

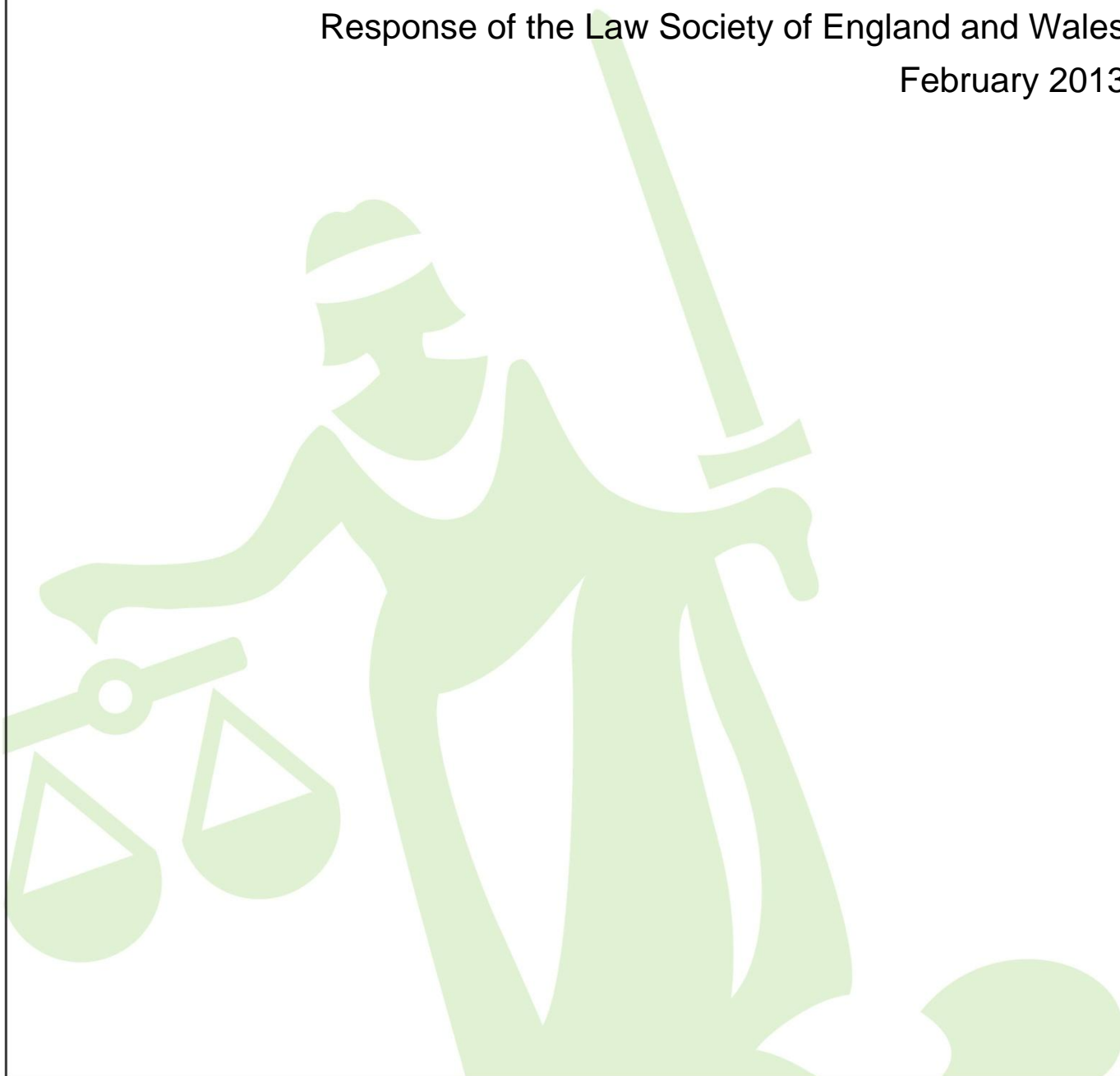


The Law Society

Simpler Income Tax for the Simplest Small Businesses

Response of the Law Society of England and Wales

February 2013



Simpler Income Tax for the Simplest Small Businesses

Response of the Tax Law Committee of Law Society

Introduction

The Law Society is the representative body for over 166,000 solicitors in England and Wales. It negotiates on behalf of the profession, and lobbies regulators, Government and others. This response has been prepared on behalf of the Society by members of its Tax Law Committee, which is made up of senior and specialist lawyers practising in this field.

The Law Society welcomes this opportunity to comment on the draft legislation published on 11 December 2012 (as subsequently amended to include transitional rules, with the updated draft legislation published on 27 December 2012), together with the Technical Note dated 21 December 2013. The comments below also follow up on a meeting at Bush House hosted by Robert Nott of HMRC on 24 January 2013 which was attended by members of the Law Society's Corporation Tax Sub-committee.

All statutory references are to ITTOIA 2005.

Executive Summary

The Law Society is in general strongly supportive of measures to simplify the tax system, and a truly simple cash-based tax system for the smallest businesses would be warmly welcomed. We do, though, share the disappointment expressed by other professional bodies that these measures remain cluttered with complexities and unjustifiable restrictions.

We strongly believe that the £77,000 turnover threshold is too high

We believe that the Government and HMRC should be listening more closely to one of the key recommendations of the Office of Tax Simplification (OTS) in its careful and detailed final report in February 2012: the cash basis should, initially at least, be restricted to those businesses with a turnover of up to £30,000 per annum.

Although the proposed higher threshold of £77,000 seems attractive in that it potentially widens the cash basis net, we understand that in practice many businesses approaching turnover of £77,000 will for other reasons (e.g. business plans, attracting investors and raising debt finance) move to a GAAP accounts based system of recognising income and expense.

It is though clear to us that this higher threshold has brought with it some seriously unattractive complexities and limitations. This link was made clear at the meeting that we attended with Robert Nott on 24 January where the higher proposed threshold was used as a key reason for some of the complexity highlighted and criticised at that meeting.

We agree with other professional bodies that what is now proposed is a regime which is several steps away from a truly simple cash-based tax system for the smallest businesses, and we strongly urge the Government and HMRC to reconsider the proposed threshold and then take a fresh look at the complexities and restrictions highlighted below and in other representations.

Unjustified Complexities and Limitations

We are aware that other professional bodies submitted detailed comments on the proposals last year and we would draw attention in particular to those from the Low Incomes Tax Reform Group and the Chartered Institute of Taxation both dated 22 June 2012. Some changes were proposed in December 2012 in light of these (and other) comments, but we would like to highlight two areas for urgent further review:

Retention of Sharkey v Wernher principles

Under a taxation system advertised as simple to operate and cash-based, it is proposed that a micro-business has to deem a wholly fictitious taxable market value cash receipt for every business asset taken (in part or in full) to private use or disposed of, for whatever reason, for less than market value (new sections 96A(3)-(7) ITTOIA 2005). To extend a doubtful rule - which can make little sense to larger businesses and their professional advisers - to the smallest businesses is in our view wholly inappropriate and, to copy the words of the CIOT, profoundly flawed as a proposed ingredient of a cash-based taxation system.

We urge you to reconsider this, and to delete section 106E which arguably goes wider than *Sharkey* itself.

Withdrawal of sideways loss relief for cash based businesses

We have seen no adequate justification for the abolition of sideways loss relief for those who elect for the cash basis. If there is concern over abuse here then we believe it is reasonable and proportionate to rely to established case-law (some of it very recent) as to when an activity constitutes a trade (or profession or vocation) rather than an uncommercial adventure or hobby. Abolishing sideways loss relief for cash based businesses will inevitably lead to unwelcome 'tactical' opt-ins or opt-outs from the cash-based regime, where ultimately most of the economic benefits will be reaped by the fees of professional advisers preparing two sets of comparative accounts.

Other Points

1. Limited Liability Partnerships

We believe that LLPs should be entitled, as with other qualifying partnerships, to elect to use a cash-based tax system notwithstanding the potential need to produce other reporting accounts for other purposes (section 31C(3)).

2. Anti-fragmentation Rules

We do not understand why a person has to aggregate all trades (professions and vocations) carried on by that person, *even if those trades are in fact completely unconnected*, to establish whether the cash basis can be used for any of them. Running several micro-businesses at the same time accentuates, rather than diminishes, the need for a simple calculation of tax due and the proposed rule unreasonably restricts entrepreneurial activity. We appreciate the need to avoid intentional fragmentation here but the provisions as they stand make no distinction between the two (see section 31A(2)).

3. Penalising pre-cash basis Tax-incentivised Expenditure

We see no good policy (or economic) reason to penalise those businesses moving to the cash basis who have previously incurred tax-incentivised expenditure and claimed allowances for a car with low carbon dioxide emissions (section 240DA), business premises renovation allowances (section 240E) or research and development allowances (section 240G). The last of these provisions also brings into charge to tax the market value of the asset “representing the expenditure” rather than the expenditure itself (although both of these formulations seem inequitable to us).

This potentially significant tax charge on entry into the cash basis will be a significant deterrent for those businesses which have incurred such expenditure (being expenditure which businesses are otherwise actively encouraged to incur through incentives in the tax system).

4. Ensuring VAT neutrality

We do not believe that the draft legislation as it relates to VAT receipts and payments always works neutrally as it should.

New section 94B(3) restricts the deductibility of a VAT payment where the underlying expense is not incurred wholly and exclusively for the purposes of the trade. However, new section 106A brings into the profit calculation *all* amounts received by way of refund of VAT, whether or not the original payment which gives rise to the refund was deductible.

We think that section 106A(b) should be amended so that the obligation to account for VAT receipts as profit is wholly/partly disapplied (a) where the business in question was opted-in to the cash basis when the VAT which is being refunded was originally paid and (b) to the extent that the VAT originally paid was not deductible due to section 94B(3).

Questions

If you have any questions on this representation and response, please contact Tim Crosley of the Corporation Tax Sub-Committee, on 020 7421 7376 or at tcrosley@memerycrystal.com.