HOUSE OF LORDS

Select Committee on Economic Affairs

Finance Bill Sub-Committee

Corrected oral evidence: Draft Finance Bill 2017

Monday 6 February 2017

3.35 pm

Watch the meeting

Members present: Lord Hollick (The Chairman); Lord Bilimoria; Baroness Bowles of Berkhamsted; Baroness Drake; Lord Flight; Baroness Kingsmill; Lord Leigh of Hurley; Lord Tugendhat; Lord Turnbull; Lord Wakeham.

Evidence Session No. 1 Heard in Public Questions 1 - 18

Witnesses

I: Mr John Whiting, Tax Director, Office of Tax Simplification; Professor Richard Murphy, Director of Tax Research UK and Professor of Practice in International Political Economy, City, University of London; Mr Robin Williamson, Technical Director, Low Incomes Tax Reform Group.

II: Mr Kevin Hart, Head of Payroll and Third Party Integration at B&CE (The People's Pension) and Chair of the Business Application Software Developers Association; Mr Kevin Dady, Group CEO, IRIS Software Group.

Examination of witnesses

Mr John Whiting, Professor Richard Murphy and Mr Robin Williamson.

Q1 **The Chairman:** Thank you very much for joining us. This is our first public hearing into making tax digital. It has certainly struck a chord, because we have a heavier than usual postbag. Many of the topics raised in the letters we have received will be discussed this afternoon. We have only a relatively short period to take evidence, so I would be grateful if you could keep your answers suitably succinct. If you agree with what others have said on the question, a nod will suffice.

Last year, this Committee suggested that the Office of Tax Simplification should become involved earlier in the process of changing tax and tax policy. Has that recommendation, which was supported by a number of other bodies, such as the Institute for Government, borne any fruit? For instance, to what extent have the Office of Tax Simplification been involved in the plans to make tax digital?

Mr John Whiting: I think that it has borne fruit. We are involved a little more at the start of the policy-making process, partly because, as you will be aware, we are now on a statutory basis, with increased powers. Those increased powers allow us to do other than look backwards at what is on the statute book, so it is within our power to look forward at what is coming. Hence, we are involved in the policy process, although, given our size, naturally we cannot cover everything.

Specifically on making tax digital, we have certainly been involved. As to whether we have influenced, I suppose there is an element of, "You had better ask HMRC". We have been involved and we have kept in touch. We have tried to make sure that simplification is borne in mind as making tax digital is thought about.

We have probably had more success in talking about simplification and making tax digital in the context of corporation tax. As you will be aware, companies will come further down the track, after the initial tranche. The reason for that is that we happen to be doing a project on simplifying and streamlining the corporation tax computation. That will be quite timely and will play well to making tax digital for companies, which is due in 2020. We have not done a similar exercise on unincorporated businesses, although naturally we have come up with some ideas in the past, such as cash basis and reforming opening year rules. My summary is that we have been involved and we have talked to HMRC. Have we really been able to influence? Not as much as I would like to have done, I have to say.

The Chairman: To push you a little further on that, in which particular areas would you like to have influenced the thinking rather more in a certain direction?

Mr John Whiting: On corporation tax, we hope our input will be useful. Among other things, we are looking at whether you can streamline the computation and make it easier. If you can get rid of some of the sundry adjustments, it becomes much easier to report, be it on paper or digitally. We would love to have done a similar exercise on unincorporated businesses and partnerships. Of course, there are things like the opening and closing year rules, where we identified that there was scope for change, improvement and simplification. It would have been good to look at that far more coherently. I could go on, but those are a couple of examples.

Q2 **Baroness Kingsmill:** The proposed changes seem quite radical. I wonder to what extent you think they are coherent. There are three elements that I would like you to address in relation to that. Will the proposals make the whole thing more user-friendly? Will they increase the revenue take? Will the costs be lower?? Is it coherent throughout?

Mr John Whiting: Dear me. How long have we got? Your first point is whether it could be easier. In a sense, that is the $64 billion question. It is the right direction. I certainly believe that digitising—making things electronic—has great scope for making things easier, although no doubt Robin will remind us of those who are digitally excluded. It has the potential to make it easier.

Could it be cheaper? That is the acid test. Richard will talk at length on that one. Most of us have some doubts as to whether it will be cheaper, but it has the potential. It is in the right direction, although—going back to where the Chairman started—I would not have started from here. I would have been happier building on the success of existing systems that are doing electronic filing, such as for a VAT-registered trader, and potentially broadening them out. I am a great believer in carrots, rather than sticks—designing a system that works for people in the way they want it to work, and improving from there.

Baroness Kingsmill: By easier, do you mean easier for the user—for the consumer or customer?

Mr John Whiting: Easier all round. We must not forget that HMRC is a player as well. It has the potential to be easier, if it all works. Of course, there are some fairly fundamental issues. Will the software be available and easier to use? The question I keep coming back to is that a lot of small businesses feel they are keeping their records digitally at the moment, by using a spreadsheet system such as Excel. That may be perfectly adequate for what they are doing, for preparing tax returns et cetera. Will it be easier for them to switch to a digital package, amid some surprise that what they are doing does not count as digital? That is a very big question, because there is a very big transition to go through to get to that. Could it be easier at the end? Possibly, if it really is easy, automatic and all the rest of it, but there is a very big series of hurdles to go over. Of course, potentially there are also a lot of transitional and ongoing costs, with, possibly, professional advice.

Baroness Kingsmill: You did not mention revenues. Do you think it will increase the tax take?

Mr John Whiting: It has the potential to increase the take, because it will lead to more accurate reporting. It has always struck me as slightly curious; having been a practitioner for many years, I know that even the firms I used to deal with used to forget to include some things. Therefore, it will also make sure that there are more accurate expense claims. Yes, it probably will help to close the tax gap, but it will also encourage people to do more accurate claims. Could it also, potentially, encourage a few more into the hidden economy, because people want to avoid it? Just possibly. Richard is bursting to come in.

Baroness Kingsmill: Professor Murphy is shaking his head and grimacing slightly.

Professor Richard Murphy: I respect everything John says. We have known each other for a long time. I should declare an interest. I am a chartered accountant. I have a practising certificate. I do not have any clients who are impacted, but I am impacted by making tax digital. I really do not like the idea. I find it extremely difficult to imagine why my current Excel spreadsheet is unacceptable for this purpose and I will have to buy software to do it. I do not see why I have to file quarterly. I do not see that the Revenue will gain one iota from my doing so. I put my cards on the table: I am not a fan of this, as a user of the system.

I am not a fan of it for many reasons. Is it user-friendly? No. Quite clearly, it is not. This morning, I asked my painter and decorator, who was in my bathroom at the time, applying emulsion, whether he was aware of what was going on. No. Was he shocked by it? Yes, he definitely was. That has been the reaction I have found right across the system. Nobody in a smaller business can imagine how it is user-friendly.

Let me be quite clear. I do not believe the figures HMRC has put out that this will benefit businesses by saving them cost. As an experienced chartered accountant who has dealt with hundreds, if not thousands, of small businesses in my career, I will tell you that I do not know any who really understand accounts. Quite bluntly, they do not. In fact, that is true of most board directors of large companies whom I have met. That is why almost everybody uses heuristics—rules of thumb—to manage their businesses. They can develop extremely good ones to suit their purposes. It might be revenue; it might be the margin that they need to make or it might be keeping their costs under control, using certain things they are aware of—mileage or whatever else—but they do not use accounts on a day-to-day basis to manage the business. I do not think that this will provide them with useful information.

Is it friendly? No. Will it increase the error rate? I believe that it will increase the error rate in accounting. People who are forced to prepare accounts in a short period of time tend to make a lot more errors than people who have a little more time to get the thing right. It is well known in accounting that the longer you take to prepare a set of accounts, the more likely the information that you supply will be right, because, for example, you will eliminate some of the estimates that inherently must underpin most sets of accounts. You will always make estimates. Is it the stock figure, for example, if you are on an accruals accounting basis? Is it the bad debt? Is it the apportionment of the use of the motor vehicle that you use for both private and business purposes? All those estimates take time to get right. I do not believe that they will be right in making tax digital if submitted quarterly.

I also think that there will be an inclination—I have seen it in my past career—for people simply to dump in estimates to meet a deadline for submission when there is a penalty attached to not filing. They hope that next time they will have the time to put it right. They do not always get to that next time and put it right. I believe that it will force some people into the shadow economy. It is a very significant risk. Remember that it will apply to businesses with only £10,000 of income, less than the personal allowance, which is after expenses. This is £10,000 pre-expenses. That will increase the number of businesses that simply do not report.

The number of errors will go up. John is right to say that more expenses will be claimed by honest businesses than were claimed before, which will push the revenue down. When it comes to cost, I suggest that the Revenue’s figures are wildly inaccurate. I did an analysis, which I have sent to the Committee. I kept on doing the numbers, because I could not quite believe it. According to the Revenue, the ongoing cost of making tax digital is £170 million a year. Remember that is the cost it estimates for submitting 23.6 million returns a year—5.9 million businesses submitting four returns a year. If you divide one by the other, you get to £7 a return. In practice, that cost also has to cover additional software. I am advised that I have made an exceptionally generous estimate by assuming that it will cost only £67 million a year, for those who do not have it.

The cost that the Revenue estimates of complying with making tax digital is £4.36 a submission, which is 35 minutes for a person paid the national minimum wage. That is in no sense plausible. My estimate, based on the fact that 65% of self-employed taxpayers and 78% of small companies now use an accountant, is that the real cost will be about £1.8 billion—£305 per taxpayer. That is a massive additional burden on small business. Will it raise any extra tax? I do not believe so.

The Chairman: Mr Williamson, have you anything to add to the two opinions you have heard so far?

Mr Robin Williamson: I agree with both speakers. John gave me the opportunity to expand a little on how the smallest businesses—the microbusinesses—will cope with making tax digital. The exempt categories that HMRC has set out are pretty well in accordance with the law as established in a tribunal case with which we were involved. Basically, it found that those who were digitally excluded because of age, because of some disability that prevented them from using a computer without difficulty or pain, because they were living in a remote part of the country where broadband was inaccessible or for any other valid reason that meant they genuinely could not use digital, would be exempt. If implemented properly, that is the right direction to take.

We are still very worried about the low turnover limit of £10,000, on which the Revenue has still not moved. The rest of the profession and the tax charities favour a substantially higher limit of £83,000 or thereabouts, in accordance with the VAT threshold, on the basis that most VAT payers will be more familiar with doing tax digitally. Much below that, I very much fear that, as Richard and John have said, a lot of people will drift into the hidden economy, rather than face the fairly substantial compliance costs this change will involve them in.

Baroness Kingsmill asked about coherence. That will depend very much on the sector of HMRC's customer base from which you view the changes. Those viewing the changes from the perspective of running a business very competently without access to computers or the need for technology may now need to upgrade their mobile phones, invest in more sophisticated hardware, perhaps, and certainly invest in more sophisticated software, purely for the purpose of complying with an HMRC requirement making tax digital. Is that reasonable? Is it reasonable that a business that is so small as to be a claimant of universal credit should have the burden of accounting monthly to the DWP for universal credit, drawing up accounts on a cash basis annually for HMRC for tax purposes, and jumping through all sorts of other hoops in order to keep two different departments of government satisfied about its compliance aspects? The DWP's cash basis is similar to, but not the same as, HMRC's cash basis. Notably, it operates on a monthly rather than an annual principle. The business will be reporting monthly to one department and quarterly to another. The whole thing will be so confusing that the business is bound to come unstuck somewhere.

Q3 **Lord Tugendhat:** Mr Williamson has answered part of the question that I was going to ask. I would like to put the second part, which I should perhaps have put when we had our previous meeting. Clearly, the effectiveness of the system will rely a great deal on the effectiveness of the Revenue's computer systems. It will also rely a good deal on the level of computer sophistication on the part of the small businesses to which it is directed, quite apart from whether they have to upgrade their kit. To your knowledge, has any research been done as to whether the level of sophistication among the great majority of small businesspeople is sufficient to deal with this? Whether or not it has been done, do you think that the level of computer sophistication among them is sufficient for them to be able to manage this system?

Mr John Whiting: You will find that both the Chartered Institute of Taxation and the ICAEW have done extensive surveys; they may even have put in some evidence to you. They certainly found suggestions that the sophistication is not there at the smallest end, with the fallback that, if they are in doubt, people will get advice. That may be good for the professional bodies, but it is not necessarily totally efficient.

Perhaps I can illustrate. I am sure that everybody in the room has some amazingly powerful device in their pocket that enables them to make phone calls and things, but that does not necessarily translate through to total record-keeping. There is a deal of potential; we all have to accept that things are getting more sophisticated and easier, but I put my hands up: the car I now have allows that device [my phone] to be connected, but I had to get my daughter to show me how it all worked and got connected. Being 24, she knows these things, whereas I do not find it terribly easy. Forgive me—I am sure that your Lordships are much better at these things than I am—but I feel that is where we are. Very probably, the younger generation will find these things easy and automatic, but a considerable cadre will, I fear, find it more difficult.

Lord Tugendhat: That is what I thought.

Lord Bilimoria: I declare my interests, as in the register of interests and what has been declared to the Committee.

Professor Murphy, could you expand on something you said earlier? You said that two-thirds of taxpayers now submit tax returns professionally and ask agents or advisers to help them with their submissions. You quantified the estimated cost at £1.7 billion a year. You also estimated additional software costs at another £1.78 billion. To put it into context, £1.8 billion is 50% of the annual cost of running HMRC.

Professor Richard Murphy: Can I clarify that? I estimated that the cost of preparing the submissions would be £1.71 billion, to which I added my estimate for software that, I think, the Revenue has already implicitly put into its figures—£67 million. It therefore comes to £1.777 billion.

Lord Bilimoria: So it is £1.7 billion plus—

Professor Richard Murphy: It is all included in one figure.

Lord Bilimoria: It reads as if it is another £1.77 billion on top.

Professor Richard Murphy: I like to put numbers into context, because it is incredibly important when we sanity-check these things, which I do not think anyone did with the Revenue's estimate; that is what worries me about it. I went back and looked at HMRC's accounts and noticed that it costs £3.6 billion a year to run. Therefore, this additional cost for small business will be equivalent to the cost of half of HMRC. Its objective in running the programme appears to be the contribution towards the 5,000 staff that it wishes to lose by 2020. Of course, that is not half the staff at HMRC, so the benefit to HMRC is relatively marginal. The cost to small business of achieving it is very high. To go back to the previous question for a second, HMRC has not published an estimate of its own costs for putting the system in place, which I find deeply worrying. Clearly, that is something it should now do.

I have a very good reason for not using small business software. While it is relatively easy to learn small business accounting software—I am pretty IT savvy—in most packages it is a nightmare to undo your mistakes. It is really difficult to work out how to correct something that you have put to the wrong account, and very time-consuming indeed, on most occasions. There are some that have a simple reverse button, if you realise immediately, but, if you do not, sometimes it is quite hard to work out how to put it right. That is another reason why I think that errors will rise. People might learn how to enter data, but getting the data correct is another step altogether, which may take a lot longer.

Lord Wakeham: Most of the information I am getting seems to be that most people think this is a good idea, even if it cannot be done quickly, and there are a lot of difficulties in getting it done. Richard, do I take it that you would not start it at all? You are totally opposed to it.

Professor Richard Murphy: I am not totally opposed to the idea of digital tax returns. As John said, it is obviously the direction of travel we are going in, but I would start at the other end of the scale, with larger companies, where there is a significant problem of capture of data by HMRC already. I would end up with small landlords. We are going in completely the wrong direction of travel. We should try it out on businesses that have accountants, quite probably employed within them, which will be the case for some of the smaller companies involved; they are small, but they are not that small. The £83,000 VAT registration threshold makes a lot of sense at the moment, because a lot of those people will either be using professional advice already or will have software that can be used for the purpose. At the level of £10,000 a year, I cannot even see what the marginal gain to the Revenue will be.

Q4 **Lord Turnbull:** Can I follow up with Professor Murphy the question of quarterly reporting? Am I right in saying that the Revenue does not make any use of the figures and that there are no penalties? It is doing it because it wants to improve accounting generally. If that is the case, will people not simply put in their revenue figures, not bother much with all their invoices and then package them all up in the last quarter to get the annual figure right?

Professor Richard Murphy: Your Lordship is right, in a sense; that is obviously one of the directions of travel in which people could go. However, we do not know what the penalty regime is going to be. Is it possible that you could be penalised for submitting an incorrect return that does not include penalties in the right quarter? That may be the case; we do not know.

I am particularly worried about the accounting implications, and the encouragement the system provides for the adoption of cash-based accounting, about which I have enormous concern. Cash accounting encourages a business to think that it is doing really well when it does not pay its creditors. That is rather like a person jumping off the top of a building; they think that it is going fine until they hit the ground, or until the bailiff turns up and asks for payment. It is the wrong direction of travel. We must have small businesses taxed on their true earnings, not on a cash-flow basis, which could be deeply misleading and is highly variable from quarter to quarter. We should expect that, in due course, it will become the basis for charging tax on an estimated basis, which could give rise to significant overpayment.

Remember, too, that the system does not include all the deductions that a person might claim against their taxable income, so it will inherently overstate income. It does not include a capital allowances estimate, for capital expenditure. It will not include the offset for pension contributions, which may again lead to overstatement of profits. It could, therefore, lead to the Revenue asking for additional payments on account, which would be unjustified.

Lord Turnbull: All those things come in when the annual reconciliation is done. Is that right?

Professor Richard Murphy: Yes, but if HMRC asks for payments on account based on the quarterly information, which is what we expect to happen at the end of the day, that is a dangerous precedent to set.

Q5 **Lord Turnbull:** I am intrigued that you are so opposed to cash accounting, because I am told that the Office of Tax Simplification originally proposed it.

Mr John Whiting: We did.

Lord Turnbull: Would the two of you like to try to reconcile your positions?

Mr John Whiting: I can state mine reasonably simply. Yes, we recommended cash accounting, because we believed that for appropriate sizes and types of businesses it was an obvious simplification. Our recommendation at the time was for businesses with a turnover of under £30,000. We thought that would be a very useful simplification—so much so that we said it would probably be on a default basis, meaning that businesses would have to opt out. Let us be clear. I am an accountant by training and origins. I will never suggest that proper accounts are not very useful indeed. For a business that has stock and fixed assets, for example, you want to do proper accounts, but, for an awful lot of very simple small businesses, cash basis offers a simplification.

I totally accept what Richard said about adjustments. In a sense, that gets us into the question of whether we will end up with five returns a year, rather than four. In my view, it does not invalidate cash basis. Of course, what we have in the proposals is that, potentially, the cash basis will become more available. I do not disagree with that, but naturally, the larger the business, the more likely it is that proper, full accounts will be useful. I am very pleased to see that cash basis will be available to landlords. To be honest, we thought that it would be in the first place. We were not making a distinction. I am pleased to see that it is more available, but—at the risk of being repetitious—as you get larger, you have to be more cautious about using cash basis. Frankly, is it going to do what you need for your business? If not, you should do it properly.

Lord Turnbull: It is starting from £83,000, which is the VAT threshold, but elsewhere we are not using that threshold. Why are we not making more use of VAT, who pays it and how they account for it? Why do we not build on that and make the two things the same? This is an historical point. I always thought that a big mistake was made in 1972, when VAT was given to Customs. At the point we moved from taxation of goods to an account-based system, VAT should have gone to the Revenue; then the two could have been brought closer together. That is an aside. Are we missing opportunities to bring VAT and this system closer together?

Mr John Whiting: In passing, I totally agree with you about where VAT ought to have been placed. This is something that should be built on. We are all saying similar things. I would start by bringing the VAT-registered business—certainly, the business that is above the VAT threshold—into making tax digital. I would look to streamline the whole VAT process—the VAT reporting—and build on that, as a way of building out towards wider scope for making tax digital. Essentially, I am agreeing.

Q6 **Lord Leigh of Hurley:** I declare my interest, as a member of the Chartered Institute of Accountants and the Chartered Institute of Taxation.

Can I focus on the tax gap? There has been much play on how this will remedy the tax gap. We have had submissions from small firms of accountants that they cannot see how it will make any difference to the tax gap, in that people either declare income properly or do not. Secondly, on a tax simplification point, is it your understanding that the software will transform accounts into tax returns? I caught the tail-end of the video, which showed somebody putting through a bill for gym membership, which in my tax training days—admittedly 1985—would not have been an allowable item, yet the Revenue, in its own video, showed it going through as an expense. Is the purpose of the software to try to allocate expenses appropriately, or is it just to make accounts?

Professor Richard Murphy: I suppose that gym membership is an allowable expense, depending on the nature of your business. I can think of those where it might be. Let us come back to the tax gap. I have serious problems with the basis for estimation that the Revenue has used there as well. It is looking only at two components of the tax gap on this issue. One is errors, which are the mistakes that people make having tried to satisfy themselves of the true basis on which they should make the declaration. The second is the mistakes they make having failed to take due care. The Revenue says that errors are £3.4 billion and failure to take due care is £5.5 billion. In total, that is £8.9 billion. It claims that it is going to recover 10% of that.

First, if people have tried to take due care, I cannot see how using software will make any difference. I do not think you will recover any more of that. They have already tried to get it right. I do not think that a piece of software with a little annoying nudge that comes up will help. Can you remember how annoying it was when Microsoft Office had that little paperclip in the corner? That is what will happen in this software, apparently. You will be asked, "Did you really mean that?" We will all try to turn it off as soon as possible. I do not think it will change the errors at all.

That brings us down to £5.5 billion that could be recovered. It is quite clear from what HMRC says in its latest tax gap publication that failure to take due care does not exist only in the small business sector. In fact, it is spread right across tax returns. Only 51% of the tax gap is attributable to the SME sector. We are now down to a maximum recovery of about £2.7 billion, of which it claims it will get 10%—£270 million, not £925 million. A simple analysis says that its numbers must be wrong.

The bigger issue is the hidden economy, at over £6 billion, the criminal economy, at over £4 billion, and the tax not paid, at £3.6 billion. Those are the other things that are directly affected by the SME sector. Why is the Revenue not looking at those? It seems that it is looking at the problem that it can see and completely ignoring the problem it should be looking at but cannot see—the hidden economy. It will penalise people who try to be compliant and ignore all those who opt out of the system altogether. That is totally the wrong direction of travel with regard to the tax gap, in my opinion.

Mr John Whiting: Could I comment briefly on Lord Leigh's point on software, which was: is the software going to do it all? That is what we are all waiting to see. We will all be much more confident about making tax digital when we see and can touch, if you will forgive the odd analogy, the software—the apps—that, potentially, will take our records and immediately give us the automatic returns or uploads that we have to put in. If we can see that Richard's painter and decorator can immediately plug in and upload invoices at the touch of a button and that, potentially, it will sift out your gym membership, but not Richard's, because he needs it more, or something like that, we will all be much more confident. We are waiting for proof on that.

Mr Robin Williamson: There are three types of errors we should look at. We should look not just at the errors that taxpayers make, but at the errors that taxpayers make in favour of HMRC—John referred to that earlier—and the errors that HMRC itself makes. Those of us who interest ourselves in the affairs of the low-paid see some rather horrifying errors on PAYE coding notices. Even now, Tax Help for Older People is still seeing an error rate running at about 50% for pensioners on low incomes. We could see what sorts of errors HMRC thinks are being made by small businesses if it would publish the report it promised last summer on the investigation it carried out into record-keeping by small businesses. That closed in 2015, but we have still to see the report. If we could see that report, we would be better informed as to whether its figures are reliable.

Baroness Bowles of Berkhamsted: I had better declare my interests, as a landlord and as someone with a consultancy business. I am looking forward to having a play with one of these apps, because I think I am one of the people who could score by managing to feed in all the irritating things that I tend to staple somewhere and lose by the time I think about my accountant.

Could we go back to the film we saw and the way these apps work? You can happily scan in the receipts. Presumably, there is some way of putting in your sales. Ultimately, will HMRC be looking to gather even more data than just those raw numbers? If it is only the numbers that matter, why can you not just feed in an Excel spreadsheet and get it converted? If HMRC wants somehow to see the invoices or receipts and where the money is, is it, effectively, doing a tax inspection on you all the time, or having the potential to do that? Unless that is the case, why can you not just feed in the numbers that have come through another route? Why do you have to scan the invoice?

Mr John Whiting: That is a very good challenge. The premise is that if you are keeping your records digitally—potentially, that includes scanning, although it will not have to—you will have a more solid evidence base. It is a slight reflection of something Lord Turnbull asked. Potentially, there is a lot more information flowing into HMRC, something that we have seen on RTI with information from employers and on iXBRL with information from companies. That may be a good thing to take forward compliance, but we would all like to be sure that it will be used and that it is useful information—frankly, that it is worth the effort.

Baroness Bowles of Berkhamsted: Or is it Big Brother, completely and utterly?

Mr John Whiting: Could there be an element of that? Some countries use a system of so-called fiscal tills, where people are required to give you a VAT invoice, in our terminology, for any services or goods that you buy, and a copy automatically uploads to the tax authority in the country. That has a lot going for it, if it is properly managed and monitored, because it will undoubtedly cut down on fraud and defaults—the sorts of things Richard pointed to which we are not getting at. That is not quite what we are looking at. It is not the case that, when you and I buy something, we know that the supplier will send in the information; it is up to us to send it in. It is not a totally integrated system. That comes back to Baroness Kingsmill’s starting point: is this is a strategic direction? I am not yet convinced that it is an absolutely strategic direction, apart from a belief that, generally, digital has to be good, which many of us would subscribe to.

Baroness Bowles of Berkhamsted: The fiscal tax till does not necessarily work, because people do not put it through the till. Then they have to pay for cards of a special colour and they come to inspect you. That is well known on the continent, where I have spent some time.

Mr John Whiting: That is a fair challenge. I am just pointing to that system. Chile is one country that we in OTS happen to have looked at a bit. It is pretty good at making sure that people are doing it properly. It is just the way you decide to impose your system.

Professor Richard Murphy: John raised a good point about the fiscal till. I think it is working. For example, I am told that it is working quite well in Portugal—partly because the receipt becomes an entry into a national lottery, so everybody wants a receipt. That is an interesting way of encouraging compliance, but it shows a broad level of imagination that is absent from these proposals.

I do not think the Revenue will use the data that it gets in any meaningful way. That is one of my concerns. This whole process is linked to the Revenue moving to 14 regional offices. I know that the credibility of that as a strategy has been questioned. It is also linked to a significant reduction in the number of trained staff who might look at the data. In that case, there is very little credible threat that the Revenue will follow up on the data and actually use it.

I am old enough to remember when telling a client that Customs and Excise was going to turn up and it would be one of the most miserable experiences of their life was one way of making sure they complied with the requirements to keep books and records. When one or two of them discovered that it was one of the most miserable experiences of their lives and spread rumour to that effect, it was even better as a threat. That threat does not exist any more. There simply are not the people to come and inspect. I do not believe that that will be done digitally either, because the staff will not be present anywhere in the country to do it. It is a hollow threat. You need not worry much about invasion of your privacy in that sense, because I do not think the data will be used. Therefore, why do it?

There could be more innovative thinking of the type that John has just described with regard to fiscal tills, for example, or the Revenue could require that all turnover be analysed. Blow the expense; mistakes in tax returns are in underdeclared revenue, by and large. People suppress their income. They tend to overstate their expenses, if anything. I proposed this a decade ago, and I know that the Revenue looked at it. If people were required to declare their top 10 customers on their tax return, you would discover, for example, all those who have disguised self-employment or who are working for one client and, therefore, are not really self-employed. You would discover trends in the data straightaway that indicated a great deal of information. That would be useful, but I do not think that what is proposed at the moment will provide any useful data to the Revenue that it will manage in any way.

Q7 **Lord Flight:** I declare my interests as set out, which include being chairman of the EIS Association.

The whole justification for these proposals appears to be that they will narrow the tax gap. Gentlemen, I cannot see that you have said anything that persuades me that they will narrow the tax gap in the slightest. I asked my accountants how much extra work this would entail. Happily, they said they did not think it would make much difference, but I feel great concern that people will have to spend time and money digging out masses of detailed information that, as has been commented on, will not get used. To me, the whole process is an expensive and undesirable waste of time, and is not at all to the benefit of small business.

Mr John Whiting: To go back to the discussions that we had with Lord Leigh, if the systems—the software—do things automatically and seamlessly, so that you or your accountant do not have to intervene manually, potentially this has quite a good direction about it and is the right way to go. I just keep coming back to the four updates a year plus, potentially, a fifth tweak at the end of the year. I struggle to see how that will be quicker and easier. I am sorry to be repetitious, but if and when the software and the apps come, and they really work in the way my daughter occasionally shows me apps work, I am prepared to be convinced. My view—to use a Scottish term you are probably familiar with, my Lord—is that the case is not proven.

Professor Richard Murphy: The Revenue's estimate is that, apparently, this will take about 35 minutes to submit. I attached to the full version of the evidence I supplied a list of the tasks that I think each small business would have to undertake each quarter to make sure that its return was right. That could, quite reasonably, take half a day, or two days of work a year, or 1%, broadly speaking—by the time you have allowed holidays and so on—of the working time of the average self-employed person. What will the impact of that be on the small business economy of this country? Will it produce any meaningful extra GDP or well-being for this country? I seriously question that. I estimate that it will increase turnover for accountants by £1.4 billion, but I am not sure that that is necessarily beneficial overall to the economy, even though I am a chartered accountant.

Q8 **Lord Bilimoria:** Could I go back to the income threshold of £10,000, which has been touched on? Is that not a ridiculous figure? We said that earlier. Should it not be in line with the VAT threshold of £83,000? To me, it shows that HMRC has not consulted properly on this at all. A survey was conducted by IRIS on making tax digital. Under the heading, "What does Making Tax Digital mean to you?" it asked, "Do you feel HMRC have informed you of the changes"? Ninety-eight per cent said, "Not well at all". When asked, "How well do you feel HMRC have informed your clients of the changes required for Making Tax Digital?" 98% said, "Not well at all". That is ridiculous. The survey asked, "By 2020, HMRC plan to abolish the tax return. Most businesses … and landlords will … be required to keep records digitally … Do you feel the changes are achievable in the time frame given by HMRC?" Eight-six per cent said, "Not achievable". What is going on?

Mr Robin Williamson: Part of it is to do with the mandation problem. If everybody with turnover of over £83,000 were mandated and everybody under that threshold were allowed to opt in, it might be a different matter, although there would still be some over the £83,000 who would have to be exempt, on the grounds of being too remote from broadband contact and so forth. It is the mandation that seems to create the problem, not only with regard to the £10,000 threshold, but with regard to the speed with which the whole thing is being brought in. If people with a turnover of under £10,000—if there are any serious commercial businesses with a turnover that low—were exempt, and only them, there would be a drift, as we have said many times during this session, into the hidden economy by those who simply found that the costs of compliance were disproportionate, given the amount of their chargeable time that it took to comply with the requirements.

Lord Bilimoria: Does that not demonstrate HMRC's complete lack of commercial reality? Over the last 26 years, I have built businesses into global businesses from scratch. This shows that HMRC is not listening to business and does not understand business. If HMRC puts in a threshold of £10,000, and thinks that it will make it easier for business by asking it to do things five times a year instead of four times a year, it does not understand business. This is nonsense. It is not living in the real commercial world. Which world is HMRC living in?

Professor Richard Murphy: I too have built businesses from scratch. Being a professor is a late career move, you might say, although quite a welcome one. For the last 32 years, I have been self-employed. It is very strange that I now have income turn up in my bank account without my issuing an invoice.

You are absolutely right. There is no apparent awareness in the Revenue of what the business reality is. That extends to the point about abolishing the tax return. When that was first announced, we did not have the benefit of Donald Trump's experience, but I think it should go into the category of alternative facts. Quite clearly, it is just not true. We will not have abolition of the tax return. We will have five tax returns a year—four MTD returns and a fifth adjustment return. I cannot see how that will abolish the tax return, and I do not believe that anybody will think that is the case either.

I am very worried about that. It is important from a social perspective, because we rely on people to trust HMRC, including to tell them the truth and to talk to them in plain language that they understand. If you look at most of the language about making tax digital, that is not going on. People do not think they will end up making no tax return; they think they will end up making lots of tax returns. They are told that they will be better off by doing that, but—let us be honest—I have not found anybody who believes that that is the case. That undermines HMRC's credibility, which is incredibly important from the tax gap point of view.

Mr John Whiting: I very much endorse what Robin said. I have two points. Lord Bilimoria points to something that I think is a big issue for HMRC, which is a real information challenge. If this is going to start in 2018, there is a huge amount to be done to educate a lot of people and to get a lot of words over. You question whether HMRC has been hearing anything. To HMRC's credit, it has taken a leaf out of the OTS's book, which I am quite proud of. We go around, we tour and we gather evidence. Over the last year, to its credit, HMRC has done a great deal of that with making tax digital and has heard about a lot of these issues. It remains to be seen what will happen—whether, for example, the £10,000 limit will go up to something a little more sensible, even if it is only the personal allowance. That would at least be a step in the right direction.

Lord Turnbull: I wonder whether any of you can put this into context for the small business sector. On the one hand, the Revenue is trying to get another £900 million of revenue out of the sector and is asking it to incur costs of £1 billion or more. At the same time, there is a business rates thing going on and there is corporation tax—big companies are having their tax cut. When you put all that together, is it not a complete failure to have any antennae for what people are going to think of it?

Mr John Whiting: There is one interesting factor, which I am sure the Committee has thought about at some point. One of the big worries is tax-motivated incorporation—a push towards incorporating. You are looking at a corporate tax rate of 17% soon, versus the income tax rates you have alluded to. I have certainly heard it said as I have trotted around that one interesting little thought is, "Perhaps this is an extra push to incorporate my business. It will then be two further years, at least, before I have to come into making tax digital". More than one business has said that to me.

Lord Leigh of Hurley: I have had a listen to your direction of travel, which is fairly clear. How do you think that people who want their tax returns to be digital—perhaps younger people in start-ups and so on—should be accommodated?

Mr John Whiting: It picks up a point that Robin made—make it optional. I still think very much that it is the right direction of travel. Our concerns are about mandation, speed and whether it will be possible for everybody. A younger person may be entirely comfortable with keeping records digitally—keeping them on their phone or whatever. The app will enable them to upload data. Let us be clear—I am talking just about uploading data. I accept the concerns we talked about earlier as to what happens to that data. It is on a cash basis. If they have a simple business and no year-end adjustments, they can dispense with a tax return.

Let us not lose sight of the fact that that will work for quite a lot of today's people. It is very interesting, with working trends going into things like the gig economy and the sharing economy, all of which are facilitated online. We can see a growing cadre of situations where that will work. A lot of our concern is about the more traditional business, if I can use that term, which will take more time to adapt. Again, it comes back to this question: why not start at the easy end? If you prove it works and build a system that works for people, people will follow it. Look at income tax self-assessment, where nowadays 90% file online, because it is so much better and easier.

The Chairman: Mr Williamson, you wanted to come in.

Mr Robin Williamson: I was going to make the point that John has just made. You can compare it with income tax self-assessment over a period. The vast majority of taxpayers now use it, because it is so much easier than doing it on paper. If you make the systems good and reliable, and invest time and trouble in doing that, people will naturally gravitate towards them, and you will not have to mandate them.

Q9 **Baroness Drake:** I have a question for Mr Whiting. The Inland Revenue says that the new regime will reduce the number of errors and reduce the tax gap. Earlier in your contribution, you said that, in your view, quarterly reporting would increase the number of errors, because people would be under pressure to report within a tighter time period. I am sorry—it was Professor Murphy. I apologise. I have two questions. First, why would the final annual reconciliation of the tax returns not mean that you could net out those errors, because you would have a final chance? Secondly, do you have any quantitative sense of how great the increase in errors would be from quarterly reporting?

Professor Richard Murphy: No. Off the top of my head, I do not think I can give you a certain estimate of what the change will be. According to the National Audit Office when it looked at the issue—admittedly a while ago; it reported in 2010—the range of errors appears to be 15% in the tax returns of those who have an agent and 35% to 40% in the tax returns of those who do not have one. That is for the liability owing, so we are talking about substantial figures. By the way, broadly speaking, those figures reconcile with experience in the States, where there has been much more research. We know that there is a substantial error rate already. If there is haste—in particular, if, as a result of this, people move away from using an accountant—we will see an increase in the error rate. One thing the Revenue says about that is that it might encourage people not to use accountants in the future, as if that were a bad thing. In fact, the evidence is that those who use accountants at least halve their error rate, on average.

Can I come back to a point that Lord Turnbull raised about incorporation, because there is another error rate that is very significant? Of the corporation tax returns that HMRC requests at present from small businesses, only 80.4% are submitted. In other words, there is a 19.6% total non-compliance rate already with corporation tax returns. There is no indication in MTD of how we are going to get quarterly returns when at present we cannot get annual returns from those companies. There, I suggest, is another gap that is not being addressed.

The Chairman: Can we come briefly to the last question?

Q10 **Lord Wakeham:** I do not know which question to ask, because we have asked so many questions across the board. It seems to me that, in the end, we have to say something in our report. We cannot put in all the stuff that you have said and all the criticism in that way, so I am trying to get in my own mind the sort of thing we should say. First, you have indicated that digital taxation is probably the right way forward, if it can be done properly. Clearly, however, there needs to be a delay in doing it, because we do not think that we are up to it at present. We think that the level of turnover needs to be substantially higher than has been indicated, and that quarterly reporting will not necessarily produce any great advantages and has lots of disadvantages. Am I right to assume that those are the principal things that have come out of what you have said?

Professor Richard Murphy: You might also suggest that we start with companies and end up with the smallest business, rather than going the other way around. We have the wrong direction of travel on implementation.

Mr John Whiting: Can I put one gloss on it, my Lord? A lot of it is about the costs, to which you alluded. HMRC has come up with some costs. Of course, Richard has talked about his differing costs. HMRC bases a lot of its information on the so-called standard cost model. One useful thing that might come out of this is pressure to update that model. It is 20 years since it was devised and developed. Life has moved on a bit since then. I do not think we are convinced that it is capturing all the data and costs. I have no doubt that it is being run properly as it is, but it could do with being modernised—possibly to pick up some of the things Richard talked about—so that we have a better basis.

Lord Wakeham: I should have declared my interests when I started, but they have been the same for many years. I have been a chartered accountant for 50-something years. I am also a director of family companies.

Mr Robin Williamson: There is one other point about costs. It relates to assistive technology. Quite a number of small businesses are run by people with disabilities. That does not necessarily preclude their using computers—in fact, the use of computers helps them with their disability—but it requires the use of assistive technology. The big question, of course, is: who should pay for that? If you make the disabled business owner pay for their own assistive technology in order to put themselves in a position similar to that of a non-disabled person, and they have to incur that extra cost themselves, arguably HMRC is going against its public equality duty. It is not entirely clear from the equality impact assessment who will pay for that.

The Chairman: Gentlemen, thank you very much. Your evidence was very clear, very helpful and, in many cases, very compelling.

Examination of witnesses

Mr Kevin Hart and Mr Kevin Dady.

Q11 **The Chairman:** Welcome. You heard the cut and thrust of the last session, so you know what we are looking into. Mr Hart, I gather that you want to make a short opening statement. If you would like to give us your remarks, that would be helpful.

Mr Kevin Hart: Thank you very much. As chair of BASDA, I represent a number of software houses in the community. Clearly, we welcome this opportunity. We also very much welcome the principles of making tax digital, with the potential to reduce burden and introduce greater simplification, particularly for small businesses, and more digital engagement in a wider context. Our mantra has always been "Right first time", because that minimises a lot of the overheads for a number of businesses. As a taxpayer, I note that there is also the potential to increase the tax yield, from a declaration perspective. In particular, this has had the useful impact of raising the profile of the industry developing software for businesses. That has always been quite a challenge for us in the whole arena of government, particularly in HMRC.

Naturally, we have a number of concerns, which you have addressed incredibly well through some of the questions. They are very much around the fact that, as an industry, we have just come off the back of providing both RTI, the biggest change in PAYE since its inception, and shortly after that auto-enrolment. We are now in the midst of that, having gone from 60,000 businesses a year enrolling in pensions to an average of 60,000 a month. A not inconsiderable amount of effort and work is required there. Therefore, we have some concerns about the speed and scale of change, particularly about clarity on the services and information we require to be most effective with HMRC, and about its capability model. As many of you have just indicated, this is a huge change. That produces a number of risks to the industry, as well as potential opportunities. Let us not downplay the potential opportunities, which we are all quite excited about, provided that there is a net upside.

Q12 **Lord Tugendhat:** Gentlemen, you heard the evidence that was given earlier. We will go over quite a lot of the same ground. I will begin with a point that certainly came up before. The Government's proposals for making tax digital depend on the technology working properly for both HMRC and taxpayers. You heard what was said before. We need not go over all the same ground. Do you agree with what we heard before, or would you put a different view?

Mr Kevin Hart: As an industry, we have been engaged for a while with HMRC. There is definitely a positive direction of travel from the software industry. There is commitment to be available for the timescale that HMRC is targeting, but that commitment is very dependent on HMRC being able to deliver clarity of information and services. There is huge interdependency, the scale of which has never been sought before.

Lord Tugendhat: Are you saying that the industry is ready and HMRC is not?

Mr Kevin Hart: We are in the direction of travel. We are not ready; it is hand in glove and we need HMRC to be as ready for us. There is significant commitment in the industry to be ready, on the basis that HMRC can get access to the industry.

Mr Kevin Dady: To position IRIS in this particular marketplace, we have 17,000 accountants. In the last year, there were 3 million tax returns on the IRIS software. From a third-party point of view, just over 40% of all tax filings were through IRIS software, in the hands of 17,000 accountants. We also have about 55,000 SMEs using our cloud bookkeeping product. I am using that to contextualise the answer.

You asked whether the industry is ready. I can speak about IRIS, which is as ready as it can be. That is how I would answer the question. We are in a leading cohort of suppliers and are talking to HMRC weekly, on a technical basis, about what it intends to do and when it intends to do it. Could we be better prepared? Yes, we could, to be frank with you. In fact, the information flow between HMRC and the suppliers has been okay, but has it been as expedient as it needs to be to meet the timetable?

From an IRIS perspective, we will support our customers with our products through the next two years of change and in what MTD means for them. We usually have about six months to test our main products, which serve those 17,000 accountants. Our MTD-ready software for our accountants will be ready some time in October or November this year. Our bookkeeping product, which serves the 55,000 SMEs that will be required to comply with some of the MTD legislation, will be available in April, based on current knowledge, but we still do not have final specifications on all the items required from HMRC.

That said, HMRC recognised very recently—in the last few weeks—that the pace of information flow between itself and suppliers needs to pick up. In fact, some of our leading developers will be with some of the HMRC team over the next two weeks. The information flow is accelerating. Is it accelerating quickly enough? Time will tell. At the moment, we are as prepared as we can be, based on the information we have to date.

Lord Tugendhat: In the last session, I gained the distinct impression that there was doubt as to whether taxpayers themselves had the level of technical sophistication to operate this system, and that, even if the kit is okay, it may be beyond the capability of many of the people who are expected to use it. Do you share those doubts?

Mr Kevin Dady: In the IRIS survey that was quoted in the previous session, we asked all our accountants about their preparedness for MTD. We had just under 1,000 responses. They thought that currently only 47% of their customers use any sort of accounting or bookkeeping package. By default, you can assume that just over half use no technical aid at the moment. That is quite a large proportion of their customer base. Whether they can use the software is not a question for me to judge. They have the ability, if we give them the time to do it and lead them through it. One of the things we need to do as a responsible supplier is to help the particular customer on the journey, which means of course that we need to know what the journey is and what the timescales for it are.

Lord Tugendhat: A question was raised about how difficult it was in the system envisaged to undo mistakes. All of us have suffered from that with our computers, but I was very struck by that point. Did it resonate with you?

Mr Kevin Hart: A number of our members—software developers such as IRIS—have onward-developed their products to be able to provide some form of rollback, so that you can correct mistakes. That is something that has been addressed more in recent times. Like all things, it is down to what mistake was made and when it was made. That determines how far one has to roll back.

Q13 **Baroness Drake:** The industry's state of readiness will be dependent, in part, on knowing what the settled requirements of HMRC are. I turn to that issue. The implementation of large IT projects is rarely problem free. What is your hard assessment of the readiness of HMRC's systems for implementing its side of making tax digital? Is it allowing sufficient time for piloting and testing?

Mr Kevin Dady: We do not have line of sight of the readiness of the HMRC systems, to be fair to myself. What we have line of sight of, in part, is what we require our systems to do. We have a reasonable degree of certainty about what HMRC wants our systems to do. We do not have line of sight of how they interface or integrate with its systems.

On preparedness and the pilot, it would be ideal to have more time to pilot the system, depending on how soon HMRC gives us its final specification. We are trying to get ready for a public beta, which is due to commence in April 2017, ready for the formal introduction in April 2018. We understand the requirements, but it is not finalised yet. We would say that preparedness is tight. Given the cohort of people we are trying to move into this digital age, some of whom may have challenges in achieving that, as we have already discussed, and the fact that we are asking them to use new systems, it will be a challenge for the software industry. I am here to support my customers on that journey.

Baroness Drake: What timescale do you think the software industry will get from knowing the settled requirements, as against what you would prefer? What is the gap between the time you are likely to be given to prepare your software and what you think you would need to do it well?

Mr Kevin Dady: This is sidestepping the question, but it depends on what the requirements are.

Baroness Drake: Based on your intelligent understanding of what the requirements are likely to be.

Mr Kevin Dady: Ideally, we would probably want another three to six months.

Baroness Drake: Over and above what you anticipate getting.

Mr Kevin Dady: We can prepare our general software that is in use for our 17,000 practitioners in about six months. We can implement the changes in six months and test it adequately. If we did that today, it would be ready some time in August or September. That is what our usual testing cycle regime would lead us to do.

Mr Kevin Hart: To build on Kevin's point, we had a gentlemen's agreement between BASDA and HMRC that for small changes we needed a minimum of six months' notice, but for large-scale changes we needed 18 months. That is on receipt of specifications—Kevin's point—so that we can factor them in and undertake appropriate development and testing. Timescales have shrunk from a development perspective. They are shrinking quite rapidly at the moment. It is fair to say that it would have been ideal if we could have been in the position that we were running at the beginning of April and had a full year's experience, so that we had four solid quarters of submission experience. The very nature of this process is that it is compacting it down, in a number of cases, to two—no more than three—quarters' experience.

Baroness Drake: It is possibly as low as 50% of what you would ideally like.

Mr Kevin Hart: Our preference.

Mr Kevin Dady: That said, for the cloud bookkeeping product, of which there are several suppliers in the marketplace, we are still reasonably confident that we can make an April deadline. That would enable a small SME to submit a digital record to his or her accountant.

Q14 **The Chairman:** In the IRIS survey of opinion among accounting professionals, perhaps unsurprisingly, one of the most enthusiastically welcomed aspects of making tax digital is that it will come free to smaller companies. Who is paying for it? What is the deal with HMRC? If you are giving it for free, what do you expect to get afterwards?

Mr Kevin Dady: We have not yet formally decided whether we will offer a freemium product. The reason why we have not decided commercially whether we will operate that model is that we are not yet clear how many people will be in the cohort that requires the model. If the £10,000 threshold is elevated or changed, that significantly changes the eligible marketplace for us. Once we have the final specification and understand how many people are in the eligible market, we will make a decision about whether to offer a freemium product.

We are also expecting—although, to be absolutely clear, we have not been told categorically that it will do this—that on HMRC's website, which we are expecting publicity to drive people to, there will be a reference to freemium suppliers. Clearly, there will be a level playing field for all of them, but we are expecting some sort of signpost to suppliers in our marketplace. We already have a level of familiarity with that way of working, because we are also a supplier of software in the payroll marketplace, so we are familiar with AE and RTI. We offer freemium products in that space as well.

The Chairman: What would be your definition of a small company?

Mr Kevin Dady: A small company may be a sole trader or two or three persons.

The Chairman: What would its turnover be?

Mr Kevin Dady: It may be turnover or the number of transactions. If a company is doing one or two invoices per year and making a tax return on a quarterly basis, as MTD requires it to do, it is likely to be in the cohort that will attract a freemium product.

The Chairman: What engagement has your industry had with HMRC to define exactly what products you will give to whom?

Mr Kevin Dady: HMRC has told us what it would expect from a freemium product. The various suppliers have decided, in their own commercial entities, whether they want to play in that arena. Some, such as us, have yet to make a decision. Others have decided, allegedly, that they do not want to play in that arena and offer a freemium product. Others have already done so. At the moment, there are three different camps in the industry.

The Chairman: How big is the freemium camp?

Mr Kevin Dady: I do not know. We have not been told by HMRC—

The Chairman: Are you in that camp?

Mr Kevin Dady: Not yet. We are in the middle, yet to decide.

Mr Kevin Hart: In fairness to Kevin and IRIS, they are not dissimilar to a number of software houses. It is a real challenge, because there is no clear understanding of exactly what is required, for what markets. That makes it incredibly difficult for a lot of people to come up with a commercial, viable proposition. There are already a number of free providers in the market, and there will continue to be so, because that is their commercial model. However, the degree and depth of functionality HMRC is looking for in freemium is almost identical to that of a paid-for product, so coming up with a commercial proposition is not the easiest of matters.

The Chairman: This is work in progress—or discussions in progress. Nothing is fixed yet. What is the timetable for introduction?

Mr Kevin Dady: There is meant to be a public beta, as it is called, from April, and then formal rollout from April 2018.

The Chairman: Are you on course for that?

Mr Kevin Dady: We are on course to launch our bookkeeping product, which is called KashFlow.

The Chairman: But not the freemium product.

Mr Kevin Dady: We can make that freemium once we understand the implications of what freemium means.

The Chairman: Presumably, it means free.

Mr Kevin Dady: It is not whether it is free or not; it is how many people will be on the eligible customer list. It is not just writing the product but having the support organisation behind it.

The Chairman: The business model is that you provide something free to somebody in the expectation—indeed, in the hope—that they will then buy some additional software from you.

Mr Kevin Dady: Correct.

The Chairman: That would probably cut out quite a lot of the smaller businesses, which have relatively few transactions and are not necessarily a market in which you would be interested.

Mr Kevin Dady: But those businesses will grow, potentially. They may also be attractive to some of our accountants.

The Chairman: The principle of freemium, even to quite small companies, is attractive, but there is an awful lot of work and discussion to be done before you can specify and introduce it.

Mr Kevin Dady: There are a few key items of data that need to be decided by HMRC to enable us to decide how the freemium model would work for us.

Q15 **Baroness Kingsmill:** I would like to declare an interest in addition to those that are listed. I am the chair of a business that currently employs 60 software engineers and developers.

This is very complicated, is it not? A big or medium-sized business can probably pick and choose. It probably employs people who can pick and choose what is the best software package for it to have. This will be quite a difficult thing, perhaps, for smaller businesses—people who are not as digitally sophisticated as some of the larger people. Would it not be a lot easier if HMRC just gave them a free app that they could download and that you—the experts—had told HMRC would be the best overall package for people to have to get the information they require? Would that not be the best way of encouraging people to use it?

Mr Kevin Hart: There is a lot of merit in your proposition. There is also merit, as we recommended to HMRC, in asking what we mean by "free". Do we mean free at the point of consumption, for example? If that is what we mean, there is more than one commercial model, potentially, with HMRC that would facilitate that. For example, to stimulate the market, from both a supply and a demand perspective, there could be a voucher system or some credit on people's tax. It would be free at the point of consumption and would stimulate that. The software house industry could see a true commercial model in that.

Baroness Kingsmill: It would make life easier for you.

Mr Kevin Hart: We have proposed this. We believe that it would make life easier for everyone—certainly for the very small businesses that are not familiar with this, to address the Chairman's question about applicability. They are going to need a lot of support. Even before then, education will be paramount, which begs the question: who is going to undertake the education? Often it falls upon us, as an industry, to do that, as well as providing software and ongoing support. We think that alternative free models could be a significant win-win-win for all concerned. We would very much like that to be pursued.

Baroness Kingsmill: I assume that you would prefer to contract directly with HMRC, rather than with a load of little businesses.

Mr Kevin Hart: There is an ecosystem already in place within some of HMRC's IT supplier perspective. Potentially, that could be the case. You could have a carousel selection process, to ensure fairness and equality as well. In essence, it is down to who understands the customers best. I would suggest, as a lot of the discussion with learned colleagues earlier indicated, that we as a market understand those customers extremely well.

Mr Kevin Dady: There are some advantages in where the current support comes from. A business's accountant or current supplier for another product could coach people through the changes required. We are trying to educate our market—the SMEs—via the accountants. Obviously, our 17,000 accountants then have another cohort—their customers.

Baroness Kingsmill: When you talk about SMEs, it covers a very wide range of businesses.

Mr Kevin Dady: Correct.

Baroness Kingsmill: I do not remember what the figure is. Is it the case that 50% of them, or something like that, use outside agents, and the others do not? We are talking about a substantial number of small businesses that prepare their own accounts, by hand, in the old-fashioned way, and will be expected to choose the best piece of software for them to do that. It is asking quite a lot if they are doing it like that, is it not? HMRC is selling a digital taxation system. Would it not better if, like any other business that wants people to join in with whatever it is selling, the Inland Revenue had a free app that people could download to enable them to get on with it? That strikes me as being very straightforward, instead of this rather complex business of having to pick and choose what suits and so on. Is that not right?

Mr Kevin Hart: I could not agree more.

The Chairman: We will take that as a yes.

Q16 **Lord Leigh of Hurley:** The IRIS report is very powerful, and we might be leaning on it heavily. Lord Bilimoria referred to its percentage returns earlier. I take the point that the HMRC questionnaire, with 129 questions, was probably going to be ignored by most. Can you clarify the sampling statistics a little?

Mr Kevin Dady: We wrote to 17,000 accounting practices. We had 900 returns. I will share some highlights with you. Eighty-six per cent of the people who responded—the accountants—felt that the changes were not achievable by 2020. They told us—I am repeating myself—that only 47% of businesses that are their customers currently use any sort of bookkeeping product. Interestingly, given the debate in the previous session about the threshold, only 4% of the respondents agreed with the £10,000 income threshold. You can clearly see the wave of thought behind that. Conversely, 48% thought that the VAT threshold, at £83,000, should be the threshold adopted. Those are some of the highlights from the report. We shared them with several thousand of our customers at roadshows and events that we held last autumn. Those sorts of thoughts and feelings were echoed from the floor, even by people who had not responded at the time.

Lord Leigh of Hurley: The fact that 50% of those people’s customers or clients have either no software or Excel indicates that they are probably smaller practitioners. I am trying to understand what the sampling was. What was the nature of the base of the people you were talking to?

Mr Kevin Dady: We do not know the nature of their customer base. We only know the nature of our customer base. We did not ask them to separate their customers into different sizes.

Lord Leigh of Hurley: Can you clarify the nature of your customer base?

Mr Kevin Dady: Generally, our customers are what I call middle England accounting practices, with anything from two or three up to a dozen partners and annualised turnover of between £1 million and £3 million. We deal with a large cohort of the typical businesses that make up the middle ground of English business.

Lord Flight: Do you think that it is practical to start off on an optional basis, as was suggested earlier this afternoon?

Mr Kevin Dady: It was a good point. As I sit here grey haired, I can see the younger generation wanting to opt in with their smartphones and digitising their receipts as they go about their daily business. I can see it being advantageous for that particular community; I can see them wanting to adopt the practice of digitising their receipts as they go. There may be a slightly older generation that will find that more challenging and more of an overhead, rather than an asset. Allowing people to adopt a commercial model—or opt into one, as you put it—is probably more challenging, as we do not know what market we are trying to serve, how to scale up the operation to service that market or how many customers will opt in. We would probably need slightly more guidance from HMRC on how it was going to ask people to opt in, rather than mandating it.

Mr Kevin Hart: It puts additional commercial case pressures on software houses. Regulation is very useful when it is definitive and something has to be delivered by X. If it becomes purely voluntary and there is no indication of take-up, naturally that makes it a lot more challenging to put cases together. It has worked quite well in cases such as auto-enrolment, where, from certain points in time, anyone providing pensions has to go down that route. Retrospectively, among the masses, it can be voluntary, but if at a certain point it is mandated, especially for millennial-based businesses, that gives more certainty.

Q17 **Lord Turnbull:** In its latest update, HMRC estimates the net cost of this as £1 billion, at an average cost of £280 per business. Do you think that is remotely realistic as an average cost?

Mr Kevin Hart: No. Historically, the regulatory impact analysis has always been a little light, to put it politely, from a business-based perspective. If anyone requires educational support, particularly from a training perspective, and has to go to some sort of paid training, £280 will disappear in a morning seminar.

Lord Turnbull: What should the figure be?

Mr Kevin Hart: I had a horrible suspicion that you would ask me that. It must be at least double that.

Lord Turnbull: It has to cover software, unless it is free, training, an agent or accountant and their own time. It seems to me to be completely ridiculous. The other thing is that it is an average. You have drawn attention to the fact that there are some people who will be pretty well equipped and for whom it is just a small step to get into this world. Others will start more or less from scratch. It seems to me that the impact we should be looking at is the cost for people who are coming to this world fresh, because they probably start off with smaller businesses, are less experienced and look like having to face the largest bills. If the average is £280, how much will it cost a starter to get started in this world?

Mr Kevin Dady: I will take a few facts, as we see them today. We asked a few of our accounting customers what their annual fee range was for some of their small customers. They said that it was anything between £300 and £1,000 per annum. We also asked what they thought they would increase their fee structure by to cope with MTD. Their answer was anywhere between 10% and 20% annualised. If we use the midpoint of that, we are probably talking about an increase in fees of £100 or £150 a year.

Then we have software. Currently, we market software that does bookkeeping in the cloud at between £7 and £15 per month, so there is another £150 or £200, depending on the level of package. That brings it up to about £350 or £400. So far, they have got some professional advice from their accountant and have probably bought some software. They probably also want some help. In reality, if it is software help, it will probably be racked into their annual fee or monthly subscription. They will get most of that training over the phone or online, via online chat, but they will want some professional training as well. I agree that the figure of £200-odd looks awfully low. I concur with Kevin. Nearer to twice that would look more appropriate, just on the rough numbers.

Lord Turnbull: Is it twice that for what you get to once you have got going? In the first year, surely, you have to spend a lot more.

Mr Kevin Dady: You could argue that both ways. In fact, you could argue that, in the first year, there are fewer scenarios you need to cope with in a bookkeeping product and, therefore, there is less volatility in what you need to do. I admit that there is a learning curve, but if it is a new business, with a person from a younger generation, they might learn more quickly than I would.

Lord Turnbull: In general, you subscribe to the reservations that were expressed earlier about starting at the bottom and moving up, as opposed to starting at the top and moving down.

Mr Kevin Dady: I am not sure that I said that. I said that it is likely that costs are underestimated, based on the HMRC estimates. I agree with Kevin that they are probably double that. About £500 looks right, on a back-of-a-fag-packet estimate. To be frank, the way people take on that requirement, and learn the product and what they need to do, will depend on their own aptitude for digitisation. Whether it is a small or a large business, it depends on the person leading that business.

Lord Turnbull: It is something beyond being familiar with a tablet and social media.

Mr Kevin Dady: A little more. Youngsters adapt very quickly. Taking a photograph of receipts, sending them to a depository and having that depository sort your receipts, according to the type of receipt, is something that some people will do in seconds or minutes. I agree that others will struggle for a little longer.

Lord Turnbull: Yes. I think my scaffolders would find it difficult.

Lord Bilimoria: Baroness Kingsmill said that it could be as simple as an app. On the other hand, should people not be allowed flexibility? Your statistics show that 50% of them are using Excel or nothing. There are issues of compatibility, cybersecurity and storage space. Then there is the key issue. A week ago, there was an article in the *Sunday Times* in which a small businessman was interviewed. He said, "It is the time. It distracts me from getting on with running my business". It is not just the costs; it is the nuisance and the time of doing it. Almost 40% of small business owners lack digital skills, according to a recent report by Lloyds Bank.

Mr Kevin Hart: There is cross-over with Lord Turnbull's points.

Lord Bilimoria: Yes. I am following on from Lord Turnbull as well.

Mr Kevin Hart: It is a capability issue. As Kevin referenced, it is also about the types of customers. In certain verticals, there will be a greater appetite to embrace MTD than in others. The construction industry has been mentioned. That is a beautiful example of probably a slightly lower appetite to be engaged.

A little earlier, you touched on Excel. For us as an industry, that is probably a concerning development. We fully understand that, if you are already an Excel user, you will want to continue to be an Excel user. However, software needs to be able to interact with Excel on a trustworthy, consistent basis. Let us be honest: any of us who is on Excel has played with the odd macro and developed our own little routines. It then becomes incredibly difficult consistently to translate information coming from someone's Excel spreadsheet.

That is quite an underscored issue. It is probably also underestimated by HMRC. People who are using Excel and have been told that they can continue to use it will not necessarily welcome any changes that HMRC says you have to make to your Excel spreadsheet. As a number of you will know from being in the accountancy trade, you will also be providing guidance—chartered accounts-type Excel sheets—for the different verticals for your customers, so you will be working in a certain way with which you are familiar. It is critical that we address certainty around Excel fairly early.

Baroness Bowles of Berkhamsted: I would like to continue exploring that. Let us be simple and divide people into two universes. There will be the shoebox universe, where they have not done anything before. The idea is that now, instead of giving their shoebox to the accountant annually, they have to sit down with it themselves every three months, as they go along, take a photograph of the receipt before they put it in the shoebox or throw it away—which they might be able to do—and, hopefully, learn to press a few buttons. Then it will produce something a bit akin to the bottom lines that you might have got in your Excel spreadsheet. Hopefully, one can teach them to do that and it will not cost too much.

Then you come to the other universe, which is doing Excel spreadsheets.

Instead of people entering it on their laptop, or whatever they are doing, they too will be taking photographs and ending up with something that looks like an Excel bottom line. Why cannot they just straightforwardly provide that bottom line? You have just gone to SnapCell, in the sense that you are taking a photograph, instead of putting it in.

Mr Kevin Dady: As I understood some of HMRC's announcements last week, it has decided to relax and to accept spreadsheets as a way of digitisation. That creates a path for the second community that you mention, but it also creates an extra conundrum for the software supplier, which will be required to convert that data from a spreadsheet into a format that HMRC finds acceptable. I am sure that last week's announcement will be welcomed by many SMEs in the particular cohort you mention, but at the same time it provides an extra dynamic for the software supplier to cope with. It was announced only last week, for something that we are attempting to deliver this year.

Q18 **Lord Flight:** Overall, do you see HMRC meeting its timetable targets? If not, what do you see as the likely revised timetable?

Mr Kevin Dady: I fear a catch question there, to be honest. HMRC can meet the target of making tax digital achievable for April 2018. It needs to accelerate its dialogue with the whole supplier community, and we need a very vigorous pilot period. The beta pilot has been announced from April 2017, only seven or eight weeks away. I understand that the target audience for that period was 400,000 taxpayers. Maybe this is my problem, but I do not understand today how HMRC will attract those 400,000 taxpayers. Frankly, what is in it for them to be in a beta pilot during those 12 months? I do not know. Those things need to be considered more fully. The quality of the pilot period will definitely influence the success of the main rollout, from April 2018 onwards.

Having been involved in other rollouts by other government departments—not in taxation, but with DWP and DfE—I think that we probably need to be in dialogue with greater intensity, both within industry and with the policy people and the technicians from HMRC. There has been recognition more recently—in the last few weeks—that we have probably been too slow to get to where we are now.

The Chairman: Your advice to HMRC would be, "Take it rather more slowly, have a longer period for piloting and start with the larger companies first, before going down to very small ones".

Mr Kevin Dady: I am not sure. There is ability within the industry to respond and to make MTD live for April 2018.

The Chairman: You do not think that is cloud-cuckoo-land.

Mr Kevin Dady: I do not think it is cloud-cuckoo-land, but there needs to be greater intensity and tenacity, particularly from HMRC, to make that timetable. There needs to be a far greater degree of clarity on the objectives for the beta pilot period, which is meant to be April to April, on how they will be measured and on what success looks like. If we have those measures and we understand what success looks like, we will not go into April 2018 with our eyes closed. We will have them wide open and, if necessary, HMRC and the industry can decide to delay. At the moment, I do not think we should give up on that target, on the basis that if we do not set our targets reasonably tightly we will not achieve them.

The Chairman: To go back to Lord Turnbull’s question about the cost, in your experience of introducing software packages to relatively small and possibly IT-unsophisticated companies, how much handholding do you have to do, over what period?

Mr Kevin Dady: That will depend on how complicated the application that we have to build is. At the moment, we have a reasonably good idea of how complicated it is. It is not awfully complicated. You asked about handholding. Some will probably get through it with just a few phone calls, or maybe some chat online. Some will take to it like a duck to water, to be frank, if they are the more digitally enabled. It will not be huge. However, given the volume of customers we are talking about, the bow wave of customer contact between any supplier and its customer base will be large. That is in the very nature of the number of people whose lives and businesses we are trying to transform.

Mr Kevin Hart: To build on Kevin’s point, it is about the resources within HMRC. Clearly, there are challenges on its resources. Earlier, we talked about HMRC’s capability model. Kevin’s point was about increasing the pace and engagement. It is about the capability and resource that people have to support the industry, because it is already feeling very stretched. We are dedicated to making this happen, but there needs to be the resource on that side to support us.

The Chairman: What is the role of your organisation in that consultation? Do you attend regular meetings? Are you one of a number of trade bodies attending? Tell us how it works.

Mr Kevin Hart: We have regular engagement. I was on the digital advisory group for HMRC, to help to point it in the right direction. We are heavily engaged, but there is a point about hearing and listening. We still have a number of challenges to work through. On the positive side, as Kevin said, HMRC realises that, because the heat is most certainly on. We are there to support that.

Mr Kevin Dady: If we are to maintain the current published timetable, the supplier community needs to know that it will be maintained, so that we can resource adequately and lead our customers through it. Frankly, it will probably be the phones in my call centres that are ringing when people cannot use the products or find that there are some stumbling blocks. If they cannot get through to HMRC, they will probably ring me.

The Chairman: Thank you very much. That was very helpful. You have indicated quite a few questions that we need to take up directly when we see HMRC.