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Tax compliance costs for small and medium sized enterprises: the case of the UK

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Abstract

This paper presents a section of the findings from the UK arm of an international research project that is evaluating and comparing tax compliance costs affecting small and medium sized enterprises (SMEs) across four countries.

It has been argued that the regulatory requirements on businesses, particularly those on SMEs, are burdensome and can be a constraint on their growth and so success. There have been considerable developments in tax policy, which have impacted on compliance costs within the UK over the last 20 years, and these are reviewed in order to set the current findings into context. The literature review considers developments in the

1.

A full literature review is considered unnecessary (See Evans, 2001 for full details), but there have been a number of studies specifically focusing on small firms. These include studies in Australia (Wallschutzky, 1995), Malaysia (Ariff and Pope, 2002), New Zealand (Ritchie, 2001), U.S. (Slemrod, 2004) as well as a multi-country study (OECD, 2001). None of the studies specifically focusing on SME tax compliance costs have been carried out in the UK, which we consider to be a gap in prior literature.

In the recent *Mirrlees Review* conducted by the Institute of Fiscal Studies, Crawford and Freedman (2010, pp. 1080-1083) reviewed the compliance cost literature as it affects small firms. They suggest that the high VAT threshold in particular may cause problems for SMEs (especially with regard to expansion and efficiency).

While there can be a link between the level of compliance costs and actual tax compliance, this does not mean that policy should ignore the high burden placed on small businesses. For example, small businesses such as sole proprietors tend to exhibit the lowest voluntary compliance rates while also facing the highest compliance costs (Sandford et al. 1989; Slemrod, 2004). One reason is that they may have the opportunity to not comply, but additionally, such firms simply may not understand their tax obligations, especially those without access to expert professional advice.

Attempts by successive governments to make it easier for small businesses to develop and grow have had mixed outcomes. From a policy angle, the U.K. government has had a mantra of reducing compliance cost burdens with it featuring as a Public Service Agreement (PSA) target for HM Revenue and Customs (HMRC). The Department carried out an exercise with KPMG to measure compliance cost obligations using a Standard Cost Model (HMRC, 2005) resulting in various initiatives that are worth reviewing briefly at this stage.

Following publication of the KPMG research HMRC published a reflection on how changes were going to be implemented in order to address some of the issues raised (HMRC, 2006). The overarching targets were to reduce by at least 10% the administrative burden on business of dealing with HMRC forms and returns over a five year period and reduce the burden of dealing with audits and inspections by 10% over three years and 15% over 5 years. Practical manifestations of these include the requirement that businesses should have to provide information only once, have a single point of contact with HMRC and receive support, education and guidance at the time when they most need it. The KPMG research identified complexities and, what they term, the “irritation factor”, which it identified a number of obligations that impose the majority of administrative burdens on businesses dealing with the UK tax system; the most important one being the main tax returns. In addition there was an acknowledgement that “We know many of our customers want to comply but are unsure of what to do or where to find appropriate help” (HMRC, 2006, p. 21).

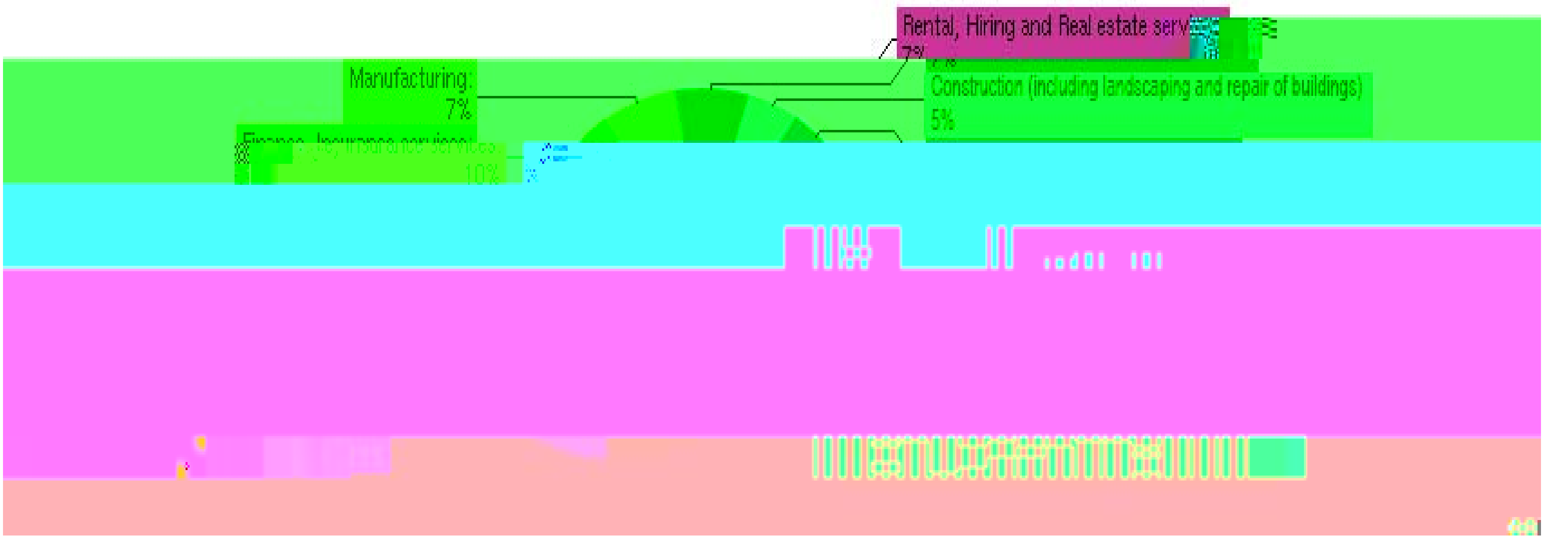
Compliance cost reviews (CCRs) introduced by HMRC had an overall aim of minimising the costs of complying with new and existing tax obligations. In order to achieve this improved training and guidance was introduced for those dealing with impact assessments, better support with quality assurance of each impact assessment and regular liaison with the Better Regulation Consultative Committee (HMRCa, 2010). The outcomes identified included the need to give more consideration to the effects of changes on all sizes of business, to address the lack of understanding of commercial practices and business models in impact assessments need to better identify data sources and more clearly explain the analysis they contain and underlying assumptions, including the impacts on tax agents (HMRCb, 2010).

The next section outlines the stages in our questionnaire design and method adopted in collecting data and we also acknowledge trade-offs encountered and limitations in our method.

3.

The questionnaires were sent out in June 2011 to members of ACCA and so by definition all responses were filled out by a qualified accountant. Forty one ACCA members responded and of those over half (55%) had been admitted to membership over ten years ago, with a further 15% admitted 5-9 years ago and 12 respondents admitted in the past four years. They represented firms from a variety of sectors (see Figure 1). In terms of legal structure, 35 firms (85%) were private limited companies.

Figure 1: The sector of the respondents to the questionnaire



The number of years the firms have been trading ranged from over ten years for 24 firms (60%) to one firm that had been in business for less than a year.

In terms of size by turnover, two firms reported a turnover under £73,000 (the current UK VAT registration threshold) with two firms reporting turnover exceeding £25,900,000. The median firm had a turnover between £1,350,000 and £6,500,000, so being between the VAT cash accounting limit and upper turnover limit for a small company.

For the opinion driven questions (detailed in Section 4.2) respondents were asked how

4.1.2 In-house Compliance Costs and Time

Apart from fees paid to external advisers, internal compliance activities can be significant in terms of the actual hours taken in that area and activity and the commercial value of that time. Our survey focused on four distinct areas: VAT, Income Tax and Corporate Tax, PAYE and Capital Gains Tax.

Table 2: In-house Compliance Costs and time spent allocated to different taxes

	VAT	Inc./Corp. Tax	PAYE	CGT	Total
Average Cost	£ 6,062	£ 4,362	£ 3,645	£ 602	£ 14,671
% in-house cost	41.3%	29.7%	24.9%	4.1%	100.0%
Average Hours	219	85	115	15	434
% in-house time	50.5%	19.6%	26.5%	3.4%	100.0%

The results show that VAT consumes, on average, over half of all in-house time spent on tax compliance and incur over 40% of the value of that time. In contrast Income Tax and Corporation Tax only incur roughly 20% of in-house time, but cost approximately 30% of the value of that time. This might be due to the, often, complex nature of direct tax in the U.K. PAYE consumes about one-quarter of firms' time and value, and lastly, CGT oca lam7.4( )o1131 -1ly
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4.1.4 Total Tax Compliance Costs

Total tax compliance costs are the sum of in-house and external costs of complying with taxes. The mean total costs of compliance were £21,362 (standard deviation £19,825) ranging from £1,375 to £76,950. However, these costs are skewed by several large observations and the table below reports these costs by quartile. As not all respondents answered each question, and some respondents use external advisers only (or in-house compliance activities only), the rows are not additive.

Table 4 shows variation in in-house, external and total compliance costs for the sample. The means reported in the final column (All Firms) show that all classes of compliance cost figures, in addition to the number of full time employees, are skewed by large observations. For this reason, we report quartile statistics. Note that relatively, more costs are incurred on internal activities relative to the fees paid to external advisers.

Table 4: Total Costs of Tax Compliance

	1st Quartile	Median	3rd Quartile	All Firms
Total Compliance Costs	£ 8,267	£ 13,070	£ 37,400	£ 21,362
In-house Compliance Costs	£ 2,800	£ 9,960	£ 22,431	£ 14,671
External Compliance Costs	£ 1,000	£ 2,500	£ 5,000	£ 5,485

[Note: Due to differences in numbers of available respondents per category (in-house / external compliance costs), columns are not additive]

In terms of the behaviour of compliance costs by size of firm, we use reported turnover to segment the firms into three categories. There are small firms with turnover less than £600,000; intermediate SMEs with turnover between £600,001 - £6,500,000 and large SMEs with turnover exceeding £6,500,000. Table 5 reports mean / median statistics with this data then scaled by number of employees.

Table 5: Mean / Median Compliance Cost Data Split by Firm Size

Turnover	< £600,000	£600001-6.5m	> £6.5m
N	12	16	12
Full time Employees	6/3	33/30	98/37
	£	£	£
Total Compliance Costs £	23687/10876	16657/13015	24908/13540
In-house Compliance Costs £	16278/6200	14063/11070	14938/9960
External Compliance Costs £	2683/500	3284/2,500	9970/5000
Total Costs / FT employees	8526/4410	698/448	768/361
In-house Costs/ FT employees	6687/2800	567/415	497/172
External Costs / FT employees	537/125	125/93	271/134

As larger observations skew the mean statistics upwards, our discussion draws upon the median statistics reported in the preceding table. First, the smallest size category reports lower median compliance costs (external, in-house, total) than the other two groups with higher turnover.

When compliance costs are scaled by the number of full time employees then the regressive nature of these costs becomes apparent, especially for in-house and total compliance costs. For example, for total compliance costs per full time employee, median costs decrease from £4,410 to £448 to £361 as turnover increases. A similar trend occurs for in-house costs per employee: £2,800 to £415 to £172 as firm size category rises. The results in Table 5 thus again, like earlier studies, confirm the economies of scale associated with tax compliance costs in the U.K.

4.2 Record keeping and Accounting

Apart from measuring tax compliance costs, our aim is to study the amount of time spent on various in-house managerial accounting tasks, whether these tasks are viewed as important or unimportant, and finally whether the process of tax compliance is viewed beneficially, and how.

4.2.1 Breakdown of Time spent on in-house accounting activities not related to tax compliance, by type of activities, SME firms

Earlier, in Section 4.1.3 we reported the average hours spent for various tax compliance activities. The largest of these was recording information needed for tax (289 hours). This was followed by calculating tax, completing tax returns and paying taxes (47 hours), dealing with external advisers and providing them with information (29 hours) and learning about tax laws, reading newsletters, Revenue websites, bulletins etc. (33 hours). bulletins etc. (33 hours).

In terms of the use of accounting records, results from our respondents show that one firm only used their accounting records for tax purposes solely; whereas most firms used their accounting records for other reasons as well. These include the monitoring of business profitability, cash flow and financial position, debtors collection, payments to creditors/lenders. However, fewer than one in five firms used their accounting records to monitor trading stock.

4.2.3 Benefits derived from having to keep tax records

While the prior sub-section outlined the purpose of keeping accounting records, we also asked respondents their level of agreement on the benefits that their business derives from having to keep tax records. The results (including percentages and cell counts) are shown in Table 8.

Table 8: Benefits of Keeping Tax Records

Benefit of Tax Compliance:	Strongly

The results would indicate that there is some way to go before it can be said that the aims of the Compliance Cost Review have been met. Table 3 shows that over three quarters of in-house costs relate to record, calculating and returning information on tax returns. Table 7 shows that 95% of our respondents consider record keeping to enable the tax calculations to be computed are moderately or very important. On balance our respondents were just positive in assessing whether having to comply with

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