

15 February 2017

House of Lords
Select Committee of Economic Affairs
Finance Bill Sub-committee

Sent by e-mail to: financebill@parliament.uk



Dear Sirs

Re: UK200Group's Response to Making Tax Digital Consultation/2

Thank you for the opportunity to provide evidence relating to the Making Tax Digital ("MTD") project.

We are responding on behalf of the UK200Group, which is the UK's leading membership association of independent chartered accountancy and law firms. Collectively, we provide a voice for more than 150,000 SME's across the UK and we provide our members with services that support them in the following areas:

1. Business development
2. Business risk
3. Business delivery.

Our Quality Assurance and Standards (QAS) mark is a beacon of excellence for SMEs seeking the highest level of accountancy services; it both underpins and unites our members enabling them to work together to deliver seamless services for our client groups.

As you would expect, our member accountancy firms offer the full range of accounting services to their SME clients. They are acutely aware of the need to engage SMEs in the digitalisation agenda and therefore we are pleased to make this submission on their behalf.

In the past representatives of our Tax Panel have met and made recommendations to the Treasury on various budgetary issues, to an All Parliamentary Party Group on PAYE Reform, and to the Office of Tax Simplification.

We wrote to you on 3 February with evidence we have gathered from our member firms concerning the methods of book-keeping practised by our clients. This letter presents further evidence as to the likely impact of MTD. We have confined our comments to questions 3-6 of your call for evidence; we should be more than happy to provide evidence in other areas, should you request it.

Overall view of MTD

HMRC's responses to the consultation were published on 31 January, along with draft legislation. It appears that in most cases HMRC have not changed their proposals, and so the comments we made to HMRC in response to the six consultation documents still stand. We enclose a copy of these comments, for your information.

Our overall attitude to MTD is that we applaud and welcome the concept, but we have concerns over the implementation.

We particularly welcome the proposal for Digital Tax Accounts, bringing all information together where it can be reviewed and amended as required. The way that the need for Self-Assessment tax returns will be reduced as a result of this is an excellent reduction in the administrative burden: there should be no need for an employee to report income which has already been reported under PAYE/RTI.

However, we have concerns that HMRC are trying to re-write tax obligations in order to fit the digitalisation agenda, dispensing with aspects that cannot easily be done online rather than using digital tools only where appropriate.

We are particularly worried by HMRC statement (at paragraph 3.44 of the “Better use of Information” consultation response) that *“Part of Making Tax Digital is a move away from Self-Assessment principles”*. We do not think it appropriate that Self-Assessment principles, which are fundamental to the UK tax system, should be undermined for the convenience of HMRC’s IT systems.

In our view, the MTD project should be taken in three stages:

- 1) First, build a better infrastructure to share information currently provided
- 2) While that is being done, establish the principles of the various relationships
 - Under the current regime
 - Under a future digitised regime
- 3) Once both the above are complete, identify new areas of information provision to help people understand the principles of the new relationships in a digitised regime.

This would deliver immediate efficiency gains for HMRC and taxpayers, while ensuring that future developments deliver benefits which outweigh the administrative burdens.

The current proposals, however, are the reverse of this order: they envisage making changes to taxpayers’ obligations before they have been properly considered, which will risk imposing burdens without having established how benefits will be obtained from them.

Draft legislation

The draft legislation for the introduction of digital reporting appears to be almost entirely devoid of content. The phrase “The Commissioners may by regulations...” is so frequent that the whole draft Schedule A1 could just as well have read “The Commissioners may by regulations set up a system for Making Tax Digital”, and saved six pages.

We are unable to make any meaningful comment on the draft legislation without sight of the regulations themselves.

We are therefore forced to assume that the regulations will eventually implement the proposals set out by HMRC in their responses to the consultations.

This situation is particularly disappointing given that the draft legislation was originally due to be published two months ago at the time of the Autumn Statement. Of the sixteen months between Autumn Statement 2016 and the introduction of MTD in April 2018, two have elapsed with no meaningful movement.

We find it extremely disturbing that although time is very much at a premium, it does not appear that it is being wisely spent.

The Digitally Excluded

HMRC’s main comment concerning the digitally excluded is that:

45. *The government agrees that access to broadband, age, remoteness of location and disability must all be taken into account when determining whether someone can engage digitally. The government agrees that it is possible for just one of these factors to be sufficient to ensure that a person does not find it reasonably practicable to comply with the MTDfB obligations; and will make this clear in any guidance and relevant communications.*
46. *The government will legislate for an exemption to MTDfB for taxpayers who cannot engage digitally. This exemption will be based on the existing VAT online filing exemption and will therefore exempt the following groups from the MTDfB requirements, where HMRC is satisfied that they qualify:*
 - *a person who is a practising member of a religious society or order whose beliefs are incompatible with the use of electronic communications; and*
 - *persons for whom MTDfB is not reasonably practicable for reasons of disability, age, remoteness of location, or any other reason.*

47. The government will ensure that taxpayers are able to apply easily for an exemption to MTDfB and that non-digital means of applying for this exemption are available. The government will also ensure that taxpayers are clearly informed of the choices available to them.

This is extremely vague. It boils down to saying that an opt-out will be available for:

- Those who are currently excluded from certain VAT reporting for religious reasons; and
- Some other people.

Our primary concern here is that we are currently unable to advise clients as to whether they will be within the scope of MTD, and the very clients who are most worried by the prospect of MTD are the ones who cannot be advised.

The damage is currently limited by the fact that very few clients are aware of MTD at present. However, HMRC will have to start publicising MTD very soon if they are to get taxpayers on board by April 2018, and it is essential that the exemptions are clearly defined before awareness starts to grow. Failure to establish clear exemptions will result in widespread concern among SMEs, and disengagement from MTD in particular and the tax process in general.

Anecdotal evidence already exists of taxpayers (and, in some cases, agents) deciding that they will wind up their businesses rather than deal with what they perceive to be overly onerous requirements. This may not be a serious expression of concern, but the fact that it has been fairly widely voiced is significant. We would expect that raising the threshold from £10,000 to (ideally) the VAT threshold would reassure most of these businesses.

A secondary concern is that an exemption must be applied for in advance. There would appear to be severe timing constraints for exempt businesses. Before MTD is introduced in April 2018, the business must have time to:

- 1) Become aware of the criteria for exemption
- 2) Consider whether it qualifies for exemption
- 3) Obtain the appropriate form to apply for exemption (it appears likely that a specific form will be required, this being HMRC's normal modus operandi)
- 4) Complete the form and submit it to HMRC
- 5) Receive confirmation that exemption has been granted.

This assumes that all goes well. Based on HMRC's normal turn-around time for routine correspondence of this nature (comparing it to registering for Self-Assessment, for example) we would expect a delay of up to a month between submission of the application and receipt of confirmation from HMRC. Should HMRC query the application, each letter in either direction could add a month. The process could therefore easily take three to four months, and so must be underway by the end of this year.

However, we note that the vast majority of SMEs are so far completely unaware of MTD. HMRC will have to work hard to raise awareness in sufficient time to allow for exemptions to be applied for.

Two particular obstacles to success are prominent:

- 1) HMRC will be receiving a large number of queries regarding exemption, together with a large number of queries from businesses seeking to set up their Digital Tax Accounts. The resulting strain on resources could delay correspondence significantly.
- 2) Tax agents will be in the midst of preparing Self-Assessment returns in December and January, and will not have the time to assist SMEs with the decision-making process

Working backwards, if it is assumed that three months should be allowed for the process, but that December and January should not be such months, then SMEs should ideally be making their applications for exemption by October or November. This leaves a maximum of six months to decide and publicise the criteria for exemption. As noted above, time is a precious resource.

A final point in this area is that HMRC have so far been relatively silent regarding the obligations of businesses which, for whichever reason, are not caught by the quarterly reporting obligations of MTD. We gather that businesses under the threshold will have the quarterly reporting obligation removed,

but the taxpayer will still have to maintain a Digital Tax Account. It is however not clear whether they will also have to maintain records electronically to support the end of year update.

Exempt businesses will presumably not have to maintain a Digital Tax Account at all, but will continue to file under the existing provisions. However, we are not clear how this could work in practice, given that most VAT and PAYE filing already has to take place online and the intention is to integrate them into MTD. We note that HMRC's response to the consultation refers only to exemption from the requirements to keep digital records and to report quarterly, but is entirely silent about annual reporting.

Assuming that MTD does indeed bring advantages to most businesses, we should be most interested in understanding how HMRC will ensure that non-MTD businesses are not disadvantaged.

Time constraints

Some concerns regarding timings for exempt businesses have been set out above. Of the other groups mentioned in the call for evidence, we can speak for those businesses which are within the scope of MTD, and for their advisors.

As set out in our previous submission, we believe that something over half our SME clients currently keep either no records, or merely manual records. These will all need to migrate their systems either to a full accounting system, or else to a spreadsheet system compatible with MTD filing.

There is no "one size fits all" answer to how long it takes to migrate to a new accounting system. However, our view is that in the majority of cases SMEs will require external assistance to achieve it. Our clients of course already have advisors, but there is an open question over who will advise clients who currently prepare their own tax returns and supporting accounts.

In our view the following rough process would need to be followed:

- 1) Advisors identify suitable software packages to recommend to clients. This will in turn require:
 - External developers to have designed, produced and marketed the software
 - Advisors have been able to assess the relative merits of different products
 - Advisors have familiarised themselves enough with their chosen packages to be able to assist with implementation
- 2) Advisors convince clients that MTD does indeed apply to them and must be complied with (this crucial step does not seem to be recognised at all by HMRC)
- 3) Advisors recommend appropriate software to each client
- 4) The client obtains, installs, and becomes familiar with the software
- 5) The client sets up the Digital Tax Account
- 6) The client runs the new system in parallel with the old until confident that it is being used correctly
- 7) The old system is discarded in favour of the new.

In this case, where no system is currently being used the parallel running can be dispensed with, although it will of course be necessary to ensure that clients retain documentation in case of error.

The start and end points of the process are the availability of appropriate software, and the first filing date under MTD. We understand that the software industry estimates that it might be ready in November 2017, assuming all goes well and information is made available by HMRC. As MTD will apply for the first period starting after 5 April 2018, for SMEs which use the tax year as their accounting period the new systems will need to be in place at that date.

This leaves a period of at most five months between November 2017 and April 2018 for advisors to assess suitable software, recommend it to clients, and help them adopt it. We note that the first three of these five months are the busiest time of the year for advisors involved in preparing Self-Assessment tax returns, who are by definition those who will have this sort of SME client.

We do not consider that this timetable is achievable, primarily because advisors will not be able to provide the advice and support which is required.

In practice, we suspect that in a large number of cases the software will be adopted shortly before the first filing is required, with records being kept as they are now and added to the system at the last minute. We would therefore expect:

- 1) A significant increase in errors
- 2) A large number of late filings
- 3) A large number of omitted filings
- 4) Significant disenchantment on the part of taxpayers.

Overall, we would not expect that the figures filed in the early stages could be relied on for any purpose.

We note that HMRC do not propose to charge penalties in the first year. This will, in our view, significantly reduce or delay compliance with filing obligations. On the other hand, charging penalties would result in even more significant disengagement, together with an increase in filings made with arbitrary figures simply to avoid penalties.

A vital element of a successful software deployment is pilot testing. We are assured by HMRC that the process is to be, and indeed is being, tested before 5 April 2018. However, MTD involves not only quarterly in-year reporting, but also a year end update. For the year-end update process to have been tested before April 2018, it would be necessary to have accounting periods ended before March 2018: that is, tests must be carried out on accounting periods which have already started, using software which will not be available until November.

Any tests which HMRC is undertaking must therefore be using software which is not yet finished, to achieve filing requirements which have not yet been defined; to have results by April 2018 means rushing through the process, and still not leaving time to address any issues which arise.

We cannot see how such a test can have any validity.

A proper beta-test of the system would use final software. If this is available in November 2017, and is deployed for a number of businesses with accounting periods starting over the next few months from November, the first periods would be ending from October 2018 to say March 2019. The ten months for the year end process could perhaps be shortened in a test situation; doing so would allow meaningful results to be gathered during 2019 and the issues to be addressed by April 2020.

If MTD is made mandatory before 5 April 2020, then in our view it cannot be said to have been properly tested.

Simplification of profit calculations

We have significant concerns over the cash basis as set out by HMRC, which does not appear to represent any form of simplification.

The overall effect of the “simplifications” appears to be to deny relief for business expenses, and thereby increase taxable profits.

In particular:

- 1) The cash basis is mandatory unless certain criteria are met, or the business opts out. This would potentially mean that a small business which is accounting correctly under GAAP, but neglects to notify HMRC that it wishes to do so, is accounting incorrectly for tax purposes. This is somewhat absurd: an opt-in system would be far preferable.
- 2) The disallowance of a range of capital items is extremely complicated. The aim seems to be to disallow expenditure which would not qualify for capital allowances, but the effect is to go well beyond this.

The most egregious aspect is to disallow the cost of a car, which is a vital business tool for many businesses. Other items disallowed (such as land) could be expected to retain much of their value, but cars do depreciate relatively quickly and so should not be treated in the same way.

The impact of this provision would be to either force SMEs to hire cars rather than purchasing them (hire charges being revenue, and therefore deductible), or else to hold them personally and claim business mileage expenses.

Either of these outcomes results in arbitrary tax rules distorting commercial decisions, which is not desirable.

- 3) HMRC note that many objections to the cash basis proposals come from accountants who could be expected to understand the accruals basis of GAAP and so see no need for the cash basis. They suggest that unrepresented taxpayers would prefer the cash basis, finding it much simpler to operate.

The draft legislation on capital items under the cash basis is however much more complex than is reasonable for an unrepresented taxpayer – it is far more extensive than the rules on Annual Investment Allowance, for example. If it is more complex than Capital Allowances, it is not a simplification.

It also seems to be somewhat inconsistent with the type of business which will be employing the cash basis. We would be surprised to find that many businesses with turnover below £300,000 install new lift shafts in their buildings, for example. This suggests that the rules have not been written with their target businesses in mind.

Overall, the new regime seems too complex. A cash basis should be a cash basis: money in is taxed, money out is relieved. Complicated provisions about which entries may be included and which should be disregarded are not a cash basis, they are simply a different set of accounting principles - which do not have the merit of being generally accepted.

Simplification of accounting periods

We do not have such strong views on this area, which seems broadly reasonable.

However, we do not see any policy reason for the system of creating and taxing overlap profits. Overlap profits have no basis in any commercial result: they simply ensure that a full year's profit is taxed in the first tax year, even though only a part year's profit has been earned. As such they are simply a way of raising revenue by creating an artificial profit. HMRC has expressed a number of entirely reasonable views on the creation of artificial losses, and we are disappointed that these views do not operate in both directions.

In our view overlap profits should be eliminated, and a mechanism devised for relieving those which have already been taxed (deducting them over the next three years, say).

Penalties

We note that the details of the new penalty regime are still to be consulted on. We are broadly in favour of the overall approach proposed by HMRC, but would make the following comments:

- 1) HMRC has very limited powers to enquire into quarterly reports, as the tax liability is determined by the end of year position. This is a welcome acceptance of the fact that quarterly reports cannot be expected to be accurate.

We have some difficulty with the concept of a report which required to be made, but which is not required to be accurate. What is the position of a taxpayer who, for example, dutifully files quarterly reports showing nil in all boxes, and then updates this to a correct and complete position at the year end? It would appear that this would lead to no penalties.

- 2) HMRC propose that penalties should be fixed, with no regard to the size of the business.

Flat-rate penalties already cause many problems and much distress for small businesses and unrepresented taxpayers. For example, the cumulative £1,300 penalty for failure to file a Self-Assessment return (which shows no tax payable) is well known to dissuade taxpayers from engaging with HMRC at all.

Conversely, for larger businesses they become irrelevant. Listed companies are far more worried about the extended enquiry window resulting from filing a CT600 late than they are about the £100 penalty.

We would urge that this proposal be reconsidered, and a mechanism be found for keeping penalties proportionate.

- 3) HMRC's responses include a section which says:

"Suggestions were made by respondents about providing additional education in the form of awareness courses as an alternative to sanctions. HMRC provides a wide range of guidance and supporting materials and tools. These ensure customers are aware of their obligations, liabilities, entitlements and the consequences of their transactions." (Our emphasis).

We consider that HMRC is altogether too sanguine about the efficacy of HMRC publications. Even if it is granted that they can enable taxpayers to become aware of their obligations, that is a long way from ensuring that they do so. The DVLA's driver education courses do seem to be an effective supplement to, or replacement for, fines and penalty points for drivers; HMRC may do well to emulate them.

Summary

Overall, our reaction to the HMRC consultation can be summed up as follows:

- 1) HMRC do not seem to be taking account of responses to their consultation. In too many cases they appear to say, in effect "not everyone objected, so we will go ahead"
- 2) Despite the lack of changes, the proposals are still not in a form that can be properly assessed. Too much is yet to be consulted on, or yet to be drafted.
- 3) Time is of the essence, but is being frittered away. To implement MTD starting in November 2016 based on known principles would have been difficult, but we are now in February 2017 and the principles are not known. Implementation must be delayed by at least one, if not two years.

Making Tax Digital is an excellent concept that we whole-heartedly support in principle, but we would urge that the approach to it be reconsidered.

Should you require any further information, please do not hesitate to contact us.

Yours faithfully



Andrew Jackson
Chair UK200Group's Tax Panel



Declan Swan
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Enclosed: Making Tax Digital Consultations – Summary of Questions with responses