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MAKING TAX DIGITAL FOR BUSINESS (MTDfB)

UPDATED IMPACT ASSESSMENT

This note covers the methodology and assumptions behind HMRC's work on the administrative burden impacts, steady-state and transitional costs of the MTDfB reforms.

HMRC used the well-established Standard Cost Model (SCM) methodology together with internal customer insight and information obtained from engagement with stakeholders to derive the MTDfB impact assessment estimates.

HMRC also took account of responses to the consultation "*Bringing Business Tax into the Digital Age*", published on 15 August 2016, which included a substantial amount of narrative feedback on anticipated business impacts, largely anecdotal, with only a small number of respondents providing any financial estimates.

Methodology – Administrative burden impacts and steady-state costs

The SCM methodology was used to estimate administrative burdens impacts and steady-state costs for the MTDfB impact assessment.

The SCM represents the cost of complying with the tax system for a normally efficient business. This provides a consistently calculated and informed set of estimated costs for each tax obligation, averaged across the entire business population. The SCM is a comprehensive model for estimating administrative burdens that uses data collected externally directly from businesses. The OECD recognises the SCM as a quantitative methodology that can be applied in all countries and at different levels. Furthermore, in this area, the European Commission has recognised the UK's approach and efforts to measure customer costs as among the most advanced among EU member states[1]. The SCM methodology:

- is based on cost estimates informed by data collected independently by KPMG from business accountants who work with small businesses and sole traders, and their own experience as a provider of tax related services and advice;
- is updated regularly by HMRC when new evidence becomes available; wage rates, postage and acquisition costs, populations and underlying assumptions have all been updated on a regular basis during the existing SCM's lifetime;
- was the subject of a large scale update in 2015, utilising both externally commissioned research and internally sourced taxpayer data;
- includes estimates of price (that is, the activities that a business has to undertake to be compliant with UK tax legislation and the cost to the business of these activities) and also quantity (that is, the numbers of businesses affected by a particular obligation or piece of legislation);

[1] EC Working Paper N.40 'A review and evaluation of methodologies to calculate tax compliance costs' http://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_40.pdf - published 25.10.2013

- therefore uses a consistently calculated and informed set of estimated costs for each obligation;
- contains data for the majority of HMRC business obligations; and
- uses an internationally recognised framework.

The SCM methodology therefore allows HMRC to apply a standard set of principles for estimating administrative burdens across all impact assessments carried out by HMRC and HMT, meaning that published impact assessments are consistent across a range of obligations.

HMRC's assessment of steady-state administrative burden impacts for MTDfB was developed by considering the time businesses spend complying with HMRC tax obligations. Our approach comprised the following key steps.

Step 1: identify the key customer groups impacted by MTDfB

- HMRC identified about 3.5m businesses (including landlords) as falling within the initial phase of MTDfB. This population excludes those businesses covered by the under £10,000 exemption and incorporated businesses (our modelling did not consider more complex businesses or those subject to corporation tax because the policy design for these areas will be subject to further consultation in 2017). This population impacted by MTDfB was then segmented into business size: small, including nano and micro (c. 3.4m); medium (c. 0.04m); large (c. 0.01m).
- Within this impacted population, we isolated three main customer groups: (1) sole traders under Income Tax Self-Assessment; (2) simple partnerships under Income Tax Self-Assessment; (3) unincorporated businesses subject to VAT (these businesses are likely to span all three business segments identified above).

Step 2: analysis of the customer journey for each of the three groups

- For each of the three customer groups, we mapped every tax obligation from gathering and then providing HMRC with the information required for the current Income Tax return, completing a partnership tax return, making payments on account of income tax and Class 4 National Insurance , submitting a VAT return, etc.
- Having mapped the obligations and processes through these customer journeys, we used this to review and consider the full list of obligations incorporated in the SCM <u>now</u> for each of these three journeys. This identified that customers currently meet over 100 separate obligations across the three journeys. We then identified just over 80 of the current obligations which MTD may either remove, reduce or otherwise affect.
- We reviewed each of these obligations, within the context of each of the mapped customer journeys, to understand how the new MTDfB requirements might change the current 'time taken' data ascribed to each of the obligations in the current SCM database i.e. our obligations review compared the 'As is' and the 'To be' positions.

- HMRC recognised that some businesses will already be using record-keeping and accountancy software (about a quarter of the identified population), whereas others will be operating largely paper-based systems including the use of spreadsheets, and we took account of this in our modelling and assessment of impacts.
- HMRC's ongoing and extensive engagement with a wide range of stakeholders, our close working with the software developer community to better understand the potential and the capabilities of the new MTDfB software products being developed to help businesses meet the new requirements, and our awareness of the detail of the MTDfB policy design, meant that we were better able to use this insight, understanding and knowledge to determine the potential impact of the MTDfB reforms between the two positions described above ('As is' and 'To be') than we were able to do for the initial impact assessment published last year. At the end of this stage of the detailed review of the impacted obligations, we applied a reduction factor to our estimates to eliminate the potential for optimism bias; the reduction factors here were 25% for the Income Tax Self-Assessment (ITSA) obligations and 50% for the VAT obligations.

Step 3: application across the identified business population

- The estimated reduction or increase in time was applied across the unincorporated business population as a whole.
- The SCM methodology incorporates standard adjustments to account for business sizes, digital capability and agent usage.
- The overall SCM methodology was applied to apportion and average the estimated impacts across each relevant business population segment (small, medium, large).

To summarise, HMRC's assessment of the administrative burdens impacts here considered all the relevant tax and National Insurance obligations for the identified unincorporated business population.

Administrative burden impacts

Applying the SCM methodology, HMRC estimated that there would be ongoing savings in businesses' administrative costs (a combination of an overall reduction in time spent complying with existing ITSA and VAT obligations, plus the complete removal of certain obligations).

HMRC believes that the new MTDfB software products will be user-friendly, and that these integrated software products will cope with all of the required processes much more effectively than the current largely paper-based systems.

It is these paper-based systems – or in many cases no proper systems at all – which combined with the long time lag between when transactions occur and when the provision of business income and other related information needs to be made to HMRC that leads to the time wasted by both businesses and their agents in recollecting the details of particular transactions many months after they actually took place.

HMRC expects the new integrated MTDfB software products to provide for the automatic categorisation and summarisation of income and expenditure (we understand that many existing accounting and tax software products already offer this level of functionality). The integrated accounting record keeping and tax software should ensure that the quarterly updates and end of period activity will be a simple straightforward process. The software should ensure that routine work will be done automatically. Furthermore, HMRC has made clear that there is no requirement to make tax adjustments or prepare accounts each quarter. All this will help manage the impact on those businesses and their agents who are busier at one time of the year than another. Additionally, reducing the amount of avoidable errors will reduce the cost, uncertainty, worry and time that businesses and their agents face when HMRC is forced to intervene to put things right.

These ongoing savings in businesses' administrative costs were estimated by HMRC at £270 million. Savings are assumed to apply when all relevant businesses are making full use of software capabilities, i.e. they are in steady-state. A breakdown of these overall administrative burden savings (from steady state in 2021/22) is set out below.

Table 1: Steady-state administrative burden savings

Business size	**£m**
Small (incl. nano / micro)	240
Medium	10
Large	20
Total (£m)	**270**

*The presented figures have been individually rounded to the nearest £10m, therefore the totals may not sum due to this rounding

Steady-state cost impacts

Our approach on the steady-state cost impacts assumed:

- a multi-year transitional period for businesses;
- steady-state achieved from 2021/22 when all unincorporated businesses will be within MTDfB;
- transitional costs being incurred by a business in their year of transition only (which will of course vary per business);
- the inclusion of ongoing software subscription / purchase costs (software upgrade costs are captured in the transitional cost estimates);
- no steady-state additional costs in relation to agents or accountancy fees from 2021/22 (see additional comments below); and

- steady-state costs excluding training and familiarisation or the purchase / upgrade of hardware (see comments below – all these appear in transitional costs).

On agents or accountancy fees post the multi-year transitional period, HMRC took account of the responses received during the consultation as well as discussions with stakeholders, and we assumed that, in steady state from 2021/22, accountants and businesses would be familiar with the necessary MTDfB requirements and processes, and that competition in the agents' market should mean that there would be no overall increase in agents or accountancy fees after the transitional period.

This assumption is supported by HMRC's experience with Real Time Information (RTI) for PAYE, where concerns of multiplied agents' fees did not materialise. Furthermore, HMRC's experience with VAT and ITSA is also instructive. With VAT, we have seen businesses with a lower agent penetration than in ITSA make regular returns of information derived from business records by themselves while with ITSA, there is high agent penetration for the annual returns of computed profits. Frequency of interaction seems to lead to lower use of agents.

HMRC's assessment of steady-state costs not including training and familiarisation or the purchase / upgrade of hardware takes account of the responses received during the consultation.

New MTDfB obligations

We also considered whether the MTDfB requirements introduced new obligations that needed to be incorporated into the SCM modelling, and identified two – digital record keeping and quarterly updates.

Record keeping in itself is not a new obligation in the SCM methodology, however digital record keeping is. For the purposes of the impact assessment, we have assumed that digital record keeping supplants the current requirement to maintain paper records, and that it also reduces the burden of a range of other current obligations.

For the quarterly update process, as mentioned, HMRC expects that the new MTDfB software will provide for the automatic categorisation of income and expenditure so that routine work will be done automatically, and that it will produce the quarterly update using the information already captured about income and expenses. Given that there is no requirement to make tax adjustments or prepare accounts each quarter, the burden associated with quarterly updating is therefore likely to be minimal – little more than uploading the information to HMRC, although we have estimated an amount using the SCM methodology.

Table 2 below aggregates the estimated steady-state costs for ongoing software subscriptions / purchases and the additional administrative burden costs for the quarterly updates.

Table 2: estimated steady-state MTDfB costs

Steady-state ongoing costs	£m
Software subscriptions / purchases	160
Quarterly updates	20
Total (£m)	**170**

* The presented figures have been individually rounded to the nearest £10m, therefore the totals may not sum due to this rounding

Ongoing steady-state costs are therefore estimated at £170 million. Overall, this produces a net administrative burden saving of £100 million (from steady state in 2021-22).

Approach to steady-state software costs

The government is committed to ensuring the availability of free software for businesses with the most straightforward affairs, and HMRC's work with software developers suggests that there will be a range of free software available with a good level of functionality, potentially covering a significant section of the small business population.

Taking into account the broad criteria (published in our response document on 31 January 2017), and reviewing the small business population, we have assumed:

- approximately 60% of the small business population of about 3.4m businesses (about 2m businesses) will be entitled to, and will take up, the free software on offer;
- 40% of small businesses would need to subscribe / purchase new software (transitional costs for this group are covered later in this note);
- with MTDfB compatible software capable of running on most current and recent technology (potentially even a dial-up connection is sufficient to transfer data) we have assumed that businesses in the medium and large segments will not need to acquire completely new software – these businesses may find that their existing software systems may only require an upgrade (covered in the transitional costs section);
- however, we have assumed that all these businesses in the medium and large segments will still need to keep their software current and up to date through ongoing steady-state subscriptions.

HMRC estimated steady-state software costs, across the three business segments (see Table 3), based on a combination of qualitative and quantitative analysis; taking account of estimates provided by consultation respondents, commercially available software products, internal customer insight and stakeholder discussion.

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Table 3: Estimated steady-state ongoing software subscription / purchase costs

Business size	£m
Small (incl. nano/micro)	150
Medium	10
Large	negligible
Total (£m)	**160**

* The presented figures have been individually rounded to the nearest £10m, therefore the totals may not sum due to this rounding (where value under £3m = negligible)

Transitional costs

The government expects most businesses to incur transitional costs in moving to the new MTDfB requirements. In arriving at these costs, HMRC considered and took account of the lessons from the introduction of Real Time Information (RTI) for PAYE. We recognise that costs will invariably differ from business to business, and the transitional cost estimates published on 31 January 2017 represent an average across the unincorporated business population

These estimated average costs were arrived at through a combination of qualitative and quantitative analysis, evidence drawn from estimates provided by consultation respondents, commercially available software products, internal customer insight and discussions with stakeholders.

Transitional costs fall into four broad categories:

1. training and familiarisation time to include both new digital tools and the new cycle for updating HMRC;
2. purchase of new hardware or the upgrade of existing hardware;
3. additional agents or accountancy costs – HMRC will also be providing guidance and support to help businesses move to the new processes;
4. upgrading existing software and apps.

Training and familiarisation costs

HMRC has been working with software developers on the development of MTDfB related products, and developers are aiming to make their products as easy to use and straightforward as possible. For those already using digital software and apps to keep their business records, there will be little change between the way they work now, and how things will work under the new system. Medium sized and large businesses may already have sufficient staff expertise in-house in relation to software and tax which may mean that any training and familiarisation support required is reduced. Also gaining familiarisation with an app is likely to be faster than for software, so overall, for those already using digital tools and software, the MTDfB requirements may be largely intuitive. HMRC also assumed that smaller businesses would prefer to undertake any required training and familiarisation more flexibly than medium sized and large businesses.

However we recognise that there is likely to be an opportunity cost to become familiar with MTDfB. Our assumptions are that:

- Small businesses will spend on average 6 hours to familiarise themselves with MTDfB. We have applied the standard SCM wages rate.
- For medium sized businesses, we assumed 8 hours opportunity costs, plus the cost of one day training at standard market rates.
- For large businesses, we assumed 16 hours opportunity costs, plus the cost of two days training at standard market rates.

Based on those assumptions, Table 4 summarises the total transitional costs for training and familiarisation.

Table 4: Training and familiarisation costs

Business size	**£m**
Small (incl. nano/micro)	430
Medium	20
Large	10
Total (£m)	**460**

* The presented figures have been individually rounded to the nearest £10m, therefore the totals may not sum due to this rounding

Hardware costs

We know from earlier research that a large majority of businesses and agents have access to various IT hardware tools, either desktops, laptops, tablets or smartphones. Even amongst those small businesses that do not currently operate digitally, they may have equipment at home suitable for operating MTDfB software.

Ofcom's "*Communications Market Report 2016*" (published August 2016), shows 74% of semi-skilled, unskilled or non-working households have the internet at home, with the percentage being 92% for those at higher or intermediate managerial, administrative or professional levels. The ONS "*Internet Access – households and individuals: 2016*" survey (published 4 August 2016) indicated that 89% of households in Great Britain had internet access.

The Department for Business, Energy and Industrial Strategy (BEIS) research[2] indicates that 90% of zero employee businesses had access to the internet for work purposes with 59% having their own website. 95% of SME employers had access to the internet for work purposes. Further BEIS

[2] BIS RESEARCH PAPER NUMBER 290- 'Longitudinal Small Business Survey Year 1 (2015): Businesses with no employees' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/522366/bis-16-226-zero-employees-report.pdf Published May 2016

research[3] suggests that those that did not have access to the internet were most likely to be micros (5% compared to 3% of small businesses and 1% of mediums). This suggests a high level of businesses have access to the internet and the required hardware to enable this online access.

HMRC believes that VAT-registered, medium sized and large businesses are very likely to already have good or adequate IT hardware. If anything additional is required for MTDfB, this may only require a minor upgrade.

Taking into account existing research, and in arriving at the hardware costs detailed in Table 5, we have assumed:

- 10% of small business will need to acquire hardware; and 50% will need to upgrade their existing hardware; and
- for medium sized and large businesses, we have assumed around 10% will need to upgrade their hardware (none of these businesses were assumed to need to purchase hardware).

Table 5: Hardware costs

Business size	**£m**
Small (incl. nano/micro)	330
Medium	negligible
Large	negligible
Total (£m)	**330**

* The presented figures have been individually rounded to the nearest £10m, therefore the totals may not sum due to this rounding (where value under £3m = negligible)

Additional agents or accountancy costs

Some businesses will find that the new MTDfB software means they can do more for themselves in relation to book keeping and tax. Those businesses that are recording transactions digitally may choose to make the quarterly updates themselves and final end of period activity should be a simpler process than for a business maintaining its books and records on paper. Some businesses who currently use agents for all their record keeping and tax requirements may in time use them less, or differently.

More broadly, individual partners in a partnerships will no longer have to complete a separate return where the only reason for their being in ITSA is because they are in a partnership. They should therefore save agents or accountancy costs at year end.

[3] BIS RESEARCH PAPER NUMBER 289- 'Longitudinal Small Business Survey Year 1 (2015): SME employers' https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/522364/bis-16-227-sme-employer-report.pdf Published May 2016

However, we do recognise that businesses may need reassurance in relation to the new MTDfB requirements. Medium sized and large businesses may already have sufficient expertise in-house which may mean that any additional support they require from their agents is not significant. Costs for these businesses will be negligible; much will be in house and they will be in a good position to move to digital.

In arriving at the additional agents or accountancy costs – as detailed in Table 6 – we have made the following assumptions:

- 30% of small businesses would incur additional agents or accountancy costs as they help clients prepare for MTDfB;
- 5% of small businesses would incur a slight saving; and
- for medium sized and large businesses, 50% would incur additional fees.

Table 6: Additional agents or accountancy costs

Business size	**£m**
Small (incl. nano/micro)	90
Medium	5
Large	negligible
Total (£m)	**90**

* The presented figures have been individually rounded to the nearest £10m, therefore the totals may not sum due to this rounding (where value under £3m = negligible)

Software upgrade costs

As mentioned previously, the government is committed to ensuring the availability of free software for businesses with the most straightforward affairs, and HMRC's work with software developers suggests that there will be a range of free software available with a good level of functionality.

Our modelling therefore took into consideration the proportion of businesses that would be using free or paid software. Those using free software are assumed to incur no additional costs. It was assumed that all medium sized and large businesses would need to upgrade their software.

Table 7 below sets out our estimate of these software upgrade costs, and which assume:

- 10% of small businesses would need to pay to upgrade their software (in the section on steady-state costs, we assumed that 40% of small businesses would need to subscribe / purchase software, and here for transitional costs, we make the further assumption that of this 40%, 25% i.e. 10% of this particular population will also need to pay to upgrade their software as well); and
- for medium sized and large businesses, we assumed 100% of these two populations would need to do so.

Table 7: Software upgrade costs

Business size	£m
Small (incl. nano/micro)	10
Medium	50
Large	30
Total (£m)	**90**

* The presented figures have been individually rounded to the nearest £10m, therefore the totals may not sum due to this rounding

Summary transitional costs

HMRC estimates that, on average, businesses will incur about £280 in the year of transition, although the transition process is spread as businesses will join at different points during the period.

Transitional costs may be lower for some smaller businesses, for example those already using digital tools or those who are eligible to use free software. For those businesses that have limited existing digital capability and / or need to purchase hardware and software, costs may be higher.

We recognise that business size and digital capability are not necessarily correlated, other factors such as demographics and / or the business sector can affect this. No adjustment has been made in our estimates for wider digital benefits, for example, through productivity and efficiency improvements. Table 8 below presents the total transitional costs for MTDfB.

Table 8: Total transitional costs

Business size	Population (m)	£m
Small (incl. nano/micro)	3.4	870
Medium	0.04	80
Large	0.01	30

HMRC's overall methodology has been discussed with the Administrative Burdens Advisory Board. HMRC believes that its methodology is comprehensive, and it reflects all the impacts from the introduction of MTDfB for those businesses paying Income Tax and VAT.

Quantitative estimates of the one-off transitional costs and steady-state ongoing savings will continue to be iterated through ongoing research and consultation with businesses to ensure that these are reflective of the final software solution and MTDfB policy design, and our large scale public beta should help provide further insight.

HMRC believes that, while there will be a level of transitional impact for businesses, MTDfB will deliver clear, ongoing benefits for businesses helping them get their tax right and supporting our ambition to tackle the tax gap due to avoidable error and failure to take reasonable care.