A DUTY TO REFORM

MAKING TAX WORK FOR SMALL BUSINESSES IN A DIGITAL WORLD

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Experts in Business

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ABOUT FSB

The Federation of Small Businesses (FSB) is the UK's leading business organisation. Established 47 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. Our mission is to help smaller businesses achieve their ambitions.

As experts in business, we offer our members a wide range of vital business services, including legal advice, financial expertise, access to finance, support, and a powerful voice in Government. FSB is the UK's leading business campaigner, focused on delivering change which supports smaller businesses to grow and succeed.

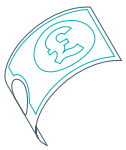
Our lobbying arm starts with the work of our team in Westminster, which focuses on UK and England policy issues. Further to this, our expert teams in Glasgow, Cardiff and Belfast work with Governments, elected members and decision-makers in Scotland, Wales and Northern Ireland.

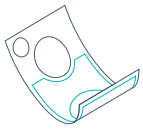
DUTY TO REFORM

MAKING TAX WORK FOR SMALL BUSINESSES IN A DIGITAL WORLD

£25 billion

Annual cost of tax compliance to the small business community





£4,562

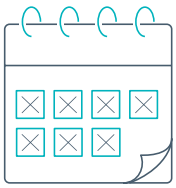
Average annual cost to businesses that have switched to **Making Tax Digital**

£2,690

Average annual cost to those yet to make Making Tax Digital switch

1.4 million

small businesses view the **Value Added Tax (VAT)** threshold as a **barrier to growth**



7 working days

Average annual time spent on **tax compliance** each year by a small firm

Only 4%

of small businesses recognise the Government's new **Super Deduction** as a top incentive to **invest & expand**

Challenges managing the system

63%

say the **number of taxes** is **too confusing**

72%

struggle to accurately forecast their earnings for the year

75%

say their **financial security fluctuates**

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FOREWORD

The UK Government has embarked upon a Tax Administration Framework Review with the aim 'to design a trusted, modern tax administration system that is simpler, easier to navigate and more responsive to taxpayers' needs. In order to inform its response to HMRC's call for evidence, FSB has commissioned a comprehensive, in-depth survey of members' experiences of the tax system.

The survey clearly shows that the current tax system, with its plethora of taxes, reliefs, and thresholds, is too complex, expensive in time and money to comply with, a substantial barrier to growth, and inherently unfair for SMEs. Small businesses do not have the dedicated tax teams and specialist knowledge available to large corporates and consequently they miss out on many reliefs. SMEs face a disproportionate compliance burden relative to turnover.

FSB welcomes the move to reform the tax administration system. The current system is based on the Taxes Management Act 1970 with half a century of subsequent incremental adjustments. It is not fit for purpose in a digital age. The introduction of Making Tax Digital (MTD) was supposed to alleviate many of the issues arising from the hyper-complexity of the tax system, easing tax compliance, increasing efficiency, and aiding cashflow planning for businesses. Yet, just over two years since its initial introduction, small businesses are complaining that MTD has done little to smooth the tax administrative process but has significantly increased their costs of compliance.

In order to be trusted, any new system must not only be fair in design; it must also be fair in operation. With a large majority of taxpayers' complaints reportedly upheld, especially those concerning automatic, computer-generated charges, the burden of checking liabilities wastes time and resources that could be used to grow businesses. The tax system needs to be fully transparent. Small businesses are now required to use approved software to report to HMRC. For many, the software subscriptions have added significantly to their compliance costs. There is genuine concern that these software subscription costs will continue to increase as MTD spreads across the different taxes. MTD is a major reform step that will require continual adjustments. We urge HMRC to ensure that its MTD framework is developed to alert small businesses to available reliefs.

A fundamental principle of good taxation is that it should be neutral in its impact on economic decisions, except where deliberately designed for a public-good end, as with the sugar tax. The current system erects significant barriers to growth. Most notably, the current VAT threshold is a major constraint on business growth with many businesses deliberately restricting their turnover to below £85,000. The costs associated with employing people also hinder business expansion.

FSB acknowledges that the Government needs to restore public finances following the sharp rise in public sector debt resulting from the pandemic. We support measures that would reduce the tax gap – all taxpayers should pay the right amount due and MTD should help with this. However, we note that the recent introduction of a Health and Social Welfare Levy adds to the complexity of the tax system and is a tax on jobs, which will impede business growth.

The best way for the Government to bring down the budget deficit, is to encourage economic growth, thereby raising tax revenue. The recommendations put forward in this report are designed to help ensure that the tax system is supportive, not destructive, of growth in the vital small business sector.

Tony Baron,
Tax and Finance Chair, Federation of Small Businesses.

EXECUTIVE SUMMARY

The tax system

The UK's tax system has been built up through decades of incremental changes, creating the very complex system businesses face today. This complexity has led to many small businesses feeling somewhat disenfranchised by the tax system. Given its complexity, larger organisations that have dedicated tax teams are in a much better position than small business owners who have to spend significant resources to pay their liabilities and comply each year. Reform is needed and Making Tax Digital has the potential to rectify some of these issues.

All changes to the tax system need to consider the primary principles of taxation to ensure that the system is fit for purpose:

- **Fairness**: each business should pay its fair share of taxes, and the rates paid should be similar to those conducting comparable activities. Equally, businesses should be receiving any reliefs they are entitled to.
- **Adequacy**: the tax collected by government should be enough to cover government expenses on public services.
- **Simplicity**: each taxpayer should have a clear understanding of the tax system, the taxes they need to pay, when their liabilities are due, and how much is due.
- **Transparency**: taxpayers should have an understanding of how their tax payments are being used.
- **Administrative ease**: the payment of tax liabilities should be a simple process that is not burdensome to either the taxpayer or the tax collector.

The Government should also keep neutrality in mind when proposing any tax changes, to minimise any potential harmful effects on the UK economy. VAT is a good example of a harmful, non-neutral tax; many small businesses deliberately slow down their activities so as not to pass the £85,000 threshold and become liable. This therefore supresses economic activity within the economy. There are occasions where non-neutral taxation can be appropriate, for example when policy outcomes rely on using taxation as a tool, such as the possibility of green taxes to reduce carbon emissions. Where taxes are not neutral, this should be due to a conscious policy choice to influence behaviour, rather than an unintended consequence.

The small business tax sphere

Small businesses often have difficulty estimating and organising their finances throughout the year. Although the vast majority are aware of what they owe and when (80%), a significant proportion struggle to accurately forecast their earnings for the year (72%). It is equally worrying that many small businesses do not save adequately; only 49 per cent of small business owners manage to save from earnings each month, and 42 per cent do not pay into a pension account each month.

Small businesses primarily pay liabilities on Personal Income Tax, PAYE for employees, VAT, Employers' National Insurance Contributions, and Corporation Tax. Tax compliance is a significant undertaking for small businesses, both in terms of time and cost. The average small business spends 52 hours a year completing their liabilities at a cost of £4,100. These are significant funds and time that could be better spent on more productive business activities, such as marketing and development, if the tax system was streamlined and simplified.

Particularly challenging is that awareness around tax reliefs is limited amongst the small business community. The average small business is only aware of five potential tax reliefs and the significant majority rely on their accountants for this information (82%). The relief small businesses are most aware of is the small business rates relief (64%), followed by capital allowances (55%) and pension tax relief (52%). For reliefs that involved investment (R&D credits, capital allowances etc.), small businesses tend to apply through third parties which comes at a significant cost. This means that small businesses are not fully making use of the reliefs they are entitled to, and those that are may be losing a significant share of the savings through third party fees.

Making Tax Digital

Making Tax Digital was introduced to improve the efficiency of tax compliance, ease cashflow management, and create certainty in liabilities. The uptake has been significant so far, with 70 per cent of all small businesses already using it; 60 per cent as a result of having a turnover greater than the VAT-taxable threshold, and 11 per cent from voluntarily switching.[1]

However, despite a significant share of small businesses using Making Tax Digital, concerns remain. The largest issue small businesses are concerned about with respect to Making Tax Digital is the significant cost increase. Small businesses that file through Making Tax Digital have an average cost of compliance of £4,562 per annum. Those yet to switch have an average of £2,690 – 1.7 times less. The issue doesn't end there: small businesses are genuinely concerned that once they switch to Making Tax Digital-compliant software subscriptions, they will be trapped by software providers, and are fearful that there are no checks in place that prevent software companies increasing prices in a rent-seeking way once Making Tax Digital is mandatory for all businesses.

Small businesses that have switched to Making Tax Digital also tend to disagree that it has reduced the complexity in the tax system (35%), made cashflows easier to manage (33%) and improved efficiency i.e., time spent on compliance (34%). The perception of those yet to switch is worse than those that have, suggesting that these businesses are potentially overestimating the issues with Making Tax Digital. However, despite this, Making Tax Digital has not been as innovative as it was intended to be; businesses are still struggling with the time and cost taken to comply with taxation and there have been few gains with reducing complexity and easing cashflows.

1 Figures may not sum due to rounding.

KEY FINDINGS

The small business tax sphere

- Small business owners often have financial insecurities:
  - 75 per cent report that their financial security fluctuates, and 72 per cent struggle to accurately forecast their earnings for the year.
  - Only 49 per cent of small business owners manage to save enough money from their earnings, and 42 per cent do not contribute to a pension scheme each month.
- Small business owners find compliance with the tax system costly, time-consuming, and very complicated:
  - On average, 63 per cent of small business owners agreed that the number of different taxes is too confusing.
  - The average small business spends 52 hours complying with tax per annum at a cost of £4,100. This is equivalent to £25 billion spent by all small businesses in the UK each year.
  - The VAT threshold acts as an artificial barrier to growth for 24 per cent of all small businesses and supresses economic activity.

Tax reliefs

- There is a systemic under-awareness of reliefs available for small businesses:
  - The average small business owner is only aware of five potential tax reliefs they may be eligible for.
  - Small Business Rate relief was the most well-known (64%) followed by Capital Allowances (55%). However, only 25 per cent of small businesses are aware of the Small Employer's Relief.
  - Small businesses overwhelmingly go to their accountants for advice on tax reliefs (82%) followed by searching Government websites (35%).
- Small businesses reported that cuts to taxation would be the approach most likely to incentivise them to invest and expand their businesses:
  - A cut in Corporation Tax was ranked in small businesses' top three approaches by 44 per cent, followed by a cut to National Insurance contributions (34%), and a cut to dividend tax (32%).
  - The Government's new Super Deductions Scheme was only top rated by 4 per cent of small businesses.
  - 13 per cent of small businesses do not wish to expand their business at all.

Making Tax Digital

- Making Tax Digital has been utilised by a significant share of small businesses:
  - 70 per cent of all small businesses have switched to Making Tax Digital; 60 per cent through necessity as their turnover was greater than the VAT threshold, 11 per cent voluntarily.[2]
  - 71 per cent of small businesses in England have switched, 65 per cent in Scotland, and 71 per cent in Wales.
  - Only 56 per cent of small businesses with no employees have switched compared to 76 per cent with businesses with employees.
- Small businesses have significant concerns about Making Tax Digital:
  - 71 per cent of small businesses agree that Making Tax Digital brings with it additional costs through new software, subscriptions, and time spent learning the new processes.
  - Cost of compliance is significantly higher for small businesses that have switched to Making Tax Digital, at £4,562 per annum compared to £2,960 for those yet to switch.
  - Only 25 per cent of small businesses agree that Making Tax Digital has reduced complexity in the tax system.
  - Only 22 per cent agree that Making Tax Digital software has made it easier to organise their businesses' cashflows.

2 Figures may not sum due to rounding.

RECOMMENDATIONS

- **The basic VAT taxable turnover threshold should be raised from £85,000 to £100,000 to encourage suppressed economic activity. VAT payments should also be smoothed, as suggested by the Office of Tax Simplification (OTS), to minimise the immediate VAT liability businesses receive once passing the threshold. HMRC should also retain its central focus on ensuring that Making Tax Digital for VAT alleviates the administrative burden of paying liabilities**

The VAT threshold at its current level acts as an artificial barrier to growth for 24 per cent of small businesses. Small businesses have explained that they have taken measures to reduce their economic activity to ensure that they do not cross this threshold and become liable to pay the tax. This tax threshold is therefore supressing genuine economic development in the economy. A higher threshold level could unlock this pent-up activity and bolster the economy, especially in light of the COVID economic crisis. Likewise, a stepped rate increase in the form of a smoothing mechanism, as suggested by the OTS, also ensures that businesses are not faced with a significant liability once the single threshold is reached. By raising the top threshold to £100,000 and including a smoothing mechanism, HMRC will encourage growth while also raising revenues.

- **Given the significant burden of tax compliance for small businesses, the Government should not exclude tax administration costs from regulatory oversight, and should ensure that any changes in regulation policy do not add to the burden already faced**

Taxation is the second most burdensome form of regulation that small businesses have to comply with. However, the Regulatory Policy Committee (RPC) excludes any impact assessments that relate to tax or spending decisions while still stating that its role is to ensure the Government has minimised the regulatory burdens on small and micro businesses. This is a significant inconsistency. We urge the Government to expand the scope of the RPC to include taxation, such that the large regulatory burdens of and changes to taxation are regularly assessed for their impacts in line with other regulatory changes. The exclusion of the regulatory burden of taxation undermines the whole process of reducing the regulatory burden small businesses face.

- **The Government should introduce a system whereby the self-employed can smooth their income tax liabilities over a three-year rolling average through the availability of tax credits**

Three quarters of small businesses struggle to accurately forecast their earnings each year, and state that their financial security fluctuates. The Government could alleviate many concerns around income through introducing a three-year rolling average taxable income scheme for the self-employed. This would limit small businesses' exposure to shocks to their income, as they would be able to offset losses on the previous two year's gains. Looking backwards, where a year's income exceeds the three-year average, that effective overpayment could be considered a tax credit towards liabilities in years where income is below average, thus smoothing overall liabilities.

- **The Government should expand reliefs on investment to ensure that businesses are no longer deterred from investing more in the economy**

Small businesses would be more likely to engage in investment and R&D if they knew they could write off losses at a similar rate at which gains are taxed, producing a more symmetrical and equal system. The ability to write off losses means that investments that do not yield expected results may not be as devastating to a business as they may otherwise be. Overall, more investment in the economy is the Government's ambition and this would significantly encourage small businesses.

- **The Government should reform the Super Deductions investment incentive**

There is insufficient clarity available to small businesses as to the scope of the super deduction, particularly it's applicability to intangible investments. A tax incentive that is too opaque will not work as intended if it is not readily understood by the population it is meant to influence.

Moreover, only four per cent of small businesses rated it in their top three incentives, which shows it is of very limited use to small businesses. This is despite the fact that this incentive was projected in Budget 2021 to cost the exchequer over £12bn a year. Given the recent increases that have been announced to National Insurance Contributions – a tax on jobs which will hit small businesses hard – we believe it would have been more appropriate to reduce the cost of the super-deduction.

- **The Government should promote greater awareness of the tax reliefs available to small businesses, both externally and through Making Tax Digital software**

Small businesses have limited awareness of the available tax reliefs they may be eligible for, which means they pay their fair share of taxes, but don't get their fair share of reliefs. Small businesses are on average only aware of five reliefs – a very small number considering the wide variety available. Fixing the gap in knowledge around reliefs would go a long way towards restoring more faith that the tax system is fair towards small businesses; they pay their liabilities and thus should receive their fair share of reliefs. The Government ought to do more to publicise available reliefs for small businesses such that their use is maximised, addressing the fairness issue within the tax system. We urge the Government to create a system within the Making Tax Digital software that utilises the information provided by businesses to create nudges around potential reliefs they could apply for. Importantly, this should be a free feature of all Making Tax Digital software and not a paid-for add-on.

- **The Government should commit to ensuring that the software providers of MTD do not increase prices in a rent-seeking manner**

Making Tax Digital has already created a significant cost burden to small businesses that have adopted it. There is genuine worry amongst small businesses that this cost will only increase as they become more dependent on Making Tax Digital-compatible software for returns. We urge the Government to commit to ensuring a competitive market exists within MTD-software such that rent-seeking behaviour is minimised, and prices remain competitive.

- **The Government must provide a free online tool for Making Tax Digital to ensure that small businesses have the choice not to be burdened by additional costs to file their taxes**

The cost burden of tax filing is already significant to small businesses, and Making Tax Digital has not eased this situation. For the complete rollout, a free online tool should be made available so that the smallest of businesses do not need to acquire costly subscriptions for tax administration services they may not fully utilise.

- **HMRC must work with software providers to ensure that the Making Tax Digital software does streamline, simplify, and create greater efficiencies in tax compliance, and ensure that Making Tax Digital actually provides additional value**

Making Tax Digital is viewed by small businesses as relatively burdensome – 71 per cent agree it has increased the cost of tax compliance through new software, subscriptions, and time spent learning the new processes. However, MTD has done little to address the fundamental issues in the tax system; few agree that complexity has decreased and that cashflow management is easier. We urge the Government to continue to work towards these goals, and to address the issues of complexity and cashflow management through Making Tax Digital while keeping a small business focus. We would also like to see the OTS become more directly involved in the process, ensuring that the final MTD product does indeed simplify the complexities of the tax system.

- **The Government should increase the Employment Allowance to £5,000 for eligible small businesses to alleviate some of the job losses from the planned National Insurance contributions increase**

Employer National Insurance contributions act as a tax on jobs. The recently announced increase of 1.25 percentage points is going to have a detrimental effect on jobs throughout the UK and will disproportionately affect small businesses that will now face a greater employment cost bill. Over one million small businesses used the Employment Allowance in the last financial year, the vast majority of them being micro employers. The Government is funding its own departments at a cost of £1.8 billion so as to not reduce their spending power in light of the NICs increase. This should be extended to small businesses, alleviating employment cost pressures, aiding their post-pandemic recovery, and sustaining employment throughout the UK.

THE NEED FOR REFORM

The UK taxation system is widely recognised as being in need of reform and updating towards a system that is fit for the 21st century. Decades of incremental changes have left the tax system highly complex and difficult to navigate. Part of the reason for these incremental changes has been due to an evolving economy and the need for complex tax structures to properly account for all activities. However, even with this consideration, there is scope to simplify the process and ease the administrative burden placed on individuals and companies.

In addition to the complexity, the UK's tax structure is not suited to the behavioural and technological developments of the 21st century. Profit-shifting and base erosion is a growing issue as a result of large multinational online platforms. These are companies which do not necessarily need a permanent 'brick and mortar' residence to operate, but can shift their tax liabilities abroad, often to tax havens.[3] This has the impact of reducing the integrity and fairness of the tax system and creates a competitive advantage that domestic companies struggle to compete with.

The need for tax reform also stems from technological advances that are being made. Many taxes that the Government relies on now will become redundant over the next three decades en route to the Government's target of Net Zero by 2050. Fuel duties in the 2020-21 financial year amounted to just over £27.5 billion.[4] This is a tax that, in theory, will trend to zero over the next few decades as electric cars and alternative fuels become the norm due to the ban on new petrol and diesel cars from 2030. Likewise, tobacco duty accounted for £8.8 billion in the 2020-21 financial year[5] – this is another tax that one would expect to decline as the UK population's consumption of tobacco products decreases over time.

The tax system also needs to better incentivise entrepreneurial decisions. As it stands, gains from investments in the form of interest and returns are taxed relatively heavily; however, there is no relief for losses that takes account of the balance of risk. This asymmetrical treatment limits risk-taking activity and thus limits innovation, investment, and economic progress. As of 2019, the UK ranked 20th out of the 38 OECD countries with respect to spending on research and development (R&D) at only 1.8 per cent of GDP.[6] Israel by comparison ranked 1st with 4.9 per cent of GDP spent on R&D.

The Government also needs to update the tax system to better reflect the modern technological world. Digitalising the tax system, as has begun through Making Tax Digital, will allow for more complete information and timelier assessments when addressing emergencies, like the COVID-19 pandemic. If tax data is closer to real time, emergency funding and reliefs could be better targeted with a shorter delay in rolling out. This would help to future-proof the tax system against emergencies and major economic crises that could occur in the future. The digitalisation of the tax system offers a unique opportunity to cut the complexity many businesses face with their tax filing. Digitalising tax in a way that makes it clear what is owed, and when and what reliefs may be available, could streamline the entire process and should be a clear goal for the Government.

3 OECD, What is BEPS?, https://www.oecd.org/tax/beps/about/#:~:text=What%20is%20BEPS%3F,they%20suffer%20from%20BEPS%20disproportionately.
4 HMRC, HMRC tax receipts and National Insurance contributions for the UK, August 2021, https://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk
5 HMRC, HMRC tax receipts and National Insurance contributions for the UK, August 2021, https://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk
6 OECD, Gross domestic spending on R&D, 2021, https://data.oecd.org/rd/gross-domestic-spending-on-r-d.htm

THE AIMS OF TAXATION

The whole aim of taxation itself can vary depending on who is asked. In 2011, the Commons Treasury Select Committee stipulated that the primary purpose of taxation in the UK is to raise revenues to fund government activity,[7] i.e., revenue maximisation. That should imply that most taxes issued by HMRC are with the purpose of simply raising revenues. This is the conventional footing for governments as it ensures a reliable flow of receipts from which they can fund their expenditure programmes (filling the adequacy criteria of good tax).

However, as also mentioned within the 2011 Parliament document, different groups will have different goals when it comes to taxation. This can vary from using taxes as a way to redistribute wealth and pursue equality of incomes or using taxation to alter behaviours with a specific agenda in mind.

Although raising revenue is, of course, of vital importance to the Treasury, having a singular goal of revenue maximisation may not be the optimal stance to take. A more nuanced approach utilising different groups' viewpoints to utilise tax to change behaviour, while still ensuring that government expenditure is funded, is likely a more efficient approach.

Taxes like the Sugar Tax, introduced in April 2018, which introduced a 24p or 18p charge per litre depending on the sugar content of the drink, were not intended solely for a revenue purpose, but rather to incentivise soft drink companies to reformulate their products and thereby reduce sugar consumption.[8] Since the levy's introduction, the amount of sugar in soft drinks sold per person has fallen by 23 per cent.[9]

Given that population health and a reduction in obesity is a general goal for the Government, this is a clear example of a tax that succeeds in behavioural change but is not intended solely for revenue maximisation. If it were intended for revenue maximisation, the goal would not be a reformulation of drinks which would eventually make the tax obsolete.

This joint approach means that the Government can target specific areas that it deems need changing and can do this through behavioural taxations, while also maintaining a consistent flow of income for its expenditure plans. The joint, nuanced aims mean that the Government can be flexible regarding changes in the future.

A primary focus of HMRC, irrespective of taxation goals, is ensuring that tax owed is actually paid. The current tax gap – the difference between tax that should be paid and what is actually paid – stands at 5.3 per cent, equivalent to £35 billion.[10] Although this has fallen from 7.5 per cent in 2005, it still shows there is some way to go.

The UK Government has attempted to address some of the areas where there is tax leakage. One of the most pronounced areas is through base erosion and profit shifting by large multinational online companies. The Digital Services Tax, introduced in April 2020, aimed to tax the revenues of search engines, social media services and online marketplaces which derive value from UK users.[11] The focus of this tax is on revenues from sales, as opposed to Corporation Tax which focuses on profits. The reason for this is that profits can be skewed for companies operating in one country but claiming tax residence in another, thus minimising their tax liabilities in countries where they operate. Revenues cannot be as easily shifted through internal company accounting and offer a way to tax companies that utilise their complex multi-national structures.

However, as with all new taxes, there are unintended consequences. Amazon, a key target of the Digital Services Tax, announced that it would be passing on the new tax to its sellers through a fee hike, thus reducing the effectiveness of the tax itself, while burdening individuals and businesses selling through its platform. [12]

7 Parliament, The principles of tax policy, January 2011, https://publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/memo/taxpolicy/m38.htm

8 UK Government, Soft Drinks Industry Levy comes into effect, April 2018, https://www.gov.uk/government/news/soft-drinks-industry-levy-comes-into-effect

9 Full Fact, Spectator report on the effect of the sugar tax needs more context, January 2020, https://fullfact.org/health/sugar-tax-effect/#:~:text=For%20drinks%20affected%20by%20the,the%20limitations%20with%20this%20data.

10 UK Government, Tax gap remains low at 5.3%, September 2021, https://www.gov.uk/government/news/tax-gap-remains-low-at-53

11 UK Government, Digital Services Tax, March 2020, https://www.gov.uk/government/publications/introduction-of-the-digital-services-tax/digital-services-tax

12 CityAM, Amazon to pass on UK digital tax to sellers in fees hike, August 2020, https://www.cityam.com/amazon-to-pass-on-uk-digital-tax-to-sellers-in-fees-hike/

The OECD has created a framework on Base Erosion and Profit Shifting (BEPS), which includes 137 countries with the aim of creating a multilateral agreement on international taxation to combat multinational companies' profit shifting behaviour.[13] We would encourage the UK Government to continue working within this joint approach so that all companies pay their fair share of tax, irrespective of their tax residency. Unilateral responses to a multilateral issue are unlikely to produce effective outcomes.

13 OECD, International community renews commitment to address tax challenges from digitalisation of the economy, October 2020, https://www.cityam.com/amazon-to-pass-on-uk-digital-tax-to-sellers-in-fees-hike/

CHARACTERISTICS OF A GOOD TAX SYSTEM

There are five primary characteristics to strive for as laid out by the Oklahoma Policy Institute: fairness, adequacy, simplicity, transparency, and administrative ease.[14] These go slightly beyond what Adam Smith first laid out in his Tax Canons, which were certainty, equity, and convenience,[15] but the additional characteristics are useful benchmarks for a modern tax system.

The **fairness** of a tax system ensures that each individual or company pays their fair share of taxes. This should be done through both vertical and horizontal equity distributions. Vertical equity describes the way in which the tax burden is distributed along the socio-economic spectrum; those who earn more should be taxed more.[16] In the UK, PAYE is a progressive tax. This means that at each incremental tax bracket, the share of income taxed increases. Horizontal equity means that similarly-situated individuals are subject to similar tax burdens.[17] Horizontal equity ensures that everyone is treated by the tax system equally, i.e. two businesses selling the same type of goods are taxed in the same way.

The second characteristic is **adequacy**. This simply means that the tax collected by governments should be enough to cover expenses and demands on public services. If the tax system is not adequate, governments would be unable to operate sufficiently as their capabilities would be limited.

The next is **simplicity**; the tax system should avoid a maze of taxes, forms and filing requirements, so that taxpayers have a clear understanding of what taxes are owed, and when.[18] This is an area where the UK's tax system lacks; taxes are exceedingly complicated, differing by type of employment, entity, and income source. In addition to simplicity of understanding what taxes are owed, it should also be made clear to taxpayers what reliefs are available in a simple way.

The tax system should also be **transparent**. This refers both to taxpayers being able to understand how their taxes are being used, and how much tax they are actually paying. It also allows individuals to understand who is being taxed for what and how much – this is particularly important when it comes to corporate taxes. The less transparent a tax system, the more opportunity there is for large businesses to utilise tax loopholes to minimise their liability.[19] The fuel duty in the UK is an example of a less transparent tax as individuals are not generally aware of how much tax they are paying on the given price of a litre of petrol.

Finally, **administrative ease** means that a tax system should not be too complicated for either taxpayers or collectors. This builds on the simplicity characteristic, in that rules should be well-known, payment should be simple, and both individuals and the Government should know if taxes are paid on time. Ultimately the cost of tax collection should be very small compared to the receipts collected.[20]

Results from FSB's 2021 Tax Survey emphasise that small businesses do not view the current taxation system favourably, and that many of the characteristics of a good tax system are not being met. Figure 1 highlights that small businesses tend to view the tax system as too complex (53%), and that the number of different taxes is too confusing (63%), with 30 per cent and 24 per cent of respondents strongly agreeing respectively.

Favourably, 80 per cent of respondents reported that, despite the complexities, as a business they were fully aware of what taxes they owed, how much they owed, and when these liabilities needed to be paid.

14 Oklahoma Policy Institute, Characteristics of an Effective Tax System, https://okpolicy.org/resources/online-budget-guide/revenues/an-overview-of-our-tax-system/characteristics-of-an-effective-tax-system/#:~:text=A%20good%20tax%20system%20should,%2C%20transparency%2C%20and%20administrative%20ease

15 PwC, A tax system fit for the future, 2014, https://www.pwc.co.uk/tax/assets/a-tax-system-fit-for-the-future.pdf

16 Elkins, D, Horizontal Equity as a Principle of Tax Theory, 2006

17 Ibid.

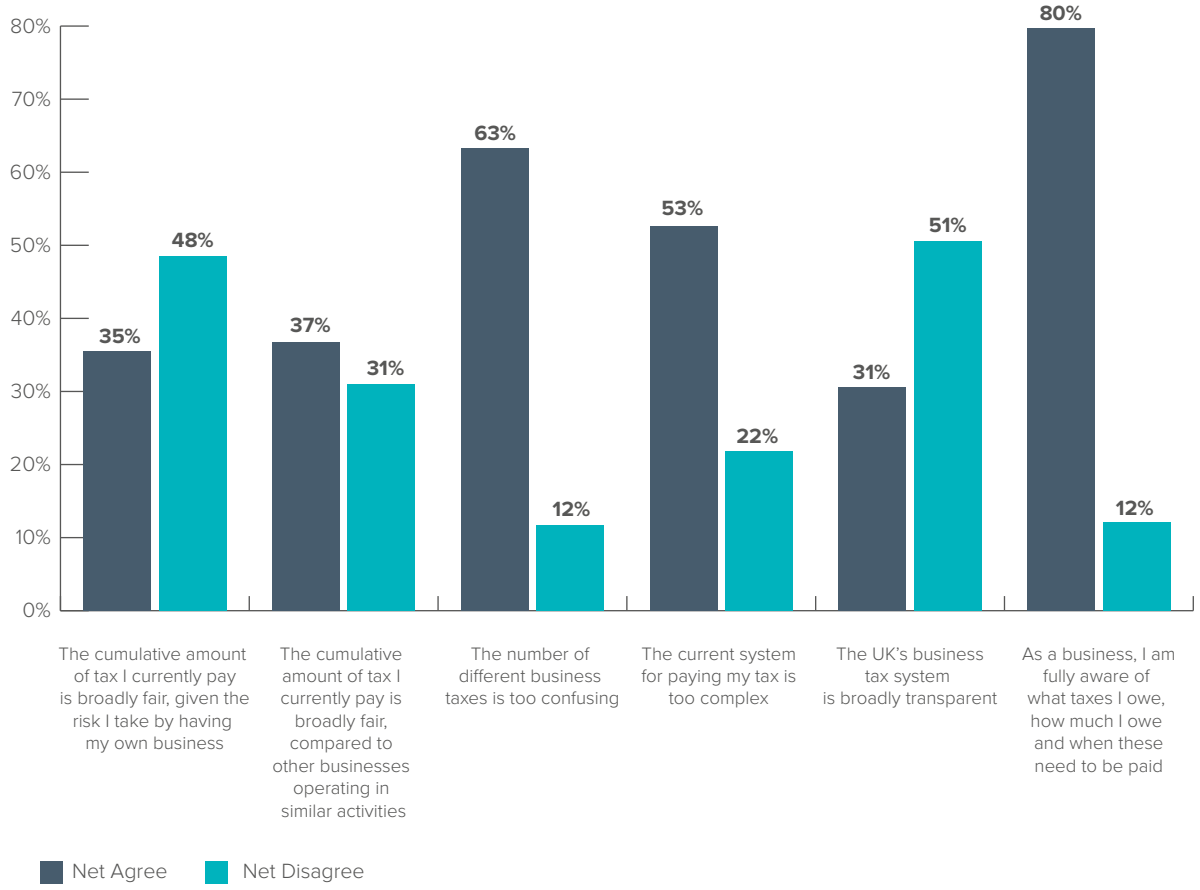
18 Oklahoma Policy Institute, Characteristics of an Effective Tax System, https://okpolicy.org/resources/online-budget-guide/revenues/an-overview-of-our-tax-system/characteristics-of-an-effective-tax-system/#:~:text=A%20good%20tax%20system%20should,%2C%20transparency%2C%20and%20administrative%20ease

19 European Commission, Combatting corporate tax avoidance: Commission presents Tax Transparency, 2015, https://ec.europa.eu/commission/presscorner/detail/et/MEMO_15_4609

20 Oklahoma Policy Institute, Characteristics of an Effective Tax System, https://okpolicy.org/resources/online-budget-guide/revenues/an-overview-of-our-tax-system/characteristics-of-an-effective-tax-system/#:~:text=A%20good%20tax%20system%20should,%2C%20transparency%2C%20and%20administrative%20ease

Figure 1: Small business views on the UK tax system under normal circumstances i.e., when not impacted by COVID-19

Source: FSB Tax Survey, 2021



The complexity of the tax system is a significant issue for small businesses, many of which are microbusinesses – 96 per cent of all businesses are microbusinesses.[21] Small businesses, given the nature of their size, cannot afford to have dedicated tax teams within their business like many large organisations. Similarly, business owners are often not well-versed in tax compliance procedures, all of which adds to the burden through having to spend time learning the processes. The system is stacked against small businesses in this regard; compliance is more difficult, and they face a large financial and time burden to ensure they complete their liabilities each year.

21 Ward, M, Business statistics – House of Commons Library Briefing Paper, January 2021 https://researchbriefings.files.parliament.uk/documents/SN06152/SN06152.pdf

The average small business spends 52 hours a year on tax compliance, equating to an average cost of £4,100 on tax compliance. Of those businesses that agreed or strongly agreed with the statement that the current system of paying tax is too complex, the time burden and cost of compliance increases. This is highlighted below in Figure 2.

Figure 2*:* Time and financial cost of tax compliance by small businesses in the UK

Source: FSB Tax Survey, 2021

	Cost of tax compliance per year	Share of business spending more than £10,000 per year	Hours taken to file taxes per year	Share of businesses spending more than 70 hours per year
Average small businesses	£4,100	10%	52	35%
Businesses that find the tax system too complex	£4,255	10%	56	41%

This tax compliance burden is disproportionate on small businesses. Given that most small businesses will not have a dedicated tax team, their compliance will be largely reliant on the business owner's time, reducing the capacity for productive activities in a given year. It is very significant that 35 per cent of small business owners will spend almost two working weeks on their tax liabilities, which only grows for businesses that find the system complex. It is worth noting that these time and financial burdens are faced despite 80 per cent of small businesses stating that they know which taxes they owe, how much, and when it's due.

A large and continuing issue for HMRC is that small businesses do not have a huge amount of faith in the tax system. The results showed that only 31 per cent of respondents agreed that the current tax system is broadly transparent; 51 per cent disagreed, with 24 per cent strongly disagreeing. Adding to this, 49 per cent of small businesses disagreed with the statement that the level of tax they pay is fair given the risk they take by owning their business.

Although many steps are being taken to address different elements of the standard characteristics, the tax system in the UK fundamentally needs reforming to sufficiently target each characteristic. New consultations and processes like Making Tax Digital[22] are steps towards addressing issues on administrative ease, simplicity, and transparency, and could benefit the entire economy if done well.

22 UK Government, Overview of Making Tax Digital, November 2020, https://www.gov.uk/government/publications/making-tax-digital/overview-of-making-tax-digital

TAX NEUTRALITY

Tax neutrality is often academically highlighted as a primary aim of any taxation system. It states that governments should aim to raise revenue without distorting the decisions that individuals or companies would make for purely economic reasons.[23] What this means is that if an individual or company would choose to purchase product A over product B due to preference, any tax placed on either product should not distort this preference. If a levy were placed on product A such that B became relatively cheaper and swayed purchasing decisions, that tax would not be neutral and would thus have some negative welfare effects as the preferred product is no longer purchased.

This is a very basic example of how tax can affect decisions and impact social welfare, but it can be taken further. Many large businesses will hire lawyers and dedicate time and effort to transforming their activities to reduce their tax liability.[24] This effort could otherwise be spent more optimally, which in theory could increase output and efficiency. It is likely that tax neutrality cannot be fully achieved as there will always be companies striving to minimise their liabilities. However, an optimal tax system would reduce the share of companies attempting this, producing a more socially optimal outcome overall.

A clear example of how the current tax system produces inefficient outcomes due to not being neutral is how the £85,000 VAT threshold affects businesses. The current regulation on VAT means that businesses must register once their VAT-taxable turnover passes this threshold.[25] FSB's research found that 24 per cent of small businesses agreed that the £85,000 VAT threshold presents a barrier to growth. With a UK small business population of just over 6 million, this is equivalent to 1.4 million small businesses suppressing growth due to an artificial barrier.

The threshold of £85,000 suppresses economic activity of businesses that would otherwise expand but do not want the additional administrative and liability burden. Raising this threshold would release some pent-up economic activity, bolstering the UK economy.

However, it is not only the threshold that presents a barrier; the act of paying the tax itself does, too. Crossing that threshold requires liabilities to be paid for VAT. As it stands, small businesses do not view the ease of paying tax favourably. Should the system for paying tax be streamlined, the artificial barrier, irrespective of the level it is set at, would become much less burdensome.

"For a small business, crossing the VAT threshold means we're suddenly accountable to significant VAT liabilities. It has prevented us from looking at expanding."

FSB Member, Hospitality, South Cumbria

Although it is important not to distort decisions and lower overall output, welfare, and efficiency, there is an argument to be made for a targeted tax system in special cases. Government policy agendas will always mean that some neutrality will be lost. The Sugar Tax is a prime example of this; the tax intended to change behaviours and thus was not neutral. However, the Government should strive for targeted tax policies which achieve policy agendas, but should also attempt to maintain neutrality as best it can to sustain overall efficiency and economic welfare.

The Government has announced its roadmap and ambition for Net Zero 2050, and given the importance of this overarching aim, it will be intertwined within all subsequent policy decisions, including tax. To achieve this aim, tax policies will need to be amended and introduced, even if only short-term ones, to incentivise certain behaviours. Our survey found that 45 per cent of small businesses agree that the tax system has an important role in disincentivising business activities that harm the natural environment.

Fuel duty, which is a non-neutral tax to begin with, will begin to decline as a result of the drive to implement environmental policies, leaving a substantial hole in the Treasury's pocket. It may be the case that to accelerate the take-up of electric vehicles, i.e., to incentivise behaviour, new carbon taxes will be introduced. These, of course, will not be neutral in nature as their purpose will be to alter consumption choices towards greener outcomes.

This highlights that although neutrality in a hypothetical sense appears to be the most sensible tax ambition, policy agendas reduce its viability. The tax structure as a whole should thus take neutrality into

23 Furman, J, The Concept of Neutrality in Tax Policy, 2008, https://www.brookings.edu/wp-content/uploads/2016/06/0415_tax-_neutrality_furman-1.pdf
24 Furman, J, The Concept of Neutrality in Tax Policy, 2008, https://www.brookings.edu/wp-content/uploads/2016/06/0415_tax-_neutrality_furman-1.pdf
25 UK Government, VAT registration, https://www.gov.uk/vat-registration/when-to-register

consideration when reforming, aiming to maximise welfare and minimise distortions, but should do so while targeting policy aims. Thus, neutrality should be thought of as a guideline of best practice within general tax policy rather than the definitive outcome.

Recommendations

- **The basic VAT taxable turnover threshold should be raised from £85,000 to £100,000 to encourage suppressed economic activity. VAT payments should also be smoothed, as suggested by the OTS, to minimise the immediate VAT liability businesses receive once passing the threshold. HMRC should also retain its central focus on ensuring that Making Tax Digital for VAT alleviates the administrative burden of paying liabilities**

Business decisions should not be influenced by the burden of taxation as taxes should aim to be as neutral as possible. The VAT threshold at £85,000 does not fulfil this, as 24 per cent of businesses – equivalent to 1.4 million small businesses – stated it was a barrier to their growth. The VAT threshold should be increased to £100,000, so that small businesses can grow without the overhang of additional tax compliance burdens. Allowing businesses to reach a higher turnover threshold before adding the extra tax administrative burden will likely mean that the business is in a stronger place to process the tax compliance procedures and bolster the economy more broadly. Moreover, unlocking this growth potential has ramifications for other taxes; as revenues increase and workforces expand, the revenues raised from Corporation Tax, personal income tax, PAYE, and NICs would logically increase too.

However, this would not alleviate the barrier entirely, just shift it to a higher level. As such, we propose that the Government should also adopt the Office of Tax Simplification's smoothing mechanism in addition to increasing the base threshold level. Under the smoothing mechanism, businesses would be liable to VAT bands once they cross the threshold, retaining a proportion of the VAT that would otherwise be paid to HMRC.[26] The example provided by the OTS would be a good approach, paying 70 per cent of VAT for the first £10,000 above the threshold, 80 per cent for the next £10,000, 90 per cent for the next £10,000 and then the full rate thereafter – we do agree that the exact banding would need to be explored to establish optimal rates.

Making Tax Digital also has the potential to further streamline this approach: the digitalised nature of the system should mean that calculating and paying liabilities is much more efficient than has previously been the case. This should remain a key and central focus of HMRC as Making Tax Digital expands, and more businesses begin filing their taxes through it. The smoother the system, the less the threshold appears as a barrier to growth which will inevitably spur on suppressed economic activity.

26 Office of Tax Simplification, Value added tax: routes to simplification, November 2017, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/657213/Value_added_tax_routes_to_simplification_web.pdf

TRANSITION PERIODS

Tax reforms are substantial undertakings that have large ramifications for individuals and businesses throughout the economy. They need to be well-thought-out and they need to improve upon the current situation.

Any changes to the tax process will be disruptive to businesses. This is especially true of small businesses who often do not have the legal and tax expertise in-house. The time taken for small businesses to adapt and implement changes is thus more costly when compared with what may be a relatively painless process for large firms. This needs to be considered given that small and medium-sized enterprises (SMEs) account for 99.9 per cent of all businesses.[27]

Reforming tax can be troubling for companies that are accustomed to the current processes. It is essential that if any reforms do take place, the period in which they are implemented occurs over a long enough transition period. Importantly, the more substantial the change in the system, the longer the transition should be.

There will be a significant administrative burden for companies when adapting to reformed tax policies. This will include a period of understanding what and how policies have changed, and how this will affect their own business. Adding to this, implementing the change itself will take time, and if the changes lead to new processes and systems, the time taken will grow as individuals have to become accustomed to new platforms.

This is amplified for small businesses. Larger firms often have designated tax teams which will take on the burden of reforming the businesses tax to comply. Small businesses, by their nature, do not have this luxury and owners and directors may have to sacrifice time spent on business activity itself to update their tax. This is especially burdensome following the pandemic and subsequent economic crisis; small businesses do not have the spare capacity to restart their businesses and implement radical changes to their tax frameworks.

New systems or processes may also result in new software or technical expertise which businesses need to access. This immediately creates an additional cost for firms which may need to be offset over an extended period. Small businesses often have cashflow issues and creating an additional cost that would add to this could be detrimental to their business welfare.

In addition to this, many companies have structured their cashflow cycles to follow the tax year and tax structure. If any shifts occur in this area, firms will have to significantly alter their business cycle to be able to comply with their tax liabilities. If a sudden change occurs of this nature, many businesses will not have the cash reserves to pay their liabilities, placing them under undue pressure. Although there may be benefits to increasing the volume of payments each financial year, this is an important area to consider as many businesses have seasonal revenue and thus may struggle with tax liabilities during off-season.

Hence, the more substantial the change of policy, the longer the transition needed. If the shift is significant, small business owners may struggle with adapting to the new tax system while efficiently running their business. Substantial changes in short periods of time will disproportionately affect small businesses and given the demographics of UK businesses, this will have negative connotations for the UK economy.

27 UK Government, Business population estimates for the UK and regions 2020: statistical release, October 2020, https://www.gov.uk/government/statistics/business-population-estimates-2020/business-population-estimates-for-the-uk-and-regions-2020-statistical-release-html

THE SMALL BUSINESS TAX SPHERE

Self-employment

Small businesses and the self-employed are the engine that has driven record levels of employment. Self-employment, start-ups, and small firms drive growth and keep markets competitive. The self-employed often face a detriment compared to employees on a range of crucial issues – in particular on family rights, the volatility of their income, access to government programmes, and treatment through both tax-funded spending on policies, such as pensions auto-enrolment, and private markets in areas such as insurance and mortgages. From the design of the benefits system – in particular the application of the Minimum Income Floor – and on social issues, the self-employed are too often treated as the poor relation. This needs to change.

The Global Entrepreneurship Monitor Global Report, 2020/21 found that 'the United Kingdom's Total early-stage Entrepreneurial Activity (TEA) rate fell from 9.3 per cent in 2019 to 7.8 per cent in 2020. Within the respondents involved in TEA, 49 per cent of UK early-stage entrepreneurs saw opportunities because of the pandemic, which represents the highest figure among European countries. Despite the challenges the pandemic has presented this highlights the entrepreneurial prowess within the UK, as the report states, 'this suggests a level of adaptability to the pandemic that is rare among peer economies.'[28]

While the UK's entrepreneurial spirit should be celebrated, we also need to discuss and find solutions for the challenges faced by the self-employed. The self-employed and small business owners are aware that they are foregoing certain protections by deciding to work for themselves, but there are certain areas of social policy where the Government should provide a baseline of provision for all workers, irrespective of their legal status. There are other areas of social protection where the next Government should look to increase its support for the self-employed, particularly around bringing the Maternity Allowance closer in line with Statutory Maternity Pay and exploring the feasibility of providing Statutory Paternity Pay and Statutory Adoption Pay to all eligible self-employed parents.

Self-employment is one of the most effective routes in moving people from inactivity into economic activity. To support those moving into self-employment from unemployment, the start-up period where the Minimum Income Floor is not applied should be increased from the current 12 months for a longer time period, on the basis that it normally takes three years for a business to get up and running and generate profit. Supporting people to move from unemployment into a meaningful and fulfilling career is not only creating economic activity but adding to social wellbeing.

Setting aside money each month to go towards a pension can be a significant challenge for many self-employed people, particularly those on low or fluctuating earnings. This problem is often compounded by the prevalence of late payments, which can bankrupt a self-employed person who completes their work on time and with reasonable care and skill. The self-employed are still waiting to see the Government introduce policies to improve pension saving for the self-employed.

Of course, there are limits to role of the state in providing direct spend to address the risks of the self-employed. This includes benefits like Statutory Sick Pay, the right to request flexible working, and the right to a minimum level of paid holiday. These are rights and benefits that arise as a result of a contract of employment. However, this does not mean that issues like income protection need to become entirely individualised risk.

Expectation of income is a central quandary of being self-employed. Unlike employees, the self-employed have no definite expectation of future income. One month could yield a substantial amount of income while the following month may result in little or no income. The Government should recognise this volatility in income when debating and deciding on policies for the self-employed.

28 Global Entrepreneurship Monitor, 2020/2021 Global Report, 2021, https://www.gemconsortium.org/report/gem-20202021-global-report

Financial security

The vast majority of small businesses face volatile incomes: 75 per cent of small businesses when surveyed reported that their financial security fluctuates – 38 per cent strongly agreed with the sentiment. Making the matter more difficult, 72 per cent of businesses agreed that they often struggle to accurately forecast what their earnings for the year would be. In essence, financial planning for small businesses is very difficult due to these two factors.

It is likely that the pandemic-related lockdowns over the past 18 months have added to this uncertainty, with many small businesses relying on national and local government support to survive. FSB research undertaken in 2020 found that 39 per cent of small business owners stated that better access to Universal Credit in times of need would have the greatest impact on their own self-employment during recovery. This rose for small business owners located in the East Midlands (41%), the South West (42%), and London (48%).

It is not that surprising, given the evidence on fluctuating incomes, that only 49 per cent of small businesses tend to save enough money from their earnings, and 42 per cent do not put money towards a pension account each month. Hence, small businesses are relatively insecure with respect to their financial stability.

"Running a business can be lonely and a test of endurance at times. I think HMRC often overlooks this."

FSB Member, Hospitality, South Cumbria

Small business owners operating within accommodation and food services had the highest share reporting that their financial security fluctuates, at 85 per cent. Small businesses in this sector also reported the lowest share of being able to save adequately from earnings each month, at only 25 per cent. This is likely influenced by the ongoing impacts of COVID-19 and the subsequent lockdowns imposed on this sector, but nonetheless highlights the vulnerability of businesses operating in this industry.

The introduction of the stamp duty holiday and extension benefited the mortgage industry during the pandemic. Obtaining and paying for a mortgage can be a challenge for the self-employed, due in large part to fluctuating and uncertain income. Accessing a mortgage in the first place can be problematic for self-employed people, as lenders require proof of regular earnings for loan repayments – something which those on fluctuating earnings struggle with – alongside company accounts, SA302s, or tax returns going back at least three years. While there are good reasons for this – not least to prevent unsecure lending of the type that occurred with now-banned self-certification mortgages – it can make it more difficult for the self-employed to get on the housing ladder. FSB research in 2020 found that 36 per cent of small business owners reported that improved access to mortgages would be of benefit.

Small business taxes

Small businesses in the UK on average are liable to pay five different taxes – the specific ones are dependent on the individual business. The larger the business, the more likely it is to be liable for a wider range of taxes. Businesses with no employees have on average four different taxes to pay. Businesses with 1 to 9 employees have five, and businesses with greater than 10 employees have, on average, six different taxes.

The amount a business spends on tax compliance also has a relationship with the number of taxes they, on average, pay. For businesses that pay nothing to comply with tax, they on average have three taxes to comply with. For businesses that spend up to £5,000 on tax compliance, they have five taxes, while businesses that spend more than £5,000 have on average six taxes. It is unsurprising that the more taxes a business pays, the more complex the compliance procedure is likely to be.

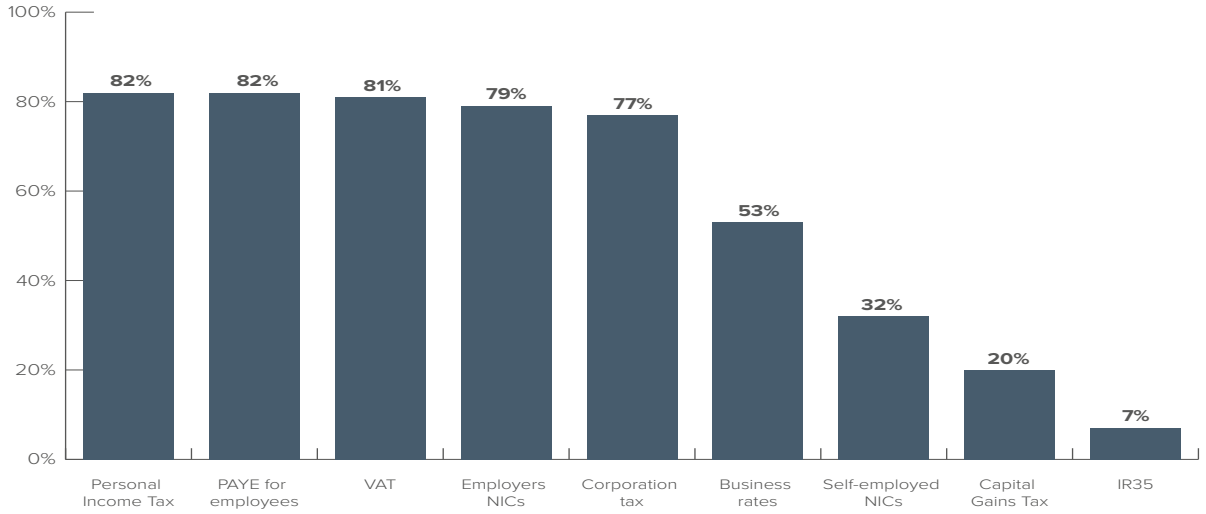
Figure 3 illustrates different taxes and the share of small businesses that reported that it was relevant to their business. There are five taxes that dominate the small business sphere: Personal Income Tax (82%), PAYE for Employees (82%), VAT (81%), Employers' NICs (79%) and Corporation Tax (77%).

"IR35 has added a layer of complexity and awkwardness to operating my business and the increased administrative burden means I have less capacity for marketing and business development."

FSB Member, Management Consultancy, Scotland

Figure 3: Selection of taxes relevant to small businesses

Source: FSB Tax Survey, 2021

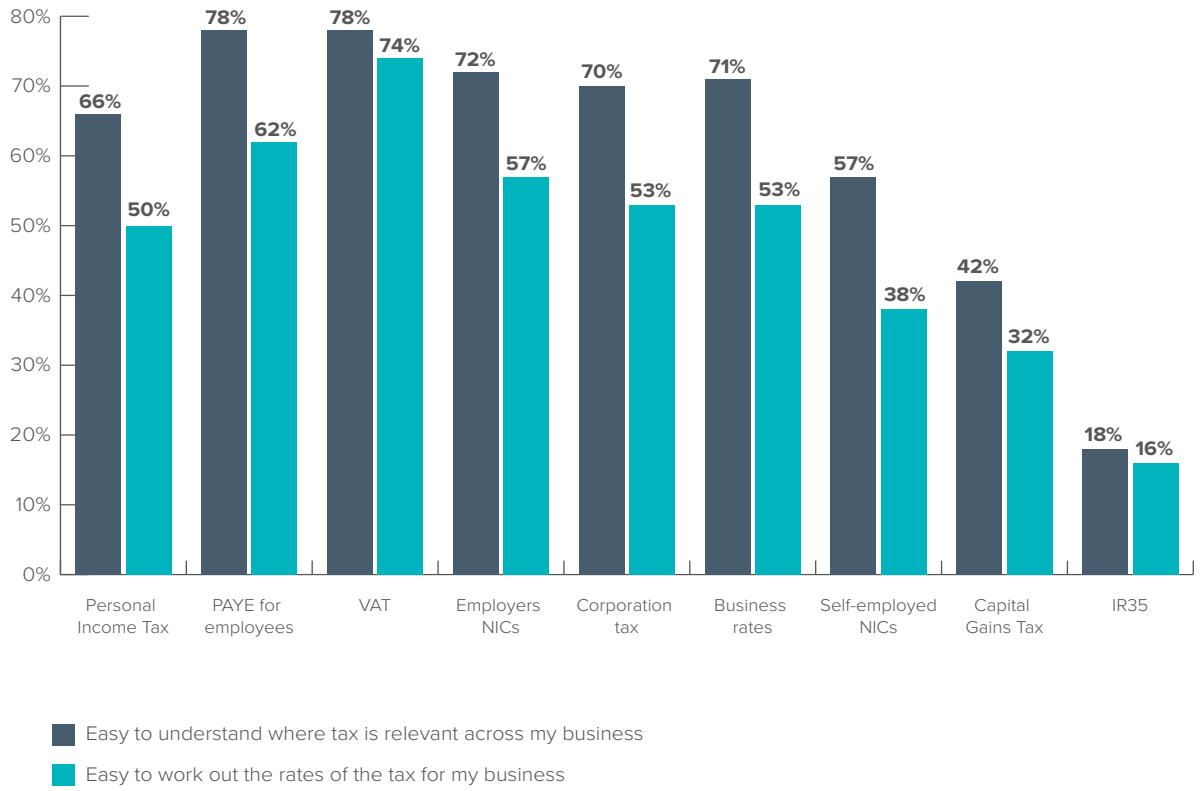


There also exists a discrepancy between a business understanding where a tax is relevant to its operations, and the ease of calculating the rate of said tax. Personal Income Tax, for example, saw 66 per cent of small businesses agree it was easy to understand where the tax was relevant, but only 50 per cent agreed that it was easy to work out the rate relevant for their business.

Some taxes are much more difficult to understand than others: IR35 is a notoriously difficult tax to understand, with only 18 per cent of small businesses stating they knew when and where the tax was relevant. The difficulty with IR35 also comes from the fact that the CEST tool, which is meant to make identifying if one falls into IR35 easy, does not work particularly well.

Figure 4: Small business ease of understanding each tax

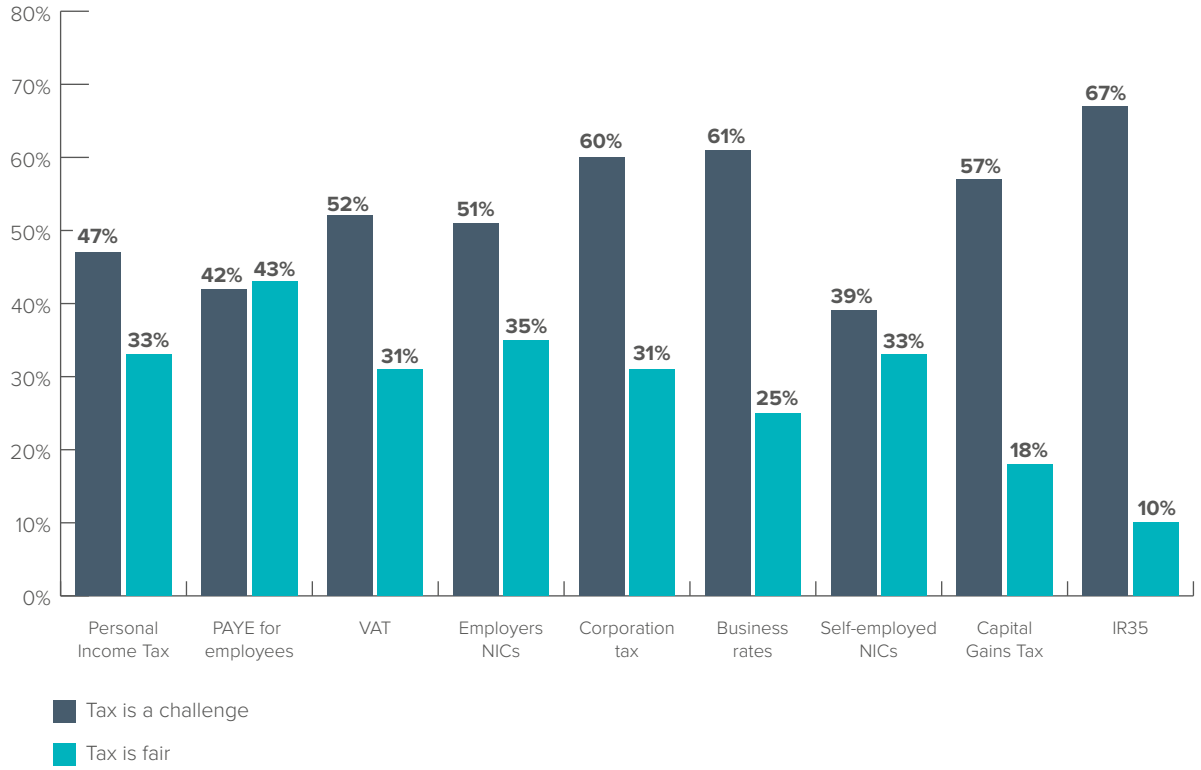
Source: FSB Tax Survey, 2021



Certain taxes exhibit a greater challenge to small businesses than others. As Figure 5 below shows, the rate at which IR35 is set is considered a challenge by 67 per cent of small businesses closely followed by Business Rates (61%), Corporation Tax (60%) and Capital Gains Tax (57%). The fairness of each tax appears to be an issue for most small businesses, too. The same taxes are also viewed as being set at an unfair level by a significant share of small businesses.

Figure 5: Small business views on whether the tax rate is a challenge and fair to their business

Source: FSB Tax Survey, 2021



These difficulties and complexities in the tax system creates a disproportionate burden of compliance for small businesses. Given that small businesses do not often have tax expertise or specialist tax teams like larger organisations do, compliance takes up time and resources that could otherwise be spent on productive activities if the tax system were made simpler.

The cost of compliance

The average small business spends 52 hours per annum on tax compliance, while 35 per cent of small businesses spend more than 70 hours. A third of all small businesses effectively spend two working weeks per year on tax compliance – time that could otherwise be spent on more productive activities. Of those small businesses that reported that the current system for paying tax is too complex, the average time spent on tax compliance is 56 hours, and 41 per cent of those businesses spend greater than 70 hours per annum.

"The administrative burden of paying tax means I have less capacity for the rest of my business such as marketing and business development."

FSB Member, Management Consultancy, Scotland

This time spent on tax translates to an average cost of £4,100 to small business to comply with their tax liability. There is significant variation in this cost between the nations. The cost to the average small business in Britain varies by nation – illustrated below in Figure 6.[29]

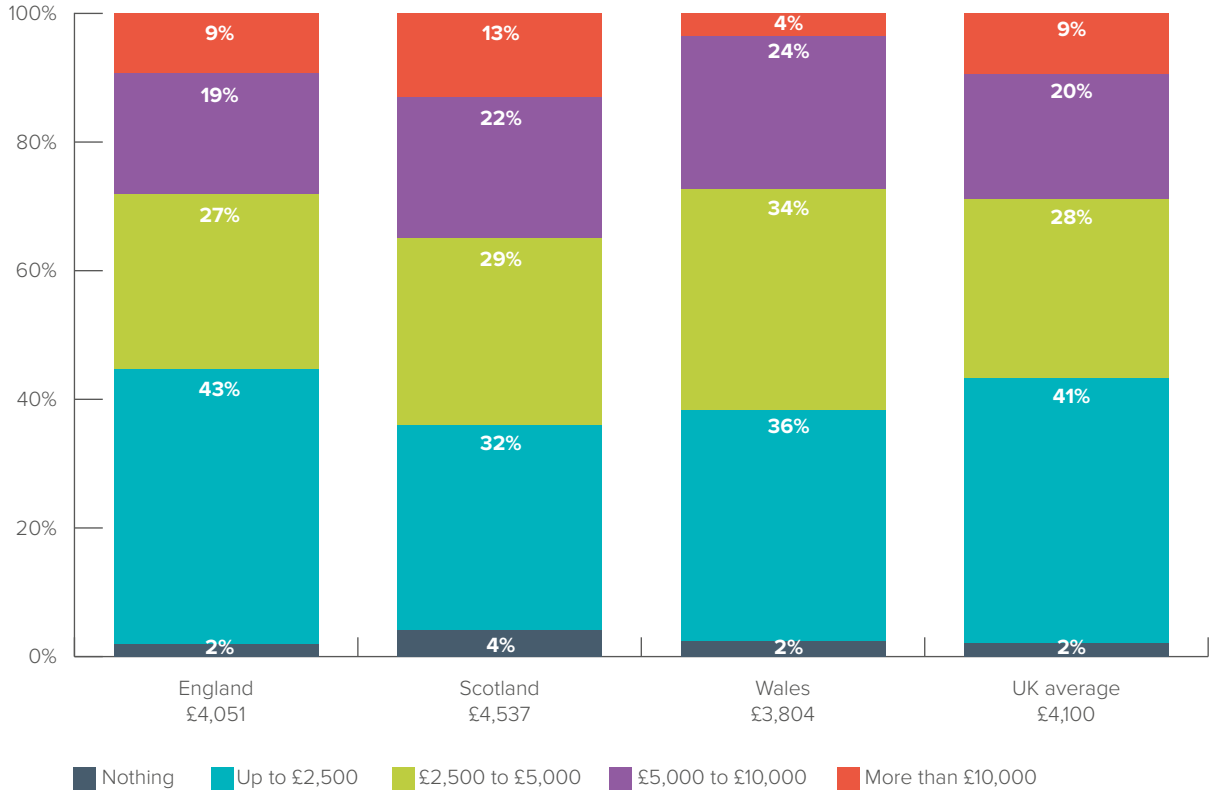
Figure 6: Cost of tax compliance for small businesses across Britain

Source: FSB Tax Survey, 2021

Nation	The average small business cost of tax compliance per year
England	£4,051
Scotland	£4,537
Wales	£3,804
UK average	£4,100

29 Northern Ireland has been excluded due to a low sampling base of 18.

Figure 7: The cost of tax compliance for the average small business by nation
Source: FSB Tax Survey, 2021



There are 6,070,575 SMEs in the UK, according to the Government's latest Business Population estimate in 2020.[30] Given that the average cost of compliance is £4,100, this means that on average, just under £25 billion is spent each year on tax compliance by the entire small business population in the UK. Not only that, given that small businesses spend on average 52 hours per year on compliance, the entire small business population spends 315 million hours on completing their tax liabilities each year. This is time and money that could be much better utilised for productive purposes.

30 UK Government, Business population estimates for the UK and regions 2020: statistical release, October 2020, https://www.gov.uk/government/statistics/business-population-estimates-2020/business-population-estimates-for-the-uk-and-regions-2020-statistical-release-html Note: sum of the number of businesses with fewer than 250 employees inclusive of businesses with no employees.

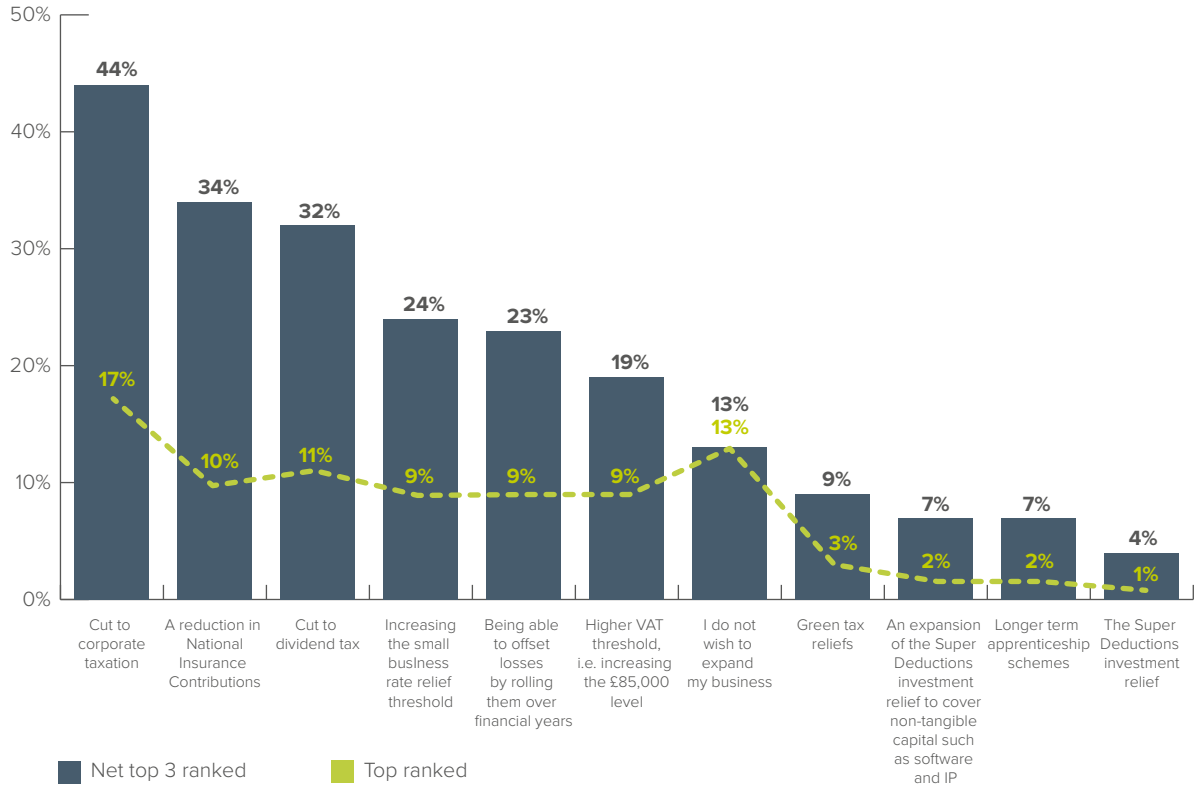
Incentives to invest

Investment and R&D are top agendas for the Government and are crucial to developing the economy while emerging from the economic crisis that has arisen from COVID-19. The Government has announced it is aiming for 2.4 per cent of GDP to be spent on UK research and development by 2027.[31] Achieving this aim will rely heavily on small businesses and, as such, incentives need to be given for businesses to invest and expand.

Figure 8 below illustrates what small businesses consider their top three ranked incentives which would encourage them to invest and expand their business. A cut to Corporation Tax ranks highest in both absolute terms and when aggregated as part of small businesses' top three picks.

Figure 8: Top incentives for small businesses to invest and expand their business

Source: FSB Tax Survey, 2021



The recent Super Deductions incentive ranks last out of the selection of incentives, with only 4 per cent of small businesses placing this within their top three incentives. The Super Deduction allows a business to claim 130 per cent of capital allowances for qualifying plant and machinery investments.[32] The issue is that the qualifying plant and machinery investment is limited in scope and is more directed towards larger businesses who are more likely to make investments greater than the Annual Investment Allowance, and have the extensive finance teams in place to be able to direct their activity so as to maximise their use of this sort of scheme.

What's more, the Super Deduction's focus on plant and machinery means that there is less focus on investments in intangible assets such as digital software and intellectual property. The UK is primarily a service-based economy and is a hub for innovation, growth, and scale-ups. According to the Scaleup Institute, the UK is home to over 36,500 high-growth scaling businesses.[33] Expanding investment opportunities to cover service-based assets would likely do a lot to spur additional investments.

31 UK Government, UK Research and Development Roadmap, January 2021, https://www.gov.uk/government/publications/uk-research-and-development-roadmap/uk-research-and-development-roadmap

32 UK Government, Super-deduction, March 2021, https://www.gov.uk/guidance/super-deduction

33 Scaleup Institute, Number of Scaleups in UK rises but action is still needed to address regional disparities, 2019, https://www.scaleupinstitute.org.uk/news/number-of-scaleups-in-uk-rises-but-action-is-still-needed-to-address-regional-disparities/

"Because of the complexity and difficulty of the tax system and how much paying liabilities worries small businesses, many do not explore all the options available to them, leading to underused investment incentives and tax reliefs."

FSB Member, Tax Consultancy, South Wales

Notably, 13 per cent of small businesses do not wish to invest and expand. It needs to be remembered alongside any policies that not all small businesses wish to expand; many are content being the family-run, local business. Moreover, as our research was conducted during the reopening of the economy under COVID-19, many businesses will have been focused on survival rather than investment and expansion.

As it currently stands, the way in which investments are treated through taxation often discourages investment and risk taking; good outcomes are taxed more than bad outcomes are subsidised, creating asymmetrical investment decisions. The appetite for risk needs to be relatively high given this asymmetrical treatment.

The ability to offset losses improves upon the fairness characteristic of the tax system. This is because individuals will then be liable for tax on overall income rather than from specific streams of income. Thus, an increase in areas like Capital Gains Tax while increasing reliefs and the ability to offset losses would likely incentivise investments, shift investment towards the Government's 2.4 per cent R&D target and improve economic efficiency.

This is particularly relevant for small businesses. Investments into new businesses help economies thrive and new industries emerge. Disincentives to invest in small businesses due to tax form rather than the business itself are an inefficient outcome for investors, businesses, and the economy as a whole. All large, successful businesses once started out small. Aiding these investment decisions will bolster the economy and could be particularly important during the recovery phase of COVID.

Recommendations

- **Given the significant burden of tax compliance for small businesses, the Government should not exclude tax administration costs from regulatory oversight, and should ensure that any changes in regulation policy do not add to the burden already faced**

Taxation is considered by 34 per cent of small businesses to be the most burdensome form of regulation they need to comply with, ahead of areas such as employment, health and safety, environment, and corporate governance.[34] The Regulatory Policy Committee (RPC) states that it brings an external perspective on how regulatory proposals impact businesses and focuses on ensuring that the Government has minimised the burdens on small and micro businesses.[35] However, the Committee excludes impact assessments that relate to tax or spending decisions.

Given that tax regulation is considered the second most burdensome form of regulation by small businesses, the fact the RPC doesn't cover this area is a significant issue. Small businesses spend significant resources complying to the complexities of taxation, and changes to these complexities should be scrutinised in the same way other regulatory changes are. We urge the Government to introduce taxation within the scope of the RPC so that small businesses complying with the regulatory burdens of tax are not overlooked.

- **The Government should introduce a system whereby the self-employed can smooth their tax liabilities over a three-year rolling average through the availability of tax credits**

Nearly three quarters of small businesses admitted that they struggle to accurately forecast their earnings each year, and that their financial security fluctuates. Many small businesses will still be feeling the effects of the COVID pandemic crisis and will be worrying about the future of their business. Anything the Government can do to lessen this worry would go a long way towards improving small business confidence.

The Government could alleviate many of these worries by creating a three-year rolling average taxable income scheme for the self-employed. This would begin to limit the volatility of income year-to-year, as

34 Federation of Small Businesses (FSB), Escaping the Maze, June 2021, https://www.fsb.org.uk/resource-report/escaping-the-maze.html
35 Regulatory Policy Committee (RPC), About us, https://www.gov.uk/government/organisations/regulatory-policy-committee/about

significant increases or decreases in income would be balanced out over a three-year period. Significant losses one year, for example, would be less disastrous as they could be offset against the two previous years' tax payments, allowing the business owners to recoup income. Effectively, this scheme would create an average liability for each three-year period, and in the current year, the business would either contribute towards its liability or reduce it through tax credits created by overpayments (payments of tax above that three-year average liability). This would provide more certainty to income over a longer time period and also ease the business against unexpected shocks. For illustration we provide two simplified examples below:

Take an example where a self-employed person earns income of £70,000 each year for two years, then in the third year of the period they suffer a drop in income to £20k. At the moment their income tax bill would be £15,500 in each of the first two years, then £1,500 in the third year. Overall, they will have paid £32,500 in income tax.

Over the three years, they have earned £160,000, or an average of £53,333 per year. If they had earned exactly the average amount of £53,333 each year, then they would have paid only £8,167 in tax each year, resulting in a total tax bill of £24,500 – £8,000 less than they did in fact pay. This is negative from a fairness perspective, as it puts entrepreneurs who are taking risks by investing in their businesses at a disadvantage against others who choose a steadier, but perhaps less productive, income. Also, the business owner might be more likely to invest more in their business, or take more risks, in the knowledge that if they have an unexpectedly poor year then they are likely to have some of the negative impact cushioned by tax credits.

Under FSB's policy proposal, after three years the self-employed person would benefit from a tax credit equivalent to the difference between what they did pay (£32,500) and what they should have paid over a three-year average (£24,500). They would get a tax credit worth £8,000. This is money that would then help in the bad year and can be reinvested into their business for additional growth, bolstering the economy.

As a second example, take a self-employed start-up that earns £15,000, £35,000, and £70,000 in their first three years of business. In year one, their tax bill would be £500, in year two £4,500, and in year three £15,000. Overall, they would pay £20,500 across the three years.

Over the three years they have earned £120,000 which averages to £40,000 per year. If they had earned exactly the average each year, they would have only paid £5,500 in each tax year for a total of £16,500 – £4,000 less than what they actually did pay. This, again, from a fairness principle, is effectively punishing businesses that invest and expand their enterprises.

Under FSB's proposal, after the third year in business, the self-employed individual would compare their tax liability to the hypothetical three-year average tax liability and receive a tax credit for the value of overpayment across the three-year average – in this case, £4,000. This would enable the start-up to further reinvest in their business and grow. Thus, although tax liabilities may be somewhat smaller for income tax, you would reasonably expect total liabilities to grow through other means of taxation such as Corporation Tax, NICs, and so on.

For businesses that do not expand their businesses and have stable income, the rolling average would be effectively the same as the year-to-year liability and hence they would not receive any tax credits.

- **The Government should expand reliefs on investment to further cover losses in a more symmetrical way in which it taxes returns to encourage more continual investment in the economy**

The Government is pushing for a significant increase in investment and research and development. However, the current taxation system means that the gains accrued from successful investments are taxed disproportionately higher than losses are relieved, leading to an asymmetrical incentive investment market.

Businesses would be more likely to engage in investments and expansion if they knew they could write off some short-term losses. Development and expansion of businesses will be crucial post-COVID; the more the Government can do to nurture this, the better the economy will recover.

- **The Government should reform the Super Deduction investment incentive**

The Super Deductions investment incentive was intended by the Government to encourage business expansion. However, it is relatively limited in scope; it primarily focuses on physical capital such as plant machinery. Although businesses can get the relief for intangible assets, the process is a lot more opaque making it relatively inaccessible for small businesses.

The issue lies in the fact that the UK is a hub for digital ingenuity and scale-ups. The UK has a very significant services sector, which does not rely on traditional plant and machinery as the manufacturing and construction industries do. Rather, non-tangible assets such as software and intellectual property dominate. We urge the Government to clarify for small businesses how the Super Deductions scheme applies to non-tangible assets, so that the scheme can be utilised by small businesses outside of the current narrow scope wishing to expand. The Government has itself estimated that the digital sector is worth more than £400 million a day to the UK economy;[36] it should capitalise on this and encourage further investment.

Moreover, only four per cent of small businesses rated it in their top three incentives, which shows it is of very limited use to small businesses. This is despite the fact that this incentive was projected in Budget 2021 to cost the exchequer over £12 billion a year. Given the recent increases that have been announced to National Insurance Contributions – a tax on jobs which will hit small businesses hard – we believe it would have been more appropriate to reduce the cost of the super-deduction. The super-deduction marks a less significant shift in incentives for small business, given they are more likely to make investments that fall entirely within the Annual Investment Allowance. Unlike large businesses with teams of finance professionals who will be able to give confidence in decisions designed to make the most of the super deduction, small businesses are unlikely to be incentivised by a confusing relief.

36 UK Government. (2020). 'Digital sector worth more than £400 million a day to UK economy.'

MAKING TAX DIGITAL

Making Tax Digital businesses

As of April 2019, all VAT-registered businesses with a turnover exceeding £85,000 are required to begin filing their VAT return through Making Tax Digital (MTD).[37] This will be extended to all VAT-registered businesses from April 2022, and further expanded to other forms of taxation thereafter.

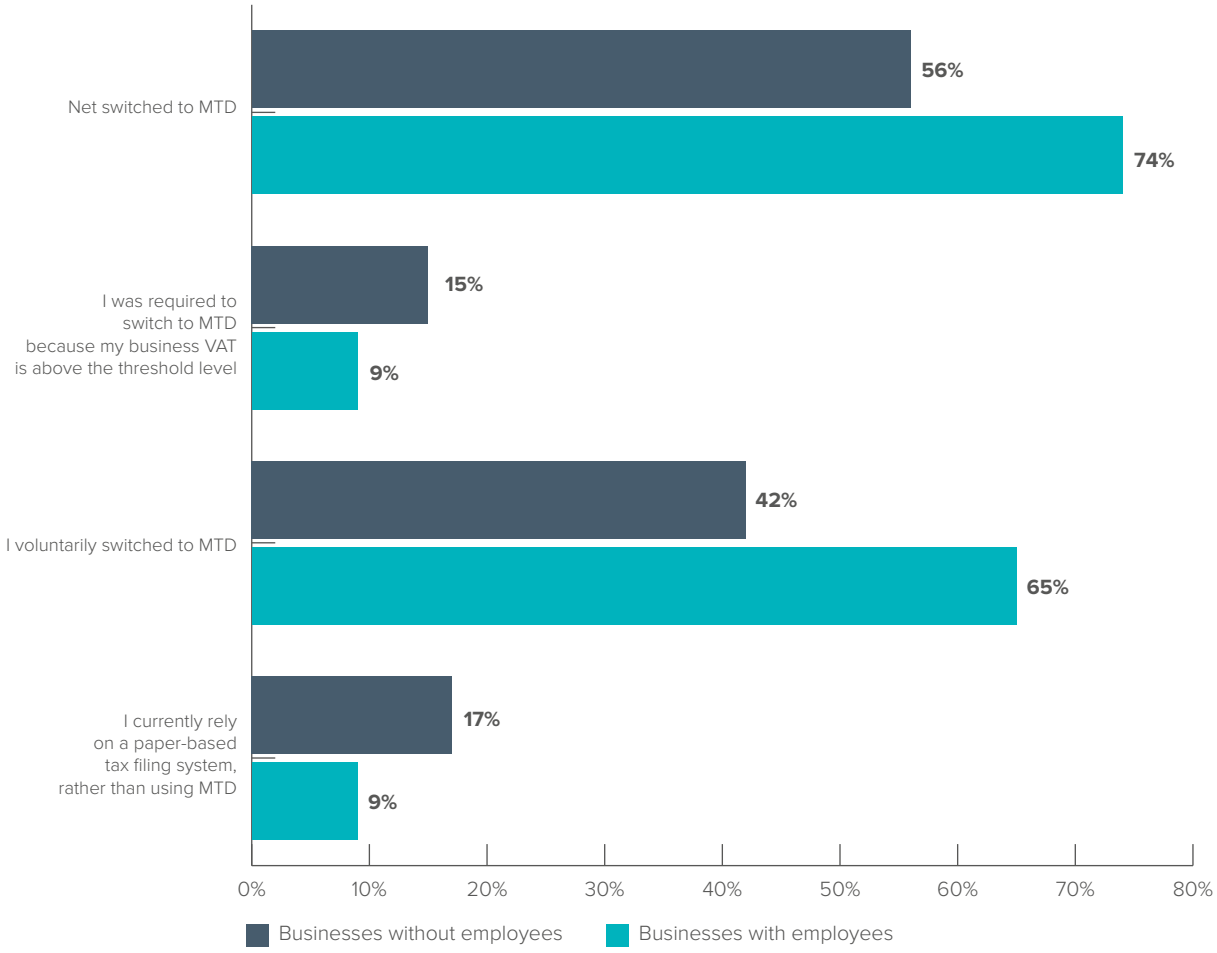
FSB evidence provides a valuable insight into the roll-out of MTD; 70 per cent of small businesses say they have switched to MTD, 60 per cent say they have switched to MTD as a result of being above the VAT threshold while 11 per cent switched voluntarily and 11 per cent are still reliant on paper-based filing rather than MTD.[38]

The rates at which businesses have switched to MTD overall vary by employee size, as illustrated in Figure 9. Overall, 56 per cent of small businesses with no employees have made the switch, compared to 74 per cent of those with employees. Small businesses with employees were also more likely to switch voluntarily than businesses with no employees.

> *"Making Tax Digital does bring the UK's tax system into the 21st century. However, the tax code itself is so complex that it still really needs to be simplified to benefit businesses."*
>
> **FSB Member, Tax Consultancy, South Wales**

Figure 9: Share of small businesses that have switched to Making Tax Digital reporting, by whether the business has employees

Source: FSB Tax Survey, 2021



37 ICAEW, MTD for business overview, 2020, https://www.icaew.com/technical/tax/making-tax-digital/mtd-guidance/mtd-for-businesses#:~:text=MTD%20for%20VAT%20started%20in,registered%20businesses%20in%20April%202022 Note: for more complex businesses there was a six-month deferral to October 2019.

38 Numbers do not sum due to rounding. 'Not applicable' and 'None of the above' excluded (13% and 6% respectively).

There is also some variance between the nations: overall, 71 per cent of small businesses in England have begun using MTD, with 65 per cent in Scotland and 71 per cent in Wales. Similarly, there is also a variance across sectors in the UK. Small businesses in the manufacturing sector report the highest usage of MTD at 86 per cent, followed by those in construction at 84 per cent. This dips considerably to only 67 per cent for small businesses in accommodation and food services.

Notably, there is no significant difference between rural and urban businesses, both of which report approximately 70 per cent of small businesses having made the switch to MTD. Given the digital nature of MTD, there was concern that switching would be more costly and difficult in more rural firms, thus impeding numbers. However, this does not seem to have proved to be the case.

Recording transactions

Almost all (98%) small businesses use some form of software to record their transactions. This includes methods such as paid-for and free accounting software, spreadsheets, online bank statements, and bespoke accounting systems. However, 60 per cent of small businesses still use some form of manual process to record their transactions, so the majority of small businesses are using both software and manual processes at the same time.

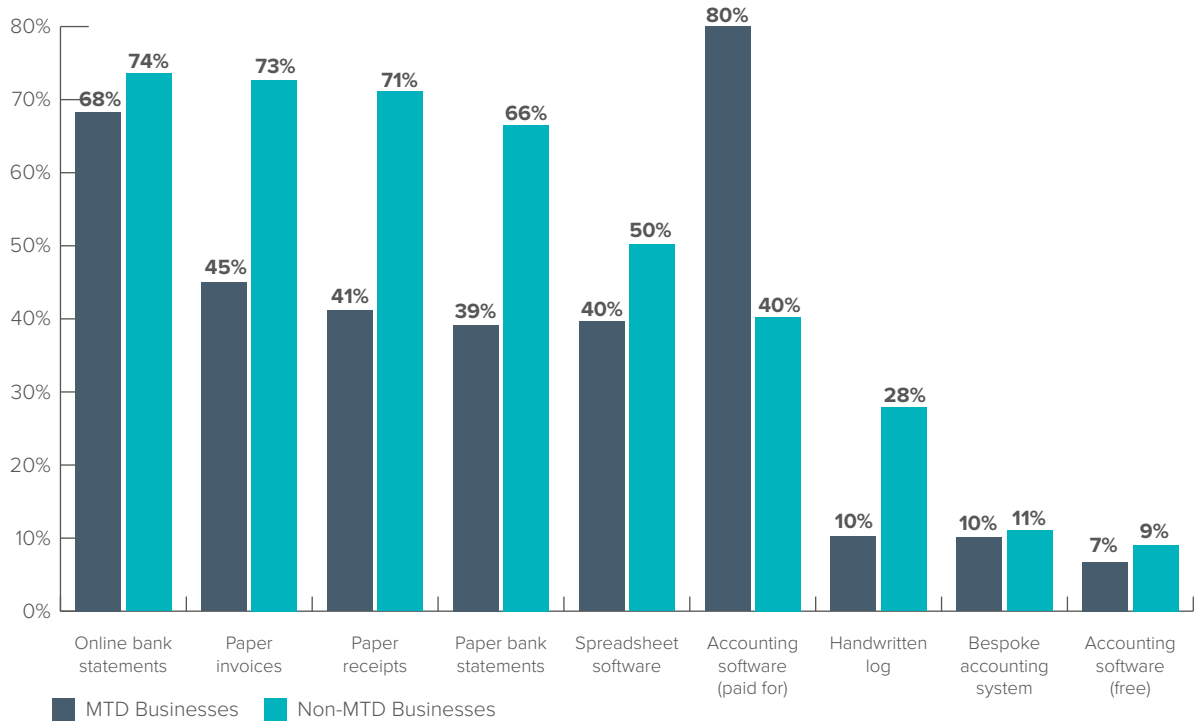
Almost three quarters (71%) of businesses surveyed reported that they use paid-for accounting software. This is a marked increase on FSB's previous 2018 tax report *"Taxing Times"*,[39] which found 56 per cent of small businesses using paid-for software. This increase is likely partly attributable to the fact Making Tax Digital has since been implemented and businesses thus need compatible software.

A significant proportion of small businesses still use manual processes to record transactions: 47 per cent of all small businesses use paper invoices, 43 per cent still use paper receipts, and 41 per cent use paper bank statements.

For those small businesses that say they have yet to switch to MTD, the difference in recording methods is stark. Only 40 per cent say they use paid-for accounting software, compared to 80 per cent of small businesses that have switched to MTD. For those businesses that use a manual method to record their transactions, 73 per cent of non-MTD businesses report using paper invoices and 71 per cent say they use paper receipts, compared to 45 per cent and 41 per cent of MTD businesses respectively. These disparities are further highlighted below in Figure 10.

Figure 10: Processes of recording transactions by MTD and non-MTD small businesses

Source: FSB Tax Survey, 2021



Overall, it is clear that digital methods of recording transactions are becoming increasingly common, but many small businesses supplement their digital recordings with paper processes. The shift in the tax system towards digital in 2019 undoubtedly accelerated this trend and the differences between MTD and non-MTD small businesses in how they record transactions are stark. The shift in 2022 for all VAT-registered businesses to start using MTD may come with a significant cost burden as small businesses are required to change their processes and use MTD-compatible software. Easing this process and ensuring costs are kept to a minimum should be a priority for the Government.

39 FSB, Taxing Times, 2018, p.12

Tax reliefs

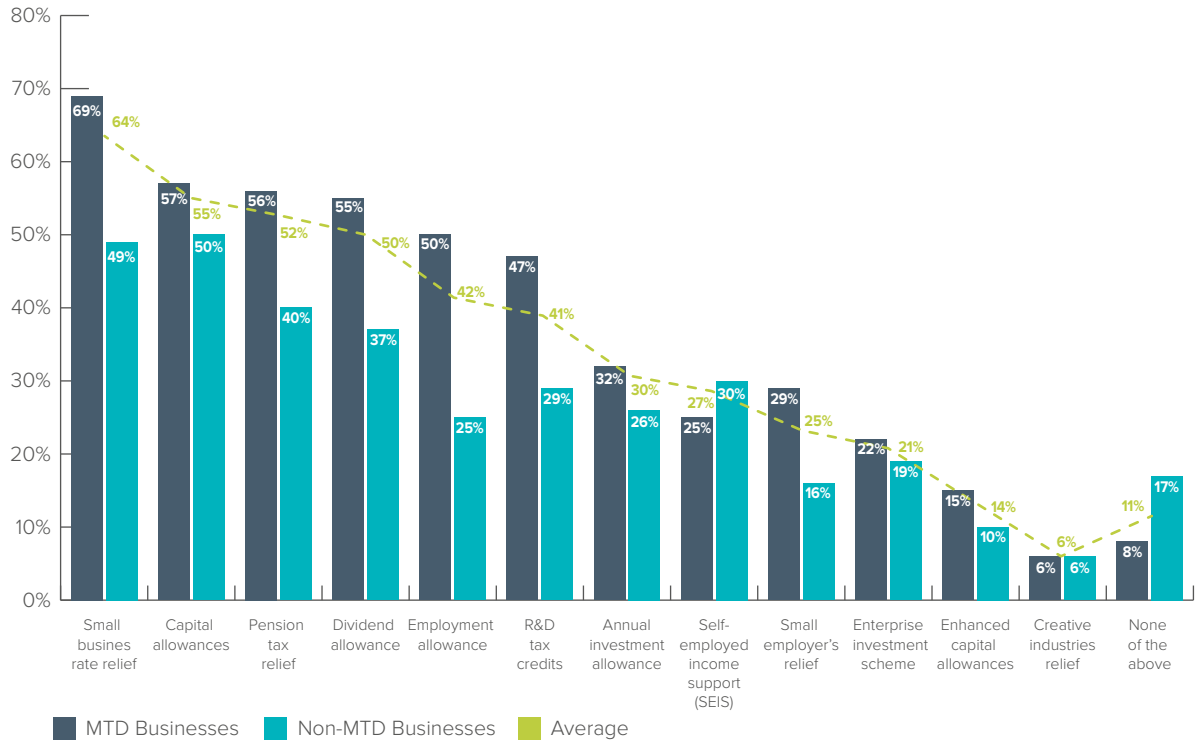
There are many tax reliefs available to small businesses, ranging from the likes of Small Business Rate Relief and Small Employers' Relief to capital allowances and investment allowances. The issue for small businesses with the range of reliefs available is awareness. FSB research indicates that small business awareness of tax reliefs is low; on average, small businesses were only aware of 5 out of 12 listed reliefs. This awareness doesn't significantly change by business size, nation, or sector.

Awareness of reliefs does, however, vary considerably between small businesses that have shifted to MTD process and those that have not. This is highlighted below in Figure 11. The most common relief small businesses are aware of is the Small Business Rate Relief, which lowers the rateable tax on a property used for business. Overall, 64 per cent of small businesses are aware of this relief, with 69 per cent of MTD small businesses but only 49 per cent of non-MTD small businesses aware.

The largest discrepancies between MTD and non-MTD small businesses are found in awareness of the Employment Allowance: 25 per cent more small businesses that have switched to MTD are aware of the Employment Allowance than non-MTD small businesses. Similarly, non-MTD businesses reported a much higher response to not being aware of any of the listed reliefs, at 17 per cent compared to 8 per cent of MTD small businesses.

Figure 11: Awareness of various tax reliefs by MTD and non-MTD small businesses

Source: FSB Tax Survey, 2021



Irrespective of the differences between MTD and non-MTD businesses, there exists a very large gap in knowledge when it comes to tax reliefs available to small businesses. The highest-rated relief for awareness, Small Business Rate Relief, still only came in with 64 per cent of all small businesses aware of it. The rates of awareness from here drop off considerably, too; capital allowances are only reported by 55 per cent of small businesses, pension tax relief by 52 per cent, R&D tax credits by 41 per cent, and the Small Employers' Relief by only 25 per cent.

Notably, the Employment Allowance has quite a low awareness amongst small businesses, at only 42 per cent. The Employment Allowance alleviates some of the costs employers face as a result of employer National Insurance contributions. Given the Government's announcement of a 1.25 percentage point

increase in all NICs,[40] the Employment Allowance will become more important for small businesses in dealing with the associated costs of employment. Currently, eligible businesses can reduce their Class 1 NICs contributions by £4,000 per annum, and in the 2020-2021 financial year, just over a million businesses made use of the relief – 86 per cent were businesses with under 10 employees.[41]

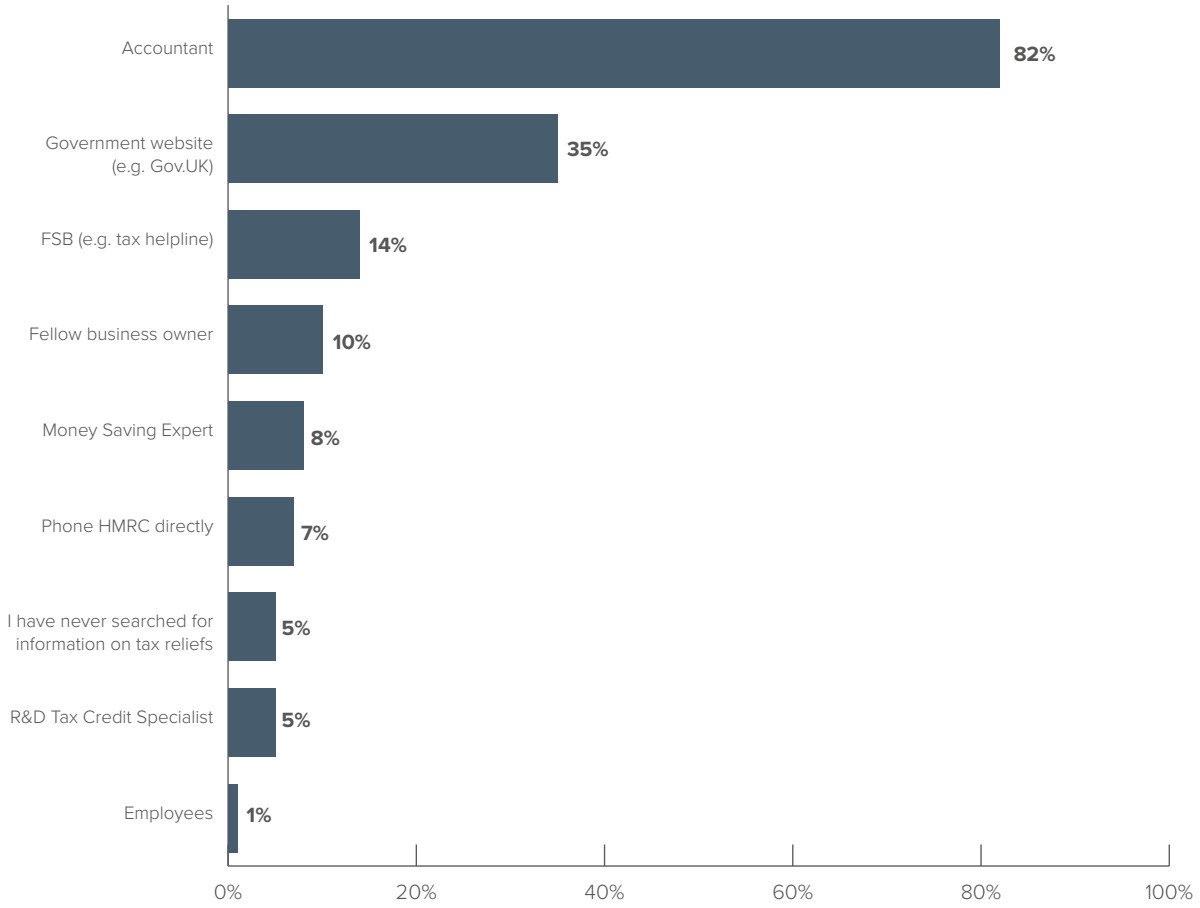
> *"I rely almost exclusively on my accountant for information on reliefs as it's very time-consuming to search myself. The issue is that this relies on him knowing about all the available reliefs."*
>
> **FSB Member, Retail Firm, London**

This is a clear issue with reference to the tax characteristic of fairness. Small businesses pay their tax liabilities and should be receiving their fair share of reliefs. The complexity of the tax system hinders this process. As it stands, the vast majority of small businesses tend to go to their accountant for advice on reliefs (82%). A third (35%) of small firms use GOV.UK to access information on tax reliefs and five per cent say they have never searched for information on tax reliefs.

Given small businesses already spend almost two working weeks on tax compliance alone, it can become arduous to spend additional resources searching for reliefs they may be entitled to. A streamlining of the system would go a long way to address this issue and begin combatting the unfairness of the disparity between liabilities and reliefs.

Figure 12: Where small businesses go for information on tax reliefs

Source: FSB Tax Survey, 2021



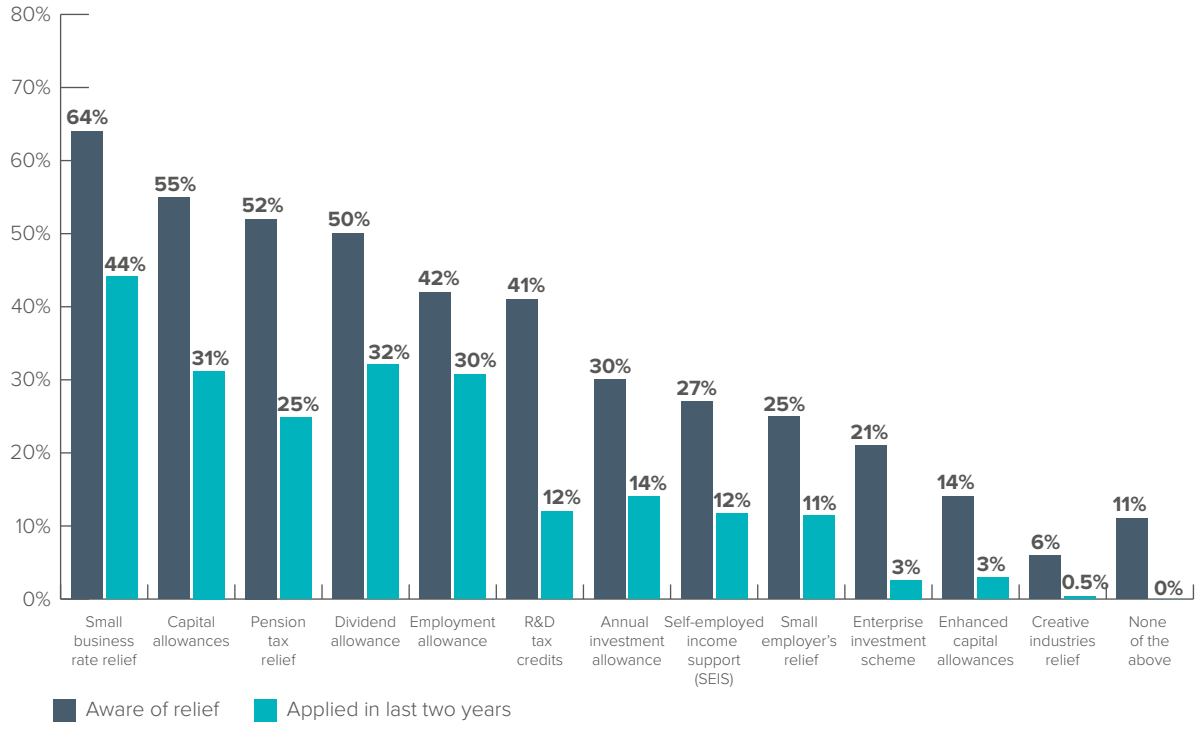
40 UK Government, Build Back Better: Our Plan for Health and Social Care, September 2021, https://www.gov.uk/government/publications/build-back-better-our-plan-for-health-and-social-care/build-back-better-our-plan-for-health-and-social-care

41 UK Government, Employment Allowance take-up statistics: 2020 to 2021 tax year estimate, June 2021, https://www.gov.uk/government/statistics/employment-allowance-take-up-2020-to-2021-tax-year-estimate/employment-allowance-take-up-statistics-2020-to-2021-tax-year-estimate

As illustrated, awareness of tax reliefs by small businesses is relatively weak. However, the rate at which small businesses have applied for reliefs is even lower. This, of course, could be partly due to some reliefs not being applicable for their businesses, but this is unlikely to explain the entire gap between awareness and application for all reliefs.

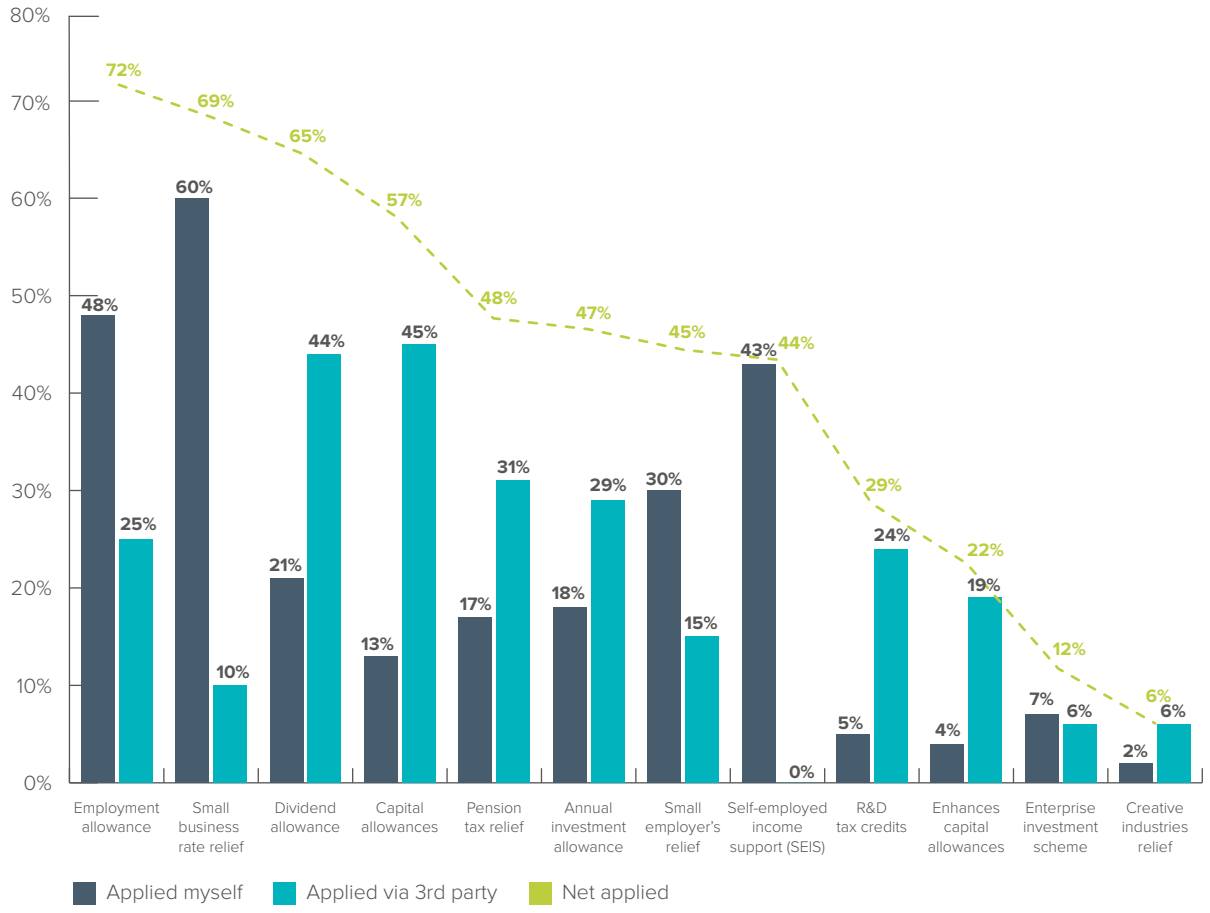
Figure 13: Share of small businesses that have applied for tax reliefs in the past two years

Source: FSB Tax Survey, 2021



Of those small businesses that have applied for a particular tax relief they are aware of, how they applied varies considerably from relief to relief. Typically, small businesses appear to apply for Small Business Rate Reliefs, the Employment Allowance, and the Self-Employment Income Support Scheme (SEISS) themselves. However, dividend allowances, capital allowances, pension tax reliefs, R&D tax credits, and investment allowances tend to be applied for through a third party such as an accountant, agency, or tax specialist.

Figure 14: Of those businesses aware of each relief, how they applied
Source: FSB Tax Survey, 2021



It appears that for the more complex reliefs, typically around investment, R&D, and capital expenditure, small businesses opt for more specialist advice. What this does mean is that small businesses are fronting a cost to receive reliefs they are entitled to. On average small businesses claiming tax reliefs through a third party end up paying up to 25 per cent of the savings in service fees.

For R&D tax credits, 57 per cent of small businesses paid up to a quarter of the relief as a service fee. For Small Business Rate Relief, 14 per cent paid more than 75 per cent of the relief as a service fee.

Clearly there is a significant gap in awareness of the available tax reliefs small businesses may be eligible for. This lack of awareness harms the confidence small businesses have in the tax system; they pay their liabilities but are not receiving their fair share of reliefs. The complexity of the system adds a significant burden to small businesses in this regard. Small businesses already spend significant time and money on their tax compliance; spending additional resources to search for reliefs takes away further time that business owners could use productively for their businesses. Moreover, businesses that opt to use third parties are then hit with significant service fees. MTD has the potential to streamline this entire process, increasing awareness of reliefs, reducing the complexity of applying, and potentially reducing the costs of using tax reliefs.

Views on Making Tax Digital

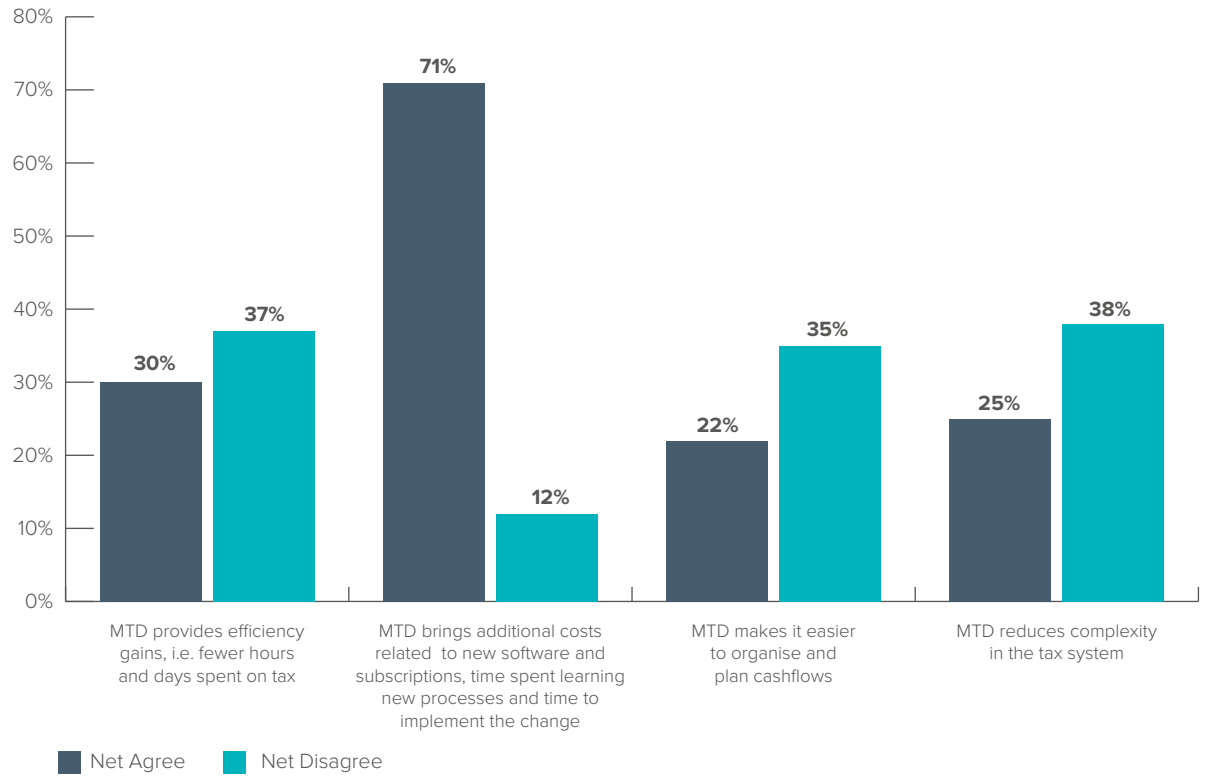
Making Tax Digital aims to make tax easier for individuals and businesses, and to make tax administration more effective, more efficient, and easier for taxpayers to get their tax right.[42] The issue here lies with the fact that small businesses do not view the introduction of MTD favourably – this is illustrated below in Figure 15.

A significant share of small businesses do not view MTD positively; 37 per cent disagree that it improves efficiency of tax, 35 per cent disagree that it makes cashflows easier to organise, and 38 per cent disagree that it reduces complexity in the tax system. One of the biggest concerns for small businesses regarding MTD is the associated cost: 71 per cent agree that compliance via MTD will bring additional costs through software, subscriptions, time spent learning the new processes, and time taken to implement the change.

> *"My business is very low cost and my cashflow is easily managed. Making Tax Digital hasn't really added anything apart from having to acquire the software."*
>
> **FSB Member, Management Consultancy, Scotland**

Figure 15: Small businesses' views on Making Tax Digital

Source: FSB Tax Survey, 2021



When splitting results by those who have already adopted MTD and those yet to, the results become quite interesting as they contrast actual views since adoption versus perceptions of MTD. Of those small businesses that have already adopted MTD, they are slightly more encouraging than those yet to adopt it; however, overall, their views on MTD are not positive.

Of those small businesses that have shifted to MTD, roughly equal proportions agree and disagree that MTD has provided efficiency gains through fewer hours spent on tax compliance. In contrast, those yet to adopt MTD have a very negative view on efficiency gains, with 56 per cent disagreeing that it will increase efficiency, compared to only 12 per cent agreeing.

42 UK Government, Overview of Making Tax Digital, November 2020, https://www.gov.uk/government/publications/making-tax-digital/overview-of-making-tax-digital

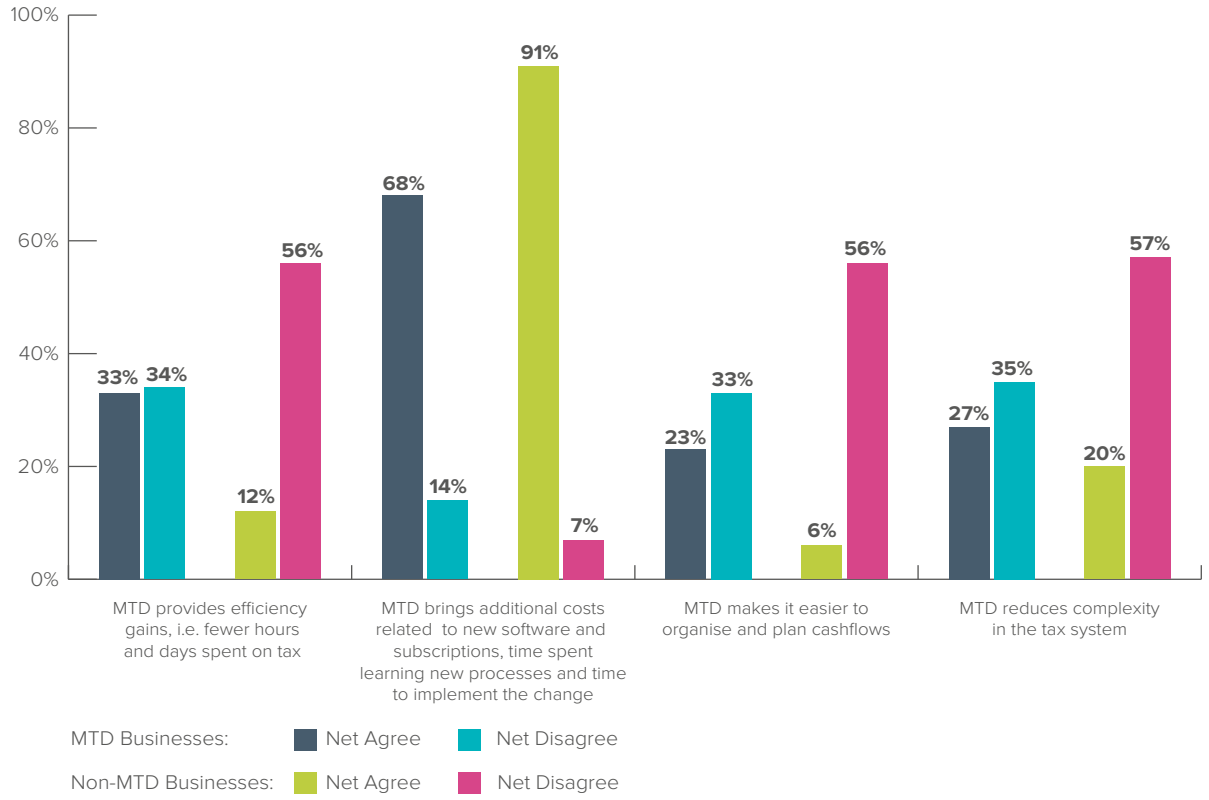
Similarly, 33 per cent of MTD businesses disagree that MTD has made cashflows easier to organise and plan, while 35 per cent disagree that it has reduced complexity in the system (two key aims of the policy). Perceptions around this are worse: 56 per cent and 57 per cent respectively of those small businesses who are yet to adopt MTD respectively disagree with the statements. This does highlight that perceptions around MTD may be worse than they ought to be and that small businesses yet to adopt MTD are more concerned than may be necessary.

"The Government hasn't spent enough time explaining how Making Tax Digital works to the average small business. We need a step-by-step guide explaining what's changed and what we need to do."

FSB Member, Hospitality, South Cumbria

Figure 16: Views on Making Tax Digital, split by MTD and non-MTD small businesses

Source: FSB Tax Survey, 2021



The complexity of the tax system is something that needs improving. The Office of Tax Simplification was founded in 2010 with the sole purpose of providing advice to the Chancellor on how the tax system could be simplified.[43] Although measures have been taken, and MTD is a significant step towards an easing of the system, there is a long way to go. The complexity of the system adds to the burden small businesses face; paying taxes should not divert time and resources away from the business's main purpose and activity.

The more pressing issue of MTD is the related cost; 68 per cent of those already using MTD agreed that it brought with it additional cost burdens through new software, subscriptions, time spent learning the processes, and time to implement the change. For those yet to adopt, this spikes to 91 per cent, of which 63 per cent strongly agreed with the statement - a significant concern.

As it stands, the average small business spends £4,100 on tax compliance per year. When splitting this out between MTD and non-MTD businesses, the difference is stark. MTD businesses, on average, spend £4,562 on tax compliance per year; 11 per cent more than the average. Small business yet to adopt MTD, however, spend on average only £2,690 per annum; approximately 35 per cent less than the average and 1.7 times less than MTD businesses.

43 Office of Tax Simplification, Office of Tax Simplification framework document, August 2021, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1012983/OTS_Framework_Document_20210823.pdf

This is further highlighted in Figure 17. It is clear that the small businesses yet to adopt MTD typically spend much less to complete their tax liabilities than MTD businesses. In fact, 72 per cent of small businesses yet to adopt MTD have tax compliance costs up to £2,500 compared to only 35 per cent of MTD small businesses.

There is a big concern for small businesses in this space. Many small businesses have a tried-and-tested way in which they complete their tax liabilities. The shift to MTD has been accompanied by a cost overhang with requirements to use MTD-compatible software. For larger businesses and those more digitally advanced, this may not have required much of a change from their current systems. However, for those yet to switch and those still reliant on paper-based methods, this is a large change. The issue doesn't stop there. Once all businesses are required to submit via MTD, and hence all have the relevant software subscriptions, software companies may increase their prices in a profit-seeking manner as the alternatives are extremely limited. This could create a cost spiral situation where businesses are trapped by MTD-compatible software requirements and are forced to accept higher costs to complete their liability. We urge the Government to take a stance on this and ensure that profit-seeking behaviour is minimised in this sphere, through ensuring a competitive market is upheld and, if needed, the Competition and Markets Authority runs a study into the market itself.

With reference to time spent on compliance, the picture is much the same. The average time spent on compliance per year is 52 hours. For MTD small businesses this increases to 57 hours; a 9 per cent increase. For small businesses yet to adopt MTD, their average time spent on tax compliance per year is only 43 hours; 18 per cent less than the average and 1.3 times less than their MTD business counterparts. Hence, MTD appears to have a greater impact on costs than on time, but, importantly, MTD does not appear to have improved the efficiency of tax.

These results appear to be in contrast to results that HMRC has found in its report, "Making Tax Digital: An evaluation of the VAT service and update on the Income Tax Service",[44] where it concludes that *"many aspects of the introduction of MTD have worked well, both for HMRC and its customers"*. The report also appears to downplay the fact small businesses are facing significant costs as a result of the introduction of MTD, relying on the fact that the Government's estimate is based solely on the minimum requirement, rather than looking at what firms are likely to spend.

44 HMRC, Making Tax Digital: An evaluation of the VAT service and update on the Income Tax Service, March 2020, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/873574/Making_Tax_Digital_-_An_evaluation_of_the_VAT_service_and_update_on_the_Income_Tax_Service.pdf

Figure 17: Cost of tax compliance, split by MTD and non-MTD small businesses
Source: FSB Tax Survey, 2021

Of course, the entire gap in costs and time cannot be attributed to MTD alone. MTD businesses are those with turnover above the VAT-registered threshold and early adopters, and so is likely their tax complexity is greater, pushing up costs. However, given the results shown in Figure 16, even these small businesses report that MTD has had a cost impact on their business. Given how burdensome taxation is to small businesses already, the fact that MTD pushes up costs through software, subscriptions, and the time taken to implement and learn new processes is a significant issue. This goes further when considering that small businesses, given their scale, do not have dedicated tax teams like larger organisations, and thus face this cost burden more acutely than their larger counterparts, adding to the disproportionate burden.

Making Tax Digital has the potential to truly change the tax system, reducing its complexity, increasing efficiency, and easing compliance. The ways in which small businesses interact with tax could change following MTD, should MTD software incorporate areas where the current system is lacking. A simplified user interface, detailing tax liabilities and when liabilities need to be paid, would streamline the efforts of calculating payments. Likewise, the software has the potential to include nudges and alerts for relevant reliefs, so that small businesses do not need to seek professional advice or search government websites to see what they may be eligible for. A system that benefits small businesses rather than just shifting the current tax system online would take significant steps towards reducing complexity, increasing awareness around reliefs, and restoring trust in the tax administration by small businesses.

Recommendations

- **The Government should promote greater awareness of the tax reliefs available to small businesses both externally and through Making Tax Digital software**

Small businesses generally lack awareness of the tax reliefs they may be eligible for. On average, small businesses are only aware of five potential reliefs. Of course, not all reliefs will be relevant for all small businesses; however, there is a systematic issue of lack of awareness around reliefs. For those that are aware of the reliefs available to them, applications are also not as high as they could otherwise be, and those that apply via a third party are facing significant costs for doing so, especially for the more investment related reliefs.

Making Tax Digital software has the potential to significantly change this. Given the tax data that will be collected by the systems, the software should include prompts to alert business owners of tax reliefs that may be relevant to their business. The complexity of the tax system and the time it takes to research reliefs could be significantly improved through including this in the base level software. This should be included at all levels and not be a potential add-on that comes with a cost. Adding this would do a lot to reaffirm small businesses' views that they are being treated fairly as they will be nudged towards reliefs while paying their liabilities.

- **The Government should commit to ensuring that the software providers of MTD do not increase prices in a rent-seeking manner**

Making Tax Digital is already viewed as a very cost-intensive shift for small businesses, by both those who have already shifted and those yet to. The difference between the average cost of compliance for small businesses yet to switch and those who have already adopted MTD is stark. Many small businesses are accustomed to how they currently file taxes, and changes to this have costs beyond just the software. There is a significant learning curve around how to pay through the new systems, with significant time and effort needing to be invested to ensure it is done correctly.

Given that small businesses are required to use MTD-compatible software, there is the risk that third-party software companies could rapidly increase the subscription costs once all small businesses have shifted to MTD filing, as there are few alternatives. Given the already burdensome cost of tax compliance, this is a real concern to the small business community. We urge the Government to put in place some regulatory standards to ensure the market remains competitive, allowing ease of entrance of new competitors and no price collusion between software providers, so that prices themselves remain competitive. Small businesses should not have to waste valuable income simply to pay their liabilities.

- **The Government must provide a free online tool for Making Tax Digital to ensure that small businesses have the choice not to be burdened by additional costs to file their taxes**

The cost burden of tax filing is already significant to small businesses and Making Tax Digital has not eased this situation. For the complete rollout, a free online tool should be made available so that the smallest of businesses do not need to acquire costly subscriptions for tax administration services they may not fully utilise. These are businesses that do not need the most advanced filing systems, rather just a way to comply with the new regulations.

- **HMRC must work with software providers to ensure that Making Tax Digital software does streamline, simplify, and create greater efficiencies in tax compliance, and ensure that Making Tax Digital actually provides additional value**

Making Tax Digital is currently not fulfilling its ambition of creating a more effective, more efficient, and easier tax payment system. Both small businesses that have yet to adopt MTD and those that have already done so view MTD as a very costly new system that does little to improve upon the complexity of the tax system, organise cashflows, or reduce the hours spent filing.

Making Tax Digital does have the potential to improve upon all these areas if it is done right. Shifting the current tax system towards a digital-only process, with no improvements, adds no value to the consumer and, given the additional costs, acts as more of a burden than a benefit.

We urge HMRC to work alongside the OTS when designing, implementing, and updating Making Tax Digital for VAT and income tax. The OTS should become more directly involved in order for MTD to deliver on its promise to provide a simplified, easy-to-use tax framework for individuals and businesses.

- **The Government should increase the Employment Allowance to £5,000 for eligible small businesses, to alleviate some of the job losses from the planned National Insurance contributions increase**

Employer National Insurance contributions act as a tax on jobs. The recently announced increase of 1.25 percentage points is going to have a detrimental effect throughout the UK and will disproportionately affect small businesses that will now face a greater employment cost bill. When small businesses were asked about how they responded to the additional wage cost of an increase to the National Living Wage (NLW) in FSB's 2021 NLW Survey, 5% said they reduced the number of employees though redundancies, 14% said they recruited fewer workers, 19% said they reduced the number of hours worked by staff, and 12% said they reduced the rate of pay growth. Given that the NICs increase acts in a similar way to wage costs, small business reaction is likely to be similar, reducing employment opportunities overall.

Over one million small businesses used the Employment Allowance in the last financial year, the vast majority of them being micro employers. The Government should seek to alleviate employment cost pressures on small businesses, aiding their post-pandemic recovery and sustaining employment throughout the UK.

The Government is alleviating the additional cost burden for its own departments at a cost of £1.8 billion per year;[45] this should be extended to small businesses, too. Given that the previous Employment Allowance increase was estimated to cost £445 million for the £1,000 increase,[46] a similar cost should be expected for the increase to £5,000. This small increase in the Employment Allowance would reduce the cost pressure for small businesses and could save thousands of jobs and is still only a fraction of the funds set aside for the Government's own departments.

45 HM Government, Build Back Better. Our plan for health and social care, September 2021, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1015736/Build_Back_Better-_Our_Plan_for_Health_and_Social_Care.pdf

46 UK Government, Employment Allowance increase for National Insurance from April 2020, March 2020, https://www.gov.uk/government/publications/employment-allowance-increases-for-national-insurance-from-april-2020/employment-allowance-increases-for-national-insurance-from-april-2020

METHODOLOGY

The FSB tax survey was conducted with members across the UK. Individuals were invited to participate in the survey via email and social media channels. The survey was administered by the research agency Verve and was in the field from 16 June to 6 July 2021. The survey questionnaire was completed by a total of 1,000 small businesses. The survey findings are all weighted according to FSB membership weighting (to reflect the demographic balance of FSB members throughout the UK). All percentages derived from the survey are rounded to the nearest whole number, which is why some percentages presented in the figures do not add to 100 per cent.

The semi-structured interviews were primarily conducted over the phone in July and August 2021, included members from devolved nations, and purposefully drew from a variety of regions and sectors.

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