27 August 2021

Via Email to: businessprofits.admin@hmrc.gov.uk

FSB Response to the consultation on basis period reform

The Federation of Small Businesses (FSB) welcomes the opportunity to respond to the consultation on the tax administration framework. The Federation of Small Businesses (FSB) is the UK's leading business organisation. Established over 40 years ago to help our members succeed in business, we are a non-profit making and non-party political organisation that's led by our members, for our members.

Consultation Questions
Section 3. Proposal: The tax year basis

Question 1:

Do you think that the proposed 'tax year basis' for trading income is the best option for simplifying the basis period rules, and the best way to achieve simplicity and fairness between businesses? If not, do you think there is a better option?

Fairness of the tax system is an issue for small businesses. In FSB's 2021 tax survey it was found that only 35% of small businesses agreed that the cumulative amount of tax they pay is fair given the risk they take by having their own business and 37% agreed that their tax was fair compared to other businesses operating in similar activities. Moreover, only 30% agreed that the tax system itself is broadly transparent, 63% agreed that the number of different taxes is too confusing and 53% agreed that the current system for paying tax is too complex.

FSB agree that the UK's tax system does need to be reformed and simplified such that small businesses can streamline their compliance. From FSB's *Escaping the Maze* report, it was found 34% of small businesses think that tax is the most burdensome regulations are from tax.

Most small businesses are honest and want to pay their liabilities correctly. The system is very complex, and many small businesses are never sure precisely how much they owe. This is further complicated by the fact the tax periods and payment dates are some months after they receive incomes – unifying this through the basis reform would add a lot of certainty to small businesses when filing their taxes.

FSB agree that the basis period reform as outlined in this consultation would reduce the complexity of tax liabilities for those businesses that do have alternative tax years. The five-year transition is also good to see included as it will reduce the immediate burden on small businesses that do need to transition, easing their cashflows and allowing the transition to be less disruptive to their business welfare. However, this transitionary period should be expanded for indebted small businesses. From FSB's research, it was found that 60% of small businesses have some form of debt. Of this, 47% view their debt as unmanageable. Given the support provided by policies like Pay As You Grow that alleviate the debt burden brought on by the COVID crisis, it would be good to see the transition take account of this too. The government should explore an extension to the five years for small businesses that have made use of Pay As You Grow such that the transition does not place undue financial stress on the small businesses.

Question 2:

Will the proposed tax year basis have an effect on how businesses choose their accounting date, and whether they choose 31 March or 5 April?

We believe that most small businesses will opt for 31 March as opposed to 5 April as it is much easier to work with a month end.

Question 3:

For businesses with a non-tax year accounting date, what would be the cost of the additional administrative burden of apportioning profits into tax years? Are there any simpler alternative approaches to apportionment?

Small businesses already spend a significant amount of time and money filing taxes each year. In FSB's 2021 tax survey, it was found that the average small business spends 52 hours a year filing tax at a cost of £4,100. Notably, 35% of all small businesses spend more than 70 hours a year and 10% more than £10,000. Adding to this significant burden in any form would be highly detrimental to small businesses. Unlike larger organisations, small businesses do not have dedicated tax teams and so resources spent on tax filing are resources not being spent on business development. These are resources that could be better spent on productive business activities rather than tax administration.

Note that for a 31 January year-end, for example, two months of apportionable profits would have to be extracted from the next year's accounts, which will not have been finalised. HMRC's suggestion of estimating profits and revising at a later would involve more work and cost. We suggest that, given the variability in SME profits, tax should be based on a rolling average of actual profits over, say, a three-year period

Question 4a:

Businesses with accounting dates later in the tax year will have to estimate profits for a proportion of the tax year, before accounts are prepared. For which accounting dates do you think this would be necessary? Do you expect that businesses that have accounting dates earlier in the tax year than 30 September will have to estimate profits? If so, which types of business would be affected?

SME turnover and profits are volatile with 3 out of 4 saying that their financial security fluctuates. Estimating profits would be difficult, involve administrative costs and would dampen investment as SMEs would need to carry higher working capital if they are taxed on estimated profits that do not materialise. To account for the fluctuation in turnover and profits, small businesses should be taxed on a rolling average of actual profits. This would ease financial planning and aid investment.

Question 4b:

Will estimation be a significant burden for those businesses affected, and what will the cost be? Are there any simpler alternative methods of estimating profit or finalising estimates, which could mitigate any extra administrative burden?

From FSB’s 2021 Tax Survey, it was found that 72% of small businesses struggle to accurately forecast what their yearly earnings will be – asking firms to accurately estimate their profits for tax is likely going to incur a significant error margin which will add another administrative step to correct. As it stands, small businesses already spend 52 hours per year on tax compliance, equating to a cost of approximately £4,100. The government should seek to minimise these costs as far as possible, and it is unlikely that asking small businesses to estimate a portion of their in-year earnings will result in that.

A three-year rolling average taxable income scheme would add a lot of certainty to small businesses and reduce the volatility between quarters and years. Estimating year end taxable profit would be simpler and less burdensome than asking for a single year estimate which could be affected by volatility. This would also go a long way to secure small businesses’ finances; our research found that 75% agreed that their financial security fluctuates.

Question 5:

Would the proposed equivalence of 31 March to 5 April help businesses that would have to make apportionments to work out their profit or loss under the tax year basis? Would extending this equivalence to property income help property businesses, which would otherwise have to apportion profit or loss each year? Are there any problems with this equivalence proposal?

The offer to accept 31/3 as being co-terminus with 5/4 would be welcome as it is easier to work to a month end.

Question 6:

Are there any specific issues, costs, or benefits to the tax year basis for partners in trading partnerships?

Filtering FSB's tax survey for businesses that identify as partnerships, 71% state that their financial security fluctuates and 69% struggle to accurately forecast their earnings for the year. Similarly, 62% state that the number of taxes is too confusing and 59% agreed that the current system for paying tax is too complex. However, despite this, 76% agreed that as a business they were fully aware of what taxes they owed and when they needed to be paid.

In terms of resources spent on tax compliance, partnership-based businesses on average spend 54 hours a year on tax compliance (2 more than the average small business). However, their cost to complete their filings is somewhat lower at an average of £3,677 compared to £4,100. Note, this is still a significant cost to the businesses to simply just comply with their taxes and their time spent could be hours spent more productively in terms of business development.

One benefit of the current tax year basis that cannot be overlooked is that businesses will be accustomed to it. Many businesses have organised their cashflows to coincide with their tax liabilities. Changing this may have the effect of forcing businesses to re-establish their cashflow cycles and could be disruptive to their business as a whole; there needs to be assurance that the new basis would actually be beneficial rather than making businesses change their processes for the sake of it. Likewise, this transition should be considered in the wider context. Businesses are only now recovering from the economic crisis caused by COVID-19, any disruption to this recovery will harm small businesses.

Question 7:

Are there any other issues and interactions to consider for the tax year basis, or the transition, in the areas of tax outlined in paragraph 3.33?

Section 4. Implementation and transition

Question 8a:

Experts in Business

Does the proposed method of transitioning to the tax year basis using a long basis period combined with allowing all unused overlap relief achieve the best balance between simplicity and fairness? If not, is there a better option for transition?

Small businesses do not typically have dedicated tax teams and most interactions with tax are conducted by the business owners. As such, the longer the transition periods can be, the more time it gives the business owners to adjust to the new processes and prepare for the transition itself. A long transition period that allows for excess profits in the transition year to be spread over a five-year period will reduce the financial stress placed onto businesses that do have to shift their basis period. Many small businesses will be paying off COVID debts such as BBLS or CBILS at the same time as this if implemented and so avoiding any additional financial burdens should be a priority.

It is worth noting that small businesses will be very reliant on the expertise of agents such as accountants to oversee any changes to Overlap Relief which will undoubtedly incur a cost. With any structural changes, the cost to small businesses should be minimised as far as possible.

Question 8b:

Are there any other specific circumstances on transition to the tax year basis that would require additional rules?

Question 9a:

Would the proposals for spreading excess profit mitigate the impact of transition without affecting the simplification of moving to the tax year basis? If not, are there any other ways of mitigating the transition impact that you would suggest?

Yes, the proposal to spread profits that arise in the transition year across the subsequent five years relieves the pressure of the small businesses having to effectively pay multiple years' worth of tax in a single tax year. Given small businesses are often cash strapped, without this measure the transition would be very costly and potentially detrimental to their businesses' welfare. This is especially true while businesses begin recovering from the COVID pandemic and pay back the emergency loans they took out.

Question 9b:

Would the proposal to spread excess transitional profits over five years be enough to resolve the cash flow impacts of the proposed reform? Are there any situations which would need additional rules or anti-avoidance provisions?

Given the significant levels of debt many small businesses have taken on over the past two years, some additional consideration could be beneficial for indebted firms. Our research shows that 60% of all small businesses have some form of debt. Of these small businesses, 37% consider their level of debt unmanageable. Given repayments of BBLS, CBILS and deferred VAT have begun, any additional cost burdens will have a significant impact on the cashflow of these small businesses. A five year spread for excess profits during the transitional year would likely be enough for small businesses not facing large debt repayments, but extra consideration through an extension of repayments for the indebted businesses would aid their welfare significantly.

Question 10:

Are there any other impacts, benefits, or costs in the core policy, transition, or mitigation proposals that we have not considered above?

Section 5. Assessment of impacts

Question 11:

Please tell us if you think there are any other specific impacts on other groups or businesses that we have not considered above.

We trust that you will find our comments helpful and that they will be taken into consideration.

Yours sincerely,

Tony Baron, Tax and Finance Chair

Federation of Small Businesses