

A REVIEW OF SMALL BUSINESS TAXATION

A TECHNICAL NOTE BY THE INLAND REVENUE
MARCH 2001

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1. INTRODUCTION

1.1 Small businesses have a vital role in maintaining the success of the UK economy. The Government is committed to reducing the regulatory burdens on small businesses thereby increasing their competitiveness and productivity. This proposal seeks to achieve, through consultation, a radical simplification of the way in which small businesses are required to calculate the tax due on their profits by aligning their profits for tax purposes much more closely with those reported in their accounts.

1.2 The objective is to:

- Reduce regulatory and compliance costs
- Improve Revenue support
- Build “e” services with small business input
- Work with accountants and business to improve the overall support available to small businesses.

1.3 Consultation on a number of other measures has helped to refine Government proposals and increase their effectiveness. The Government therefore wishes to discuss this proposal with small businesses and their advisors to design policy and regulation around their needs. The Government is particularly interested in what additional refinements and further ideas could be built into it.

2 What is a Small Business?

2.1 In the Companies Act, a “small company” is one that has at least two of the following features:

- A turnover of not more than £2.8m
- Balance sheet assets of not more than £1.4m
- No more than 50 employees

This is the definition used by the Small Business Service and for recent Capital Allowance measures. We believe that this definition also describes the range of small companies that should be included in this review.

- 2.2 In the Companies Act the limit is the same for a single company and a group. That is, the group as a whole must meet the tests to qualify as “small”. Applying the same rule to the tax proposal would meet the aim of simplicity and would allow businesses to decide which structure best meets their commercial needs.

3. The Current Rules

- 3.1 The Companies Acts require companies to calculate business profits on a “true and fair view” basis. There are a number of accounting standards which have to be met for the accounts to be accepted as showing a true and fair view.
- 3.2 But the commercial profits shown in these accounts are only the starting point for tax. There are special rules for dealing with non-trading income such as rents and dividends, for which separate tax computations are required.
- 3.3 Even for trading income, numerous adjustments have to be made to the accounts profit to arrive at the taxable profit. For example, capital receipts and capital deductions have to be excluded. Instead, capital profits are calculated under rules applying to the separate capital gains regime, and deductions for commercial depreciation are replaced by tax capital allowances.
- 3.4 There are also further adjustments that have to be made to disallow for tax items such as business entertaining and expenditure which is not incurred “wholly and exclusively” for the purposes of the company’s trade.

4. Moving Towards Accounts Profits for Tax

- 4.1 This review will look at how these differences can largely be eliminated while preserving the value of the additional reliefs and benefits that small companies currently enjoy. It is likely that some adjustments will still be required but the aim will be to create a much simplified system for most small companies.
- 4.2 Views are sought on how best to achieve simplification while ensuring that small companies can still have access to the reliefs and allowances that the Government has introduced to support them. In particular: 100% first year allowances for expenditure on IT; 40% first year allowances on plant and machinery; and research and development tax credits.

4.3 In addition, we want to consult on whether it would be desirable in looking for radical simplification, to consider:

- Removing the special tax rules for rental income and other investment income and using the commercial accounts basis
- Allowing commercial depreciation instead of tax capital allowances for the majority of business assets
- Taxing capital profits (and allowing capital losses) on the basis shown in the accounts, as already happens for loan relationships.

Views on such fundamental changes would be welcome, particularly in relation to the treatment of capital receipts where the capital gains regime provides for various reliefs, and rules to address the many different situations that can arise. These can produce very different results from the profits (or losses) shown in the accounts.

4.4 Moving over to an even greater reliance on companies' accounts for tax will bring into sharper focus the quality of those accounts. It will also raise issues about managing the risk of leakage at the boundary between business expenditure and directors' private expenditure. We would like to work closely with small businesses, accountancy firms and the accountancy bodies to provide support and guidance to improve standards and practice where this is necessary. This is considered further in Section 6.

4.5 Implementing the proposals discussed in this note would create two tax regimes for the corporate sector: small companies operating broadly on the accounts profits basis, and the larger companies under the current corporation tax regime. There are issues that need to be resolved when companies move between the two regimes: for example, a deduction for commercial depreciation for one year, and entitlement to capital allowance in the next. Views on this and other issues concerning the "small"/"large" company interface would also be particularly welcome.

5. Unincorporated Small Businesses

5.1 Small companies are only part of the small business population. The self-employed are a large and important segment. The Government is equally committed to reducing the regulatory burdens on these enterprises by simplifying, where possible, the tax rules that apply to them.

- 5.2 We would like to use the consultation exercise following publication of this Technical Note to identify the key issues for the self-employed. We aim to work with them and their representatives on possible measures to tackle those issues, using similar principles to the simplification proposals for companies but recognising that there are differences to be addressed, for example in the requirements for accounts.

6. Working with Small Businesses, Accountants and Representative Bodies

- 6.1 Aligning more the taxable profits of a small business with its accounting profits provides the scope for a major simplification of the system, and with it a reduction in regulation and compliance costs. But the new system will only meet the needs of small businesses if they, together with their agents and the accountancy bodies, are involved in the policy design from the outset.
- 6.2 In addition to inviting written comments on the proposals, we shall welcome the opportunity to meet the representative bodies and other interested parties to discuss the issues that such a new regime will inevitably raise, and how these can be resolved. We shall also be particularly interested in hearing the views of the smaller firms of accountants and their clients, and we will be arranging regional meetings to make it easier for them to participate fully in the consultation exercise. We hope that the consultation will also assist us in quantifying the reductions in compliance costs these proposals will have, and therefore inform the Regulatory Impact Assessment.
- 6.3 We aim to finish the first part of the consultation by 31 May 2001. We will produce a draft Regulatory Impact Assessment alongside the publication of the responses to the consultation.
- 6.4 But engaging in extensive consultation on the new policy design is only part of the work we would like to do with small businesses and their representatives. The introduction of the new regime will enable us to build on the assistance and support that is already available to small businesses and their accountants. For example, the Revenue Business Support Teams (BSTs) already give advice to small and new employers. From April 2001 the support offered by BSTs will be extended to new businesses, particularly on record keeping.
- 6.5 Simplifying the tax system will also enable some of the resources currently used on monitoring the application of specific tax rules to be re-deployed to help companies and their accountants to improve standards and practice. Work is already under way with the accounting

bodies to help achieve this objective.

- 6.6 An 'e' services project is also under way to investigate how the Revenue can best design and build a system to communicate electronically with its corporate customers. Simplifying the design of the tax system for small companies should facilitate 'e' services and we see further advantages in linking the consultation on the small business tax review with this project.
- 6.7 Following consultation with the payroll industry and software houses, the Revenue now "kitemarks" those payroll packages which incorporate the essential features to administer accurately PAYE, NICs and Tax Credits. We would like to build on this and work with the accountancy bodies and software houses to enable the Revenue to "kitemark" commercial accounts packages which produce accounts in accordance with accepted accountancy standards and principles. This, together with the tax simplification envisaged in this review, should give small companies greater certainty about their tax liability. Compliance costs will be reduced because companies using such packages will have a reduced risk of being selected for technical enquiries.

7. Consultation

Comments are invited on all of the issues raised in this Technical Note and should be sent to:

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to arrive no later than 31 May 2001.

Once the outcome of the consultation is announced, we will make available, on request, responses to consultative documents, unless any respondent has asked for her or his comments to be treated as confidential. If you wish the whole of your comments, or your name and address, to be treated as confidential, please say so when you return your comments.

**Government Code of Practice on written Consultation:
the consultation criteria**

1. Timing of consultation should be built into the planning process for a policy (including legislation) or service from the start, so that it has the best prospect of improving the proposals concerned, and so that sufficient time is left for it at each stage.
2. It should be clear who is being consulted, about what questions, in what timescale and for what purpose.
3. A consultation document should be as simple and concise as possible. It should include a summary, in two pages at most, of the main questions it seeks views on. It should make it as easy as possible for readers to respond, make contact or complain.
4. Documents should be made widely available, with the fullest use of electronic means (though not to the exclusion of others), and effectively drawn to the attention of all interested groups and individuals.
5. Sufficient time should be allowed for considered responses from all groups with an interest. Twelve weeks should be the standard minimum period for a consultation
6. Responses should be carefully and open-mindedly analysed, and the results made widely available, with an account of the views expressed, and reasons for decisions finally taken.
7. Departments should monitor and evaluate consultations, designating a consultation co-ordinator who will ensure the lessons are disseminated.