all self-employed fairly and ensure more parity with employed people earning similar amounts. We think that people who earn the same amount over a 12-month period should on balance end up with the same amount of benefit – whether they have income earned at regular intervals or with large variations during a year and whether they are self-employed or employed.

We believe our proposals should reduce the administrative burden on claimants, make the system fairer and support the self-employed at the same time as providing reassurance to the Government that universal credit will not provide support for people to continue businesses that are not viable in the long term and are more akin to pursuing a hobby.

# 2. Introduction

The last ten years have seen a very significant rise in the number of people who are self-employed, estimated at 4.6 million, approximately 15% of the UK workforce,[1] many of whom are on a low income and therefore unable to afford professional advice. During the passage of the Welfare Reform Bill, which introduced universal credit and later became the Welfare Reform Act 2012, LITRG raised a number of concerns about how universal credit would work for the self-employed. We formed a coalition of like-minded professional bodies, charities and trade associations and wrote to the Minister for Welfare Reform setting out our main concerns (see Appendix 1).

Although some minor changes to the self-employment rules have been made since then, worryingly many of the major concerns remain. Without further changes, there is a real possibility that the current rules will discourage people from starting self-employment and cause existing self-employed claimants to give up their work.

The purpose of this report is to summarise the areas that concern us most with the current universal credit system in respect of the self-employed and to suggest positive changes to the current model that would address these. If implemented, we strongly believe our model would strike a fairer balance between protecting public funds and supporting genuine self-employment as well as being administratively easier for both the DWP and claimants. One of the primary aims of our model is to strive for fairness for self-employed universal credit claimants when compared to employees earning the same overall income, while at the same time fully recognising that often the self-employed have less certainty regarding their earnings over a short period of time.

This report does not consider any other elements of the universal credit system that may impact on all claimants. The latest estimate published by the Office of Budget Responsibility is that the introduction of the MIF will reduce universal credit spending by £1.5 billion relative to where it would have been. This figure is the expected saving by 2021/22.[2] This report does not analyse the cost implications of the changes we have recommended, neither have we calculated the savings that could be made from the administrative changes we have suggested. This is work that will need to be carried out if these proposals are taken forward.

## Who we are

The 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.

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.

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.

1 Information from the Self-Employment Review – An independent report by Julie Deane OBE: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/529702/ind-16-2-self-employment-review.pdf

2 http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/ (see supplementary fiscal tables: expenditure)

# 3. Current system – areas of concern

## 1. Accounting basis – alignment with the tax system

HMRC introduced a cash basis for small business for 2013/14 and subsequent tax years.

For universal credit purposes, the DWP operate a crude cash basis for calculating monthly profits from self-employment. However, the universal credit rules for working out self-employed earnings are substantially different to the ones introduced by HMRC. There are a number of differences which are summarised in the table below, such as the method of giving loss relief, the treatment of refunds of income tax and National Insurance, the choice of using the simplified expenses rules, and not least the period over which profits are assessed – the HMRC method operates on a yearly basis, the DWP monthly.

| | Accounting under universal credit | Accounting under HMRC's cash basis |
|---|---|---|
| Reporting time frame | Monthly reporting. | Annually by January 31 after the end of the tax year (although this may change under HMRC's proposed digital strategy). |
| Mandatory or optional use of accounting basis | There is no choice on how the monthly accounts are prepared for DWP – they must conform to the universal credit regulations. | The cash basis is optional and eligible businesses can elect to use it on an annual basis. However, certain trades are not allowed to use the cash basis and there is also a turnover 'exit' threshold (see below). Alternatively, businesses can use the 'accruals basis' (Generally Accepted Accounting Principles). |
| Thresholds | There are no thresholds – all self-employed universal credit claimants must use the same accounting basis. | Universal credit claimants must leave the HMRC cash basis if their annual turnover is greater than £300,000. |
| Transitional rules | There are no transitional rules for DWP; when completing their self-assessment tax returns universal credit claimants must adjust their annual accounts to ensure that income and expenses are only declared once. | On switching to the cash basis (and from it to the accruals basis), transitional rules ensure that income and expenses are accounted for only once. |
| Carry forward of losses | There is currently no facility to carry forward losses from one assessment period to another (see point 6 Loss relief below). | Business losses may be carried forward to set against the profits of future years but not carried back or set off 'sideways' against other sources of income (which is possible when using the accruals basis). |

| | Accounting under universal credit | Accounting under HMRC's cash basis |
|---|---|---|
| Simplified expenses | There is no choice about using specific rules in calculating expenses such as mileage costs for cars or working from home. | There is a choice whether to use all, some or none of the simplified expense rules. |

Not all businesses will be affected by these different rules, but we anticipate that most could be affected at some point in time as the differences are so wide-ranging. The fact that there are two separate systems based on cash in and out of the business compounds the complex and time-consuming administrative burden on the self-employed who often have little time or expertise to understand their tax and reporting responsibilities.

HMRC's initial consultation stated it was 'working with the DWP to identify how it may be possible to align aspects of the cash basis for tax and self-employment income reporting for universal credit'.[3] It would seem that the original intention was to have a cash basis system which would be simple for the self-employed to use both for completing a tax return and for claiming universal credit.

It should also be noted that many low-income self-employed may still be using the accruals basis of accounting for the purposes of reporting taxable profits to HMRC and would therefore need to calculate their income for universal credit purposes in a completely different way, causing a considerable administrative burden. There are numerous reasons why the self-employed may use the accruals basis of accounting: it may be that the transitional rules to move to the cash basis are deemed too complex, there are tax efficiencies of using the accruals basis such as tax relief on loan interest and more flexible use of losses; also, some businesses are not allowed to use the cash basis of accounting due to their size or trading activity. Therefore, it is not a simple choice for many businesses to switch accounting basis so that some accounting figures being used to report profits to HMRC may be more in line with the universal credit cash accounting basis.

The alignment of the different systems will become more important to self-employed claimants when the Making Tax Digital quarterly reporting system for HMRC is rolled-out.

There is also a potential for a lack of consistency in determinations around whether someone is carrying out a 'trade, profession or vocation'. DWP guidance is based on the HMRC badges of trade developed for tax purposes, however the DWP guidance[4] makes it clear that DWP staff are not bound by an HMRC decision and so it is possible that someone could be found to be trading for tax purposes but not for universal credit purposes or vice versa.

## 2. Reporting obligations

Universal credit requires self-employed claimants to report their earnings soon after the end of each monthly assessment period. The current universal credit monthly reporting requirement should normally work effectively for employees as the information is mainly provided through the Real Time Information PAYE system. However, the monthly reporting for the self-employed is a potentially time-consuming administrative burden. This burden is likely to be greater where the person is not using the cash basis for HMRC purposes as the reworking of accounting results necessary for each monthly report will be considerable where Generally Accepted Accounting Principles (GAAP) (the 'accruals' basis) is used for tax.

3 HMRC Consultation document: Simpler Income Tax for the Simplest Small Businesses paragraph 1.8.

4 See para H4017 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/618963/admh4.pdf

HMRC are currently developing their Making Tax Digital programme and there will almost certainly be very considerable disadvantages for businesses if the two systems are not fully aligned, particularly in terms of additional unproductive administration; but until we know in more detail exactly what the final product will look like we cannot make firm recommendations.

## 3. Measurement of income

Universal credit was designed around monthly assessment periods. While this may work well for employed claimants with steady income, it does not work at all well for many self-employed claimants.

The rigidity of monthly assessment periods means that the current system cannot accurately account for:

- Self-employed claimants who have uneven earnings throughout the year – for example farmers.
- Self-employed claimants who have big expenses – such as an annual insurance premium – falling in a particular month.
- Periods in which losses are made – either in the early years of the business or due to an unexpected change (such as the loss of a contract, a bad debt or damage from flooding resulting in a period when the business is unable to trade).

Many of these claimants would, if viewed over an annual period, make more than the National Minimum Wage (NMW), but due to their income/expense patterns can be unfairly penalised by the rigidity of the monthly assessment periods. The new surplus earnings policy, due to be implemented from April 2018, will not only erode the monthly assessment period rule, but is also exceptionally complex for both the employed and self-employed (see number 7 below for further discussion).

Appendix 2, examples 1 and 3, show the impact of fluctuating incomes and one-off big business expenses on universal credit payments.

## 4. Minimum Income floor (MIF)

Perhaps one of the most concerning parts of universal credit for the self-employed is the MIF, under which for any month in which the self-employed claimant's profits (as defined)[5] fall below the MIF, the claimant's universal credit award is assessed as if he/she had profits at least equal to the MIF.[6] The level of the MIF is equal to the NMW for the claimant's age group, assuming they worked their expected number of hours each week (i.e. the National Living Wage (NLW) rate for those aged 25 or over). For most people, the expected number of hours will be 35 hours a week, although it may be less for example if the claimant has caring responsibilities, is responsible for a child under the age of 13, or has a physical or mental impairment.[7]

During the many debates on universal credit, the Government repeated the need for the MIF to stop people staying at a very low level of activity and receiving state support. In December 2015, Lord Freud said:

> "The welfare system is not there to prop up unproductive or loss-making businesses. The minimum income floor is there to incentivise individuals to increase their earnings from their self-employment. Those subject to the minimum income floor are exempt from having to search for or carry out any other work, allowing them

5 Universal Credit Regulations 2013/376, reg 57.

6 The MIF only applies to those who are in the 'all work' requirements group. Those placed in other groups, for example due to their limited capability for work and work related activity, will be exempt from the MIF requirement.

7 Universal Credit Regulations 2013/376, reg 88.

> to concentrate on making a success of the business........ the other thing that the minimum income floor does is address a loop-hole in the tax credits system whereby individuals can report little or zero income but still receive full financial support, which is neither a desirable or sustainable situation to maintain."[8]

We agree that there should be equality between the employed and self-employed. We also understand some of the concerns about people who are more likely to be classed as 'hobby traders' claiming state support for long periods of time.[9]

However, we do not believe a broad brush approach with a tool like the MIF is the right way to address this problem.

Firstly, the MIF only applies to those who are gainfully self-employed – the very people who DWP have assessed as carrying on a trade, vocation or profession that is regular, organised, developed and in expectation of profit, so not the 'hobby traders' that HMRC are concerned with in respect of working tax credits. The design of the current system actually creates an incentive for some self-employed people to push for classification as not being gainfully self-employed. This means they would avoid the MIF and have their universal credit paid on their actual self-employed income and although they would be subject to conditionality requirements we understand that this could take the form of support and help to grow their business and any self-employed earnings would count towards the conditionality threshold.

Secondly, it currently applies independently each month without considering what has gone before or what may happen in the future. It means the MIF negatively impacts those who:

- Have fluctuating earnings
- Pay large business expenses in one month (rather than spread across the year)

This is not only unfair, because in some cases these claimants will earn above the MIF level if their income is considered over a longer period, but it also leads to disparity between the employed and self-employed. It is possible that a self-employed person earning the same as an employed person over 12 months will receive significantly less universal credit and we do not believe this is right or fair.

Appendix 2 includes some examples that show the harshness of the MIF for self-employed claimants with fluctuating earnings or one-off expenses. It also highlights the disparity between the employed and self-employed.

Finally, the MIF does not take into account pension contributions. Employed universal credit claimants can deduct their pension contributions from their income and their payments will be calculated on this new net amount. Although a self-employed claimant can also deduct pension contributions in calculating their net income from self-employment, if that takes them below the MIF then they will be brought up to the MIF level and so not have their contributions fully reflected in their universal credit award. We have shown how this works in practice in Appendix 2, Example 4. We cannot see any rationale for this unfairness.

For the reasons outlined above, we support the recommendation by the Work and Pensions Committee[10] that the MIF risks stifling viable new businesses and that the Government should commission an independent review

8 https://www.publications.parliament.uk/pa/ld201516/ldhansrd/text/151214-0003.htm

9 Although we disagree that such a loophole necessarily existed in the tax credits system – for further discussion of this see our submission to the Work and Pensions Committee inquiry on self-employment and the gig economy. http://www.litrg.org.uk/latest-news/submissions/170302-self-employment-and-gig-economy

10 https://www.publications.parliament.uk/pa/cm201617/cmselect/cmworpen/847/84707.htm#_idTextAnchor013

of the MIF with a view to improving its sensitivity to the realities of self-employment. Until this is complete, the Committee recommended the MIF should not apply to self-employed claimants.

### 5. Start-up period

The current universal credit rules allow newly self-employed claimants a 'start-up' period of 12 months and during that time the MIF is not applied even if they are gainfully self-employed and their profit is below the MIF. Claimants are allowed one start-up period every five years.

We agree that the concept of a start-up period is crucial for those starting out in self-employment, however we do not think that the current start-up period is long enough to allow businesses to reach their initial potential. Research by the RSA, referenced by Citizens Advice, shows that on average it will take three years for a self-employed person to be earning the equivalent of the NMW from their business.[11] Having a shortened start-up period means that some claimants, who could go on to have strong, profitable businesses that reduce their need for state support in the future may not be able to continue their self-employment due to the harsh effects of the MIF after 12 months.

### 6. Loss relief

As the rules currently stand pre-April 2018, there is no recognition in universal credit for self-employed losses as there is in the current tax credit system (but see point 7 below). As we noted above, the monthly assessment periods are too rigid for many self-employed claimants.

For tax purposes (and tax credits) losses are only created once accounts are finalised for a given accounting period. However, a number of scenarios are possible in universal credit in which monthly losses can be artificially created, for example:

- A large expense which may have accrued over a whole year is paid in one assessment period, for example, under the cash basis an annual insurance payment would be treated as an expense in the month it was paid, however under the accruals basis the expense would be spread equally over the period which it related to, and so would not cause a monthly loss.
- Income is received in only a few months of the year due to the nature of the business (eg farming and tourism), so in other months there are only expenses.
- The business is forced to temporarily stop trading due to unforeseen circumstances such as flood damage.

In these situations, the business may, for tax purposes – and on any 'true and fair' accounting basis – be profitable. The losses may be apparent only, and occurring solely, because of the forced monthly assessment periods requiring the use of the DWP cash accounting basis (rather than the HMRC accruals basis).

The other scenario is of course that a business has a difficult time or is in a start-up period and makes a loss over their normal accounting period.

To be effective for the self-employed, universal credit needs to recognise short term losses in a fair way that reflects the true reality of a growing business.

11 Citizens Advice report – Going Solo (2015), Page 14 referring to research by the RSA: https://www.citizensadvice.org.uk/Global/CitizensAdvice/Work%20Publications/GoingSolo.pdf

## 7. Surplus earnings policy

From April 2018,[12] in 'full service' universal credit areas, the rules will be amended to introduce a surplus earnings and loss policy.[13]

These are some of the most complex rules we have ever seen and we doubt that DWP staff or claimants will be able to fully understand and implement them. They erode the concept of monthly assessment periods. We believe that the concerns set out by DWP in order to justify the Regulations are neither valid nor backed up by any evidence or data. The new rules are also cumbersome and unfair for employed claimants. They are worse for many self-employed claimants due to their interaction with the MIF and lead to further unfairness between employed and self-employed claimants who are earning the same annual amounts.

The changes introduce the concept of 'surplus earnings' into universal credit for both employed and self-employed claimants. This means that if someone has a universal credit award terminated (for example because their income goes up due to a new job) a calculation will be done to work out their 'surplus earnings' for that month and the following five months. Surplus earnings are essentially the amount of income they have above the point at which their universal credit would reduce to nil plus a £300 ***de minimis*** (for an illustration see example 2, page 20). If they then need to reclaim universal credit within that period, say because they lose their job after four months, the surplus earnings for those four months will be applied to their new claim as income. This means they will receive either a reduced universal credit award or a Nil award and that will continue until either the surplus has been reduced to zero or a total of six assessment periods have passed since their last universal credit award terminated.

The Regulations were introduced to tackle two issues that DWP identified in the current system. The first was the potential for employees to manipulate their earnings to increase their universal credit award, for example by agreeing with their employer to be paid twice a year and thus getting maximum universal credit for the remaining period. The second issue was concern about those with fluctuating incomes who may benefit from the fluctuations by receiving more universal credit.

However, what the DWP failed to address was that the MIF already creates a disincentive for the self-employed to manipulate their income in the ways shown in the DWP explanatory memorandum presented to the Social Security Advisory Committee.[14] The surplus earnings policy interacts with the MIF in a way that further worsens the position of the self-employed person and means that in some cases a self-employed person would receive over £3,000 less universal credit over a year than an employed person earning exactly the same net income.[15] We cannot believe this was the intended consequence.

Alongside surplus earnings, a method of giving loss relief will be introduced for the self-employed from April 2018, whereby a loss in one universal credit assessment period may be carried forward over the eleven subsequent assessment periods. While preferable to no loss relief at all, this method does not give full relief as each assessment period is subject to the operation of the MIF. Accordingly this method of loss relief does not reflect actual losses of the business. Besides, by introducing recognition for losses alongside a surplus earnings policy, DWP have created an exceptionally complex system for the self-employed. There is further disparity in that losses cannot take account of pension contributions for the self-employed (see point 8 – 'Unfairness between employed and self-employed').

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12 The Surplus earnings policy was due to commence in April 2016 in digital areas. This was later postponed to April 2017 and then again to April 2018.

13 The Universal Credit (Surpluses and Self-employed Losses) (Digital Service) Amendment Regulations 2015/345.

14 See Appendix 2 Example 2 which is based on an example DWP explanatory memorandum.

15 See Appendix 2 Example 1 – £2,600 of the £3,000 is due to the operation of the MIF and the remaining difference is the impact of the surplus earnings policy in addition to the MIF.

## 8. Unfairness between employed and self-employed

There is a serious issue with the current system regarding the unfairness created between the employed and self-employed. When discussing the universal credit regulations in Parliament, the Minister for Welfare Reform Lord Freud promised there would be parity between the two groups.[16] While some changes were made, they did not go far enough and the proposed surplus earnings policy makes this disparity even worse. It should not be the case that an employed person and a self-employed person earning the same net income over a 12-month period end up with significantly different universal credit amounts.

We have modelled numerous examples that show a self-employed person earning the same across a 12-month period as an employed person can be worse off. In one example, the self-employed person received £2,600 less universal credit than their employed counterpart (for an illustration see Appendix 2, example 1). We cannot see how this can be fair.

Similarly, the employed can make pension contributions and their universal credit will be increased as a result. The self-employed can do that only down to the level of the MIF, below that level they do not receive any recognition for pension contributions. Similarly, the new loss relief provisions do not take account of pension contributions. For an example, see Appendix 2, example 4.

## 9. Support and guidance offered by Jobcentre plus

We have concerns about the level of support new businesses and businesses experiencing trading difficulties will receive from Jobcentre Plus advisers. Self-employment covers a large number of occupations, some of which require very specialist knowledge to fully understand the nature of the business and provide adequate support when needed. Jobcentre Plus advisers must have suitable in-depth training to understand and help all businesses.

16 Work and Pensions Committee hearing in September 2012
Q.288 – http://www.publications.parliament.uk/pa/cm201213/cmselect/cmworpen/576/120917.htm

# 4. Self-employment under universal credit – an alternative model

Based on the areas of concern explained above, LITRG have developed an alternative model of self-employment in universal credit to calculate self-employed profits for universal credit purposes. This is not how we would design universal credit for self-employed claimants if we were given a ‘blank canvas’ however we have taken a pragmatic approach of suggesting tweaks to the current DWP model to show how some changes could result in a less burdensome and more equitable system. We have focused on the areas of the DWP system which we consider are the most unfair to the self-employed when compared to employed universal credit claimants, such as the MIF, losses and the surplus earnings policy.

### The LITRG model – general principles

In suggesting changes to the current system of universal credit for the self-employed, we have taken account of the following general principles:

1. Ensure that administrative burdens on the self-employed are kept to a minimum

2. Ensure greater parity between the employed and self-employed as far as possible

3. Ensure that claimants (both employed and self-employed) are not encouraged to manipulate income or expense figures to gain additional universal credit entitlement

4. Ensure that claimants cannot access support for an unlimited time without growing their business to at least NMW level or accepting some conditionality

5. Ensure that those with fluctuating income and expenditure are not penalised and that the system can take fair account of their income and expenses

6. Ensure that those who are genuinely self-employed receive appropriate support in order to establish and grow their businesses

7. Ensure, that as far as possible, there is alignment with the tax system

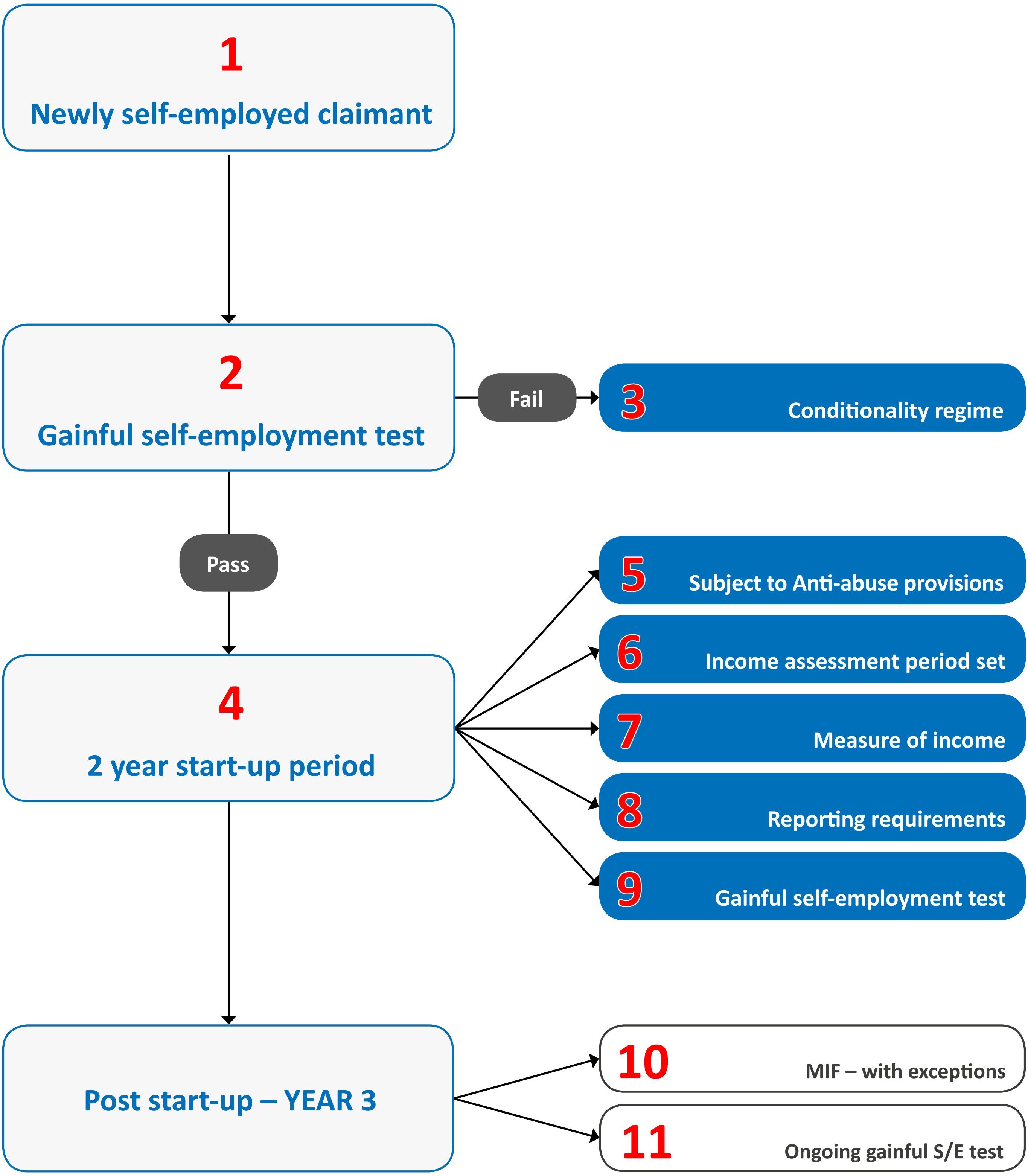
8. Ensure that it is not cumbersome for DWP to administer

### The LITRG model – Outline

Based on the principles outlined above, we have set out in detail below how universal credit could be structured to be a fairer, more equitable system for the self-employed and easier to administer for DWP.

The chart below shows an outline of how the system would work for a newly self-employed universal credit claimant. The table following the chart explains in more detail each of the stages. We also include further examples which highlight how certain stages of our model would work.

*Chart showing the journey of a newly self-employed claimant under the LITRG model*



| | Proposal | Benefits |
|---|---|---|
| 1 | **All newly self-employed claimants would have a first interview with an adviser**: We suggest that in each Jobcentre office a small number of staff undergo specialist self-employment training in order to become 'subject experts' and that they have access to a central expert team, who are supported by HMRC.<br><br>At this point, under the current legislation, the DWP adviser would need to apply the 'badges of trade' to assess whether the claimant was carrying on a 'trade' or vocation or profession. This should ensure that there is a consistent approach between DWP and HMRC as HMRC apply the same rules for tax. If in doubt, any HMRC decision should be followed. | This ensures that all aspects of self-employment can be fully considered and that the process can be fully discussed with the claimant so that the expectations on the claimant are clearly set out. |
| 2 | **Gainful self-employment test**: This would be similar to the current test.<br><br>We propose that there should be a minimum requirement of one meeting every 12 months between DWP and the self-employed universal credit claimant to ensure compliance with the gainful self-employment test. These meetings should be increased where there is a regular pattern of earned income below the MIF threshold (see below). | All claimants are required to pass the gainful self-employment test in order to be classified as self-employed otherwise they will be subject to the conditionality rules. |
| | Claimants passing the test should also have the opportunity to access business support from trained Jobcentre Plus advisers. | Appropriate ongoing business support may alleviate some of the problems faced by small businesses and reduce the number of businesses earning profits below the MIF threshold. |
| 3 | **Failure to pass the gainful self-employment test**: If the claimant fails the gainful self-employment test, then they would be subject to the full conditionality regime requiring them to look for work. If they are found to be carrying on a trade, profession or vocation, any self-employed earnings would still be taken into account as income and should count towards the conditionality threshold. | Proper use of the gainful self-employment test reduces the need for the MIF because if the test is applied correctly then DWP should be satisfied that only genuinely self-employed claimants are receiving universal credit (rather than those who are considered 'hobby traders').<br><br>Reducing the impact of the MIF on fluctuating-income businesses by allowing averaging of income will be beneficial to many self-employed claimants and will reduce the disparity between employed and self-employed claimants, as would investment in staff training and the support of a specialist expert team who can provide further information and support. |

| | Proposal | Benefits |
|---|---|---|
| 4 | **Two year start-up period**: If the claimant has passed the gainful self-employment test then they will enter a two-year start-up period without any conditionality requirements or possibility of the MIF being applied. ***See examples 1 and 2**, **page 22.*** | We have extended the start-up period to two years. We do not consider that one year is long enough for businesses to establish themselves and demonstrate viability.<br><br>During this start-up period, the gainful self-employment test should be applied at least annually. |
| 5 | **Anti-abuse provision:** We envisage legislation that would ensure people cannot manipulate their income in order to claim universal credit or claim more universal credit. This would apply to both employed and self-employed claimants. For the self-employed, DWP would have the power to average their income over a reasonable period that is more reflective of their situation. ***See example 3, page 23.*** | The proposed surplus earnings regulations[17] are not workable from either a DWP or claimant perspective. We do not believe enough evidence exists that employed claimants will or are able to manipulate their income in order to claim more universal credit and the self-employed already have a disincentive to do so due to the MIF. We believe a general anti-abuse provision is fairer because it targets those who are setting out to abuse the system rather than imposing complex rules that result in significant loss on a larger number of claimants. |

17 The Universal Credit (Surpluses and Self-employed Losses) (Digital Service) Amendment Regulations 2015/345.

| | Proposal | Benefits |
|---|---|---|
| **6** | **Income assessment period**: We propose that claimants with irregular income or profits should be given an option of averaging their income over a period other than one month for the purposes of their universal credit claim. This would be discussed and determined at their initial meeting with DWP advisers (or at a later meeting if it became apparent that profits were irregular), the MIF would remain calculated on a monthly basis (see below). Claimants with fairly regular and stable profits will be expected to continue to calculate their self-employed earnings monthly. Monthly assessment periods would remain the default unless the situation necessitated a different period. ***See example 4, page 24.***<br><br>As noted above, DWP would also be able to direct that income from self-employment should be averaged over a longer period where they believe a person is trying to structure their income or expenses to maximise universal credit entitlement. DWP could also opt to do this where the nature of the trade would give a more reasonable view of the profit of the business. ***See example 5, page 24.*** | The Universal Credit Regulations 2013[18] state that the averaging of income can be used in relation to the use of conditionality:<br><br>'A person's weekly earnings are the person's earned income taken as a weekly average by reference to –<br>b) in a case where the person's earned income fluctuates (or is likely to fluctuate) the amount of that income –<br>i) where there is an identifiable cycle, over the duration of one such cycle, or<br>ii) where there is no identifiable cycle, over three months or such other period as may, in the particular case, enable the weekly average to be determined more accurately.'<br><br>As the basis of averaging income is already allowed in the application of the conditionality rules, it should be allowed to assess income on an accurate basis for those same universal credit claimants.<br><br>Allowing claimants a choice of averaging income over a period of time, usually subject to a maximum period of 12 months, would benefit the many self-employed businesses who have fluctuating trading income. It would mean that these businesses would not be subject to the highly complex surplus earning rules or be penalised by the MIF regulations.<br><br>There is also a similar model in the current benefits system – an averaging approach can be used to calculate Housing Benefit (HB). The regulations state:<br><br>*'Take into account the weekly net profit from their occupation. The period over which net profit is determined is usually the last year's trading account but, if appropriate, you can use a period which is more representative of the current trading position or of fluctuations in business activity, for example the latest three months. Whatever period is chosen, it should not exceed one year. There may be some cases, for example when a business has just been set up, when it may be more appropriate to make an assumption in the short term, as to the likely future level of earnings. This avoids causing hardship to the claimant by denying benefit solely on the grounds of uncertainty.'*[19]<br><br>We propose following this same model. Further thought would need to be given as to how often estimates would need to be provided, however unlike HB, universal credit advisers will have far more interaction with claimants often in a face–to-face environment which gives the opportunity for careful monitoring of estimates. We do not think an overpayment/underpayment situation is desirable and therefore there should be no reason for DWP to go back and amend earlier assessment periods if actual earnings turn out to be higher or lower. Provided that the legislation and guidance is robust, this should not be necessary.<br><br>The averaging basis could be revisited at each gainful self-employment appointment or sooner if DWP or the claimant have concerns about further fluctuations in their level of income. |

18 Regulation 90 (6) The Universal Credit Regulations 2013

19 The Housing Benefit guidance: w2.330-W2.331 (Regulation 30) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/236962/hbgm-bw2-assessment-of-income.pdf

| | Proposal | Benefits |
|---|---|---|
| 7 | **Measure of income**: We propose that the calculation of gross profit should follow the HMRC cash accounting rules so that all definitions are fully aligned. We propose that there should be some exception for those who are not allowed to use the cash basis and who currently have to use accruals (GAAP) accounting (e.g. farmers).<br><br>Where a person makes a loss in a particular assessment period – our proposal is to treat that as Nil earnings with no carry forward or back. | Self-employed universal credit claimants will spend less time trying to understand two separate cash basis rules, this should result in fewer errors being made on universal credit reports and on their self-assessment tax returns. DWP will be able to use tax returns to verify universal credit reports if there is a concern regarding a universal credit claimant. The system would be perceived as fairer between employed and self-employed claimants as employed claimants are paid universal credit based on information submitted to HMRC via the Real Time Information PAYE system.<br><br>Some small businesses cannot use the HMRC cash basis and must continue to use the accruals basis. These include self-employed businesses using the herd basis or the profit-averaging election. Some businesses may also choose to use the accruals basis rather than the cash basis. However, if both cash bases were fully aligned this may encourage eligible businesses to use the cash basis for HMRC purposes and this could ease their business administration. |
| 8 | **Reporting requirements**: We propose that the system of reporting monthly income and expenses should be changed so that it follows the period of which earnings are averaged. This may be monthly earnings, or in some cases three monthly, six monthly or twelve monthly average earnings. | In cases where earnings are averaged, then the monthly figure used would be the average. For example, if someone is averaging over six months and expects a profit of £6,000 then their monthly income from self-employment would be £1,000. This could be automated based on information collected on the income page. |
| 9 | **Gainful self-employment test**: The gainful self-employment test will continue to be applied as in the current system. | |

| | Proposal | Benefits |
|---|---|---|
| 10 | **Minimum Income Floor**: We propose that the MIF remains from Year 3 onwards. It would continue to be calculated on a monthly basis and the averaging rules suggested above would still apply, however the MIF would be calculated after deduction of tax, National Insurance and pension contributions. See ***example 6, page 25***.<br><br>We also propose two exceptions:<br><br>1. A three month exception period built in, which would allow someone to have three monthly assessment periods below the MIF in each 12-month period. This 12-month period would begin after the end of the two year start-up period. See ***examples 7 and 8, page 26***.<br><br>2. A discretion for DWP staff to dis-apply the MIF in certain situations.<br><br>As now, the MIF will only apply to those in the all work requirements group. | Applying the gainful self-employment test properly and allowing averaging means that the MIF should rarely be needed. It will only be used in those cases where a business is not able to sustain an income above the MIF after a two-year period. We think this strikes a fair balance between providing support while a business is setting up and ensuring that state support is not ongoing indefinitely when there is no prospect of further growth.<br><br>Currently, the MIF does not allow for the deduction of pension contributions which creates a large unfairness between the employed and self-employed. Employed universal credit claimants can deduct 100% of their pension contributions and have universal credit calculated on their net income figure. Self-employed claimants can do the same, but do not see any benefit if the pension contributions reduce their income below the MIF. Our proposal removes this unfairness.<br><br>The three-month exception ensures that businesses who hit a difficult period or who have one-off expenses are not affected by the MIF. This could easily be automated so that the first three months profit falling below the MIF in a calendar year or rolling 12-month period do not trigger the MIF to be applied.<br><br>The discretion for DWP staff would allow them to remove the MIF/not apply the MIF in certain situations for a longer period. We envisage a process, again that could be automated with a question on the income screen, that allows claimants to apply for the MIF to be removed. Staff would need adequate guidance to enable this to be applied fairly and consistently.<br><br>Given all of the other suggested changes, we envisage that the only people that would be impacted by the MIF are those who by year 3 are still consistently making profits below the MIF month-to-month. It is important that if the MIF is applied, it does not exempt the person from accessing support for the business as this is the time when support is most likely to be needed as it is possible the business could be improved to get profits above the MIF. |
| 11 | **Ongoing gainful self-employment test** | Self-employed claimants, as with their employed counterparts, will meet regularly with their work coach. This will be the main opportunity to ensure the averaging basis used is the right one. |

# 5. Examples

The following examples illustrate how the LITRG model would work, we have compared our model with the current DWP approach. In all of the examples, the MIF for each assessment period has been calculated as follows: £7.50 x 35 = £262.50 x 52/12 = £1,137.50, less notional tax and NIC (£90.69) = £1,046.81.

### Example 1 – start-up period

Jackson, who is 27 years old, has recently started his own business and has spent large sums on business expenses such as stock and marketing. In the first year of trading he makes a loss of £3,000, the second year he makes a profit of £6,000 and in the third year he makes a profit of £15,000 before tax and National Insurance deductions.

*Consequence under the DWP model*

Jackson would be treated as in the start-up period for the first 12 months only, this means that after his first year he will be subject to the MIF. In Jackson's second year despite making only profits of £6,000 he is treated as making profits of £12,561.72 for the purposes of his universal credit amount (MIF of £1,046.81 x 12). Jackson cannot afford to continue to run his business with a reduced universal credit claim and he is unable to seek part-time employment and have time to develop his business. Jackson decides to stop being self-employed and look for employment.

*Consequence under the LITRG model*

Under our model, Jackson would have a start-up period of two years, this means he would not be subject to the MIF rules for the first two years of trading. This means that the MIF rules would only have to be considered from Jackson's third year of trading, and Jackson has made a profit above the MIF threshold in that year. The MIF will not apply in year 3 because Jackson's profit is above the MIF level.

*Advantages of the LITRG model*

**By providing an extra year's support to Jackson's new business this has meant that the business has successfully established itself and Jackson does not need to give up his self-employment. This allows him the opportunity to continue to grow his business potentially taking on additional staff in the future.**

### Example 2 – Surplus earnings

Bob is gainfully self-employed after starting a new business in February 2018; he receives regular income and is assessed for universal credit on a monthly basis. His business continues to grow earning monthly profits of £1,500 so his universal credit award terminates in May 2018. Bob continues to do well with profits of £1,500 in June, July and August. Unfortunately in September, Bob's business suffers an unexpected setback after being affected by flooding and he needs to make a new universal credit claim. He has no income when he reclaims.

*Consequence under the DWP model*

Under the proposed DWP Surplus Earnings policy, the 'excess' profits Bob earned in the period (going back up to six months) before the floods will be carried forward and treated as income when calculating his new universal credit claim. Surplus earnings are calculated by looking at the amount that the person's income exceeds their 'relevant threshold'. In Bob's case, his relevant threshold is £804.48. This is calculated by taking the universal credit maximum amount for that claimant less any unearned income x 100/63 plus a £300 *de minimis* limit.

In May, the month when his universal credit was terminated, Bob would have surplus earnings of £695.52. He would have the same surplus earnings in June, July and August making a total of £2,782.08 of surplus earnings by the time he reclaims universal credit in September. These surplus earnings will be applied to his universal credit award as income each month going forward until they are used up or, if earlier, a total of six assessment periods have passed since his last universal credit award terminated meaning he will receive no universal credit payments at all for two months (September and October) and then he will receive his maximum amount (£317.82) in November (assuming he still has no actual earnings). This is because Bob is expected to save some of his money when his earnings increase from May 2018 in case he has to return to universal credit within six months

*Consequence under the LITRG model*

Under our model, when Bob reclaims universal credit in September 2018 he would need to attend a meeting with a DWP adviser who would need to consider whether Bob is in 'gainful self-employment'. As Bob is in his two year start-up period, his universal credit would be calculated based on his actual monthly income from self-employment.

*Advantages of the LITRG model*

**Avoids using the complex surplus earnings rules and enables DWP to consider whether the universal credit claim is genuine and the claimant is gainfully self-employed. It also avoids hardship for the claimant which will be created if Bob has not saved money from his increased earnings just in case he may return to universal credit within six months. It is unlikely that claimants will appreciate the need to save money when they move into work, or indeed, be able to, especially as many will face increased costs at that time.**

### Example 3 – Anti-abuse provision

Graham is a newly self-employed universal credit claimant (so the MIF will not apply to him), he earns income for two months a year and then claims universal credit for the other months.

*Consequence under the DWP model*

The complex surplus earnings rules would be applied, which would reduce Graham's universal credit claim for the first six months of his 10-month period of no earnings. However, this will require DWP time and is an administrative burden as they would need to collect the earnings information for any missing months.

*Consequence under the LITRG model*

DWP suspect that Graham has been manipulating his self-employed income by ensuring that he is only paid two months during a 12-month period and claiming universal credit during the other months. Under our model DWP would use anti-avoidance legislation to ensure that Graham's total income is looked at over 12 months and averaged over that period to ensure that he is awarded universal credit on his annual rather than monthly income.

*Advantages of the LITRG model*

**This would be a more flexible and efficient system than operating the administratively cumbersome and complex surplus earnings policy. It also ensures that only those who are seeking to manipulate their income are subject to the rules.**

### Example 4 – Irregular income and losses

Rita is gainfully self-employed in a profitable seasonal business which can have an irregular income pattern, sometimes making monthly losses. Rita's business is generally profitable during the summer, making £20,000 during April to September but usually makes a loss of £2,000 during winter (October to March).

#### *Consequence under the DWP model*

Under the current DWP model, any month in which Rita failed to produce sufficient profit, or her expenses exceeded her receipts, would be subject to the MIF. This means that for the period from October to March, Rita would be subject to the MIF and, supposing she is at least 25 years old, the MIF would be calculated as £1,046.81 for each assessment period. This means that Rita would be treated as earning £6,280.86 (ie £1,046.81 x 6 months) for her universal credit claim despite actually making a loss of £2,000 over that period. In other more profitable months she would risk falling foul of the proposed surplus earning policy (covered in examples 2 and 5).

#### *Consequence under the LITRG model*

Under our model, Rita would have her income assessed over 12 months and would see her DWP adviser regularly to ensure that her income assessment period is correct and to confirm there is no manipulation of her claim.

Using Rita's previous year's accounting records, DWP and Rita agree that her estimated annual profits for the year will be £18,000 (£20,000 summer profits less £2,000 winter losses). For the purposes of Rita's universal credit claim, a monthly profit amount of £1,500 will be used when calculating Rita's universal credit.

By having her income assessed over a longer period there is no need to use the complex surplus earning rules or account for any monthly losses as these will be taken into account by using her averaging income when calculating her universal credit claim.

#### *Advantages of the LITRG model*

**Recognises that some self-employed businesses will not have regular monthly profits and by allowing averaging over an appropriate period this will enable greater parity and fairness between employed and self-employed universal credit claimants as the MIF and surplus earning and losses rules will not be required.**

### Example 5 – Surplus earnings and irregular self-employed profits

Henry is self-employed and receives payment for his invoices twice a year (April and October); he then pays his business expenses in the months he has received payment. He has income, after deducting business expenses, of £7,000 twice a year.

#### *Consequence under the DWP model*

In April, Henry has a profit of £7,000. Between May and September his profit is nil. Under the current rules, Henry will receive no universal credit in April and in May to September his universal credit will have the MIF applied. Under the new surplus earnings rules from April 2018, his 'surplus earnings' from April will be carried forward and used as income in May, June, July and August, potentially reducing his universal credit award even further.

*Consequence under the LITRG model*

At the initial meeting between Henry and DWP, DWP decide that Henry's income should be averaged over a 12-month period. His annual profits are treated as providing a monthly income of £1,167 for universal credit purposes (before deduction of any tax, National Insurance and pension contributions).

This would avoid having to calculate the surplus earnings and apply them each month. Henry would also have the certainty of what universal credit award he will receive and may decide to re-organise his invoices to receive more regular income.

If Henry did not elect to calculate his income over 12 months, DWP could use the anti-abuse provision to do this.

*Advantages of the LITRG model*

**This is simpler to use as it avoids the complex and time-consuming surplus earnings rules and enables DWP to consider whether the claimant is gainfully self-employed.**

Example 6 – Pension contributions when earning above the MIF

Ananya, who is 30 years old, has been self-employed for over two years and her monthly earnings from self-employment are £1,075, therefore above the MIF. Ananya makes pension contributions of £100 per month which takes her net earnings to £975 which is below the MIF of £1,047. Following her annual meeting with her DWP adviser it was agreed that Ananya is still gainfully self-employed.

*Consequence under the DWP model*

Under the DWP model even though Ananya is earning above the MIF her pension contributions reduce her monthly earnings to below the MIF threshold (£1,046.81). Therefore, the MIF would be applied and Ananya would be deemed to be earning £1,046.81 a month even though she has actually net earnings of £975 (£1,075 less £100 pension contribution). The MIF effectively removes the adjustment for Ananya's pension contributions.

*Comparison with an employee earning the same as Ananya*

As previously explained we have concerns about the lack of parity between employees and self-employed universal credit claimants; the treatment of pension contributions demonstrates this issue.

If Ananya was an employee earning £1,075 per month and paying pension contributions of £100 then her universal credit would be calculated using a monthly income of £975 and therefore all of her pension contributions would be taken into account when calculating her monthly universal credit benefit.

When comparing this to Ananya being self-employed, it can be seen that because of the interaction of the MIF, her income used to calculate the universal credit claim is artificially increased by £71.81 each month, so £862 per year.

*Consequence under the LITRG model*

Under our model, Ananya would have the MIF applied but the MIF would be adjusted to allow for her monthly contribution to her personal pension. For example, as Ananya makes a monthly profit of £1,075 and pays a pension contribution of £100, when calculating her universal credit her income will be treated as £975 because her actual net earnings will be higher than the MIF, which is calculated as:

£7.50 x 35 = £262.50 x 52/12 = £1,137.50, less notional tax and NIC (£90.69) and less pension (£100) = £946.81.

*Advantages of the LITRG model*

**The LITRG model recognises Ananya's pension contributions when calculating the MIF and so provides greater parity with the universal credit rules used for employees, which allows for pension contributions when calculating universal credit.**

### Example 7 – Self-employed claimant earning regular monthly profits, earning above the MIF then earning beneath the MIF

Lena is self-employed earning regular monthly profits of £1,100 per month. Lena is out of her start-up period and has been assessed as gainfully self-employed. As her monthly earnings are above the MIF, Lena's monthly universal credit claim will be based on income of £1,100. Unfortunately Lena loses a major customer and so her regular monthly profits fall to £850 per month.

*Consequence under the DWP model*

Under the current DWP model Lena's universal credit claim will be immediately subject to the MIF. This means that Lena's monthly income will be treated as the higher of her monthly profits or the MIF. The MIF is calculated using the NLW for 35 hours less notional deductions for income tax and NIC. As Lena is 25 years old or over, the MIF will be calculated as £7.50 x 35 = £262.50 x 52/12 = £1,137.50, less notional tax and NIC (£90.69) = £1,046.81. As Lena has earned less than the MIF, the MIF of £1,046.81 will be used in calculating Lena's universal credit claim despite her actually earning only £850 a month.

*Consequence under the LITRG model*

Under the LITRG model, Lena would be paid universal credit based on her new income of £850 for up to three monthly assessment periods in a 12-month period. This would allow Lena to look for new customers. Only after that period would Lena be subject to the MIF.

*Advantages of the LITRG model*

**At a time when Lena's business is struggling she receives extra support from universal credit by using her actual income rather than artificial earnings through the MIF.**

**DWP can use the general anti-abuse provisions if they do not consider that Lena is experiencing genuine commercial reasons for her downturn in profits.**

### Example 8 – Large expense in one month

Stefan is a self-employed delivery driver and is aged 26. He earns regular income throughout the year, however in September he has a large motor insurance premium which means his profit for that one month is only £600. Stefan has considered paying for his motor insurance evenly across the year but this would make the premium more expensive (due to interest) than making one payment.

*Consequence under the DWP model*

Even though Stefan has regular income, in September his profits will fall below the MIF due to having a large one-off expense. This means that in September Stefan will be subject to the MIF and be treated as having income of £1,046.81 even though his actual income is only £600. This is unfair when Stefan is in gainful self-employment and for 11 months of the year is actually earning more than 35 hours x NMW and the expense relates to the whole year but is treated through the cash accounting basis as falling entirely in only one month.

*Consequence under the LITRG model*

Stefan would not be subject to the MIF under the three-month exception rule – this rule ensures that Stefan will not be disadvantaged because he has had a large business expense in one month. This means that Stefan can use his actual profit of £600 for his universal credit claim in September.

*Advantages of the LITRG model*

**The use of the three-month exception rule will be easy to administer (especially if automated) and means that Stefan will not be disadvantaged in his universal credit claim by having occasional, irregular business expenses.**

# Appendix 1

**Text of letter from Anthony Thomas (LITRG Chairman) to Lord Freud dated July 2012.**

Dear Lord Freud

**Self-employment and the universal credit draft regulations**

We are representative of a number of professional tax, business and accountancy bodies, charities and welfare organisations.

We are writing to express our concerns about the provisions in the draft universal credit regulations for assessing the earnings of self-employed claimants, and the severe obstacles they present to anyone starting and growing a small business. These are initial comments only; each organisation will respond in detail to the SSAC's consultation on the regulations later this month.

Self-employment is a route into work for many who are either moving into work from welfare, or trying to stay in work having been made redundant from their regular employment. According to recent ONS figures, 85% of the growth in employment in the first three months of 2012 was due to people starting up in self-employment, and 29% of the self-employed work part time.

At Committee Stage in the House of Commons debates on the Welfare Reform Bill (now Act), the employment minister Chris Grayling MP observed that "self-employment plays a vital part in our economy and society . . . it can be an important route into work for many people, including some of the hardest to help". Few would disagree with that assessment.

The Government is committed to removing burdens on business. We strongly agree with simplicity in administration. Yet we find the proposals in the draft regulations at odds with those ambitions. Put simply, the draft regulations ignore how small businesses work in practice.

Our strong reservations lie in three main areas: the method of accounting proposed, the minimum income floor, and the implications of not meeting the strict requirements for 'gainful self-employment'. We take each of those by turn.

**The method of accounting**

Working tax credit (WTC) has worked well for the self-employed in terms of its mechanics. The same profit and loss figures are used for WTC as for income tax self-assessment, based on generally accepted accounting principles; this minimises administrative burdens (claimants do not have to recompute their profits twice using different measurements), recognises how the business is actually doing in economic terms, and supports businesses through start-ups and difficult periods such as the loss of a key customer, the emergence of a bad debt, the taking on of a new employee, and so forth.

We are therefore dismayed to note that under the proposed universal credit draft regulations, those advantages will be lost, with the result that the real income of self-employed earners will fall sharply making it, in some cases, uneconomic for them to continue to work. Several aspects of the changes will not only create extra administrative burdens for small businesses, but force claimants to report to the DWP on the basis of a distorted view of how their business is really doing in economic terms.

There are many reasons why we believe this to be so.

1) The self-employed will be required to report their earnings over “assessment periods” of one month starting to run from the date the claimant first became entitled to universal credit. They will be obliged to report their earnings to DWP online within 7 days of the end of the assessment period. This is wholly impractical for most businesses, who will struggle to get the necessary information together to make a full and accurate report. For example, bank statements do not usually arrive until at least two weeks after the end of the month to which they relate. Failure to comply will result in payments being suspended – an unduly harsh penalty for not achieving what is in practical terms impossible.

2) A significant minority of claimants may be unable, or find it difficult, to claim online or manage their account online because they do not have access (or have only limited access) to a computer or the internet.

3) “Self-employed earnings” will be computed on an adjusted cash basis which is entirely at odds not only with the GAAP-based assessment of trading profit currently used for tax purposes, but also the “simplified” cash basis HMRC is proposing for periods from 6 April 2013. This will force small businesses to account 12 times a year to DWP on one basis, and once a year to HMRC on a different basis. This will impose unacceptable administrative burdens on small businesses, and undermine one of the key policy goals of tax simplification, which is increased compliance amongst the small business sector. Once a business grows sufficiently to be registered for VAT, yet another method of accounting will have to be adopted for that purpose.

4) The detailed accounting rules proposed by DWP will have the effect of distorting ordinary commercial decisions. To take one example, interest on a bank loan will be a non-deductible expense, although hire purchase payments will be fully deductible – this will undoubtedly interfere in decisions as to how a business will finance its assets and equipment.

5) The rules do not result in a true and fair picture of how the business is actually doing – in particular, a negative result in one month may not be carried forward to subsequent months. For example, stock may be purchased in one period and sold in the next, or a business may incur heavy expenditure in certain months due to seasonal factors (as is the case, for example, with farming). This is despite an undertaking by the Minister that “there will have to be a proper assessment at the end of the year of what a self-employed person’s income was and the amount of universal credit they received”.

**The minimum income floor**

We welcome the fact that the minimum income floor (MIF) will not apply where a claimant is subject to no work-related requirements, or to work focused interview or work preparation requirement only. We also welcome the proposed 12 months start-up period during which the MIF will not apply; although we cannot see the sense in restricting it to one start-up period per working life, which will surely discourage someone whose business has failed from having another try.

We are dismayed, however, that there is no relaxation of the MIF for periods when a business experiences a genuine dip in profits, despite ministerial assurances that this would be considered; or for periods when a business is reinvesting in order to expand, or taking on a new employee. Hitherto, WTC has successfully supported growing businesses through such difficult periods; in the current harsher economic environment, it makes no sense to be withdrawing that support.

In months when large items of expenditure are incurred which exceed trading receipts (for example an annual insurance premium, or a bi-annual income tax self-assessment bill), not only will the crude method of cash accounting eliminate any recognition of the loss for the period, applying the MIF will generate a wholly artificial profit which bears no relation to the reality. It could mean that a self-employed person ends up with less universal credit than an employed claimant earning the same.

All in all, the MIF will build in disincentives for businesses to spend what is necessary to enable their business to succeed. There must come a point where the operation of this rule makes it simply not worth while for a small business to claim universal credit at all.

**'Gainful self-employment' and the work search requirement**

Finally, we are very concerned about the proposal to require a claimant to be working at his or her self-employment for at least half the expected number of working hours, or else accept work search and conditionality requirements with no recognition of the hours worked in self-employment. This rule will effectively preclude anyone from being employed part-time and building up their own business part-time, if they are engaged in the latter activity for any less than (usually) 18 hours a week.

Given that 29% of those entering work in the first three months of 2012 went into part-time self-employment (see ONS figures quoted above), this rule will present an obstacle to a substantial minority who are trying to move from welfare to work using self-employment as a stepping stone. Apart from that, the bureaucracy and paperwork involved in preparing for and attending Gateway interviews, and proving that one is 'gainfully' self-employed, will leave that much less time for actually carrying on the business.

**Conclusion**

We would welcome the opportunity to discuss these aspects of the self-employment proposals with you as part of the consultation. We are strongly of the view that if implemented as they stand, they will do severe and lasting damage to the small business sector in the UK. It will render the Government's hope that universal credit will always make work pay merely aspirational for the self-employed – if a person faces disincentives on this scale to taking up self-employed work, but cannot find traditional employment, they will have no option but to remain trapped on welfare. That is clearly contrary to Government policy.

Yours sincerely

Anthony Thomas

Chairman, Low Incomes Tax Reform Group (LITRG)

Supported by the following organisations:

- Chartered Institute of Taxation
- Association of Taxation Technicians
- Association of Chartered Certified Accountants
- Association of Accounting Technicians
- Institute of Chartered Accountants in England and Wales
- Federation of Small Businesses
- Community Links
- National Farmers Union
- Royal Agricultural Benevolent Institution
- Tenant Farmers Association
- Farm Crisis Network

# Appendix 2

**Examples from our response to The Work and Pensions Committee inquiry into Self-employment and the gig economy.[20] The examples were submitted in early 2017 using 2016/17 tax year figures.**

## Example 1 – Fiona and Gregory

Fiona is a single parent with three children and runs a self-employed business with fluctuating profits across the year. Gregory is a single parent with three children who works 35 hours a week and earns £7.20 an hour as an employee.

Over 12 months, from April 2016 to March 2017 Fiona's self-employed income for universal credit purposes is £12,077 and Gregory's employment income for universal credit purposes is also £12,077.

Fiona will receive a total of £5,333.43 in universal credit payments over those 12 months while Gregory will receive £7,944.96

Gregory receives £2,611.53 more universal credit than Fiona because of the variable pattern of earnings that Fiona has in her business even though over the year both earn the same amount.

If the proposed surplus earnings rules applied to Fiona, she would receive £455 less universal credit than the figures above show. She would then be even worse off when compared to Gregory by £3,066.53.

The following table shows Fiona's actual self-employed earnings for each monthly assessment period, her treated earnings and the amount of universal credit received. It also shows Gregory's net earnings from self-employment and his monthly universal credit figure.

The figures in red show Fiona's universal credit if the proposed surplus earnings rules apply to her.

| Month | Fiona's actual self-employed earnings[21] | Fiona's income for universal credit calculation £[22] | Fiona's universal credit payment[23] | Gregory's net employment earnings £[24] | Gregory's universal credit payment £[25] |
|---|---|---|---|---|---|
| April '16 | 3,000 | 3,000 | 0 | 1,006.49 | 662.08 |
| May '16 | 1,500 | 1,500<br>(2,174.94) | 341.29<br>(0) | 1,006.49 | 662.08 |

20 http://www.litrg.org.uk/sites/default/files/files/170116-LITRG-response-WPC-self-employment-FINAL.pdf – note that the examples use 2016/17 rates

21 Calculated as (receipts – allowable expenses) – actual tax, National Insurance and pension contributions.

22 Applying a MIF of £1,006.49 which is 35 hours x £7.20 less notional tax and National Insurance of £85.51 each month.

23 Calculated with standard rate (£317.82) and 3 child elements (£277.08+£231.67+£231.67) making a maximum universal credit amount of £1,058.24. The work allowance (£397) is deducted from the earned income for that month and the taper of 65% is applied to the resulting figure. This is then deducted from the maximum amount figure to determine the monthly entitlement for universal credit.

24 Calculated as 35 x £7.20 (NLW for his age) x 52/12 = £1,092 minus tax, NI of £85.51. We have assumed no pension contributions have been made by either Fiona or Gregory.

25 Calculated in the same way as Fiona.

| Month | Fiona's actual self-employed earnings[21] | Fiona's income for universal credit calculation £[22] | Fiona's universal credit payment[23] | Gregory's net employment earnings £[24] | Gregory's universal credit payment £[25] |
|---|---|---|---|---|---|
| June '16 | 2,000 | 2,000 | 16.29 | 1,006.49 | 662.08 |
| July '16 | 2,500 | 2,500 | 0 | 1,006.49 | 662.08 |
| August '16 | 1,500 | 1,500 (1,674.94) | 341.29 (227.58) | 1,006.49 | 662.08 |
| September '16 | 200 | 1,006.49 | 662.08 | 1,006.49 | 662.08 |
| October '16 | 300 | 1,006.49 | 662.08 | 1,006.49 | 662.08 |
| November '16 | 500 | 1,006.49 | 662.08 | 1,006.49 | 662.08 |
| December '16 | Nil | 1,006.49 | 662.08 | 1,006.49 | 662.08 |
| January '17 | Nil | 1,006.49 | 662.08 | 1,006.49 | 662.08 |
| February '17 | 577 | 1,006.49 | 662.08 | 1,006.49 | 662.08 |
| March '17 | Nil | 1,006.49 | 662.08 | 1,006.49 | 662.08 |
| **TOTAL** | 12,077 | 17,545.43 | 5,333.43 (4,878.43) | 12,077.88 | 7,944.96 |

### Example 2 – Barry and Paul

This is based on the example used by the DWP in their explanatory memorandum[26] to the Social Security Advisory Committee during the consultation on the surplus earnings and losses proposal.

The example DWP used showed Paul and Barry, two employees who over a 12-month period, earn the same amount. It demonstrated 'the potential for unfairness and possible incentive for households to manipulate their patterns of pay to increase their universal credit entitlement'. By altering his pattern of payments so that he received just two payments over the year, Paul gained an extra £5,259 in universal credit compared to Barry over the 12 month period. The surplus earnings and losses policy was designed to combat this potential manipulation.

However, if the example was changed slightly so that Paul was self-employed the result is very different as the following example shows. This is primarily because the MIF already disincentives self-employed people from manipulating income to the extent shown in the DWP example.

We have used similar figures to the DWP paper, however we have included the increased net earnings due to the increase of the NMW, increased the disregard of £300 which was announced after the consultation and we have removed the work allowance.

26 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/364573/uc-earnings-Explanatory_Memorandum.pdf

The following table shows Barry and Paul, both employed and both earning the same net amount over 12 months. Barry receives the same earnings each month, Paul receives all of his earnings in just two payments. The figures show their universal credit payments under the current rules (before the surplus earnings policy is applied). As this table shows, Paul receives significantly more universal credit than Barry.

| Month | Barry's net earnings | Barry's universal credit payment[27] | Paul's net earning | Paul's universal credit payment |
|---|---|---|---|---|
| 1 | 1,006.49 | 101.73 | 6,038.94 | 0 |
| 2 | 1,006.49 | 101.73 | 0 | 755.95 |
| 3 | 1,006.49 | 101.73 | 0 | 755.95 |
| 4 | 1,006.49 | 101.73 | 0 | 755.95 |
| 5 | 1,006.49 | 101.73 | 0 | 755.95 |
| 6 | 1,006.49 | 101.73 | 0 | 755.95 |
| 7 | 1,006.49 | 101.73 | 6,038.94 | 0 |
| 8 | 1,006.49 | 101.73 | 0 | 755.95 |
| 9 | 1,006.49 | 101.73 | 0 | 755.95 |
| 10 | 1,006.49 | 101.73 | 0 | 755.95 |
| 11 | 1,006.49 | 101.73 | 0 | 755.95 |
| 12 | 1,006.49 | 101.73 | 0 | 755.95 |
| **TOTAL** | 12,077.88 | 1,220.76 | 12,077.88 | 7,559.50 |

The following table shows what Paul would receive if he were self-employed rather than employed. This shows that actually Paul would be worse off than his employed counterpart Barry and therefore, under the existing rules, the same manipulation is not possible if Paul is self-employed rather than employed. This is due to the impact of the MIF.

| Month | Paul's actual earnings | Paul's earnings used in the universal credit calculation | Paul's universal credit payment |
|---|---|---|---|
| 1 | 6,038.94 | 6,038.94 | 0 |
| 2 | 0 | 1,006.49 | 101.73 |

27 This universal credit payment is calculated based on maximum universal credit of 755.95 which was calculated based on the figures used in the DWP paper showing a NIL universal credit point of 1163. 755.95 x 100/65 = 1163.

| Month | Paul's actual earnings | Paul's earnings used in the universal credit calculation | Paul's universal credit payment |
|---|---|---|---|
| 3 | 0 | 1,006.49 | 101.73 |
| 4 | 0 | 1,006.49 | 101.73 |
| 5 | 0 | 1,006.49 | 101.73 |
| 6 | 0 | 1,006.49 | 101.73 |
| 7 | 6,038.94 | 6,038.94 | 0 |
| 8 | 0 | 1,006.49 | 101.73 |
| 9 | 0 | 1,006.49 | 101.73 |
| 10 | 0 | 1,006.49 | 101.73 |
| 11 | 0 | 1,006.49 | 101.73 |
| 12 | 0 | 1,006.49 | 101.73 |
| **TOTAL** | 12,077.88 | 22,142.78 | 1,017.30 |

This second table shows the operation of the surplus earnings policy on self-employed Paul. It shows that Paul would lose over £600 of universal credit compared to his position under the existing rules and would be over £800 worse off than Barry.[28]

| Month | Paul's actual earnings | Paul's surplus amounts | Amount treated as earned income if Paul claims universal credit in each month | Paul's universal credit payment |
|---|---|---|---|---|
| 1 | 6,038.94 | 4,575.94 | 6,038.94 | 0 |
| 2 | 0 | 3,112.94 | 4,575.94 | 0 |
| 3 | 0 | 1,649.94 | 3,112.94 | 0 |
| 4 | 0 | 186.94 | 1,649.94 | 0 |
| 5 | 0 | 0 | 1,006.94 | 101.73 |
| 6 | 0 | 0 | 1,006.94 | 101.73 |
| 7 | 6,038.94 | 4,575.94 | 6,038.94 | 0 |

28 The Regulations (SI 345/2015) as originally enacted are not entirely clear about how the MIF works when calculating the surplus amount. We have therefore not included the MIF as Paul's actual income when calculating his surplus amounts. If the MIF was to be included Paul would receive no universal credit in months 5,6,11 and 12.

| Month | Paul's actual earnings | Paul's surplus amounts | Amount treated as earned income if Paul claims universal credit in each month | Paul's universal credit payment |
|---|---|---|---|---|
| 8 | 0 | 3,112.94 | 4,575.94 | 0 |
| 9 | 0 | 1,649.94 | 3,112.94 | 0 |
| 10 | 0 | 186.94 | 1,649.94 | 0 |
| 11 | 0 | 0 | 1,006.49 | 101.73 |
| 12 | 0 | 0 | 1,006.49 | 101.73 |
| **TOTAL** | 12,077.88 | | | 406.92 |

### Example 3 – Alyssa

This example shows a self-employed claimant who runs a wedding photography business. Alyssa has a large insurance premium to pay which is £1,200 for the year (covering her public liability, indemnity and equipment insurance). Due to her previous credit rating she is unable to take advantage of a monthly payment plan.

Alyssa's universal credit for a 12 month period will be £12,769.89. If she was able to pay her premium monthly instead, she would receive nearly £600 more in universal credit over the year.

This is because when she pays her premium of £1,200 in month 5, her income in that month is reduced to £100. The MIF then applies and she is treated as earning £1,006.49 that month and so most of the expense of the premium is in effect disallowed for universal credit.

The proposed surplus earnings rules from April 2018 will not help someone in Alyssa's situation and this shows that the MIF impacts on people who have large expenses to pay even though over a year they are earning well above the MIF.

| Month | Actual self-employed earnings (annual insurance premium paid Month 5)[29] | Earned income for universal credit purposes[30] | Monthly universal credit payment[31] | Actual self-employed earnings (monthly insurance premium)[32] | Monthly universal credit payment[33] |
|---|---|---|---|---|---|
| 1 | 1,200 | 1,200 | 1,078.05 | 1,100 | 1,143.05 |

29 Calculated as (receipts – allowable expenses) – actual tax, National Insurance and pension contributions. Assuming that the insurance premium of £1,200 is paid in Month 5.

30 The MIF is applied in Month 5 because earned income is below £1,006.49 – the level of the MIF.

31 For the purposes of the calculation we have assumed that Alyssa's maximum UC amount is £1,600 due to children, housing costs and childcare costs. Her work allowance is £397.

32 Calculated as (receipts – allowable expenses) – actual tax, National Insurance and pension contributions. Assuming that the insurance premium is paid £100 a month for 12 months.

33 Again we have assumed that the maximum universal credit amount is £1,600.

| Month | Actual self-employed earnings (annual insurance premium paid Month 5)[29] | Earned income for universal credit purposes[30] | Monthly universal credit payment[31] | Actual self-employed earnings (monthly insurance premium)[32] | Monthly universal credit payment[33] |
|---|---|---|---|---|---|
| 2 | 1,250 | 1,250 | 1,045.55 | 1,150 | 1,110.55 |
| 3 | 1,250 | 1,250 | 1,045.55 | 1,150 | 1,110.55 |
| 4 | 1,275 | 1,275 | 1,029.30 | 1,175 | 1,094.30 |
| 5 | 100 | 1,006.49 | 1,203.84 | 1,200 | 1,078.05 |
| 6 | 1,300 | 1,300 | 1,013.05 | 1,200 | 1,078.05 |
| 7 | 1,200 | 1,200 | 1,078.05 | 1,100 | 1,143.05 |
| 8 | 1,250 | 1,250 | 1,045.55 | 1,150 | 1,110.55 |
| 9 | 1,200 | 1,200 | 1,078.05 | 1,100 | 1,143.05 |
| 10 | 1,300 | 1,300 | 1,013.05 | 1,200 | 1,078.05 |
| 11 | 1,200 | 1,200 | 1,078.05 | 1,100 | 1,143.05 |
| 12 | 1,225 | 1,225 | 1,061.80 | 1,125 | 1,126.80 |
| **TOTAL** | 13,750 | 14,656.49 | 12,769.89 | 13,750 | 13,359.10 |

### Example 4 – Aaron and Derek

Aaron is a self-employed builder – his self-employed income for January 2017 is £1,092. His notional tax and National Insurance will be £85.51.

Derek works in a call centre for 35 hours a week earning the NLW (currently £7.20). His monthly income is also £1,092 and he has deductions of tax and National Insurance of £85.51 in that assessment period.

Aaron and Derek will both receive the same amount of universal credit in January 2017, assuming their circumstances are both the same.

In February 2017, Aaron and Derek both decide to pay £75 a month into a private pension. Derek will have his universal credit calculated on his new net income of £931.49 (£1,092 gross less tax and NI of £85.51 and pension contributions £75) whereas Aaron will have his universal credit calculated on £1,006.49. This is because Aaron's actual income of £931.49 is lower than the MIF of £1,006.49.

This means that Derek will receive nearly £50 a month more universal credit than Aaron despite them having the same earnings each month and making the same pension contributions. Aaron is therefore not given any recognition for his pension contributions.

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Association of Taxation Technicians