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# ***Changing Tax for the Self-Employed***

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## I. INTRODUCTION

*although we have made extensive reforms of the personal and business tax systems, we still have a system for taxing the self-employed which is complex for taxpayers to understand and for the Inland Revenue to administer*

Norman Lamont<sup>1</sup>

The government's overhaul of the direct tax system, including the 1984 reforms to the Corporation Tax, the introduction of Independent Taxation and in 1993, the introduction of 'pay and file' for companies, has so far left the taxation of the self-employed relatively untouched. Despite many criticisms of the system, including more recently the Keith Committee report (1983) and the Public Accounts Committee of the House of Commons (1976), it is only now that the government has considered reforming the income tax system as it relates to the self-employed, with the publication of a consultative document, *A Simpler System for Taxing the Self-Employed*, (Inland Revenue, 1991a). At the heart of the proposals is reform of the 'preceding year basis of assessment' (PY basis), introduced by Winston Churchill in 1926, itself then billed as a 'simplification' of the system.

We describe the current system in section 4 of this paper, but before that, Section 2 looks at the incomes of the self-employed and the implications for the

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This paper draws on the report of a committee set up by IFS to consider the Inland Revenue's proposals for reforming the taxation of the self-employed. We are grateful to the members of the committee and the working party, and in particular to the chair, Malcolm Gammie. The views expressed are our own and not those of IFS, members of the working party, the committee or their sponsoring organisations.

<sup>1</sup> Foreword to Inland Revenue (1991a).

design of the tax system and Section 3 starts from first principles and looks at the special problems in taxing self-employment income compared with other sources of income. Section 5 looks at a number of possible ways forward and section 6 summarises.

## II. THE INCOMES OF THE SELF-EMPLOYED

Self-employment comprises an enormous range of activities in the UK, from small sole traders to large partnerships, equal in magnitude to a substantial public company. This diversity is illustrated in Table 1, which shows the distribution of incomes from self-employment (that is those taxed under schedule, cases I and II of the income tax) in 1988-89. What is most striking is the fact that the majority of those with self-employment income derive only a modest amount from this source: one half had incomes less than 6,000 and one quarter less than 3,000. There are relatively few who had or declared substantial self-employment incomes.

TABLE 1  
Distribution of Incomes from Self-Employment 1988-89

<i>Range of Income (£ per annum)</i>	<i>Numbers (thousands)</i>	<i>Per cent</i>
Negligible	52	1
1-500	135	4
500-999	131	4
1,000-1,999	260	8
2,000-2,999	316	9
3,000-3,999	297	9
4,000-4,999	282	8
5,000-7,499	623	18
7,500-9,999	409	12
10,000-14,999	472	14
15,000-19,999	185	5
20,000-29,999	162	5
30,000 and over	131	4
Total	3,460	100

Notes: Self-employment income is defined as total assessable profits chargeable under schedule D, cases I and II, after accounting for losses and capital allowances.

Those whose profits are entirely offset by allowable deductions are counted as 'negligible'.

Source: Inland Revenue (1991c).

The majority of those taxed under schedule D also derive income from sources other than self-employment: in 1988-89, 16 per cent also had

employment income taxed under PAYE, 5 per cent had other earned income, 5 per cent had money from a pension and 81 per cent some other form of investment income.<sup>2</sup> Table 2 breaks down these total proportions to look at the percentage of the self-employed with additional income from selected sources by range of self-employment income. Now a clearer picture of the incomes of the self-employed emerges. The substantial number with relatively low incomes from this source were significantly more likely to have employment or pension income which they were 'topping up'. Earnings dominate the incomes of those with the smallest employment income; it is only those with 3,000 of schedule D income who on average derive the majority of their income from self-employment.

TABLE 2  
**Proportion of Self-Employed with Income from Additional Sources by Range of Self-Employment Income 1988-89**

<i>Range of Income (£ per annum)</i>	<i>Percentage of cases</i>		
	<i>PAYE</i>	<i>Pension</i>	<i>Investment</i>
1-500	44	21	73
500-999	43	18	59
1000-1999	31	15	61
2000-2999	26	9	63
3000-3999	17	8	69
4000-4999	9	2	71
5000-7499	9	4	86
7500-9999	6	2	90
10000-14999	6	2	94
15000-19999	7	3	95
20000-29999	10	3	97
30000-49999	12	2	98
50000 and over	28	3	100

Notes: Percentage of total cases in each income range with income from additional specified source.  
 Self-employment incomes as defined in note to Table 1. Pension income includes occupational and national insurance pensions.  
 Investment income includes rents taxed under schedule A, investment income chargeable under schedule D cases III-VI, dividends from UK companies, interest subject to composite rate tax and interest from which basic rate tax has been deducted at source.

Source: Inland Revenue (1991c).

The self-employed are a significant group: at 3½ million strong in 1990-91 they formed 13 per cent of the workforce. In 1990, total income from self-employment was some 56 billion. It is important, therefore, to get the income tax

<sup>2</sup> Source: Inland Revenue (1991c).

system for the self-employed right. What the tax regime must recognise is the nature of the people it is trying to tax: first, that many have only modest income from this source and may well be fiscally unsophisticated and unable to afford professional advice; second, that their affairs are likely to be complicated by having multiple sources of income. Finally, many self-employed people move frequently between periods of employment and self-employment. We have concentrated on getting the tax system right in its treatment of these case; the large, continuing partnerships with which we are familiar should be sophisticated enough to fit in with most schemes.

### III. DIFFICULTIES IN TAXING THE SELF-EMPLOYED

Unlike the deduction of income tax at source for investment income, and under PAYE for employees, income from self-employment is taxed on the basis of accounts rather than receipts. The reason for this is a practical one: deduction of tax at source would not be possible with a progressive income tax system. First, there is more than one person (customers) who would have to make that deduction and second, receipts are not a good measure of income. But using accounts as the basis for taxation results in a number of difficulties.<sup>3</sup>

#### *1. The Basis of Assessment*

The first problem is that accounting periods will not necessarily align themselves with fiscal years. The choice of the 'basis of assessment' is the decision as to how the profits earned in an *accounting* year can be matched up with the elements of the income tax system - the rates, allowances and reliefs - which are all defined over *fiscal* years. There are three potential solutions.

A 'deeming' system in essence ignores the fact that fiscal and accounting years are not aligned, by deeming that income arising in a particular accounting year was earned wholly in a particular fiscal year. The present basis of assessment, the preceding year basis, is a type of deeming procedure: for a continuing business, profits earned in accounting year 1990-91 are treated as if they had arisen in fiscal year 1992-93.

Other deeming procedures are possible. The 'current year' (CY) basis of assessment put forward in Inland Revenue (1991a) deems forward: for example, income arising in the accounting year 1990-91 would be assumed to have been earned in fiscal 1991-92. It is also possible to deem backwards, and assign the income for a particular accounting year to the fiscal year in which it began rather than ended; income arising in 1990-91 would be taxed as if it had accrued in fiscal year 1990-91. Finally, and perhaps intuitively most attractive, would be to

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<sup>3</sup> See Kay (1981) for a more detailed discussion.

deem to the nearest fiscal year. Businesses drawing up their accounts to dates before the 30 September 1991 would be deemed to have been earned in fiscal year 1990-91, and those with accounting dates after 30 September would have their profits assigned to 1991-92.

An alternative to deeming is 'apportionment'. This is an attempt to align fiscal years more closely with the profits accruing within the fiscal year. There are two alternative possible schemes: apportioning profits to two fiscal years or apportioning the rates, allowances and reliefs for two tax years to one accounting year. For example, the first procedure would apportion part of profits earned in accounting year 1990-91 to fiscal year 1990-91 and part to fiscal year 1991-92.

The second procedure would compute the tax due with reference to accounting years. Thus, for accounting year 1990-91, the computation would involve calculating the tax due on those profits under the schedule for fiscal year 1990-91 and that due under the schedule for 1991-92. The tax liability would be computed on a proportion of each. This is the 'accounting period' basis proposed in Inland Revenue (1991a).

The third way of dealing with the problem of misalignment of accounting years and fiscal years is to prohibit it, and compel the self-employed to draw up accounts to 5 April or 31 March.

Although these different bases of assessments are all merely mechanical procedures to link the elements of the tax system with the income to be taxed, the choice between them is central to the system of taxation and is a question to which we will return.

## *2. Delays in Assessment*

The second problem with the need to use an accounts basis for taxing the self-employed is that there will be a delay between the accrual of income subject to schedule D taxation and the point at which an adequate assessment of that income for tax purposes can be made. In the current system the lag between the end of an accounting period and the date at which final liability is assessed lies between 9 and 23 months depending on the choice of accounting date.

One option for dealing with the delays necessitated by using an accounts rather than a receipts basis for tax is merely to ignore them. Under such a system, the self-employed would pay tax when income was reported. Tax on income assessed under schedule D would therefore be paid considerably in arrears.

A way of avoiding such delays is to operate some kind of payment on account system. Such a system could levy some kind of 'tax deposit' on commencement or to permit taxpayers to choose the size of their preliminary payment, with interest charged on any under- or over-estimates of tax liability. An alternative approach is evidence in the present preceding year basis, whereby reported income for the previous period is deemed to be income for the current fiscal

year. While this generates on-going payments for an established business it also involves difficulties on the commencement or cessation of a business, as is shown below.

#### IV. THE CURRENT SYSTEM OF TAXING THE SELF-EMPLOYED

##### 1. The Calculation of Tax Liabilities

The present system of taxing self-employed incomes rests on two principles. The first is the so-called 'source doctrine': a self-employed person will only be assessed for tax on income from self-employment in a particular fiscal year if they are conducting a business in that fiscal year. The second is that in that fiscal year, they are taxed with reference to the income earned in the accounting period ending in the previous fiscal year. This is the preceding year basis of assessment mentioned above.

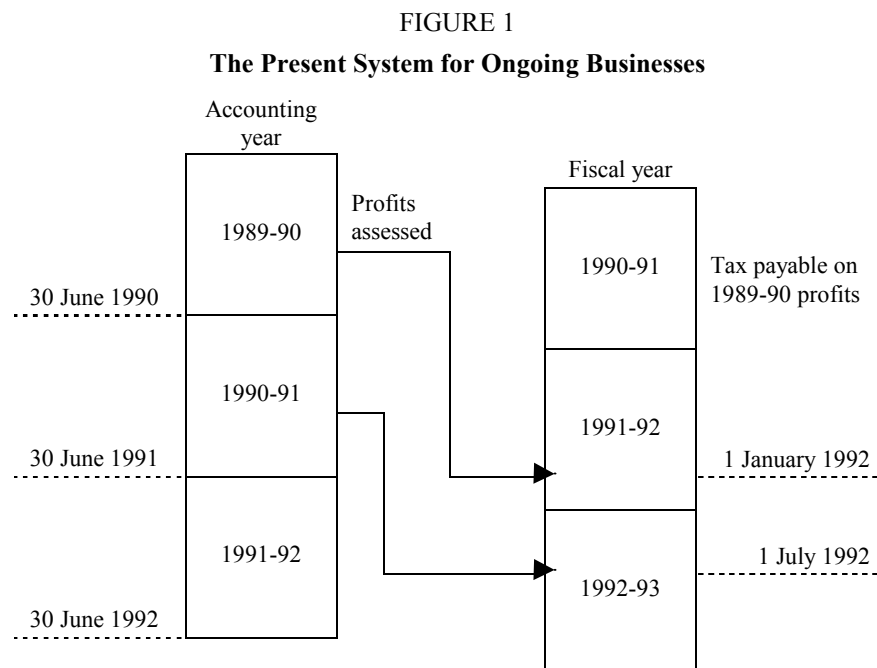


Figure 1 shows how these principles combine to generate the tax liabilities of an on-going business. In this example, the accounting year ends on 30th June. Profits earned in the year ending 30 June, 1990 will be assessed for income tax in the following fiscal year, 1991-92 if the business was continued into that

fiscal year. The tax payable on 1989-90 profits is finally paid on 1 January and 1 July 1992.

For an on-going business, income that actually arose in parts of fiscal years 1989-90 and 1990-91 is taxed as if it had arisen in fiscal year 1991-92, with reference to the rates, allowances and reliefs that apply to that year.

Whilst the preceding year basis for an on-going business may look fairly simple, the basis of assessment is modified in a number of circumstances: for businesses in the first 3 and last 3 years of their lifetime, for up to 9 years in the case of a partnership when partners are added or withdrawn and up to 3 years on a change of accounting date.

In the first year of a business, there are no reported profits on which it can pay tax, since there is no accounting year ending in the previous fiscal year. The business is therefore assessed for tax more than once on the profits arising in one accounting year early in its existence, and to compensate for this, the liability in closing years is computed with a similar period dropping out of the calculations.

FIGURE 2  
The Present System for New Businesses

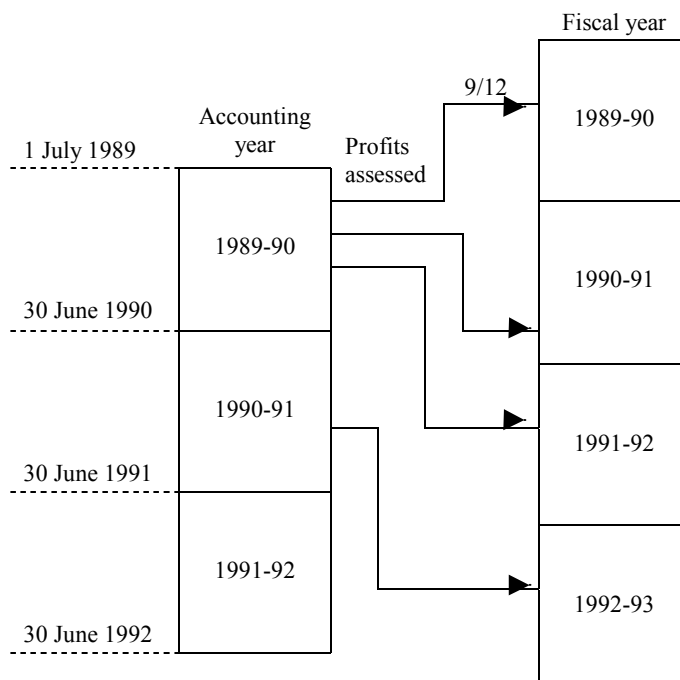
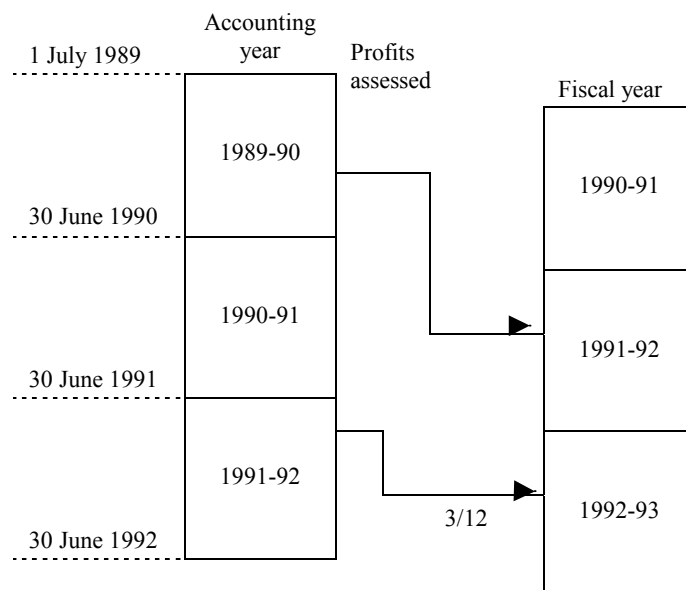


Figure 2 illustrates the tax treatment of the opening years of a business. This example is again assumed to draw up accounts to 30 June, having commenced trading on 1 July, 1989. For fiscal year 1989-90, there is obviously no preceding year on which to base the assessment for tax. Self-employment income is therefore taxed on an actual year basis. In this case, the business was set up 3 months into the fiscal year. The tax liability is therefore computed on three-quarters of the profits accruing in the year to 30 June 1990. In the second fiscal year (1990-91), these profits again form the basis of assessment. In the next fiscal year (1991-92), the preceding year principle comes into operation, so the profits in the year to 30 June 1989 again form the basis of assessment. The profits accruing in the first year of business are therefore the basis of assessment  $2\frac{3}{4}$  times.

FIGURE 3  
The Present System for Closing Businesses



To avoid hardship, the taxpayer may elect to have the second and third years of assessment using an actual basis, reverting to the preceding year basis in the fourth year of assessment. However, the effect is simply to change the accounting period which is (given a 30 June year end) taxed  $2\frac{3}{4}$  times.

To compensate for this repeated assessment, at least one year of income is not assessed for tax when the business ceases trading. This is illustrated in Figure 3.

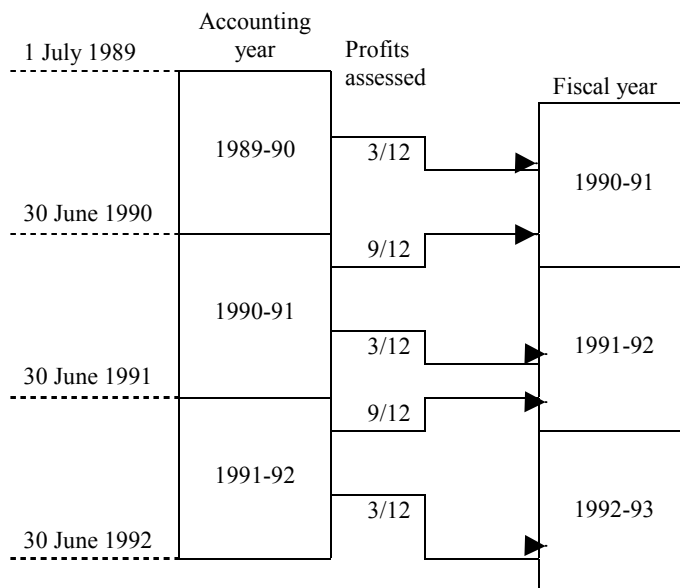


Again, the business is assumed to draw up accounts to the 30 June, and closes on 30 June 1992. For fiscal year 1991-92, the tax is computed on the preceding year basis. Thus, profits earned in the accounting year ending 30 June 1990 form the basis of assessment. The business closes three months into fiscal year 1992-93. The tax liability is not computed on a preceding year basis (that is on income in the accounting year 1990-91), but again switches to an actual year basis. The 1992-93 liability will be assessed on one quarter of the profits in the year to 30 June 1992. Income earned in the year to 30 June 1991 escapes assessment, as does three-quarters of profits for the year to 30 June 1992. This period exactly matches the period which is assessed more than once at the opening of a business.

Overall, the first year's profits may be assessed up to two times in addition to the normal assessment under the preceding year basis. This is balanced by a period of up to two years dropping out of assessment on cessation.

FIGURE 4

**The Present System for Closing Businesses Inland Revenue Revision**



Clearly, the fact that one year's income and usually a proportion of another year's escapes assessment opens up opportunities for abuse. Under provisions mirroring the taxpayer's election on commencement, the Inland Revenue must revise the basis of assessment to an actual year basis for the last three years in

which a business trades if this basis has a greater tax yield than the preceding year basis. This is shown in Figure 4. For 1990-91, the liability will be calculated on one quarter of profits accruing in 1989-90 and three-quarters of those in 1990-91. The computation for 1991-92 will be carried out in a similar manner. In the year of cessation (1992-93), tax will as before be based on one quarter of the profits earned in the accounting year 1991-92. This revision allows the Revenue to reduce the advantages that would result from businesses manipulating the time profile of their profits to maximise the amount that falls out of assessment. It should be noted that a period of profits equivalent to the period assessed more than once at the opening of the business still escapes assessment, but the revision to an actual year basis shifts this period back to 1988-89 and 1989-90.

## *2. Reasons for Reform*

For the vast majority of individuals, paying tax is straightforward. The deduction of tax at source from investment income and PAYE means that in the majority of cases, the right amount of tax is levied as income arises. If too much or too little tax is paid, the processes for payments and repayments are relatively simple. Paying tax on self-employment income is a good deal more onerous: on self-employed taxpayers who have to try and apply the rules, on their professional advisers who have to try and explain them, and on Inland Revenue staff who have to try and implement them.

Some idea of the complexity may be gleaned from the fact that 96 per cent of schedule E taxpayers were dealt with without identifiable Revenue error in 1988-89, compared with 87 per cent for schedule D.<sup>4</sup>

The cost of compliance and administration is born out by the volume of transactions between the Revenue and taxpayers. In 1989-90, the Inland Revenue raised around three million assessments on self-employed taxpayers for that tax year. Two million of the initial assessments used estimated figures as taxpayers had not filed their return and accounts. If the taxpayer feels the estimate is too high, then within thirty days they may appeal for a postponement of part of the tax. About 600,000 appeals were listed for hearing by the Appeal Commissioners in 1989-90. Once the return and accounts are submitted, they are considered by the Inspector, who may require further information or explanations. The assessment is amended when figures are finally agreed and the balance outstanding is paid or repaid. There is little incentive built into the system either to submit returns and accounts or to pay tax promptly.

The current system is also inequitable. The tax treatment of employees is a good deal less generous than that for the self-employed, but the system is also arbitrary in its treatment of different schedule D taxpayers.

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<sup>4</sup> Source: Inland Revenue (1991b).

Under the current system, it would only be by accident that the profits liable for tax over the lifetime of a business were equal to the profits earned. This is a result of the commencements and cessations rules described above, which mean that some profits form the basis of assessment for between 2 and 3 years and some not all. In general, the rules favour the taxpayer because any firm with higher profits in money terms at cessation than commencement will gain. The Public Accounts Committee of the House of Commons found in 1976 that the average partnership had paid tax on only 76 per cent of its profits during the period of investigation. The proportion of profits on which businesses are assessed is likely to be higher now, as the generosity of treatment is dependent on the rate of growth of *nominal* profits, and so is greater in periods of higher inflation. Nevertheless, on average the self-employed are treated more generously by the income tax system than employees, who pay tax on their full income.

However, some businesses with high profits in their opening year and depressed profits at cessation may find themselves being assessed for tax on more profits than the business actually made. So although the system is more generous *on average* to the self-employed, there are cases where individuals who are ill-advised or unfortunate are treated less generously than employees. There is therefore also an inequity in the tax treatment among schedule D taxpayers, as well as between schedule D and E taxpayers.

The complexity of the rules also provides opportunities for tax avoidance. The choice of accounting date, manipulating the pattern of profits over time and making particular choices at the time of commencement and cessation can affect tax liabilities substantially. There are two groups who are particularly privileged. First, sole traders are able to invoke a cessation without triggering partnership re-commencement rules (which are relatively onerous). By taking on and then dropping a single partner they are able to re-open under the ordinary commencement rules. Second, small, rapidly growing partnerships have the benefit of being assessed on preceding year profits and dividing the tax liability among a larger number of partners up to two years later. Again, this results in an inequity both among schedule D taxpayers and between schedule D and E taxpayers.

The self-employed also gain due to the delays in tax payment. Payments on account of the tax liability arising for the accounting year ending in fiscal 1996-97, for example, are due on 1st January and 1st July 1997. The 'average' of these two dates is the 1st April 1997. Thus, tax payments on account of the liability for a particular fiscal year are on average due at the end of that fiscal year. In comparison, PAYE income has no deferment as regards the employee. Comparing a stream of income accruing to a self-employed person and the same stream taxed under PAYE, at a five per cent discount rate, the present value of the tax paid is some 2.5 per cent lower as a result of delays in payment. This example assumes that business profits were constant over time. If profits are

rising in money terms then tax payments on increments in profits are deferred further, as compared with similar rises in employment income.

Again with payment deferrals, there are rather arbitrary inequities between different schedule D taxpayers. Since variation in accounting year end is not matched by variation in payment date or reporting period, those choosing accounting dates early in the fiscal year will have longer both to make their first tax payment and to submit a return.

### *3. Objectives for Reform*

The aim of the Inland Revenue consultative document is to suggest potential reforms which would 'simplify and streamline the system for taxing the self-employed'; the main thrust is therefore towards reducing costs. The rapid growth in self-employment in the 1980s has made simplification more urgent. What type of reform is needed to achieve cost improvements?

The consultative document asserts that administrative gains are incompatible with the preceding year basis, but it is not clear whether inefficiencies stem from the basis of assessment or the way that the system 'works'. The rules for commencements and cessations are responsible for much of the complexity rather than the PY basis *per se*. Reform of the PY basis, then, may well not be a *necessary* condition for simplification.<sup>5</sup>

Achieving administrative gains depends on a significant improvement in taxpayer compliance. It is far from certain that reform would have such an effect; changing the PY basis alone is unlikely to be a *sufficient* condition for cheaper administration.

The consultative document also recognises the inequities and arbitrariness in the current system. 'Fairness' is mentioned frequently, and it is stated that 'the system for collecting tax needs to be aligned more closely with the system for collecting tax from employees'. Removing some of the anomalies described above is an important goal. In particular, inequities between schedule D taxpayers should be eliminated and over the lifetime of a business it should be ensured that profits assessed for tax are equal to profits actually earned.

Finally, far broader objectives are also mentioned in the consultative document, with wider implications than the title *A Simpler System for Taxing the Self-Employed* would suggest. It is hoped that change would 'open up the way to further reforms to simplify, unify and improve the system of personal taxation'. In particular, a system with a single assessment of total income regardless of source, rather than a separate assessment of business profits is suggested. If the ultimate objective is to abolish the schedular system, then reform to the basis of assessment for self-employment income appears more obviously necessary. However, it does not appear that this goal has been taken into consideration

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<sup>5</sup> Shipwright (1992), for example, comments that in exercises with students and trainees, the proposed CY or AP bases did not prove easier to understand.

when weighing alternative proposals for the basis of assessment, nor does it seem appropriate to look for ways of general improvement to the system of personal taxation without considering the system as a whole.

## **V. A PROPOSAL FOR REFORM**

### *1. The Basis of Assessment*

We believe that the most satisfactory basis of assessment for the majority of schedule D taxpayers would be one based on the fiscal year. It is probably the option most comprehensible to the majority of taxpayers. It has the benefit of the apportionment systems described above in that profits are taxed using the tax schedule operating at the time they were earned, and the advantage of the deeming system in that the necessary calculations are relatively simple. The consultative document (Inland Revenue, 1991) summarises its advantages:

This [fiscal year] basis is used for most taxpayers in the USA. It is in many ways the ideal technical solution. It is readily understood and would be very easy for the taxpayer to get right. It produces no problems with, nor does it require special rules for, commencements and cessations. It lends itself readily to reduced Revenue involvement and to greater unification of the personal tax system.

If a fiscal year basis were able to realise these advantages, it would seem the obvious candidate for adoption. However, there are counter-arguments. Many of the self-employed currently draw up their accounts to dates different in the year, so it would be necessary to impose a fiscal year basis. Is it objectionable to require the self-employed to choose a particular accounting date? A fiscal year basis is dictated for other sources of income and gains, and this does not appear to arouse objection. Also, a compulsory fiscal year basis appears to work satisfactorily in a number of other jurisdictions. What evidence there is tends to suggest that accounting dates chosen are usually either 12 months after commencement, aligned with the fiscal year or dates early in the fiscal year. The choice of the last is generally to take advantage of the deferral of the payment of tax on rising profits.

A second argument is that a fiscal year basis would result in bunching of work for accountants. This could result in serious problems particularly for sole practitioners and small firms of accountants whose client bases may be dominated by the self-employed. With the majority of their clients on a fiscal year basis, their workload would be uneven throughout the year. There would be crowding of work near deadlines, with the concomitant possibility of penalties. But alternative proposals for the basis of assessment may also have bunching effects. Bunching is likely to occur in any regime with a tax advantage to the choice of a particular accounting year. For example, if taxpayers gain by the

choice of an accounting date early in the fiscal year, then accounting dates will be bunched. This would be offset to an extent by the longer reporting period available when an early accounting date is chosen. But, given the evidence that a major difficulty for professional advisers is the late production of information from their clients, the benefit of the extended reporting period may well not be available for accountants.

Despite these objections, we believe that for the majority of self-employed taxpayers, a fiscal year basis is the most suitable. Nevertheless, we do accept that some businesses may have a valid commercial interest in choosing an alternative accounting period to the fiscal year. We therefore propose a default fiscal year basis, which would permit taxpayers to elect to be taxed to some other accounting date. As far as bunching of work goes, we envisage that the self-employed with larger incomes, and so those most likely to be professionally advised, will be disproportionately represented among those choosing an accounting date other than the fiscal year. Accountants will therefore be able to maintain some spread in accounting dates among their client base. Second, we propose that the current 1 January reporting date be moved to 31 January. This extends the reporting period to 10 months, and moves it away from the Christmas and New Year holiday period.

We considered a wide range of options for the alternative basis of assessment to the default fiscal year; we will limit our discussion here to three.<sup>6</sup>

One option proposed in Inland Revenue (1991a) was an accounting period basis, under which taxpayers would be assessed for all their income in the year to their chosen accounting date. The tax computation in this system would be complex, since it would involve apportioning the rates, allowances and reliefs for two fiscal years to one accounting period. The Revenue suggested that if this system were adopted, they would have to require smaller taxpayers to choose the fiscal year as their accounting date. This proposal is therefore similar in spirit to our own default fiscal year scheme, though the choice of accounting date is not a matter of election but a matter of the size of the business. The Revenue suggested that the income limit for moving off the fiscal year could be aligned with the maximum business turnover permitting the submission of three line accounts, currently 15,000. When the limit was raised to this level, the Chancellor of the Exchequer suggested that 1½ million taxpayers would be below this limit.

The accounting period basis seems logical in that income accruing in a particular period is taxed using the income tax schedule for that period. However, we do not on balance believe that this system would represent a simplification when compared with the current system. This basis has a number of other problems, for example in dealing with taxpayers who shift between

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<sup>6</sup> See Macdonald (1991) for a discussion of a number of further options.

employment and self-employment, with those with more than one source of self-employment income and those with both PAYE and schedule D income.

The second alternative basis assessment proposed by the Revenue is for a current year basis, a deeming procedure which taxes income accruing in a particular accounting period as if it were earned in the fiscal year in which the accounting period ends. Though this basis is more attractive than an apportionment procedure for reasons of simplicity, it has a number of problems fitting with our default fiscal year proposal. The principal of these is that, like the preceding year basis, it encourages taxpayers to choose accounting dates early in the fiscal year, in order to maximise the advantage of tax deferral and the length of reporting period. With the exception of the period of the proposed transition, taxpayers and their advisers would tend to favour year-ends of, for example, 30 April as with the present system. This has the unfortunate effect of maximising the difference in time between the period income was accrued and the fiscal year over which the tax schedule is defined. A current year basis, then, would retain some of the less desirable features of the present system which we are keen to remove. It is also clearly difficult to propose a default fiscal year basis in a system which looks favourably on those who elect to move away from the default. It could even exacerbate the inequity between the well-advised taxpayer, and the less sophisticated or less fortunate.

The CY basis has some problems coping with taxpayers who switch from self-employment to employment or who change accounting date. In the year of cessation or change of accounting year, they would be taxed on more income than actually arose in that year. Some form of 'top-slicing' relief might be necessary to cope with the potential for being taxed at a higher rate. An alternative is to pay the year after as if the business continued, although neither appears satisfactory.

For these reasons, whilst we recognise the current year basis is administratively simpler than an accounting period basis, we have rejected the CY as incompatible with the aim of shifting as many taxpayers as possible, particularly smaller taxpayers, onto a fiscal year basis, without imposing any disadvantage on them for being taxed on this basis rather than any other.

The basis we considered most suitable is an apportionment procedure where firms with accounting dates other than the fiscal year would compute their tax liability by apportioning profits from two accounting periods to a single fiscal year. This has the advantage over an accounting period basis, since apportioning profits to fiscal years involves a more elementary computation than apportioning income tax rates, allowances and reliefs and all other sources of income to the accounting year chosen.

The principal problem with this basis raised earlier was the extension of delays in submitting returns; it would be difficult to fit in with a 31 January reporting and settlement date. This would effectively limit the choice of accounting date to a period of say 6 April to 30 September. To open the whole

year as a possible choice of accounting date, we propose that a minimum reporting period of shorter duration than the norm be granted. This could be as short as three months or, if reporting is to be simultaneous with payment date (and these are restricted to two payment dates for all taxpayers), could extend to five months. In the latter case, the majority of taxpayers would report on 31 January; those with later accounting periods ending between 1 September and 28 February would report on 31 July. (These will require special rules for computing the payments on account).

## *2. The Transition to the New System*

The question of how to tax existing businesses which are assessed on the preceding year basis is an issue which clearly needs to be resolved.

Under the fiscal year basis, the accounting date will be changed to 5 April. This may suggest that the practice currently used for dealing with changes in accounting date would be appropriate. However, that system presupposes that the preceding year basis of assessment continues and is thus not wholly appropriate. Our preferred solution is to deem a cessation on 5 April and apply the normal cessation provisions so that the old preceding year and new fiscal year provisions would effectively coincide. Assuming that the fiscal year basis applied for 1995-96, then an existing business would be deemed to cease on 5 April 1995. This under the cessation provisions of the preceding year basis, the actual basis would apply for 1994-95, so that for that year too the fiscal year basis of assessment would apply. As with any cessation, there would be a period of account which escapes assessment. Assuming a 31 December year end (and no revision of assessments for the year 1992-93 and 1993-94), the year to 31 December 1992 would have been the basis for 1993-94 assessment. For 1994-95, the actual basis of assessment would cover the period 6 April 1994 to 5 April 1995. The period 1 January 1993 to 5 April 1994 would thus fall out of assessment.

If the business continued to account to 31 December, there would nevertheless be a deemed cessation on 5 April 1995. Accounting years would be apportioned to give effect to this and the result would be that exactly the same period would fall out of assessment under the profit apportionment basis as would do so under the fiscal year basis. There would therefore be no advantage to be gained during the transition to elect to retain an accounting period off the fiscal year.

## *3. The Payment of Tax: Fiscal Year Basis*

Although the choice of the basis of assessment is probably the central issue in any reform of the taxation of the self-employed, the administrative details governing the payment of tax are essential to making any proposals for reform workable and to achieving equity and neutrality. Furthermore, the payment



system has to be consistent with maintaining the flow of revenue to the Exchequer during the transitional period.

We have suggested a 31 January reporting date for business income. This means, assuming other income is reported by 31 October, that business income will be the top slice of total income in reporting the tax liability. It will also mean that the bunching of work effect will be less pronounced than a system with a common reporting date for all sources of income.

However, if one of our objectives is to bring the taxation of business income more into line with that of employment income it is clear that collection of tax cannot wait until income has been computed and reported. There will need to be a system of collection on account together with final settlement, the latter triggered by the reporting of income.

At present, tax on schedule D case I and II income is paid in two equal instalments on 1 January of the year of assessment and the following 1 July. Thus, in the first year in which the fiscal year basis applies there will automatically be a 50 per cent tax receipt in respect of the previous fiscal year.

Under a reformed system, the six-monthly payment cycle could be continued or payments could be made more frequent. Whereas fewer payments reduce contact with the Inland Revenue they also mean larger payments. Smaller, more frequent payments would ease cash budgeting and would be more appropriate to businesses in which the proprietor has a steady level of income and withdraws most of it as it arises. Arguments similar to those used to justify the introduction of PAYE for employees could also be applied to a sizeable portion of the self-employed. More frequent payments would also mean that the inevitable bunching of payments following the first reported income of a new business would be less pronounced. In what follows, we assume for the purposes of illustration that the present six monthly pattern is retained, but with the dates being 31 January and 31 July.

Assume that the reformed system applies from 1995-96 and accounts are prepared for the year to 31 March 1996 in respect of an on-going business. The final payment for 1994-95 would then be paid 1 July 1995 and the first payment on account of 1995-96 on 31 January 1996. This would be based on the last reported profits which under our reporting regime would be for the period ended 31 March 1995.

A second payment on account, on the same basis, would be made on 31 July 1996. Thus, if profits are constant over time, so that payments on account are correct and need no adjustment, tax will have been paid within four months of the year end. Normally an adjustment will be required, and this would be made on the reporting date of 31 January 1997, which is also the date of the first payment on account for 1996-97. Thus, the reporting date is both the occasion for settling the final liability (given previous payments on account) for the previous year and the time for the first payment on account of the current year's

liability. Both of these are calculated by reference to the same reported information.

In the case of a new business preparing accounts for the year to 31 March 1996, no information will be available until 31 January 1997. Thus the payment due then would be 100 per cent for 1995-96 plus a 50 per cent payment on account of the 1996-97 liability, although if payments were on a quarterly basis the total payment would be reduced to 125 per cent of the 1995-96 liability. Where the first period of account is for less than a full year then the payments on account, being for six months, would be calculated proportionally according to the length of the first accounting period.

Loss-making businesses would attract two repayments: first, the repayment of any payments on account; second, tax on other income already paid on that income could be repaid if self-employment income is set-off against it. Both repayments would be made on settlement date.

#### *4. The Payment of Tax: Profit Apportionment Basis*

If the taxpayer elects to use the profit apportionment basis rather than the fiscal year basis, then the guiding principle is that there should be no significant advantage compared with the normal fiscal year basis.

The normal reporting date of 31 January clearly limits the accounting periods available. We therefore propose that the date should be 31 January or such minimum period after the accounting year end as may be legislated. This leaves all existing dates available but with a restricted, though we believe not impossible, reporting date. It means that if the minimum period was three months then year ending in the months to 31 October would retain the reporting date of 31 January and would settle and pay on account exactly as for the fiscal year basis; if the period was 5 months (for reporting to coincide with the six-monthly payment dates) then year to 31 August would be similarly treated.

For other year ends it is important to separate the settlement and payment on account functions: the first must be later than the norm because the information is not available, but the latter can operate as for the fiscal year basis. However, there is an added complication in computing payments on account under this basis in respect of later accounting periods. Whereas under the fiscal year basis payments on account can be computed by reference to tax paid on the previous year's income (self-employed and other income), under the profit apportionment basis the final tax liability on business income, when it is finally reported, will not be attributable to one accounting year and may not be known until one fiscal year later. This means that for payments on account to be based on reasonably current information, those in respect of the later accounting periods have to be calculated by aggregating the income for an accounting period with the other income of the preceding fiscal year in order to establish a notional liability in

respect of business income. Having done this, the delay in tax payments will only be in respect of final settlement, and can work to the disadvantage as well as to the advantage of the taxpayer. Again, an interest adjustment may be considered necessary to counteract the effect of the delay in final settlement.

TABLE 3

**Timetable for Reporting Income and Paying Tax Under the Profit Apportionment Basis with a 31 December Year End**

<i>Year</i>	<i>Date</i>	<i>Reporting</i>	<i>Payment</i>	<i>Basis</i>
1995-96	1 July 1995	To 31 December 1994	Second 1994-95	31 December 1993
	31 July 1995		First 1995-96	December 1994 + 1994-95 income
	31 January 1996			
1996-97	31 July 1997	To 31 December 1995	Second 1995-96	As first
	31 January 1997		Revised 1994-95	$\frac{3}{4}$ x 31 December 1994 + $\frac{1}{4}$ x 31 December 1995
			First 1996-97	31 December 1995 + 1995-96 income
1997-98	31 July 1997	To 31 December 1996	Second 1996-97	As first
	31 January 1998		Revised 1995-96	$\frac{3}{4}$ x 31 December 1995 + $\frac{1}{4}$ x 31 December 1996
			First 1997-98	31 December 1996 + 1996-97 income

Consider a 31 December year-end of an on going business: the reporting date would be 31 July (or earlier if reporting is not tied to six monthly payment dates). Table 3 shows the timetable for reporting and paying tax. For 1995-96, the basis of assessment would be  $\frac{9}{12}$  of the profits to 31 December 1995 plus  $\frac{3}{12}$  of the profits to 31 December 1996. The information required for final settlement would not be available until 31 July 1997. 1 July 1995 would see the final payment in respect of 1994-95 for which the year to 31 December 1993 would have been the basis of assessment. Accounts for the year to 31 December 1994 would be required to be reported on 31 July 1995. The income for this accounting year would be aggregated with other income (reported by 31 October 1995) to establish a notional tax liability for business income; this would be the basis for the first payment on account of the 1995-96 liability on 31 January 1996. To avoid additional computations, the second 1995-96 payment on account on 31 July 1996 could be based on accounts to 31 December 1994 even

though those to 31 December 1995 would be reported then. 31 July 1996 would be the occasion to adjust and settle the 1994-95 assessment in respect of the deemed cessation.

The first payment on account for 1996-97 on 31 January 1997 would also be based on these accounts. Final settlement for 1995-96 would follow on 31 July 1997 with the reporting of accounts to 31 December 1996. This would be accompanied by a second (revised) 1996-97 payment on account.

A new business would be required to produce accounts for a period ending in the fiscal year following that in which the business commenced. The existence of the source would be reported with the return for the year of commencement and election for the apportionment basis made then.

A business commencing 1 January 1995 would not report its income for the year to 31 December 1995 until 31 July 1996. At this point, settlement for 1994-95 in respect of three months would be made, plus the first and second payments on account for 1995-96 that would normally have been made on 31 January and 31 July 1996 respectively.

Loss relief under the apportionment basis would require that there be a loss for the fiscal year having apportioned the relevant accounting periods. Otherwise, the total profit for the fiscal year will be reduced by any apportioned loss, and where applicable, repayment made on settlement.

## **VI. CONCLUSIONS**

The current system for taxing the self-employed is not satisfactory: its complexity ensures that it is costly in both administration and compliance. The growth in self-employment in the 1980s has made reform of the system more pressing. However, we do not believe that either proposal put forward by the Inland Revenue would either be necessary or sufficient for simplification of the system. The main improvement on the current preceding year basis of either system would be to the rules for commencements and cessation which could be achieved without altering the basis of assessment. We believe that a move to a fiscal year basis would be a significant simplification, would reduce compliance and administrative costs, and would be compatible with greater unification of the income tax system.

Although we favour a compulsory fiscal year basis, we are aware that many would be opposed to the imposition of a particular accounting date and that some businesses may have valid commercial reasons to prepare accounts to other dates in the year. If a compulsory fiscal year basis is not acceptable, we propose that taxpayers should elect to choose an alternative accounting date and be taxed by apportioning the profits from two accounting years to one fiscal year.

This paper has described a payment schedule for both these bases assuming that the current procedure of six monthly payments is retained, though a move to 31 January and 31 July payment dates could be implemented to extend the length

of reporting period. However, some consideration should be given to having more frequent, and so smaller, payments.

The preceding year basis has survived for over 60 years already; if the new system for taxing the self-employed must also last 60 years the opportunity of the review should be taken to achieve the simplification offered by a fiscal year basis of assessment.

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