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Making Tax Digital

A brief guide to the taxpayer's obligations

With Rebecca Cave

A SimpleStep® GUIDE

Outline

The making tax digital (MTD) project represents a fundamental shift in UK tax administration and the changes it will require for accountants, taxpayers and HMRC should not be underestimated. However, MTD is being developed in an agile manner, which means the law is being formulated as the project progresses, so we don't yet have a full picture of how MTD will apply to all taxpayers or to all taxes.

This report addresses what we know so far about the impact of MTD for Business (MTDfB), which at this stage, only applies to unincorporated businesses (including most partnerships and trusts). HMRC expect MTD to be rolled out to the entire taxpayer population but the exact timing of that rollout is not set in stone (see **Timetable**). There are many hurdles to cross in order to achieve HMRC's vision of a fully digital tax system (see **Future Developments**).

Note that references to 'business' include property letting.

Why MTD?

The justification for MTD has shifted as agilely as its development. When it was first proposed by George Osborne in his March 2015 Budget, the digitisation of the tax system was heralded as a way to reduce the administrative burden for taxpayers. This goal may not to be achieved for some years, certainly not until MTD has bedded down. In fact, taxpayers may perceive the increased number of interactions per year with HMRC, as an escalation in their tax compliance burden, not as a reduction (see **Reports and Submissions**).

HMRC believe that MTD will reduce errors and mistakes in accounting data, which in turn will increase the tax collected. HMRC's reasoning follows this path:

1. Taxpayers will record all their business transactions near the time they happen, so will make fewer omission errors. Receipts will not be lost and sales will not be forgotten.
2. Accounting software will prompt taxpayers to categorise their transactions accurately and catch scale errors, such as a taxi fare of £800 rather than £8.
3. The data will be submitted directly to HMRC by accounting software, eliminating transposition or omission errors when completing an online or paper tax form.
4. Taxpayers will understand what tax is due on their profits and when it must be paid, making the tax bill less of a shock and increasing the likelihood that it will be paid on time.

This rationale does not map convincingly on to larger incorporated businesses or on to larger partnerships.

Stages of MTD reporting

The stages of reporting under MTDfB are:

1) **Record keeping:** Taxpayer records their income and expenses in an electronic form on a timely basis, sorted into categories as prescribed by regulations.

2) **Updates:** Taxpayer (or their tax agent) reports the accounting data from stage 1 to HMRC using accounting software, on at least a quarterly basis.

3) **Tax account:** HMRC updates the year-to-date figures of profit or loss in the taxpayer's digital tax account using the accounting data reported in stage 2. This is an automated function – HMRC does not examine the accounting data for accuracy or completeness at this stage.

4) **Reflection:** HMRC prompts the taxpayer to view their online digital tax account. This tells them how much tax they should expect to pay on the profit reported during the year so far. There is no requirement for the taxpayer to make a tax payment based on this information.

5) **End of period statement:** Taxpayer (or tax agent) makes any necessary adjustments to the totals reported in the quarterly updates and confirms that the figures for the full accounting period are complete and correct (*TMA 1970, sch 1A, para 8*).

6) **Trade position:** The adjustments from stage 5 are incorporated into the taxpayer's digital tax account and HMRC prompts the taxpayer to view their tax account.

7) **Final declaration:** This performs the same function as the self-assessment tax return, which it replaces. The taxpayer must report all other income which is not already reflected in their personal digital tax account and confirm that the information filed, and accompanying self assessment, are both complete and correct (*TMA 1970, s 8(2)*).

The end of period statement (stage 5) and the final declaration (stage 7) are two separate processes, which have different deadlines (see **Reports and Submissions**).

Digital records

Regulations (not yet published) will define what is meant by 'electronic form' for keeping and preserving records. HMRC has indicated that the likely categories for recording income and expenses will be those headings provided on the current self employment pages of the SA tax return, and for landlords, the categories on the land and property pages of the SA return.

The taxpayer will not have to keep every piece of accounting information in an electronic form. It will not be necessary to scan every receipt or send every invoice electronically – only the data from these sources will need to be entered as a digital record. However, there will still be a requirement to retain the source documents in some form.

Recording accounting information on a spreadsheet will be acceptable but that accounting data will have to be read into MTD-enabled software to allow it to be submitted to HMRC.

Software

Taxpayers, or tax agents on their behalf, will only be able to make MTD submissions using software which has been designed to interact with HMRC's application programme interface (API). The API acts like a door into the HMRC computer. The door can only be opened to allow data into HMRC, or out to the taxpayer/agent, if the software has been designed to unlock that door.

Currently many taxpayers submit tax information to HMRC by completing an online form. This is particularly the case for quarterly VAT returns and SA tax returns submitted without using commercial software. HMRC has ruled out this method of submitting data under MTD, as it wants the submission process to eliminate human error (see **Why MTD?**).

Free software
HMRC has encouraged software producers to make free versions of their accounting software available for small businesses, to facilitate MTD submissions. HMRC has specified that the free software needs to cope with the following conditions:

- Sole-trader business – not a partnership, company or trust
- Turnover under VAT registration threshold
- Not VAT registered
- No employees
- Accounting records kept under the cash basis

HMRC will not provide free MTD software. Tax agents will have to buy software in order to make MTD submissions on behalf of their clients and to view their clients' tax data held by HMRC.

Using the cash basis will not be compulsory for MTD but it may make the reporting process easier for the smallest businesses.

Timetable

The introduction of MTD has been designed to fit in with how HMRC holds its data, which is organised by tax (income tax, VAT, corporation tax) and not by type of taxpayer (individual, company, trust). It is important to understand that some businesses will commence reporting of different selections of data under MTD, at different dates, according to the taxes it is required to pay.

Taxpayers will commence reporting under MTD from the first accounting period that starts on or after these dates:

- 6 April 2018: Businesses with turnover exceeding the VAT registration threshold, to report income and expenses which are subject to income tax and Class 4 NIC.
- 6 April 2019: Businesses with turnover exceeding £10,000, to report income and expenses which are subject to income tax and Class 4 NIC.
- April 2019: All VAT registered businesses, to report income and expenses which are subject to VAT – in essence, the information on the VAT return.
- April 2020: Businesses which pay corporation tax, to report income and expenses subject to corporation tax – i.e. the information on the corporation tax return. Also all partnerships with turnover of £10 million or more.

HMRC has proposed that MTD will roll out for VAT and corporation tax information from April 2019 and April 2020 respectively, but it has not specified the date in April from which reporting should commence. This timetable may also be interrupted by the General Election on 8 June 2017, which will delay the passing of key parts of the MTD legislation.

When to commence

To determine when a taxpayer is required to commence MTD reporting, or if they qualify for full exemption on the basis of turnover, they should examine their total business turnover for the accounting period which has most recently ended. The taxpayer must consider the aggregated turnover from all their businesses, including rental income.

Example 1

George is a self-employed builder who makes up his accounts to 31 March. His last accounts show a turnover of £80,000. He also lets a residential property, which generates income of £12,000 per tax year. As George's total turnover from all his businesses is £92,000, which exceeds the VAT registration threshold of £85,000, he will be in the first wave to commence MTD reporting. Note, George is not VAT registered, as his annual trading turnover is below the VAT threshold, and his rental income is exempt from VAT.

George will be required to commence reporting under MTD as follows:

- from 6 April 2018 for his rental income, which is always calculated on a tax year basis
- from 1 April 2019 for his building trade.

Accounting periods

As the commencement of MTD reporting is tied to the accounting period, a business that uses a year end early in the tax year can delay MTD reporting by switching to a 31 March year end.

Example 2

Joy's hairdressing business has sales of £40,000 per year and she makes up her accounts to 30 May. If she continues with an accounting period ending on 30 May she will be required to commence reporting under MTD from 1 June 2019. However, if Joy changes her accounting period to run from 1 June 2018 to 31 March 2019, she will start MTD reporting from 1 April 2020.

Joy will need to abide by the law on changing an accounting date (ITTOIA 2005, ss 216-217), which requires notice to be given, and the first new accounting period not to be longer than 18 months (see BIM 81045). There are additional restrictions if she has changed her accounting period within the last five years. The draft law for MTD (TMA 1970, sch A1, para 18(3)) also gives HMRC a new power to disregard changes of accounting date, so caution will be needed if contemplating changing it.

Exemptions

The following taxpayers are exempt from MTD reporting:

- taxpayers with total annual turnover, including rental income, of under £10,000
- charities and community amateur sports clubs (CASC), but trading companies which are owned by charities are not exempt from MTD
- taxpayers who meet the definition of being 'digitally excluded'
- insolvent businesses
- partnerships which only receive income from OEICs or REITs
- Lloyd's underwriting partnerships.

Digital exclusion will be defined in TMA 1970, sch A1, para 14(4) as:

a) *the person or partner is a practising member of a religious society or order whose beliefs are incompatible with using electronic communications or keeping electronic records, or*

b) *for any reason (including age, disability or location) it is not reasonably practicable for the person or partner to use electronic communications or to keep electronic records.*

For a partnership to be exempt from MTD reporting on the basis of digital exclusion, every partner in that partnership must be digitally excluded.

Reports and submissions

A taxpayer will have to make six or more submissions per year to HMRC under MTD. These submissions do not all amount to a tax return or part of a tax return but each submission is an interaction between the taxpayer and HMRC, which clients may need help with.

Periodic updates

The taxpayer (or tax agent on their behalf) must use electronic communications (i.e. approved software) to supply specified information about the business to HMRC. Regulations (not yet published) may set out exactly what financial information must be provided but HMRC has indicated that it will only require summary totals of income and expenses, not details of individual transactions.

HMRC has said that a business with turnover under the VAT threshold will be permitted to submit just two figures: total income and total deductible expenses for the business, which is equivalent to the current three-line accounts concession. However, the requirements for keeping digital records mean the taxpayer has to keep a more detailed breakdown of expenses (see **Digital Records**).

Each update will transmit year-to-date figures to HMRC, in a similar fashion to the submissions made under RTI for employees' pay and deductions. This allows HMRC to reflect back to the taxpayer an indication of the tax liability which has accrued on their profits made so far (see stage 4 in **Stages of MTD Reporting**).

This update process should be an automatic data transfer from the taxpayer's accounting software, to their accountant's software or directly to HMRC. The taxpayer and their accountant won't have to use the same brand of software. For example, a client could use Product X from which summary data is imported into a practice product for adjustment and submission. Thus, no matter what products their clients use, all updates and End of Period Statements can be handled in a consistent manner. It is in this way that spreadsheets will operate to deliver the required summary data.

There will be an option to make accounting adjustments at this stage but no obligation to do so. Accountants will need to decide how much checking to do on this data before it is submitted to HMRC.

The update does not constitute a 'tax return' as the taxpayer is not making a declaration that the information is complete or correct. However, the draft legislation (*TMA 1970, sch A1, para 13(5)*), says that regulations may provide:

a) "*that information provided must meet standards of accuracy and completeness set by specific or general directions given by the Commissioners, and*

b) *that failure to meet those standards may be treated as a failure to provide the information, or as a failure to comply with the requirements of the regulations."*

This indicates that it won't be acceptable to provide estimate figures as a periodic update but until the regulations are published we do not know what standards of accuracy or completeness will be required.

HMRC have said there will be no penalties for submitting incorrect data as part of an update but there will be penalties for submitting an update late or not at all (see **Penalties**).

The update must be submitted within one month of the end of the period or interval for which the accounting data was collected. The taxpayer can provide updates on a more frequent basis, and at irregular intervals, but each update must be provided no more than three months after the last update was submitted. Normally the updates will be provided quarterly (see Example 3).

The taxpayer must submit periodic updates for each trade or business they operate, so separate updates will be required for a lettings business and a trade.

End of period statement

This is the process of finalising the accounts for the business. In practice, accountants will be able to prepare final accounts in their software, as they do today, and use this in the final figures for submission to HMRC.

Any accounting adjustments for accruals, prepayments and tax adjustments, such as disallowing entertaining costs, are made as part of the end of period statement. To make such adjustments, the accountant will have to see the detail of business transactions, not just the summary data submitted as updates. It may take more effort to correct data submitted as part of the periodic updates at this stage than it would to do that work at the time the periodic update is made. The timing of any checking process will be a decision for the accountant.

The taxpayer must confirm that this statement is complete and a correct report of their business results. It is equivalent to the self-employed pages of the SA tax return. It may be possible to submit the end of period statement alongside the last update for the accounting period but in view of the additional checking required extra time is permitted for submission.

The draft law has set the deadline for making the end of period statement as the earlier of: ten months after the accounting year end; or 31 January after the year end (see Example 3). This would leave a business with a 31 December year end with only one month to submit its end of period statement, which does not appear to be what HMRC intended.

Final declaration
The law that requires a person to make a personal tax return when sent a notice to file by HMRC (TMA 1970 s 8), is being rewritten to require the person to submit a 'final declaration' alongside the self assessment of tax due. Thus, the final declaration is the new name for the current SA tax return.

However, in practice the final declaration will be a different process to completing an SA return, as data already held by HMRC (e.g. business profits, employment income and bank interest) will be downloaded from HMRC. The taxpayer will not be able to change this downloaded data, as HMRC will require any changes to be made at source by the provider of that data (e.g. the employer to data provided through RTI). HMRC will need to consult on a dispute process to reconcile claims by taxpayers that the source data is incorrect.

The deadlines for submitting the final declaration are the same as exist for the current SA tax return: the later of 31 January following end of the tax year or three months after HMRC sends a notice to the taxpayer.

Example 3
Pete has a carpentry business with a year end of 30 April, which has a turnover of £30,000 per year. He also receives rental income of £6,000 per year, which has to be computed to the tax year ending on 5 April. As Pete's combined business and rental income exceeds £10,000 but is less than the VAT registration threshold, he will start reporting under MTDfB from 6 April 2019 for his rental income and from 1 May 2019 for his carpentry business. He also receives savings and pension income.

For the first period of MTD reporting Pete will be required to make the following submissions and declarations to HMRC, by these dates:

Deadline	Reporting transactions in:	Category of income	Type of submission
5 Aug 2019	6 April 19 – 5 July 19	Rents	Update
31 Aug 2019	1 May 19 – 31 July 19	Trade	Update
5 Nov 2019	6 July 19 – 5 Oct 19	Rents	Update
30 Nov 2019	1 Aug 19 – 31 Oct 19	Trade	Update
5 Feb 2020	6 Oct 19 – 5 Jan 20	Rents	Update
29 Feb 2020	1 Nov 19 – 31 Jan 20	Trade	Update
5 May 2020	6 Jan 20 – 5 April 20	Rents	Update
30 May 2020	1 Feb 20 – 30 April 20	Trade	Update
31 Jan 2021	6 April 19 – 5 April 20	Rents	End of period
31 Jan 2021	1 May 19 – 30 April 20	Trade	End of period
31 Jan 2021	Tax year 2019/20	Rents and other income	Final declaration
31 Jan 2022	Tax year 2020/21	All income including trade	Final declaration

Although Pete is reporting his rental and trading income side by side, those sources of income are subject to tax in different tax years:

- Rents in year to 5 April 2020 – taxed in 2019/20
- Trade in year to 30 April 2020 – taxed in 2020/21

Pete may wish to align his accounting period for his trading income with the tax year, or to 31 March.

Partnerships

MTD will apply to partnerships where one or more of the partners is subject to income tax, so it will apply to mixed partnerships which have corporate members and to LLPs.

Partnerships are responsible for keeping the accounting records for business and the nominated partner is responsible for making the periodic updates on behalf of the partnership business. These updates don't have to include a partnership share statement that divides the income between the partners. This is sensible as most partnerships don't determine the distribution of income between the partners until the accounting period has been finalised.

This means that stages 3 and 4 of **Stages of MTD Reporting** won't apply for a partner in a partnership. The partner will only have their digital tax account updated at stage 6, so until that point they will have no idea about the tax liability they have accrued on their share of partnership profits, unless the partnership provides that information.

The partnership will have to submit a partnership tax return in place of the final declaration.

Paying tax

HMRC promised that the timetable for paying tax on self-employed income under MTD will not change within this Parliament. This provides no guarantee for what will happen to tax payment dates in the new Parliament that will start after the General Election.

Penalties

There will be a new regime of penalties to encourage timely submissions and tax payments under MTD, but no penalties will be imposed within the first 12 months that a business becomes subject to MTD reporting requirements.

After that point penalties would apply. HMRC has put forward three different models of penalties in its latest consultation paper, all of which would permit the taxpayer to make one mistake or failure before penalties commenced.

Future developments

The specifications for formats to record and holding accounting data, and exactly what information will have to be submitted to HMRC, will be defined in the regulations. These regulations were not published alongside the draft legislation, so they are not open to public scrutiny. The draft law allows the MTD regulations to be passed by Parliament with no debate at all.

Large partnerships with a turnover of £10 million or more won't be required to commence MTD reporting until April 2020 at the earliest. This is because those partnerships are regarded as 'complex businesses'. HMRC has promised to issue a consultation paper on the MTD regime for complex businesses but it appears that document has been delayed once again, this time by the General Election. The complex business consultation will also cover corporations, of all sizes.

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	Clients	Sole Traders	Partner ships	LLP	Ltd.Co	Price Per annum (ex VAT)
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Trust Unlimited	x	x	**Unlimited**	x	**£175.00**
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