

**Review of the taxation of Small Companies – Consultation by Office of Tax Simplification
(OTS)**

Response from the Low Incomes Tax Reform Group (LITRG)

1 Executive Summary

- 1.1 LITRG welcomes the opportunity to contribute to the review of the taxation of small companies by the OTS. We do not believe that the tax system should be so complex that a taxpayer should be forced to engage an agent to navigate it successfully on a regular basis and as almost all small companies currently use an agent we believe there is significant scope to simplify their obligations.
- 1.2 We would like to see an improvement to the compliance process for small companies so that they can manage their affairs without needing to engage an adviser and still be confident that they are complying correctly with all their obligations.
- 1.3 Unrepresented small companies are often one-man director/shareholder companies which come about because the individual is told they must be a limited company to get work, e.g. IT contractors and supply teachers, many of whom work part time and so have only modest incomes. Also, many are low paid workers such as carers, cleaners, etc. who work through agencies and find themselves operating either as their own limited company or as part of an umbrella company, some without realising this is what they are doing. A multi-channel help service (including telephone support) for small companies should be introduced which could advise on all aspects of company compliance so that the unrepresented taxpayer would have a single point of contact for whatever help is required.

- 1.4 The registration process with HM Revenue and Customs (HMRC) for all relevant taxes (VAT, corporation tax, PAYE for company, and self assessment for the director) should be a more integrated procedure to cover all necessary registrations at one time, to avoid causing confusion and repetition.
- 1.5 The proposed quarterly reporting for businesses under the Making Tax Digital strategy should not go ahead as it will substantially increase the compliance burden, which is disproportionate for small businesses.

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 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 Detailed response

3.1 Introduction

- 3.1.1 We have considered the key questions raised in the open consultation document published on 20 October 2015 and have addressed those which are relevant to the constituents we represent below under the same subheadings:

3.2 Section 1: Background

- 3.2.1 The technical and administrative burden is substantial for small businesses in general and limited companies in particular, who have the added complexity of dealing with Companies House to file annual statutory accounts and annual returns.
- 3.2.2 In our experience many small limited companies will engage an adviser to deal with all aspects of their financial compliance obligations (year-end accounts, corporation tax, Pay As

You Earn (PAYE), VAT) if they can afford to do so, often because they are keen to be compliant but feel there is just too much to keep on top of and they worry they will get something wrong. It is also very time consuming. They consider it a sensible investment as it frees up their time to continue to focus on and develop their business. So, the engagement of an adviser is partly a question of capacity (time), but also expertise.

3.2.3 For unrepresented small companies, it is virtually impossible to be fully compliant – the accounting knowledge required to produce even a simple set of statutory accounts alone is beyond the ability of most ordinary people. We believe this is why almost all small companies engage an agent. It is also very confusing when there is contact with businesses from both Companies House and HMRC for the unrepresented company.

3.2.4 It has become obligatory for the small company to engage more with the tax system in recent years due to the additional responsibilities that have developed in relation to Real Time Information (RTI), auto-enrolment and IR35/intermediaries legislation, over and above the ongoing compliance responsibilities associated with year-end accounting, corporation tax, PAYE and VAT and so the system has clearly become more difficult for the small company. It has also become much more difficult over the years to get help and support due to the involvement of so many different departments of HMRC.

3.2.5 We would like to see the introduction of a multi-channel help service (including telephone support) for small companies which could advise on all aspects of company compliance so that the unrepresented taxpayer would be able to get help and advice on all company related matters from one port of call. We would also expect sufficient resources to be made available specifically to promote such an initiative once it is established.

3.3 ***Section 2 The life cycle of a small company***

3.3.1 Small businesses decide to trade as limited companies for a variety of reasons. Some incorporate due to what is perceived to be a more favourable tax/NIC regime (provided it is correctly managed by the company/directors, i.e. low salary together with dividends). Other reasons however, include the attraction of limited liability protection or where it becomes a commercial necessity, e.g. to continue to gain work from particular clients or it is industry driven, e.g. IT contractors.

3.3.2 Some people do not realise there is an alternative to a limited company and as it is very easy to form a limited company via Companies House website, it becomes 'limited by default'. Also, some businesses want to be a limited company as they believe it presents a more viable and stable business which is relevant for attracting potential investors, for example.

3.3.3 The main distortions between the business and personal tax systems arise due to the different NIC regimes, and also due to the treatment of drawings/profits for the self-employed as compared to the treatment of loans/dividends/salary for company directors. However these differences are generally too complex for the unrepresented business to

understand – and this will be exacerbated by the new rules relating to the taxation of dividends in April 2016.

- 3.3.4 On transition from unincorporated to incorporated status, a common problem for the business owner is recognising that the company is now a separate legal entity and therefore they need to be more structured with their financial interactions with the company than they are used to being previously. Also, understanding the concept of goodwill and how to deal with this on incorporation causes difficulties.
- 3.3.5 The tax system currently helps those businesses who need injections of capital reasonably well by providing interest relief for borrowings and by encouraging investment by outside investors through various schemes which give some degree of tax relief (EIS, etc). For those companies which need additional personal resources in the way of additional labour to grow, the rules surrounding the engagement of employed /self-employed/ part-time labour could act as a hindrance due to the unclear nature of their application in many cases and their interaction with employment law obligations.
- 3.3.6 The personal tax and business tax issues of small companies and their directors are often interwoven. As many small companies trade from the director's home, we think the expense of doing so should continue to be a business expense to the company and that this practice should not lead to compromising any claim for principal private residence relief for capital gains tax purposes, nor any complications with business rates/council tax.
- 3.3.7 There are many other regulatory obligations small companies (and unincorporated businesses) have to adhere to, particularly where they have employees, eg National Minimum Wage, employment law, health and safety. It is important that there are no conflicting requirements amongst the various regulators, and it would be extremely helpful to all businesses if there was an overarching body with responsibility for all such regulation to reduce time wasted by dealing with the various departments and their associated 'red tape' so that the time could be more usefully spent running their business.

3.4 ***Section 3 Administration***

- 3.4.1 The initial registration process for the company itself via Companies House seems to work well and is fairly easy to use, however the subsequent registration with HMRC for all other taxes (VAT, corporation tax, PAYE for company, and self assessment for the director) has to be done separately and is confusing for the unrepresented. Registration for all digital services is yet another separate application. There should be a more integrated registration process which covers all necessary registrations at one time.
- 3.4.2 There also needs to be adequate support provided for those who may have online access but who may still lack the skills and confidence to transact with HMRC online. It is also vital that a non-digital option remains available to the digitally excluded.

- 3.4.3 HMRC's current proposals for 'Making Tax Digital for Business' will require quarterly reporting of business income and expenses and will impose yet more financial reporting obligations on businesses which already spend a disproportionate amount of time on administration relating to the running of their business and so will not be welcomed by business.
- 3.4.4 We do not believe this is a workable proposal for the majority of micro businesses, in particular those which do not maintain their business records using accounting software. In our view this is not a sensible step forward on HMRC's 'Digital by Default' drive. We are encouraged to note that non-digital options will be retained for the digitally excluded and stress that they must be easily available to those who will need them in due course.
- 3.4.5 Communicating with HMRC on any business related matter is challenging in the current environment due to lengthy wait times on helplines, delayed callbacks on technical areas, inconsistent advice, guidance on www.gov.uk which is difficult to locate and often incomplete or potentially misleading. We wait to see whether HMRC's recent investment in additional resources improves the customer service experience.
- 3.4.6 It is important to streamline administration for small companies as much as possible if a significant improvement is to be made to their financial obligations. Perhaps the accounts and return for Companies House and HMRC could be combined into one so that only one annual submission is required and so only one submission date? This has broadly been the case for those who used HMRC's free corporation tax filing software as it allowed information to be filed with Companies House as well as with HMRC from the same software system but this was very cumbersome to use and very confusing for a non-expert. We are aware that a new joint system is currently being tested which we understand is a significant improvement on the previous software and so we await further information on this in due course.
- 3.4.7 The fact that companies are due to pay their corporation tax before the due date for submission of the corporation tax return is also confusing for many businesses.
- 3.4.8 We do not believe that the tax system should be so complex that a taxpayer should be forced to engage an agent to navigate it successfully on a regular basis so that they have peace of mind that it is done correctly.

3.5 ***Section 4 Uncertainty***

- 3.5.1 There are many uncertainties caused by the tax system which are usually technical in nature such as the differences in income tax and NIC treatment of benefits in kind, expenses, termination payments and the differences between standard rated, zero-rated and exempt items for VAT. Therefore uncertainties are constantly developing as the frequent changes made to the legislation bed in. The only way this can be managed by a business is to pay for

professional advice, and many small businesses cannot afford specialist advice on a regular basis.

- 3.5.2 Although in some instances there is an option to submit information to HMRC for advance clearance (eg IR35 contracts), many are reluctant to use these types of service as they fear it will raise their profile within HMRC and then prompt some kind of enquiry, etc. from HMRC on other aspects of their business affairs.

3.6 ***Section 5 Other approaches to tax***

- 3.6.1 We would support alternative means of taxing small companies if it produced simpler legislation which was fair, and adequate transitional provision was made for any business which would be adversely affected by any new rules. We would expect any proposed changes to the taxation system to be widely consulted with relevant bodies and unrepresented companies wherever possible.
- 3.6.2 The 'look through' basis for taxing small companies as described would mean shareholders would be taxed in a similar way to self-employed/partnerships. This could have some merit but may be difficult to apply to companies other than director/shareholder companies or small family companies, as external investors who are not necessarily involved in day to day running of the company may not like to be taxed in that way. Such a change will impact on other areas of taxation such as loss relief, and also income dependent in-work benefits such as tax credits and universal credit so careful consideration must be given to the wider effects of such a change.
- 3.6.3 A cash basis of accounting, or a turnover tax (presumably similar to the flat rate scheme for VAT) would be familiar to those companies who are VAT-registered and use similar schemes for their quarterly VAT returns, so there could be some advantage to such an approach as there will already be a reasonable level of understanding of the concepts amongst those companies. However, there is a danger the additional complexity that will arise by introducing a different tax regime for small companies altogether may outweigh the perceived benefits and will give rise to complications when moving into the 'large company' regime. Careful consideration would need to be given to the definition of small company and it may be preferable for it to be turnover based rather than based on the number of employees (subject to an overall maximum of say nine employees.)
- 3.6.4 Simplification for small companies might be possible if the differences between taxable profits and accounting profits such as capital allowances and depreciation could be significantly reduced or, preferably, eliminated altogether.

3.7 ***Section 6 International experience/comparisons***

- 3.7.1 No comment.

3.8 ***Finally***

- 3.8.1 We believe that one of the biggest changes that could be made to the actual taxation of small companies to make the system easier for unrepresented taxpayers is to base the tax charge on the accounts profit. However as documented above we would also like to see changes to the compliance process itself to improve the experience for the unrepresented.
- 3.8.2 We would also counsel vigorously against introducing new measures such as quarterly reporting for all companies which will only add significantly to the already burdensome process of fiscal compliance, particularly for the smallest companies which are often unrepresented.

LITRG
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