Ref: Specialist Panel/Tax Panel/HMRC/MTD/Response Letter/3 Feb 2017

UK200Group
3 Wesley Hall, Queens Road
Aldershot, Hampshire
GU11 3NP, UK
T. +44 (0)1252 350733
E. admin@uk200group.co.uk
www.uk200group.co.uk

building better together.

3 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**

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 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.

**Evidence concerning impact of MTD**

Following the publication of HMRC's consultation documents, we undertook a survey of our member firms to try to establish what our collective client base currently do in terms of record-keeping.

The current MTD proposals require all businesses to maintain records using a suitable computerised accounting system. This will then enable the business to upload information to its Digital Tax Account on HMRC's system.

We considered that this would require a significant change in behaviour from a large proportion of our client base. We therefore asked each member firm to categorise its SME clients into four styles of record-keeping:

| | |
|---|---|
| Shoeboxes | Those clients who currently do nothing with their records other than collect paperwork and forward it to a book-keeper or accountant for processing. |
| Manual records | Those who are used to record-keeping, but do not use a computer to do so. |
| Spreadsheets | Those who use computers in an informal way, typically using spreadsheets to record information from paperwork. |
| Software | Users of dedicated accounting software packages |

These are of course very broad categories. We note that, in particular, some accountants provide their clients with very sophisticated spreadsheets which are almost as powerful as accounting software; but even manual systems can provide an excellent basis for the preparation of accounts at an SME level.

We have not carried out a detailed analysis of the results of the survey, as limitations of the data do not allow for precise conclusions to be drawn. However, we can say the following:

1) Responses were received from member firms ranging from our small firms with one or two partners up to the medium/large firms with approximately 17 partners each.

   The average number of partners per firm was 6: this would represent a reasonably large local firm of accountants.

2) The overall pattern of clients across firms is:

   - 1 in 6 - Shoebox method
   - 1 in 4 – Manual records
   - 1 in 4 - Spreadsheets
   - 1 in 3 - Software

   This is a simple arithmetic average of the proportions reported by the member firms.

3) There is a general trend: the larger the firm, the greater the proportion of clients using spreadsheets or software. We suspect that this correlates with the size of clients, as larger firms tend to have larger businesses as clients.

Our survey did not include questions concerning the use of more sophisticated apps for digital record-keeping, in the manner proposed by HMRC. Anecdotal evidence suggests that although some products are available, they are rarely used at present as clients prefer either to do nothing at all with their receipts (other than put them in a shoebox), or else to enter them into some form of accounting record. Reports of the efficiency of the apps are mixed.

**Observations**

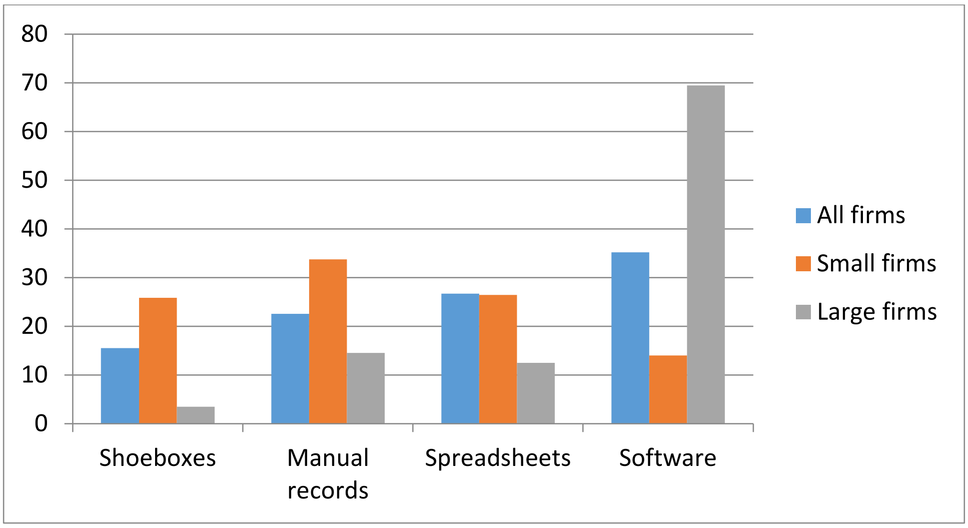
As noted above, due to the methodology care must be taken before reading too much precision into the results of the survey.

A number of general trends can be easily discerned, however. The primary observation is that across the whole of our SME client base there are large numbers of businesses with little or no computerisation of their financial records.

The second observation is that smaller firms (and, by implication, smaller SMEs) are significantly less computerised in their record-keeping.

The graph below contrasts the position for small firms (two or three partners) with that for our larger member firms (over ten partners).

*Fig 1: clients by firm size*




It is clear that there is a very significant divide. Our view is that this is almost entirely related to the size of the client businesses involved, with larger firms tending to act for larger businesses.

The overlap, with larger firms still having a number of shoe-box businesses, is consistent with our informal observations that our member firms all tend to act for a wide variety of clients.

A central tenet of HMRC's foreseen cost reductions is that SMEs will be able to automatically scan paperwork into an app, which will reduce date processing time. At present we have seen very little of this among our clients, which would suggest that taxpayers would need to develop new habits in order to make this a viable option.

We are concerned that this option would by its nature appeal to those clients who are seeking a quick and easy solution, and would expose them to considerable risk of data being omitted from the accounting system. We see two mechanisms for this:

1) Forgetfulness on the part of taxpayers leading to omission of entries.

   We already have extensive experience of having to compile accounts from incomplete data, due to the failure to obtain or retain invoices and other appropriate documentation. Entries on bank statements are frequently used to identify expenses for which proper records have not been kept.

   We are not certain that this situation would be improved by use of scanning apps. Indeed, some of our members have expressed concerns that the existence of an app would give false confidence that all entries have been recorded.

2) Errors in software.

   Although apps which will automatically interpret documents and generate system entries are not yet common, clients will frequently forward to us copies of documents taken using mobile phone cameras. On occasion these are excellent, but there is a high proportion which are unreadable even by the human eye - due to being out of focus, inadequately lit, partly obscured, taken at too low a resolution, and so on.

   It appears unlikely to us that optical character recognition software will be able to outperform humans in interpreting these poor-quality scans.

   We expect that increased reliance on scanning apps will greatly increase the proportion of unreadable documentation, particularly if false confidence leads to original documents being destroyed once they have been scanned.

HMRC have also noted that a major driver for MTD is the reduction of errors by taxpayers. In their most recent publications they estimate that this costs £8bn in lost tax per annum, with a 10% reduction to be expected from MTD. We note that errors which lead to lost tax must either understate income or over-state costs, and that to increase the tax recovered MTD must therefore reduce these errors.

In our members' experience, accidental errors on the part of taxpayers tend to be those of omission: either accounting entries are completely omitted, or the taxpayer is unable to adduce sufficient evidence to justify including the entry in the business accounts. Such accidental omissions are rare in the case of income (clearly the case is different in the case of deliberate omissions, but these are outside the declared scope of MTD), as generally it is easier to trace income than costs (the invoice is generated by the taxpayer, and so supporting documentation is usually available), and it can normally be taken as read that income is taxable even where detailed evidence is lacking.

Omission is much more common in the case of costs, where documentation is easily lost. This can be compensated for by reviewing bank statements in many cases (although this is less effective where there is no separate business bank account), but in such situations there is still a question of justifying that the expense is deductible. The effect is two-fold: omitting costs altogether increases accounting profit, and failure to support a deduction for costs increases the amount added to accounting profit when calculating taxable income.

We would therefore expect the general trend of errors to be one of understating deductible costs.

An alternative view would be that taxpayers tend to erroneously claim deductions where none ought to be available. This does not appear to be the case for our client base, although it must be noted that there is a strong element of selection bias (all our clients are represented by professional agents, for example) and so it is possible that this effect is more prevalent in the general taxpayer population.

**Conclusions**

At the smaller end of our client base, the majority (approximately 60%) of our client businesses are completely dependent on their accountants for any significant processing and would require significant reform of their systems before being able to meet their proposed obligations under MTD. Alternatively, they would be heavily dependent on their agents undertaking the MTD filings on their behalf.

We consider that this casts significant doubt on HMRC's estimates of the cost to businesses of adopting MTD. The estimated on-going cost to a business is less than £300 per annum, which even assuming junior staff are involved represents only a few hours of staff time for an accounting firm. Entering data from a shoe-box of receipts into an electronic form suitable for MTD, or re-typing manual records, is likely to occupy rather more than this amount of time if it must be repeated four times per year, in addition to existing year-end accounting and reporting obligations.

We can only assume that HMRC's estimate is based on internal costs to the business, rather than external costs of advisors. We do not generally expect however that the majority of our clients will wish to attempt to comply with MTD requirements with no assistance from us.

Our observations of the (limited) use of mobile phones in recording and forwarding information suggest to us that this element of a digital approach will lead to information being unusable. At best this would require re-scanning, which would add to taxpayers' costs; at worst it can be expected to lead to loss of data.

Our review of taxpayer errors has not been on a formal basis, but leads us to expect that accidental errors would tend to understate deductible costs and hence to overstate the tax liability. A reduction is errors as a result of MTD could therefore be expected to reduce tax receipts, which would appear to conflict with one of HMRC's assumptions underlying MTD.

However, as noted above we have concerns that certain aspects of MTD, and in particular a reliance on scanning apps, could very easily increase the rate of taxpayer errors. To the extent that such errors over-state tax liabilities this would increase tax receipts. MTD could therefore have the intended effect, but for the opposite reason to that expected by HMRC.

**Consultation responses**

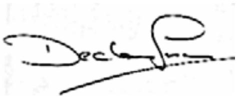
We have undertaken a preliminary review of HMRC's responses to the consultation, which were also published on 31 January. It appears that in most cases HMRC have not changed their proposals, and so the comments we made to HMRC in response to the six consultation documents still stand. We enclose a copy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

We propose to write to you separately concerning the draft clauses published by HMRC on 31 January, although given the content of the draft legislation that communication may be somewhat briefer than anticipated.

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

Yours faithfully

Andrew Jackson
**Chair UK200Group's Tax Panel**



Declan Swan
**CEO UK200Group**

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