The impact of UITF Abstract 40

A memorandum from the CCAB to the Paymaster General

Introduction
In a covering letter and memorandum to the Paymaster General dated 6 June 2005, the President of the CCAB requested a ten-year spreading relief to help counter likely hardship that would arise as a result of the adoption of UITF Abstract 40 (Abstract 40).

In her response dated 20 July 2005, the Paymaster General asked the CCAB bodies to provide further evidence to support the introduction of a spreading relief.

The CCAB bodies and the Law Society have been working on gathering evidence and this memorandum provides the further evidence that has been requested.

The impact of Abstract 40
As noted in the memorandum of 6 June 2005, Abstract 40 will have a significant impact on the taxation liabilities of a number of businesses that provide services to their customers and clients. This is because Abstract 40 requires such businesses to value uncompleted work at the year end by reference to the stage of completion and its selling price rather than on costs incurred to date.

The impact will be particularly acute for those businesses which are run by the proprietors and who did not have to put a value on their own time under the previous accounting standards and who valued WIP in accordance with the guidance note that was agreed between the accountancy profession and the then Inland Revenue in November 1998.

Business affected
As we have mentioned, we believe that a very wide range of businesses are likely to be affected by Abstract 40. We have set out in Appendix 2 a list of such businesses. For the purpose of the current exercise, however, we have limited the survey to the impact upon our own members. The reason for this is that in the time available, it was not possible to gather statistically meaningful data from a wider range of businesses as our members will not have had ready access to the necessary data. In order to measure properly the impact of Abstract 40 on the businesses of our members’ clients, it would be necessary to undertake a detailed examination of the accounts of the businesses concerned. Nevertheless, we do not believe that other businesses would have shown significantly different results if there had been an opportunity to survey them as well.

The businesses surveyed - methodology
A number of approaches were used in order to obtain data from our members.

1) The key tool used by the ICAEW was a member survey. We were concerned to seek statistically reliable and accurate data and the ICAEW therefore undertook a survey of its members with the aid of its research team. A questionnaire (attached as Appendix 3) was designed that sought to identify the impact of Abstract 40 on members. The questionnaire was principally used to undertake a formal survey of members using proven statistical methods. The number of the sample (1,500 members) was designed based upon the known likely response rate and such that the data received would provide a statistically accurate result that could be extrapolated.

This member survey was sent only to members working in firms with up to 50 partners as it was unlikely that we would obtain the required information from the largest firms by way of such a survey, not least because it would be most unlikely that the ICAEW member who received the
questionnaire would have the required, detailed, financial information about the firm for which he or she worked. As noted below the largest firms were contacted directly.

Over 80 per cent of the businesses which participated in this survey were small businesses with no more than 10 partners or owner/proprietors with the remainder of the participants working in firms with between 10 and 50 partners or owner/proprietors. The results of the survey were collated directly by the research team and 112 responses were received.

2) The same questionnaire was also placed on the ICAEW website and 75 responses were received. The data from these responses was collated separately from the main 1,500 member survey.

3) In respect of the largest ICAEW firms, namely those with more than 50 partners, there are 21 practices. Rather than send the survey to random individuals we sought to make direct contact with them. We received 8 responses.

4) The ACCA obtained data from member firms.

5) ICAS obtained some data from member firms and some solicitor firms.

6) The Law Society collected evidence from members but it was not in a form that allowed data to be incorporated into the Tables in the Appendix.

In all data from 217 businesses has been included in the Tables in Appendix 1.

The ICAEW also received some data directly from firms following a request in its Tax Faculty’s newsletter. Although this data is not included in the results, it appears to support the overall results of the data that we have collated.

The results of the data collection

The key findings of the survey are tabulated in Appendix 1. We requested details of the potential increase in WIP/accrued income (we have used the term WIP for convenience although strictly it should be accrued income) and also the extra tax payable as a percentage of profits.

The results show that there is a wide variation in the estimated effect on businesses. In respect of accrued income, about 18% are expecting an increase of under 10% by comparison with WIP. However, more than 50% of businesses will see an increase in accrued income of more than 50%, with more than 25% of businesses recording an increase in accrued income of more than 100%.

Turning to the actual tax position, 28% of businesses are expecting the extra tax payable as a percentage of profits to be 10% or less. A further 30% expect an increased tax bill of between 10 and 25%.

There are then 25% of businesses which expect an increased tax bill between 25 and 50% of their total annual taxable income. This means that the additional tax bill will be the equivalent of 3 months’ income or more and the amount of tax payable will increase by 50% or more. For a 40% taxpayer, therefore, this would result in an effective tax rate of 65% or more. In other words, almost two thirds of that year’s income will disappear in tax.

The final 17% of businesses will have a tax bill which will be more than twice as great as normal and which will represent 50% or more of their total annual taxable income. In practice this means that they will face a tax bill which is more than twice as large as their normal tax liability and represents in some cases nearly a full year’s income and in other cases much more.
In summary, 25% of businesses are facing an increase in their tax bill of more than 50% and a further 17% of businesses are facing a tax bill which will more than double.

In respect of the impact between small/larger firms, given the small sample size it is more difficult to extrapolate the results faced by the larger firms. The data for larger firms suggest that the likely charge they face is proportionately less than for many smaller firms but, nevertheless, there will be an impact for most of the firms.

**The case for spreading**
The data shows a wide variation in the effect that Abstract 40 will have on businesses. However, we believe that the data demonstrates that 40% of all businesses will be hard hit financially by the introduction on Abstract 40, with 17% of all businesses facing a doubling of their tax bill.

We believe that the evidence is sufficient to support our earlier request for the introduction of a spreading relief over ten years.

**Our conclusions recommendations**
We recognise that in her letter of 20 July 2005, the Paymaster General was not in favour of a proposal to spread the additional tax over a ten year period. We understand and appreciate that the Government would prefer any spreading to be over a shorter period. Nevertheless, we believe that the evidence we have collated confirms our concern that many businesses will face hardship. We are concerned that many businesses will struggle even with a ten-year spreading and that anything shorter may result in businesses folding. Our conclusion is that our previous recommendation for a ten-year spreading is justified and reasonable.

We appreciate that the Government is concerned in particular about the impact on small businesses. It is of course a policy decision for the Government to decide whether it is appropriate to restrict any spreading relief to businesses of less than a certain size. Our evidence from the larger firms is that, whilst proportionately the impact will be less than on small firms, nevertheless there will be an impact. Many of the reported adjustments will be substantial in size and larger firms will also be facing financial hardship. Our conclusion is that any spreading should be available to all businesses no matter what their size. This will ensure that it:

- is simple to operate;
- will avoid any issues of identifying the boundary at which relief is suddenly withdrawn; and
- is fair to all taxpayers.

**Other considerations**

**Compliance issues**
We have considerable concerns that not all businesses will fully understand and implement these changes. It is clear that the debate about the impact of Abstract 40 has caused some considerable confusion as to how this will impact on different businesses. We believe that a lack of consistent implementation will result in a considerable burden to HMRC in ensuring compliance across all taxpayers. We believe that the introduction of a spreading provision will help to encourage compliance by providing a ‘one-off’ opportunity to adopt Abstract 40

**The problem of legal aid work**
Three are a number of types of services that give rise to particular problems. One such example is legal aid work. It is common for such legal aid payments to take up to 18 months from the date of the case to be settled. With the changes arising from Abstract 40, the position will arise where these lawyers will actually be required to pay tax to HMRC before payment is received from the Legal Aid Board. A number of firms have indicated that this additional new burden will make this area of business no longer economically viable for their firm.
Early adopters
Although we did not raise the issue in our earlier letter, we are conscious that in some cases businesses took the view that Application Note G had the same effect as Abstract 40 and these businesses will have already reflected the extra income in accounts which have been submitted to HMRC.

We believe that on grounds of equity it would be reasonable to consider some equivalent form of spreading for such businesses.

Retiring partners
The memorandum of 6 June 2005 referred to the problem faced by some retiring partners who may face tax charges on income that they never received. We provided further information on the issue in a follow-up letter and memorandum dated 18 August 2005.

We trust that this further information explains the problem. We have not been able to quantify whether this will be a major problem in practice but nevertheless we think that this is an issue that needs to be addressed.

Joint guidance
We are also anxious to move forward on updating the joint guidance that we published in November 1998.

Next steps
We would welcome the opportunity to discuss the data and the conclusions we have reached with officials from HM Treasury and HM Revenue and Customs.

IKY/FJH
30 September 2005
Appendix 1
Statistical Analysis of survey results

1 EXTRA INCOME AS A PERCENTAGE OF WIP

<table>
<thead>
<tr>
<th>Extra income as percentage of wip (per cent)</th>
<th>ICAEW survey of 1,500 members</th>
<th>Other surveys</th>
<th>TOTAL (in numbers)</th>
<th>TOTAL %</th>
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2 EXTRA TAX PAYABLE AS A PERCENTAGE OF TAXABLE PROFITS

<table>
<thead>
<tr>
<th>Extra tax payable as percentage of taxable profits</th>
<th>ICAEW survey of 1,500 members</th>
<th>Other surveys</th>
<th>TOTAL (in numbers)</th>
<th>TOTAL %</th>
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<tr>
<td>Aggregate</td>
<td>217</td>
<td></td>
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</tbody>
</table>

Notes

More than 75 per cent of the businesses surveyed are small business, defined as having 10 or few partners or owner/proprietors.

ICAEW sent the survey questionnaire (electronically) to 1,500 members in firms with up to 50 partners – there are only 21 accounting practices larger than this and these were contacted directly by phone.

ICAEW also posted the survey questionnaire to its website and the results of that survey are incorporated in the Other surveys column.
The results of the ICAEW telephone survey of the largest 21 accounting practices is incorporated in the Other surveys column.

The ICAS results include data for 5 solicitor practices and is incorporated in the Other surveys column.

The Law Society has also collected evidence from its members which is consistent with the data shown in the above Tables. However it was not in a form which could be incorporated into the Tables themselves. Representatives of the Law Society will be able to present their evidence in a meeting with Government officials.
Appendix 2

Businesses that will be affected by Abstract 40

We believe that the businesses listed below are amongst those that are likely to be affected by Abstract 40.

This list is not intended to be exhaustive but it does illustrate the very wide range of different businesses on which Abstract 40 will have a significant impact.

- Accountants;
- Architects;
- Barristers;
- Builders and related trades;
- Dentists;
- Designers;
- Doctors;
- Equipment/Vehicle repair shops;
- Estate agents;
- Farmers;
- Independent Financial Advisers;
- Insurance brokers;
- IT consultants;
- Letting agents;
- Marketing consultants;
- Printers;
- Solicitors;
- Surveyors.
Appendix 3
ICAEW Questionnaire

[see attached pages]
Thank you for taking the time to help us with this consultation. It should take about 5 minutes to complete. Please click in the appropriate box(es) for each question, or type your answer in the text box supplied.

All responses will be treated in strict confidence according to the Code of Conduct of the Market Research Society. The results will only be reported at an amalgamated level.

Q1 How many partners are there in your firm?
   - Only one (sole practice)
   - 1-2
   - 3-5
   - 6-10
   - 11-20
   - 21-50

Q2 How many service providers who are not partners do you have?
   - 0 - 10
   - 11 - 20
   - 21 - 50
   - More than 50

Q3 What are the taxable profits per partner?
   - Nil or loss
   - Less than £10,000
   - £10,000 - £25,000
   - £25,000 - £50,000
   - £50,000 - £100,000
   - £100,000 - £250,000
   - £250,000 - £500,000
   - More than £500,000

Q4 What is the current value of your work-in-progress per partner?
   - Nil
   - Less than £5,000
   - £5,000 - £10,000
   - £10,000 - £25,000
   - £25,000 - £50,000
   - £50,000 - £100,000
   - £100,000 - £250,000
   - More than £250,000
Q5  Under UITF 40, how much extra income will you have to recognise as a percentage of your work-in-progress figure in Q4?

- Less than 10%
- 10% - 25%
- 25% - 50%
- 50% - 75%
- 75% - 100%
- 100% - 200%
- 200% - 500%
- More than 500%

Q6  Under UITF 40, how much will the extra tax be per partner as a percentage of taxable profits in Q3?

- Nil
- Less than 10%
- 10% - 25%
- 25% - 50%
- 50% - 75%
- 75% - 100%
- More than 100%

Q7  How will you fund the extra tax?

- Borrow from own resources
- Borrow from bank
- Other, please state

Q8  Information provided will be recorded anonymously. If you are happy for your case to be cited in the evidence we present to the Government, please submit your name and any relevant details below.

_____________________________________________________________________________
_____________________________________________________________________________
_____________________________________________________________________________
_____________________________________________________________________________
_____________________________________________________________________________

Thank you for completing this survey. Please click on the "submit" button ONCE to return your survey to the ICAEW Research Centre