

Simplification Review: corporation tax calculations and returns for smaller companies – a discussion document

November 2008



HM Revenue
& Customs



HM TREASURY

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corporation tax calculations and
returns for smaller companies –
a discussion document

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Contents

		Page
Chapter 1	Introduction	3
Chapter 2	Ideas explored	5
Chapter 3	Next steps	9

1

Introduction

Aims of this review

1.1 The Government is committed to ensuring that the UK is a world-class environment in which to do business. Tax simplification can play an important role in achieving this through helping business to interact more efficiently and effectively with the tax system, for example by removing unnecessary complexity and reducing compliance and administrative costs.

1.2 Simplification is a priority in designing and reviewing tax policy. Alongside sound public finances and fairness, the Government is committed to working in partnership with business to identify opportunities to simplify the tax system and to sharing its findings on the viability of options for tax simplification.

1.3 As part of this programme, Budget 2008 announced a review to consider whether it is possible to simplify corporation tax calculations and statutory return obligations for smaller companies¹. Since then, HM Treasury and HM Revenue & Customs (HMRC) have been listening to business' views of where complexity creates burdens and how it might be addressed. The Department for Business, Enterprise and Regulatory Reform (BERR) are also involved as close partners in this work, since all three departments are committed to reducing the administrative burdens on business.

1.4 In the case of corporation tax calculations and returns, complexity can arise from the differences between a company's statutory accounts and what it has to submit to HMRC in order to fulfil its tax obligations. At present UK companies have to prepare statutory accounts in accordance with the Companies Act 2006 and Generally Accepted Accounting Practice (GAAP) and file these, or an abbreviated version, with Companies House.

1.5 Companies then have to make a number of adjustments to the profits shown in their statutory accounts to calculate their corporation tax liability in accordance with the Taxes Acts.

1.6 These adjustments exist for a number of reasons. For example, tax reliefs and incentives such as Enhanced Capital Allowances, other capital allowances for investment in environmentally friendly plant and machinery and R&D tax credits exist to support particular types of investment and innovation. Some adjustments support other public policy objectives, for example the disallowance of expenditure on fines and entertaining. The Government also needs to protect the Exchequer and special rules are put in place to protect the tax system from avoidance and potential abuse.

1.7 The potential benefits of simplification must therefore be weighed against the range of wider Government objectives. The Government recognises that achieving this balance creates costs and burdens for business so it is the aim of this review to consider whether it is possible to make it simpler for smaller companies to comply with their corporation tax and statutory accounting obligations.

¹ The Review has to date been focusing on companies with a turnover of less than £750,000 and with fewer than 10 employees. Full details of the review are contained in the original announcement which can be found at: http://www.hm-treasury.gov.uk/budget/budget_08/documents/bud_bud08_taxsimplification.cfm

1.8 This discussion document provides an update of the work of the Review, and asks for further views on whether any of the ideas set out should be explored in more detail. A proposal is also being considered at European level that would allow Member States to vary accounting requirements for micro companies. Work under this Review will be considered in the context of any EU developments. Views from business and tax professionals on the ideas and issues raised in this document are therefore particularly welcome, since the Government will only take this work further if it is convinced that there is real support for the ideas outlined in this discussion paper.

Feedback from respondents

1.9 The Government is keen to work in partnership with business and tax professionals wherever possible in considering opportunities to simplify the tax system. As a first step in this Review, the Government has sought views through an online survey and initial discussions with representative bodies, tax professionals and individual companies.

1.10 There has been considerable general agreement that simplification of corporation tax calculations for smaller companies is a good idea in principle, but no overall consensus on the form any simplification should take.

1.11 There was no consensus on aligning tax and accounting requirements. Similarly, there was no consensus on the relative complexity of tax calculations for companies versus self-employed businesses, nor any particular support for integrating the two to arrive at a common set of rules. Several respondents emphasised the non-tax reasons for incorporation and the need to preserve the legal distinction between the two forms of business.

1.12 Some respondents thought that incorporating tax rules into accounting standards could be made to work – provided it met the overall criterion of enabling genuine simplicity and certainty and did not impose different burdens.

1.13 Some form of cash accounting for tax purposes for very small businesses was seen by some as bringing potential benefits, but there were few detailed views on how that might be achieved in practice. Respondents and stakeholders noted that without any change to the Companies Act 2006, cash accounting for tax purposes would be an additional requirement to those currently imposed on companies – thus negating the potential for savings.

1.14 Discussions with stakeholders have also highlighted that certainty and stability in the tax system are equally, if not more, important to business than changes which might deliver simplification. Change itself can impose very real burdens through transition costs and businesses were keen for the Government to only make reforms as part of this review if there is a consensus that the options identified make a real and welcome difference to business and that any costs of change are manageable.

1.15 As an initial step, the Government has drawn on these broad discussions with stakeholders and now wishes to explore whether some of the suggestions should be developed further and whether they could deliver a noticeable reduction in burdens on smaller companies.

2

Ideas explored

2.1 Discussions with business and tax professionals have highlighted a number of ways in which the present arrangements for complying with statutory accounts and corporation tax obligations might be simplified, but each idea has both advantages and disadvantages. Some can be ruled out on the grounds that they would not meet the Government's fairness objective, or would not be consistent with wider public policy goals.

2.2 The key ideas the review has considered and does not intend to take forward are outlined below.

Statutory accounts profits to be used as taxable profits

2.3 One approach considered would be to accept unadjusted accounts, prepared in accordance with UK GAAP as the basis of taxable profits. This would mean that for tax purposes no further calculations would be needed, other than applying the appropriate tax rates. While this approach would undoubtedly be simpler, there are a number of drawbacks that mean that this approach is not feasible.

2.4 Companies claiming the newly introduced Annual Investment Allowance, targeted allowances for environmentally beneficial plant and machinery, and other enhanced reliefs would be disadvantaged from having to rely on less generous accounts depreciation in accordance with current GAAP. This option would remove the ability to provide similar targeted tax reliefs in the future but still require certain adjustments needed for public policy.

2.5 For example, making no adjustments for entertainment and non-business expenditure shown in the accounts would mean tax relief being given for expenditure that Government has explicitly excluded from relief for reasons of public policy. There would also be potential Exchequer risks. There would need to be new anti-avoidance legislation to prevent abuse and this would significantly reduce the simplification benefits.

Flat rate tax allowances

2.6 Some respondents suggested a system of flat rate allowances for the smallest businesses. This would mean that expenses to be allowed against business income would be set at a flat rate for all similar businesses and tax calculated on the balance. In effect, for specific types of business, tax would become a simple percentage of turnover. This would, it was suggested, reduce the need for detailed record keeping and make the calculation of tax much simpler.

2.7 This has been considered, but the extremely wide variation in the ratio of expenses to turnover, even within the same type of trade, makes this an impractical option. Making such a scheme compulsory would mean that significant numbers of businesses would lose out, particularly those who were least profitable or making losses. Any voluntary scheme would likely mean most businesses still keeping their usual records of expenses so that they could decide whether to opt into the scheme, thus negating any simplification or administrative savings.

Ideas with potential for further exploration

2.8 Discussions with stakeholders have identified two areas which may be worth considering further in relation to smaller companies:

- Whether it is possible to align current statutory accounting and tax calculation obligations into a new accounting standard incorporating tax obligations; and
- More radically, whether a new tax regime based around company cash flow could be developed.

2.9 Both approaches could deliver savings by removing the need to make different calculations for statutory reporting and tax calculation purposes. A cash-flow approach could deliver additional savings for the very smallest businesses if they did not also have to prepare accruals accounts for any other business purpose. Both ideas are discussed further below.

Statutory accounts – incorporating tax obligations

2.10 In April 2011 HMRC will be introducing mandatory online filing for company tax returns. Currently just under 45 per cent of companies file to both HMRC and Companies House at the same time and the Government expects to provide a joint filing facility by 2011. This will contribute to the Government's drive to reduce administration burdens on business.

2.11 To complement this existing work, one idea which could simplify the system involves the possibility of unifying statutory accounts reporting and tax calculation obligations for smaller companies. This would involve devising a new accounting standard under which accounts would meet statutory obligations for preparing accounts, and be a basis for assessing tax payable without adjustments.

2.12 The profit calculated in accordance with the new standard would be the company's profits chargeable to corporation tax, removing the need for a company to prepare a separate tax computation. Under such a scheme, a company's liability to corporation tax would be the same as under the current rules.

2.13 However such an approach also raises a number of issues that would need further detailed consideration, including:

- The implication that a company would have to use capital allowance rates instead of calculating depreciation. Some of these rates are significantly different from how accountants would currently depreciate an asset. For example, some assets do not currently qualify for any capital allowances.
- Where tax and accounting treatments differ, such as for fixed assets, a company's balance sheet would show different amounts. It would be more difficult to use such accounts to assess a company's performance over a number of years if significant capital acquisitions were written off in the year of purchase under the new £50,000 Annual Investment Allowance treatment.
- How to deal with certain items of expenditure that are included for accounting purposes but excluded for good policy reasons from the tax calculation, for example entertainment and fines and penalties.
- Whether this method results in a profit and loss account and balance sheet that shows a true and fair view of the company's state of affairs.
- Whether there are other users of the accounts for whom this method would be unsuitable. It has been suggested to us that at the level of smaller companies,

accounts prepared in this way are of interest primarily to HMRC, as most other users can, and do, ask for additional information.

Questions

- 1 Would moving to a new statutory accounting standard which incorporates tax rules as outlined above deliver real simplicity and savings for smaller companies?
- 2 Where and for whom would the benefits and savings occur in practice?
- 3 What drawbacks, if any, do you see with this approach to integration of statutory reporting and tax calculation obligations for smaller companies?
- 4 What other user interests must the development of such a standard for smaller companies consider?

Calculating tax on a cash flow basis

2.14 A more radical approach would be to design an optional new tax regime for the smallest of companies, based more on cash flow than accounting profits. A number of respondents said that for the very smallest companies, monitoring cash flow may be more relevant to many owner managers than calculating annual accounting profits.

2.15 The core of such a tax calculation would be the company's actual receipts in the period, less allowable business expenditure actually paid. In principle, this could integrate all the potential components of a company's calculations of taxable profits and gains (trading, property, corporate gains etc) into one, single, simpler calculation.

2.16 Such a radical departure from current accounting practice raises many issues that would need considerable further exploration. In terms of how a cash flow based regime might be devised and implemented, if this option were taken forward, issues include:

- The treatment of interest paid on borrowings. For example, whether interest paid should be disallowed – since relief would be given immediately for the purchase of stock, work in progress and qualifying capital expenditure, irrespective of when used in the business.
- How to treat certain asset acquisition expenditure and disposal proceeds – especially how such a regime might deal simply with the more complex aspects of the full capital allowance rules, such as the purchase of cars.
- Whether companies would see any advantage in such a scheme over that provided by the current Annual Investment Allowance.
- Whether there are other users of the accounts for whom this method would be unsuitable and for whom a balance sheet would still be required.
- While some aspects of such a regime could provide a net tax benefit for some businesses (for example, earlier relief for expenditure on stock and work in progress but later relief for expenditure incurred and not paid for at the year-end), most aspects would be relatively tax neutral, though a simplified regime would not include all the benefits of the full rules – for example, enhanced reliefs.
- The timing benefit that some start up and growing businesses would obtain could be expected to give rise to significant Exchequer costs, particularly on introduction of a such a regime – which the Government would need to take into account if business believes this is an option to explore further.

- Businesses that grew beyond the scope of any simplified regime would face transitional issues, administration costs, and possibly tax costs, in switching to the ordinary tax rules.
- Currently, under the Companies Act 2006, statutory accounts must be produced using accruals accounting. This would need to change before it could be worthwhile introducing any cash-flow basis for companies. Changes have been proposed at EU level to allow scope for member states to vary accounting requirements for 'micro' companies. However, these proposals are likely to take some time to be considered, meaning that a cash-flow regime is not an option in the short term.
- Some very small businesses have said moving to a cash based regime may have real benefits for them. But given the scale of some of these issues, this area clearly needs careful further consideration. For now the review is interested in the extent to which businesses recognise some of the issues above, set against the potential benefits – and have views on them.

Questions

- 5 Could introducing a new tax regime incorporating cash flow deliver real simplicity and administrative savings?
- 6 Where and for whom would the benefits and savings occur in practice?
- 7 What are your views on the various issues this approach raises, and ideas on how a workable regime could be constructed?

3

Next steps

3.1 This discussion document has highlighted two broad ideas which may offer the prospect of real simplification for smaller companies and has outlined some of the ways in which these ideas might work in practice in the longer term. In developing any new regime, recent EU proposals on allowing member states to vary accounting requirements for 'micro' companies from current accounting directives must be taken into account.

Questions

- 8 Do you feel that either, or both, of the approaches outlined above should be pursued further?
- 9 What are your views on the size and type of business to which any new regime should apply?
- 10 Could introducing new approaches on an optional basis provide sufficient stability and certainty where this is the priority for businesses?
- 11 Are there any other possibilities that you feel the review should examine?

3.2 HM Treasury and HMRC will continue to discuss options with business and other key stakeholders, including BERR and the Accounting Standards Board, to consider in detail the challenges and opportunities presented by the ideas outlined in this paper. The Government will also consider any other ideas suggested by business and tax professionals.

3.3 The Government invites comments from interested parties in seeking to deliver genuine simplification. In particular, the Government would welcome views from smaller companies on the questions asked in this discussion document and in particular whether the simplification ideas discussed above could provide benefits to their businesses that outweigh the transitional costs. Work will only be taken forward if there is genuine support for the ideas outlined in this document.

How to respond

3.4 The Government welcomes comments on the questions in this discussion paper. Any comments should be sent to:

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Alternatively, please e-mail: ctcalculations.simplification@hm-treasury.gsi.gov.uk

Telephone enquiries: 020 270 6493

3.5 Comments should be received by 20th February 2009.

Confidentiality disclosure

3.6 Information provided in response to this discussion document, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

3.7 If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Treasury or HM Revenue & Customs (HMRC).

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