



Taxation of Micro Enterprises Consultation
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Consultation on Taxation of Micro-Enterprises

We welcome the focus in this consultation, and in Budget and Finance Bill 2013, on small businesses. The tax regime can be an important facilitator of a small business and entrepreneurial culture, particularly if it is clear, easy to understand and straight-forward to comply with.

Ireland generally performs well by international standards in this area. Ireland ranks favourably on ease of tax payment; we are currently ranked sixth out of 185 countries, and first in the EU, in terms of ease of paying business taxes¹. The ongoing development of Revenue's Online Service (ROS) and introduction of reduced filing arrangements for VAT and PAYE/PRSI for small business have been particularly helpful.

We note that the policy objective underpinning this consultation is two-fold. The aims are to (1) cut compliance costs and (2) make starting a business less daunting. We have considered the proposals in the consultation paper in light of these policy objectives, and our key observations are as follows:

1. In principle, providing an option for micro-businesses to use a cash basis for income tax has merit. However, to achieve the full benefits of such a system, it would be very important to also determine the mechanics of paying preliminary tax in the context of a cash-based system, and the overall Pay & File arrangements which currently apply.
2. The principle of optionality with any new cash-based system would be very important. Small businesses should have the right to use the accruals basis if this would be easier for them for other reasons.

¹ *Paying Taxes 2013* – PwC and the World Bank

3. The threshold proposed for entitlement to use the simplified system is €75,000 per annum. We would like to see the threshold increased beyond this level or based on a growth factor, to allow micro-businesses to grow to a level of turnover that can sustain higher compliance costs.
4. Retaining adjustments for certain business expenses (even if these were to move to a simpler flat rate system) could still keep a significant element of complexity in a cash-based system. Perhaps adjustments could be limited to significant capital spend.
5. In addition to considering the basis of calculating taxable trading income, the treatment of issues such as non-trading income, losses, and the commencement and cessation rules would also need to be considered.
6. Introducing a cash-based system such as that proposed could entail a large amount of legislative change, and this could be a complex process. Thought would need to be given to the amount of legislative change required to implement the proposals.
7. While a focus on the rules for income tax is welcome, other taxes such as VAT, PAYE/PRSI and PSWT can in fact create more complexity for small businesses, and we would request that the scope of this exercise be broadened to bring further simplification in these areas as well.
8. As well as the important policy and legislative initiatives proposed in the consultation document, the Institute believes that there is scope to build on previous good work at an administrative level to ease the compliance burden for small businesses, for example, steps to simplify tax returns and the development of information supports.

Further details on these and other issues are contained below.

Summary of Institute Observations

The proposals in the consultation paper involve introducing a system whereby micro-businesses could calculate their taxable profits on a cash basis, instead of the current earnings basis. A simplified expense deduction regime for certain business expenses would also be introduced.

The earnings or accruals basis of calculating taxable income is a fundamental tenet of the current tax system. Any move away from this system, albeit limited to certain enterprises, would be a fundamental change, and could require an extensive legislative framework to underpin it.

Due to its nature, this is not a change which lends itself well to introduction for a short period and subsequent withdrawal if it is not effective. A small business opting to prepare records and returns on the cash basis would require certainty that this option would continue to be open to them, subject, of course, to remaining below any specified turnover threshold.

It might take some time to carry out a full cost-benefit analysis of such a scheme given the complexities involved and in the meantime continued attention could be directed towards the other ways in which the tax compliance burden on small businesses could be reduced. We set out below, as part of our detailed observations, a number of suggestions in this area, related mainly to taxpayer assistance and education, and the simplification of tax returns.

1. The system only applies to unincorporated entities

The current proposal is limited to unincorporated entities, in light of the requirement on companies to file annual returns and accounts with the Companies Registration Office. However, many businesses commence as a company, due to the nature of the sectors in which they operate and the associated risks. There is merit in extending any simplified system to incorporated micro-businesses. Any simplification of the tax system applicable to micro-companies could go hand-in-hand with a review of the current regulatory regime applicable to such companies.

2. The system would only apply to entities with a turnover of less than €75,000 per annum

The threshold currently under consideration for entitlement to use the simplified system is €75,000 per annum. Perhaps the reason why the figure of €75,000 was chosen was because it corresponds with the VAT registration threshold for supplies of goods. Although this is a figure that small businesses will understand, we believe it should be increased beyond this level or based on a growth factor, to allow micro-businesses to grow to a level of turnover that can sustain higher compliance costs.

Transitioning out of the simplified system

Where a business outgrows the simplified regime, the taxpayer may not be aware of this until some months after the end of the tax year. This may be up to 10 months after the year end, when the tax computation and return are being prepared. Consideration should therefore be given to allowing the taxpayer to use the simplified regime in computing their income tax for the first year in which they exceed the threshold. For subsequent years they would need to adopt the mainstream system unless turnover falls back beneath the threshold amount.

If a threshold of €75,000 is chosen, clarity would also need to be provided on how the €75,000 turnover figure is calculated, particularly in the absence of a concession as outlined above. It would need to be clear whether the €75,000 refers to turnover accrued or turnover actually received. For example, if the €75,000 threshold were to be calculated on an accruals basis, a business availing of the cash basis, but with a cash turnover slightly below €75,000, would be obliged to keep an extra set of records, prepared on the accruals basis, in order to determine whether (and when) they exceed the threshold.

“Trade within a trade” issues

The consultation paper raises some concerns about businesses splitting their turnover to qualify for the regime e.g. to carry on “a trade within a trade”. For the purposes of VAT, where a taxable person carries on trades of a similar nature these are counted together in order to ascertain whether the VAT registration threshold has been reached. This provision could be extended to the Tax Acts to address any concerns in this area.

3. The simplified system would apply for the purposes of calculating the taxable income of the business for income tax purposes

It appears that the simplified profit calculation proposed would apply for the purpose of determining the income which is subject to income tax in the hands of the business owner. We assume that this calculation would also apply for the purposes of determining the income which is subject to the Universal Social Charge. Consideration would also need to be given as to whether the simplified basis would apply for the purposes of calculating self-employed PRSI.

We recommend that the simplified system would apply to non-trading income or chargeable gains of the business. This would include, for example, small amounts of rental income received by the business. Case V rental profits are currently calculated on an “arising” basis.

4. The simplified system would involve calculation of taxable income on a cash basis, together with some simplified expense deduction rules

Under the current regime, the taxpayer generally approaches their tax adviser to prepare their accounts and compute their tax liability several months after the year has ended. They provide their adviser with their receipts and invoices and other books and records from which the adviser draws up accounts under the accruals basis and computes the tax due for year in question. Management accounts or draft figures may be used to compute the current year preliminary tax liability.

The proposal in the consultation paper is to allow micro-businesses to calculate their taxable income on a simple cash receipts and payments basis. A simplified expense deduction regime for certain business expenses would also be introduced.

Under such a system, the taxpayer would only need to provide limited information to their tax adviser to enable them to compute their income tax liability or they may be able to compute the liability themselves. This should make it quicker and easier to compute the tax due. However, it is noted that the proposed system is a hybrid regime, rather than a pure cash system. A number of adjustments would still be required to the business’s cash profit in order to arrive at the tax-adjusted income. This means that a degree of complexity would remain under the proposed system.

We have highlighted below a number of other complexities which may need to be dealt with in designing and operating the proposed system.

Losses

Consideration would need to be given to the current loss offset rules, and whether they would continue to apply, or whether they would require amendment, under a simplified cash basis.

Where a cash loss arises in a business, it would need to be determined how this loss may be utilised, e.g. carried back and set against the profits (calculated under the cash basis or the accruals basis) of the prior year, set “sideways” against the taxpayer’s other current year income (which may be taxable on an accruals basis), set against a jointly-assessed spouse’s PAYE income, or carried forward and set against future profits (calculated under the cash basis or the accruals basis) of the trade.

Commencement and cessation rules

The commencement rules for calculating income tax for start-up businesses, set out under section 66 TCA 1997, are quite complex. In light of the stated policy objective, we assume that the simplified regime would be equally available to start-ups and current businesses. This would mean that these commencement rules would not be applicable to those start-up businesses which opt for the simplified basis. They would operate the cash basis from the beginning. We assume that this would be equally applicable upon cessation.

5. Micro-businesses will continue to account for other taxes in the same manner as they currently do

We understand that the simplified system would only apply to the calculation of the taxable business income. The business would therefore have to continue operating fiduciary taxes such as PAYE/PRSI and VAT as it currently does. In a survey of small business carried out by RedC on behalf of the Institute in 2010², VAT and PAYE/PRSI come out as the top two issues which are perceived as placing an unnecessarily high administrative burden on small businesses. The administrative burden associated with operating these fiduciary taxes, preparing the necessary returns and maintaining adequate records would remain, and would not be alleviated, under the proposals in the consultation paper.

The application of the Professional Services Withholding Tax (PSWT) regime to small businesses is an additional burden on them as it negatively affects their cash-flow. The regime for obtaining a refund is particularly burdensome.

PSWT applies to payments made by certain public bodies and other entities for professional services. This means that tax of 20% is withheld from the payments the

² *Irish Taxation Institute SME Tax Poll – RedC, May 2010*

supplier of the services receives. Credit for this tax withheld is available when the tax return for the year is filed, where evidence of the tax withheld must be provided by the taxpayer with Revenue. In some cases it may be possible to obtain an interim refund of a portion of the tax withheld during the year, but this is subject to a complicated calculation.

We think that there should be a threshold below which the PSWT regime does not apply to exclude the smallest of businesses. We would be happy to discuss ways in which this could be implemented.

6. Consideration is being given to whether the simplified system should be optional

We believe it is important that businesses are given the flexibility to opt in or opt out of the simplified system.

Some business owners may be more comfortable with operating the mainstream regime from the beginning and may never wish to opt in to the simplified regime. Alternatively, the nature of some small unincorporated businesses may mean that they grow very quickly or they may wish to incorporate after a few years of trading. It would not be ideal for these businesses to be obliged to operate one system by default (i.e. the cash basis) when they commence to trade and then have to transition to a different system within a short timeframe. We believe that an election to move between the systems every 3 years would be preferable to a 5-year option period.

An additional reason why we believe the simplified basis should be optional is that some businesses may be obliged for commercial reasons to maintain GAAP accounts. Accounts prepared on that basis may be required by banks and other creditors, or for other business purposes. We believe it would not be appropriate to require such businesses to prepare and retain the supporting books and records for two sets of accounts.

It may be necessary to update income tax returns to include a box which the taxpayer ticks to elect to file on the cash basis.

7. The simplified system would involve no change in the current income tax Pay & File deadlines

We understand that there will be no change to the income tax Pay & File deadlines as part of the introduction of the simplified system. Therefore, although businesses will be able to calculate their taxable income on a cash basis, the income tax payment dates will not be aligned with cash flow. This contrasts with the Cash Basis of accounting for VAT, where the VAT return is filed and the liability is paid in line with the business's cash flows. As noted above, this is something which we think should be reviewed. Retaining the current complex Pay & File rules for these smallest of businesses could detract from the benefit of a cash-based system.

While the alleviation of cash flow issues for small businesses is not one of the stated policy objectives of this proposal, it may be worth considering this issue.

8. Businesses will still be obliged to retain records

We understand that the introduction of a simplified system of profit calculation would not involve any change to the obligation on businesses to retain adequate books and records.

Revenue audit procedures

Revenue's audit and compliance checking activities are largely based on review of the self-assessed returns filed by taxpayers. When Revenue audit a return or seek to verify an item in the return, they will in general examine the underlying documentation such as invoices. As returns would be based on a cash basis rather than the accruals basis under the simplified regime, a change to Revenue's protocols and procedures for verifying returns may be necessary.

In addition, Revenue may receive data from a third party relevant to a taxpayer, for example from suppliers and creditors. Where this data has been supplied on an accruals basis it may give rise to unnecessary queries for the taxpayer. This will need to be factored into Revenue's protocols.

In promoting the proposed regime, it would need to be made very clear to taxpayers that while they may use the cash basis to compute their tax liability, they must still retain their records for 6 years as is currently required. We believe that a dedicated Revenue guide on record-keeping for micro-businesses would be useful in helping these businesses develop good practices.

9. Revenue neutrality will need to be achieved with the new system

We note that the consultation paper acknowledges that some loss of revenue is inevitable in moving from an earnings or accruals basis to a cash receipts and payments basis.

We believe that a cost-benefit analysis would be beneficial prior to the introduction of any new simplified system. It would be important to estimate the level of uptake among micro-businesses who would be eligible to qualify. The impact on the Exchequer arising from these businesses moving to a cash basis would then need to be assessed. One approach may be to review the impact on tax revenues in other countries which introduced such a simplified system.

To maintain revenue-neutrality, it might be preferable to focus on other ways in which tax compliance imposes an administrative burden on small businesses (see further comment below).

Information and support for entrepreneurs

In general, taxpayers want to be tax-compliant and keep their tax affairs up to date. If compliance is made easy, most people want to comply. The smallest businesses may not have a tax adviser to explain their rights and obligations to them. Therefore, they need a central repository where they can access information relevant to them, written in simple English. Their need for information is not limited to tax. They will also have questions on what grants may be available to them, what PRSI they should be paying if they engage staff, what employment rights staff have and related issues. We think the full range of information relevant to micro-businesses should be available centrally in an online “one stop shop”.

The UK Government, in partnership with private enterprise, has developed a website for people interested in setting up a business (<http://businessinyou.bis.gov.uk/>) where a range of information from across government departments and bodies is available. We suggest that a similar resource should be made available in Ireland.

Assistance with tax returns

In a survey of small business carried out by RedC on behalf of the Institute in 2010³, over three quarters of the SMEs (79%) felt it was likely that start-ups will make mistakes in their initial tax returns, with almost all (96%) supporting more guidance from Revenue on common mistakes for start-ups.

We think that it would be useful if Revenue published a list of the type of errors new businesses make. This is something which HMRC in the UK publishes in its online guides to completing tax returns –the following example relates to Forms P45 and P46: <http://www.hmrc.gov.uk/payee/employees/start-leave/common-online-errors.htm>

It would also be beneficial if Revenue adopted a policy of applying discretion when seeking to apply penalties for example for a late return or a computational error in the first 3 years of operation of a business. This would build on the existing provision in section 1084(4) TCA 1997 under which a late filing surcharge only applies to delays in filing from the second filing date of a new business.

Simplification of tax returns

The current Form 11 is 24 pages long, and the “simpler” version (Form 11E) is 20 pages in length. Completing a form of this length is a very daunting prospect for taxpayers whether they are completing a paper return or the ROS return. Revenue have made efforts to make the form easier to complete on ROS, for example by pre-populating the return with data that applies from year to year and with any employment income or social welfare income a taxpayer has.

³ *Irish Taxation Institute SME Tax Poll – RedC, May 2010*

We think that, as a next step, further reform of the Form 11 should be considered. It should be possible to have a short basic income tax return form where additional panels are completed only as required. The UK has adopted this approach for their income tax return (Form SA100), the standard version of which is only 7 pages long (<http://www.hmrc.gov.uk/forms/sa100.pdf>), and the short version (Form SA200) is only 4 pages long. The design of the new Local Property Tax return has illustrated that it is possible to capture the data that is required on a 2-page form.

It would also be useful to take the opportunity to review the length of the Form 12 (employee income tax return) and make it possible to complete and submit the return on ROS. We think this would be beneficial to both taxpayers and Revenue in reducing the time taken to complete and process the form.

It may also be timely to review whether small businesses should be obliged to complete some third-party returns, for example the Form 46G (Return of Third Party Information). On this form a taxpayer must provide information on payments made in the course of a trade to suppliers of services where payments for these services exceed €6,000 in a year. The Institute is currently engaging with Revenue on ways to streamline completion of the Form.

Yours truly



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