A REVIEW OF SMALL BUSINESS TAXATION

Summary of responses to March 2001 Technical Note and details of further consultation.

Introduction

1. On 7 March 2001 the Government published a Technical Note "A Review of Small Business Taxation" seeking views on ways of reducing regulatory and compliance costs and improving Inland Revenue support for small business. It set out for consideration a proposal to align profits for corporation tax purposes much more closely with accounting profits.

2. 40 written responses were received. The Inland Revenue held meetings to discuss the Technical Note throughout the country with small businesses and representative bodies, including the Small Business Service, the British and London Chambers of Commerce, the Chartered Institute of Taxation, the Institutes of Chartered Accountants of Scotland and England & Wales, the Accounting Standards Board and the Association of Chartered Certified Accountants.

3. Respondents welcomed the opportunity to comment on proposals to achieve simplification and work in partnership with the Government. They requested that any changes should be preceded by further consultation on the details. The Government intends to consult further on potential areas for closer alignment. Details of this further consultation are given at the end of this summary.

Compliance burden and alignment with accounts

4. There was strong support for the general aim of simplifying the tax system. Some respondents felt that closer alignment with the accounts could produce compliance cost savings. They often commented that there could be significant compliance cost savings if all adjustments were removed.

5. There was a general desire, however, among respondents to retain the effects of tax reliefs and incentives offered through the tax system, with the resultant complexity, rather than to lose the reliefs and incentives by moving towards alignment.

6. Respondents identified the main burdens for business as payroll administration and complying with VAT rules. Compared to these tasks, adjusting accounting profits for corporation tax was viewed as less onerous. Respondents suggested that for many companies the adjustments for corporation tax were relatively straightforward and were typically carried out by the company accountant as part of the wider work of preparing accounts. Some were concerned that any reduction in corporation tax compliance costs would be offset if alignment led to more Revenue enquiries.

The principle of alignment

7. Although many respondents supported the principle of moving tax closer to a commercial basis, others expressed reservations. A number of respondents were concerned that some companies could face a higher tax bill under an accounts regime, for instance if they were to lose first year capital allowances or capital gains tax reliefs. Suggestions for handling this varied. Some favoured making any changes optional. However others were opposed to this, as it could complicate the system because businesses would feel obliged to compute their taxable profits under both methods, so they could choose the one under which they would pay the lower amount of tax. Some respondents suggested selective alignment or tax cuts to prevent higher tax bills under an alignment regime.

8. Some respondents were concerned that the Inland Revenue would attempt to maximise tax by seeking to influence the Accounting Standards Board or by challenging the accountancy treatment adopted by individual companies.

9. There was concern, particularly among some of the accountants who responded, that future tax liabilities could be influenced by changes in accounting practice, for instance by moves to fair value accounting. Some respondents thought that relying on accountancy practice would introduce uncertainty and possibly unfairness.

Details of alignment

Capital allowances

10. Several of the respondents who commented on capital allowances thought they were the single most complicating departure from the accounts. However most of the respondents who suggested that depreciation could replace capital allowances proposed that companies should retain the option of claiming them, or that an alternative deduction should be provided in addition to depreciation to compensate for the loss of accelerated first year allowances. The idea of providing investment allowances in the year the asset was purchased to supplement depreciation was suggested by some respondents.

11. Other ways that were suggested for dealing with the removal of capital allowances included reducing the rate of corporation tax and allowing generous depreciation rates. Some respondents were concerned that companies could unfairly manipulate depreciation rates, or that the Inland Revenue would seek to influence depreciation rates, whereas capital allowances provide certainty. Also, for some companies there would be a tension between wishing to depreciate assets quickly to accelerate tax relief and keeping annual depreciation low to maintain balance sheet value.

Capital items

12. Some respondents wanted to eliminate the distinction between capital and revenue expenditure for tax purposes, in particular so that some capital expenditure that does not currently qualify for relief, such as certain legal expenses and abortive capital expenditure could be deducted.

13. Some said that they wanted to retain the benefits of capital gains reliefs.

Schedules, losses

14. Many respondents favoured following the accounts treatment of grouping together rental income, other investment income and income from different trades. This would remove the need to separate out different streams of income and to compute profits and losses separately, as required under the current Schedular system of assessing tax.

The "wholly and exclusively" rule

15. Some respondents thought that under an accounts regime the tax rule that expenses should be incurred "wholly and exclusively" should no longer apply. Instead, the Inland Revenue should accept the profit from accounts drawn up reflecting a "true and fair view" and should not seek adjustments in respect of "materiality". Expenses related to private use could be identified and taxed via the P11D return of expenses and benefits.

Rules disallowing certain expenditure

16. Various respondents identified particular areas where they would prefer to follow the accounts rather than apply the existing tax rules that restrict relief. These included the rules restricting the deductions for entertaining expenses, accruals for directors' remuneration and pension payments, provisions for bad debts and stock, expensive cars and legal expenses.

Other tax rules

17. Tax rules that respondents thought would need to be retained under an accounts regime included the exemption of UK dividends from corporation tax, the prohibition of a deduction for illegal payments and the R&D tax credits rules.

Coverage

18. If measures were to be focused on small companies, respondents were generally happy with the current Companies Act definition. Some respondents observed that the Companies Act limits are likely to rise.

19. A few respondents thought that changes should be focused on only the smallest companies, with a turnover up to £100,000, or only 4 -10 employees, on the grounds that the burden of complying with regulatory requirements for such companies is disproportionately high compared to larger companies that enjoy economies of scale.

20. Several respondents were opposed to changes that applied only to small companies. Some argued that if alignment was beneficial, it should be extended to all companies. Others pointed out that restricting the regime to small companies would require complex transitional rules. (Several respondents identified the transition between depreciation and capital allowances as being particularly difficult.) Others suggested a "buffer" zone between the regimes so

that companies near the threshold would not frequently have to switch between regimes.

21. Several respondents were also concerned about having different rules for small companies and for small unincorporated businesses. But there was no consensus on how to treat such businesses. Some respondents pointed out that any extension of an accounting approach could require unincorporated businesses to prepare accounts in line with Generally Accepted Accountancy Principles, which they thought would impose an unreasonable burden. Others thought preparing accounts to such a standard would not be too onerous. They pointed out that unincorporated businesses currently have to compute their profits for tax on an accounting basis that gives a true and fair view and may in any case prepare detailed accounts for internal purposes. An alternative view was that allowing unincorporated businesses to calculate their taxable profits on a cash basis would offer simplification.

Working with small business

22. The comments received and the views expressed at the various meetings held by Inland Revenue with small businesses and their representatives have been helpful in identifying the concerns of small business and planning the way forward.

23. Taking into account the wide range of views put forward in response to the Technical Note the Government proposes to consult further on particular areas, such as tax nothings and the rationalisation of the schedular system, where closer alignment could bring simplification while maintaining incentives and fairness.

24. The Inland Revenue will be inviting respondents to the Technical Note to take part in this further consultation and would welcome the involvement of others, particularly those running small companies.

25. If you are interested in taking part in this further consultation or wish to suggest aspects of the tax computation for further study, please contact

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27 November 2001