



HM Revenue
& Customs

The Rt Hon. the Lord Forsyth of Drumlean
Chair, House of Lords Economic Affairs Finance Bill
Sub-Committee
House of Lords
London
SW1A 1AA

Ruth Stanier
Director General
Customer Strategy and Tax Design

100 Parliament Street
London
SW1A 2BQ

Tel: 03000 544855

Email: Ruth.Stanier@hmrc.gsi.gov.uk

Date: 9th November 2018

Dear Lord Forsyth,

Further to my letter of 5 November, we have now completed the necessary work in order to share additional information about the impact assessment for Making Tax Digital for Business, including segmentation data on administrative burdens. This is set out in the attached paper.

Yours sincerely,

Ruth Stanier
Director General, Customer Strategy and Tax Design

Making Tax Digital for Business

1. This paper provides further information and segmentation data relating to the steady-state and transitional costs set out in the published impact assessment.
2. The estimates provided do not take account of tax relief, in line with standard methodology. In practice, costs for hardware, software and training qualify for 100% tax relief.

Administrative burden impacts and steady-state costs

3. We currently estimate a net on-going cost to businesses of c£37m per annum. Costs are almost entirely attributed to businesses that are moving to software from other processes, and hence will incur the annual subscription costs to operate MTD. Table 1 (at the end of this section) provides a breakdown of costs per business, based on size, accounting practice and anticipated change with MTD.
4. Standard Cost Model (SCM) methodology was used to estimate administrative burden impacts and steady-state costs for the MTD impact assessment. This methodology allows HMRC and HMT to apply a standard set of principles for estimating administrative burdens across all impact assessments, so that they are consistent across a range of obligations.
5. The 'standard cost' represents the cost of complying with the tax system for a normally efficient business. This considers only those costs and savings strictly related to compliance with MTD and meeting tax obligations. This provides a consistently calculated and informed set of estimated costs for each tax obligation.
6. 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 – for example, wage rates, postage and acquisition costs, populations and underlying assumptions have all been updated on a regular basis;
 - 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);
 - 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.
7. HMRC's assessment of steady-state administrative burden impacts for MTD was developed by considering the time businesses spend complying with HMRC tax obligations.
8. Our approach comprised the following key steps:

Step 1: Initial segmentation of the MTD VAT population

HMRC identified about 1.2m businesses as falling within the scope of mandate for MTD for VAT, i.e. with turnover in excess of the £85,000 VAT threshold. This population includes both incorporated and unincorporated businesses. This population was then segmented into business size:

- small (c. 1.15m businesses with turnover between £85k and £10m);
- medium (c. 30k businesses with turnover between £10m and £200m); and
- large (c. 2.5k businesses with turnover £200m+).

This initial segmentation allowed for consideration of the differing costs and requirements for small, medium and large businesses.

Step 2: Segmentation of groups by process / agent use

The VAT small, medium and large business populations were further segmented to reflect the differing processes currently employed by businesses to manage their VAT affairs, anticipated change with MTD and their use of agents / accountants. Four segments considered those businesses that largely managed their VAT affairs in-house (although adjustments for use of agents was factored in). A fifth segment considered businesses that completely rely on agents to manage affairs. It is important to note that agent roles differ across businesses; some will only use agents to help prepare and submit the VAT return whilst others will outsource all the work. The segments used were:

- *Businesses using paper-based accounting processes moving to MTD software*
- *Businesses using spreadsheet-based accounting processes retaining spreadsheets, but using 'bridging' software*
- *Businesses using spreadsheet-based accounting processes moving to MTD software*
- *Businesses using already using accounting software*
- *Businesses outsourcing all VAT work (using agents)*

Step 3: Development and analysis of customer journeys and obligations mapping

Customer journeys for each of the 5 primary segments were developed to consider current processes and anticipated changes for businesses operating MTD. This allowed for VAT obligations to be mapped against the journeys.

The SCM contains almost 300 obligations for VAT. The first step was to identify those that would see changes in burden due to MTD. This work was carried out through comprehensive impacts workshops to estimate percentage reductions in the time taken for each obligation through operating MTD.

We acknowledged 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. This was taken account of in our modelling and assessment. Similarly agent usage was factored in; for instance, HMRC internal estimates are that almost all VAT businesses with taxable turnover over £10m use an agent.

At the end of this stage, we applied a 5% adjustment to our estimates to reflect the potential for optimism bias (consistent with previous versions of the MTD savings model).

Findings of the workshops were shared for review with trusted external stakeholders, including HMRC's independent Administrative Burdens Advisory Board and representatives of principal accountancy bodies.

Step 4: Application across the identified business population

The estimated reduction or increase in time was applied across the population within the scope of mandate for MTD for VAT. 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.

Administrative burden impacts

9. HMRC estimated that there would be ongoing savings in businesses' administrative costs – resulting from a combination of an overall reduction in time spent complying with existing VAT obligations, plus the complete removal of certain obligations.
10. Ongoing savings in businesses' administrative costs were estimated at £16 million. Savings are assumed to apply when all relevant businesses are making full use of software capabilities, i.e. they are in steady-state.

Steady-state cost impacts

11. HMRC estimated steady-state software costs, across the same segmented population as the savings estimates, i.e. segmented not only by size but by current practices and anticipated change. The estimated costs were 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.
12. Those already using software to manage their tax affairs will find that MTD compatibility comes at little to no cost.
13. Software costs are the sole ongoing cost identified for the assessment. Businesses at the larger end of the VAT spectrum are more likely to be digitally capable, with many already using software and experiencing the benefits of doing so. Businesses moving to software from other, less automated processes or stand-alone accounting systems will have the impact of new annual software subscription fees. HMRC is working very closely with the software industry, and is confident that small businesses that already operate software on a subscription basis will see only nominal increases in annual fees to account for new MTD functionality. Many existing subscription-based software packages will be upgraded to provide MTD functionality at no extra cost and some providers have indicated that they are considering offering free products for smaller businesses.
14. No additional cost has been assumed for agent usage at steady state. Our assumption is that from 2021/22, accountants and businesses would be familiar with the necessary MTD 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 for Pay As You Earn taxation, where concerns of multiplied agents' fees did not materialise.
15. Ongoing steady-state costs are estimated at £52 million. Allowing for rounding, offsetting this figure against savings produces a net administrative cost saving of £37 million.

Table 1: Summary of steady-state admin burden estimates

		Savings Estimate	Cost Estimate	Net Cost	Per Business
Business Size	Business Journey				
Businesses with turnover between £85k and £10m	Paper to Soft	£15,000,000	£43,000,00	£28,000,000	£120
	Spreadsheet	£1,000,000	£6,000,000	£5,000,000	£30
	Sprd to Soft	£0	£3,000,000	£3,000,000	£30
	Software	£0	£1,000,000	£1,000,000	£30
Businesses with turnover between £10m and £200m	Spreadsheet	£0	neg	neg	neg
	Sprd to Soft	neg	neg	neg	neg
	Software	£0	£1,000,000	£1,000,000	£40
Businesses with turnover £200m+	Software	£0	£0	£0	£0
		£16,000,000	£52,000,000	£37,000,000	£30

Figures may not sum due to rounding

Transitional costs

16. Transitional costs are those costs incurred by a business in preparation for operating MTD. HMRC expects most businesses within scope to incur some transitional cost in moving to the new MTD requirements.
17. Transitional costs are estimated at £131m. These have dramatically reduced from the previous estimates. This is mainly triggered by the new target population – VAT registered businesses with turnover above the threshold of £85k are generally more capable and ready for the change to MTD than a low turnover Income Tax Self Assessment business.
18. Those businesses already using accounting software or who currently outsource VAT work to an agent or accountant are anticipated to see lower costs than for those moving to software systems from paper-based or spreadsheet systems.
19. Transitional cost calculations do not utilise the material held within the Standard Cost Model – this is in line with standard practice.
20. Four primary components make up the transitional costs estimate:
 - training and familiarisation time to include both new digital tools and new processes - this factored in opportunity cost of lost time to business;
 - purchase of new hardware or the upgrade of existing hardware;
 - additional agents or accountancy costs – HMRC will also be providing guidance and support to help businesses move to the new processes;
 - upgrading existing software and apps.
21. Estimated costs, with variances applied relative to the segmentation, were calculated with reference to both qualitative and quantitative evidence. These variances reflected both the complexity of the process change and the complexity of the business.

Software setup, training and familiarisation costs

22. HMRC has been working with software developers on the development of MTD 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 MTD 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.

23. Businesses are expected to need time to set-up any new software systems, or evaluate existing systems for MTD compatibility. They are **not** required to enter historical records into the new systems, so this is not considered.

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

- Smaller businesses expected to take roughly a working day, though this is reduced for those employing agents as they should receive advice. Medium businesses take slightly longer due to increased complexity.
- Businesses remaining with spreadsheets will need time to understand bridging software and how to adapt existing system.
- Small businesses currently using software should see no impact, as MTD functionality is rolled out 'as standard'.
- Medium and Large businesses currently using bespoke software will need to assess existing system and ensure its MTD functionality.

25. Based on those assumptions, the table below summarises the total transitional costs for setting up software.

Table 2: Transitional Software setup cost assumptions

Admin Burden Estimates		Insourced		Outsourced		Total
Business Size	Business Journey	Software Cost	Admin Burden	Software Cost	Admin Burden	
Businesses with turnover between £85k and £10m	Paper to Soft	£126	£14,000,000	£84	£10,000,000	£25,000,000
	Spreadsheet	£42	£3,000,000	£42	£3,000,000	£6,000,000
	Sprd to Soft	£42	£2,000,000	£42	£2,000,000	£4,000,000
	Software	£0	£0	£0	£0	£0
Businesses with turnover between £10m and £200m	Spreadsheet	£75	£0	£75	neg	neg
	Sprd to Soft	£75	£0	£75	neg	neg
	Software	£19	£0	£19	neg	neg
Businesses with turnover £200m+	Software	£19	£0	£19	neg	neg
			£20,000,000		£16,000,000	£36,000,000

Figures may not sum due to rounding

26. Wage rates have been applied as per data held within the SCM. Smaller businesses utilize higher level staff, whilst medium and large are able to hire dedicated staff to operate in the same role.

MTD familiarisation

27. A further element of the transitional cost estimate is the costs to businesses of familiarising themselves with the MTD policy, how it impacts on their business and understanding what changes they need to make. It also includes any on the job training staff may undergo. Based on those assumptions, the table below summarises the total transitional costs for MTD familiarisation.

Table 3: MTD familiarisation cost assumptions

Admin Burden Estimates		Insourced		Outsourced		Total (£m)
Business Size	Business Journey	Training Cost	Admin Burden	Training Cost	Admin Burden	
Businesses with turnover between £85k and £10m	Paper to Soft	£167	£19,000,000	£167	£21,000,000	£40,000,000
	Spreadsheet	£84	£7,000,000	£84	£6,000,000	£12,000,000
	Sprd to Soft	£84	£5,000,000	£84	£4,000,000	£8,000,000
	Software	£42	£17,000,000	£42	£10,000,000	£27,000,000
Businesses with turnover between £10m and £200m	Spreadsheet	£75	£0	£75	neg	Neg
	Sprd to Soft	£75	£0	£75	neg	Neg
	Software	£37	£0	£37	£1,000,000	£1,000,000
Businesses with turnover £200m+	Software	£93	£0	£93	neg	Neg
			£47,000,000		£42,000,000	£89,000,000

Figures may not sum due to rounding

Hardware costs

28. We know from 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 MTD software.

29. 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 MTD, this may only require a minor upgrade.

30. Taking into account this research, we have assumed only a very small proportion of small businesses will require new hardware to operate MTD

Additional agents or accountancy costs

31. We believe that some businesses will find that the new MTD software means they can do more for themselves in relation to book keeping and tax. Those businesses that are maintaining their own digital records may choose to make the quarterly returns themselves. Some businesses who currently use agents for all their record keeping and tax requirements may in time use them less, or differently.

32. In arriving at the additional agents or accountancy costs, we have made the following assumptions: HMRC internal estimates are that almost all VAT businesses with taxable turnover over £10m use an agent, therefore all medium and large businesses are assumed to be using agents in some capacity. Due to their size and agent loyalty, we do not expect they will be required to pay additional fees for MTD assistance.

Summary of transitional costs

33. The estimated transitional cost to the mandated population of 1.2m businesses is £131m, with these costs potentially eligible for full tax relief. The main elements are familiarisation (£90m) and software (£40m).
34. Averaged across the population HMRC estimates that, on average, businesses will incur costs of about £109 in the year of transition, although the transition process is spread as businesses will join at different points during the period.
35. Transitional costs may be lower for businesses already using digital tools. For those businesses that have limited existing digital capability and/or need to purchase hardware, costs will inevitably be higher. HMRC anticipates that a significant majority of businesses with a turnover in excess of the VAT threshold will already have the necessary digital tools to operate MTD.
36. Those businesses within scope of mandate for MTD for their VAT obligations are businesses that are likely to be more digitally ready and capable of making an earlier transition, with the majority already reporting VAT quarterly. Where they have alternative reporting arrangements, these will be maintained. Because a significant proportion of the mandated population already uses software and has less need of new or upgraded hardware to operate MTD, these transitional costs are lower than previously estimated.
37. 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 MTD for VAT.
38. 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 reflect the final software solution, and our large scale public beta should help provide further insight.