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Is tax taxing?

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Meeting the taxation and credit challenge of SMEs

ACE suggests:

- The government should combine PAYE and NIC. This will reduce the size and cost of administering these taxes to all businesses.
- The government should raise the VAT threshold because the level of administrative burden changes significantly once companies pass this point. Raising the threshold would ensure that a company had enough resource to deal with the burden imposed by VAT.
- Government should look to simplify the definitional aspects of the tax system. This would make the calculation and understanding of the system much simpler for companies.
- Considerations need to be made for SMEs. Currently, tax rules are targeted more towards the larger and multinational companies.
- Reduce corporation tax for small businesses.
- The tax system should recognise that the level of tax burden changes significantly across small to medium enterprises.
- Initiatives such as the Business Payment Support Service should be extended, as these help SMEs by allowing businesses facing financial difficulties to spread tax payments over a timetable they can afford. Cash flows for small businesses that employ fewer than ten people would often prefer a range of payment options that remove the need for paying lump sums.
- Providing certainty within the tax system is key to business with regards to assessing their liabilities and future investment potential. Tax reforms should be published as part of a larger roadmap outlining key steps and actions that will take place over the next 15 year period.
- Government should further explore the possibility of underwriting SME overdraft facilities. This would help to address some of the cash flow issues experienced by SMEs without the need for radical tax reform. Criteria could be put in place in relation to the percentage available based upon a business's current credit conditions, turnover, staffing, and spending patterns.

- Flexibility support on VAT introduced during the recession should be a permanent feature of the tax system

Introduction: taxation and small business

ACE welcomes the government's continuing efforts to provide efficient processes under which businesses pay tax liabilities (such as online submissions), and the establishment of the Office for Tax Simplification, which according to HMT[1] will:

- "Provide the government with independent advice on where there are areas of complexity within the UK tax system with the potential for simplification"
- "Conduct inquiries into complex areas of the tax system, to collect evidence and advise the government on options for reform"

The government should produce information on the cost effectiveness of policies, detailing where the cost of the taxes will fall, the likely administrative cost to business, and the sectors in the economy that will benefit from the collection. This is of particular importance if taxes are collected on a local basis as both residences and businesses are likely to feel far more engaged if the process was more transparent.

Within this it is important to recognise that the level of tax burden changes significantly across small to medium enterprises. Single traders will usually undertake such activities; as companies grow their interactions with outsourced accountants will increase and personal involvement decrease with regards to the preparation of accounts, until the point at which they can employ a full time member of staff (accountant) to undertake financial activities.

The financial crisis and tightening of credit conditions have place additional pressures on companies cash flow and investment decisions. Within the financial system the government has introduced a number of initiatives to assist in the reduction of the cash burden placed upon SMEs.

Key factors within the tax system for SMEs include:

- Will my tax burden increase or decrease?
- How will this affect my costs of administration?
- Will any new tax policies be more or less complex than previously?
- Will changes affect the level of competition within the sector?

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[1] Source: HM Treasury - http://www.hm-treasury.gov.uk/d/ots_framework_document_jul10.pdf

- Do I have the cash flow to meet tax requirements?

Given the fragility of market confidence and the need to reduce the public deficit, any measures explored in this paper will be evaluated on the basis of the role they could play in both reducing the debt or their potential cost, and the need to support SMEs.

Credit issues for SMEs

A discussion with ACE's SME members reveals that cash flow liquidity is a continuing problem. The recession has meant that businesses are waiting longer for payments while having to meet the upfront and staffing costs of tendering and completing projects, including salary costs.

Banking conditions are tightening for SMEs, and a distinct difference is emerging between those companies that require general banking assistance and those that wish to expand operations:

- Firstly, SMEs that wish to expand and acquire loans for capital investment seem to be able to do so, albeit at a higher cost than before the recession.
- Secondly, SMEs have also indicated that their overdraft facilities have been reduced, the level of service and knowledge within the customer service and account management departments within the banks is falling, and the fees charged for services rising.

Below are some selected quotes from a recent ACE SME credit conditions survey:

- "Interest rates have been squeezed as the recession has persisted."
- "We need the banks for managing a cash flow which is erratic at the best of times. Prior to the banking crisis and recession we used the bank only to provide a current account overdraft facility and a commercial loan for our office building. This need/requirement has not changed post-recession and we have certainly not sought to undertake any further loans/products."
- "Overdraft facility in operation constantly, negotiated annually, and capital expenditure financing requested an average every six months."
- "We have had to manage our operations within the constraints of our reduced overdraft. We use this to manage peaks and troughs in our cash flow."
- "Requirements have remained the same when viewing the normal day to day position. Cash is harder to collect from clients though so the working capital position has deteriorated a little."

- “We now have a loan in place, utilised to fund a recent acquisition.”
- “Cash flow issues are the most significant and crippling change. The bank's short term flexibility on overdraft limits has disappeared. Overdraft limits have in fact been reduced, partner/director salaries have been capped by the bank, interest rates have been increased, bank fees have increased, and 6-monthly reviews and renewal of terms have been introduced.”
- “Cash flow is much more difficult and invoices are taking much longer to be paid.”
- “Our bank has required that our overdraft be driven downwards in a series of increments. This has been very difficult against the problems posed by the recession, but we have been able to keep within the imposed limits.”
- “Issues relate to current account overdraft and commercial building loan facilities. loan facilities suffered from a renewal of terms, revaluation of building (affecting loan-to-value considerations) and increased interest charges & fees. The bank also limited any short term 'interest-only' repayment provisions. a reduction in current a/c overdraft limit is crippling to any business however we successfully negotiated a lower reduction than first proposed and have managed to retain this so far.”
- “The bank has tried to reduce our overdraft facility at a time when we require it to be extended.”
- “Service is the same [as prior to the recession] but banks have increased fees as well as margins on overdrafts and loans.”
- “Prior to the recession we had established relationships with bank management at a high level and full access to our manager. Relationships were informal and assistance was readily on offer for both on-going business needs and business development opportunities, including investment. When the recession hit our management team essentially disappeared and our account was taken over by a new under-manager who had no previous relationship with us. The first six months were therefore extremely 'frosty' and difficult as he implemented change. not only did fees increase but we were forced to provide interim

audited accounts and projections which doubled our annual accountancy fees also and wasted an extraordinary amount of our own time/resources."

- "We have noticed a general tendency to reduce service and increase charges. All bank statements must now be checked as the number of errors have increased."
- "Generally business services have been consistently average to poor throughout the last ten years. No difference noticed during the last three years."

Given the above, we asked SMEs to provide some feedback as to the ways in which government policy could help to address the issues SMEs are facing:

- "Underwriting an overdfaft facility as described above would be very helpful."
- Government needs to quickly affect control of the banks, limiting their activities and stopping their 'bonus culture' ethic.
- "Government should cover SME 'bad debts' which are on the increase as clients are essentially forced out of business by the recession and the banks."
- "Tax and VAT bodies should relax demands on SMEs as these are currently the most likely bodies to force liquidation."
- "The government should underwrite overdraft facilities for SMEs up to £100k or 25% of turnover. This would give the banks the confidence to lend as it reduces their exposure."

Finally, we asked SMEs to provide way in which banks could improve their policies or services to better support small business, below are some selected quotes:

- "An understanding that getting money in quickly is difficult at the moment would be helpful."
- "Help reduce costs by easing requirements for audited accounts and projections from established customers."
- "Support viable private sector development projects."

- “Reduce interest rates and fees, and agree short term overdraft assistance/flexibility.”
- “Provide 'on-the-ground' help with cash flow management difficulties, cost reduction initiatives, etc.”
- “Banks need to be more client focussed and less driven by their own bottom line and try to appreciate their role in local economies.”
- “More effort put into customer service interface - everything takes ages to organise.”

The ACE annual state of business report also reveals the extent to which companies are concerned with credit conditions, cash flows.

What do you expect to be the biggest issues over the next three years for your company?

- “No room for middle size firms in the market place. Need to merge to grow.”
- Survival”
- “Cash flow”
- “The lack of availability of bank finance, late payment, and client insolvencies.”
- “Pure lack of public and private construction contracts in Northern Ireland.”
- “Survival as the bigger firms move down the project scale chasing work.”
- “Higher taxes, more legislation and more competition in tendering for projects.”
- “Insufficient business churn.”
- “Moving from large long term projects to smaller quick start and short projects.”

Flexibility within the tax system for SMEs

The tax system needs to account specifically for the needs of SMEs, with flexibility in place to account for erratic cash flow positions, whilst being simple enough to provide businesses with certainty over their liabilities.

For example, measures that could help to introduce flexibility into the system include the provision of longer payback periods and the ability to negotiate such terms in a fair and non-discriminatory manner.

Such measures should not be at the expense of efficiency. This report recognises that there are economies in having a set processes and standards in place. Having said this, the current systems processes are implemented in a way that is detrimental to businesses that cannot employ full time accountants or have limited access to such resources.

Using the tax system to incentivise/ease employment

The UK tax system currently requires small businesses to pay VAT, national insurance, and PAYE, but whilst there is not necessarily an objection to tax itself there may be issues with regards to the business's cash flow position and payments.

When employing an individual, a business will generally be paying these taxes ahead of the income the employee initially earns for the company. This is because of the lag between the person taking on projects, tendering, and the payment of money in total or instalments for the activity they have undertaken.

The above and the potential problems it can cause vary between companies and sectors.

For example, someone employed in a small retail company should improve income flows quicker than someone in a service company that has to wait for staged payments, or possibly the completion of a project.

Another variable will be the scale of the tax liability and the lag period between the business outlay and the receipt of income.

There are a few ways in which government could assist companies through the tax system, which include:

- Delay payment – this would allow companies to close the gap between the tax liability and the receipt of income from the employment of additional individuals. Ideally a delayed payment mechanism would allow for the company to clear the liability in a lump sum or provide the option for the company to spread the liability over the next six or twelve month period. This would help to smooth the effect of the delayed tax on the company's cash flow position.
- Tax holiday – a tax holiday would allow businesses to hire new employees and stabilise their cash flows before they became liable for tax. Such a period could be set at three months.

Effective tax policy

Taxation policy has always been important for SMEs; their liabilities and administrative burden have to be carefully balanced to avoid putting undue pressure on firms as they attempt to become the big corporations of tomorrow.

What makes an effective tax system?

- Tax policies should be simple to understand
- Taxation policies need to be effectively targeted, specifying outlining where their tax liabilities lie
- Administration requirements should be minimised wherever possible

Although the above are simple goals, achieving a balance between them is very difficult.

The reason taxation is so important to SMEs is because, as the incidence of tax on a company increases, the incentive to partake in entrepreneurial activity, capital investment, innovation and employment begins to fall. The level of taxation needs to be set at a rate whereby the rate of return is still considered significant enough for firms to invest in capital goods, expand production, and improve employment opportunities.

For example, in the renewables sector a considerable amount of the innovation and employment opportunities currently lie with smaller companies. Any change in the level of taxation liabilities within this sector could make a currently profitable business unviable. This would not be conducive to the UK meeting its climate change targets or becoming market leaders in advanced technologies.

Taxation issues within SMEs

A major factor for small businesses is that, within a company where the turnover is less than around £65,000, the person carrying out the financial management of the business is generally the owner. Often this is done in addition to the day to day business activities. Only the year-end accounts would be produced by a qualified accountant or auditor.

VAT

This can be the most problematic of all taxes to a small company, and given the increase of VAT to 20% things are likely to get worse.

The increase of VAT to 20% and continuing trend of late payments to companies has the potential to significantly impact upon SME's cash flows. This in turn may lead to a number of companies failing that would otherwise have continued to operate at a profit if it were not for the combination of an increased tax burden, tightening credit conditions and late payments by customers.

As soon as small companies or sole traders register for VAT their accounting becomes considerably more complicated and much more detailed records have to be kept and analysed.

While the administration of VAT is well explained on the HMRC website and in literature available, someone who has never carried out any accounting, but just handed over receipts and payments to an accountant at the end of the year tends to find it complicated and extremely time consuming.

Producing quarterly returns which are accurate and can stand scrutiny is often difficult. The company or person is generally not acting fraudulently, but makes mistakes, not remembering to enter some items or claiming back VAT on exempt products and services. More positively, companies and traders are now issued with 'reminder' letters about a month prior to the return being due if they are registered for online reporting.

Since the credit crunch the VAT office has been much more helpful when companies are struggling, allowing deferred payments. Such flexibility within the tax system would be a welcome addition in the future and should not be abandoned as the economy improves.

Payment lags and the implications for VAT

According to the Law Society, SMEs have to wait an average of 41 days longer than the time agreed with customers before receiving payments. Some £24 billion is owed to SMEs at any one time, and recent research has shown that 37% of late payers take between one and three months to settle invoices.

The 20% VAT rate is expected to exacerbate cash flow issues; the Law Society is urging small businesses to guard against late payment.

Robert Heslett, the Law Society's president, said: "Average commercial debts caused by late payments are high in the UK, and for SMEs a lack of cash flow can be crippling. With credit less available to those businesses from banks, late payments have a far more serious consequence for SMEs." Considering the amount of red tape SMEs and start-ups are faced with, it is no surprise that seeking protection against late payment from customers does not come top of the to-do list. However, it could be the difference between the business surviving or not, especially in the uncertain economic climate[2].

VAT threshold

The current VAT threshold is too low. A turnover of around £100,000 - £125,000 would be much more realistic and would generally mean that some dedicated, part-time accounting help would be available within the company. A company would be able to voluntarily register for VAT beneath the threshold if it is beneficial for them.

PAYE/NIC

Administering this tax is burdensome for small companies. The fact that all the administration has to be carried out by the company or trader, and then they have to contribute as well, may seem unfair.

In the last year, SMEs have been forced out of business because of the amount they owe on PAYE/NIC. In these cases the companies did not expect to go into liquidation because they felt they could trade out of the situation. Unfortunately, given the size of the PAYE/NIC payments, they were given no alternative. These actions not only close potentially viable companies but also mean that valuable jobs are lost.

Employers' NI also requires reviewing. Although an employee stops paying NI at retirement age, the company has to continue until the employee leaves, no

[2] Source: Michael Letch & Partners website 9 July 2010

matter what their age. So, contrary to the government's desire for companies to continue employing older people, policies allow for the potential for companies to make redundant older workers redundant ahead of younger ones because no has to be paid, but NI is still due if they stay. If companies were no longer obliged to pay NI contributions for those employees over the statuary retirement age irrespective of their employment status, this would give a clear signal that the government is willing to encourage older people to remain in the workplace.

Corporation tax

The Chancellor's June 2010 budget outlined a reduction in the rate of corporation tax for SMEs and larger corporations. However, the incentives were very much tailored towards the larger companies, leaving SMEs struggling with cash flow, churn and employment issues as well as a continuing tax burden.

For companies with taxable profits of less than £300,000 the rate is reducing to 20% (from 21%).

By contrast, large companies with taxable profits over £1.5 million have seen a commitment from government to reduce the corporation tax rate by 1% pa from 28% down to 24% between 2011 and 2014.

This does pose the question as to why the distribution of the tax reduction is aimed at larger companies when small companies provide a significant amount of the UK's employment and economic activity.

Whilst it is important to encourage larger companies to base operations within the UK, it is important not to lose sight of the contribution of the SME segment as a whole, and the potential of today's small companies to be the large corporations of tomorrow.

If the UK is to strive in areas such as green technologies, these small companies and their continued growth will be important. Lowering corporation tax would provide further incentives for companies to grow, increasing employment, output and potentially placing the UK as a global leader in green technologies.

APPENDIX A - The financial crisis – measures to reduce the burden on SMEs

Below are some of the government initiatives that are currently in place to assist business given the constraints that now exist given the recession and financial crisis:

Working Capital Scheme

The Working Capital Scheme is an initiavte set up by government to encourage banks to lend to SMEs for capital investments. Under the scheme the government will guarantee 50% of the risk. In theory this should increase the banks willingness to lend. Companies in this scheme must have a turnover of up to £500 million a year.

Enterprise Finance Guarantee Scheme

The Enterprise Finance Guarantee Scheme provides a guarantee to cover 75% of any loan with the bank covering the other 25%. The government does not provide the capital itself, but provides an assurance that should a company default that the bank will not take on the risk for the entire loan. This guarantee is paid for through slightly higher repayments within the repayment period. The loan is still subject to the normal processes a company would need to go through to acquire capital, such as the provision of a sound business plan.

Capital for Enterprise Fund

The Capital for Enterprise Fund offers small businesses with high levels of existing debt a level of support to ensure their continued operation. The fund can be used to pay off existing debts or to invest in the business itself, in exchange for an equity stake in the business. The fund currently stands at £75 million, with £50 million of support provided by government and £25 million from the banking sector.

Short Term Aid Scheme

To help elevate worsening conditions within the market and to help ensure the viability of businesses, Invest Northern Ireland launched the Short Term Aid Scheme which supports businesses to a sum of up to €£500,000 in the form of grants help businesses retain staff by funding salaries to maintain key skills.

There are three rates for the grant support: 80% for small businesses; 70% for medium sized businesses and 60% for large businesses. Payments made in arrears, based on eligible salary costs.

European Investment Bank

Some companies are able to apply for schemes operated by the European Central Bank. As with the scheme in the UK these focus on the following areas::

- Financing your investment loans: EIB loans for SMEs
- Financing your working capital requirements
- Obtaining a capital injection and development advice

Ulster Bank Regional Fund for SMEs

This fund provides business loans of up to £25,000 and is available to businesses in Northern Ireland with a turnover of less than £25 million. This can then be used to invest in the business, or to help alleviate cash flow issues.

Comments from SMEs regarding the availability of government schemes

- “There is supposed to be some sort of government support for overdraft facilities for SMEs but although we have asked our bank and other parties, we have not been able to find out how to access it.”
- “We are not aware of any government support initiatives and know of no company which received any such support.”
- “We have not checked out the government support schemes as yet.”
- “We did ask for tax payments to be deferred and that helped a great deal about 18 months ago.”

APPENDIX B - evidence for reforms to taxation

A recent survey by the Federation of Small Businesses entitled 'Voice of Small Business' Panel report[3] revealed:

- "Two thirds would not feel confident in dealing with their business' tax without professional help. 6% would be very confident (including some FSB members who are tax specialists by profession)."
- "FSB members' perception is that VAT is the easiest tax to deal with/understand. In contrast, taxable allowances are thought to be the most complex of the options listed."
- "Three quarters believe simplifying the tax system would have a positive impact on their ability to grow their business. On the other hand, one fifth think it would not make a difference."
- "A quarter spend less than 1 hour per week on tax responsibilities. But at the other end of the scale, one in twenty spends more than 8 hours per week on tax."

This the Forum of Private Business also questioned their Tax and Budget Member Panel[4], with results broadly in line with those of the FSB:

- "The overall tax burden was the biggest issue for smaller business employers, with 45% of respondents stating that this was a very serious issue. A majority also felt that the administering of tax changes and ensuring tax compliance were also serious issues."
- "Around half of the business owners surveyed felt that large corporations had an advantage over them in terms of taxations. The importance of VAT and employment costs through the taxation scheme was felt to be unfair by around a third of respondents."

[3] Source: FSB - Voice of Small Business' Panel - January 2010 Survey - http://www.fsb.org.uk/policy/assets/fsb-icm%20panel%20january%202010%20survey_report.pdf

[4] Source: FPB - Tax and Budget Member Panel Report - http://www.fpb.org/images/PDFs/research/FPB%20Taxation%20and%20Budget%20Member%20Panel%20report.pdf

- Over half of respondents felt that administrative problems in compliance and in meeting tax changes were 'serious' or 'very serious' for their business. A higher proportion of business owners felt that changes to the tax system were 'very serious' compared to the overall compliance with taxation.

Further to the above the Centre for Economics and Business Research ltd (cebr) produced a report for the FSB entitled Small business tax increases – do the economic costs outweigh the fiscal gains?[5] in which they attempted to quantify the economic outcome of tax increases on SMEs. Below are some of the conclusions:

- "Raising the small business rate of corporation tax from 21 per cent to 26 per cent would cost around 100,000 jobs and reduce economic output by £4.3 billion."
- "Adding 1p to employers' National Insurance Contributions paid by small and medium sized enterprises would reduce the deficit by £6.3 billion over ten years, but at a cost of 57,000 jobs"
- "Reducing the small business rate relief threshold by £5,000 would cost around 4,300 jobs in small businesses, but would only reduce the public sector deficit by £0.6 billion over 10 years"

It is important that the UK balances its tax regime in a way that encourages SMEs to grow. The latest statistics from the ONS reveal that the five year survival rate of SMEs is 46.6%.

	Rate (per cent)				
	Births 2003	Births 2004	Births 2005	Births 2006	Births 2007
One year survival	92.6	94.2	94.3	96.5	95.5
Two year survival	78.0	78.7	79.8	80.7	..
Three year survival	63.6	65.3	64.7	..	..
Four year survival	54.3	54.7	..	..	..
Five year survival	46.6	..	..	..	..

.. Data not available

Source: ONS - http://www.statistics.gov.uk/pdfdir/bd1109.pdf

[5] Source – cebr/FSB - Small business tax increases – do theeconomic costs outweigh the fiscal gains? - Final Report for the Federation of Small Businesses - October 2009http://www.fsb.org.uk/policy/assets/091026_final%20report.pdf

These rates are not only dependent upon a wide range of variables, while it would be inaccurate to suggest that the taxation system is directly responsible, it would be one of many contributory factors.

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