Behavioural Reporting Noise and the Risk of Compliance Misdirection Under Making Tax Digital for Income Tax

Practitioner Submission to HMRC on MTD for Income Tax Implementation

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Disclaimer
The views expressed in this paper are those of the author and do not represent the views of HM Revenue and Customs or any other government body. This submission is offered independently to support discussion of Making Tax Digital for Income Tax implementation.

Author's Note
This submission is based on sustained observation of small business reporting practice, tax compliance processes, and implementation risks relevant to Making Tax Digital for Income Tax.

Executive Summary

This paper identifies a specific implementation risk within Making Tax Digital for Income Tax. Quarterly reporting will change not only when taxpayers report but also the conditions under which figures are prepared. In practice, more figures will be produced under tighter deadlines, with greater reliance on software defaults, incomplete categorisation, provisional reconciliations, and partial records. That shift is likely to introduce systematic distortion into early quarterly data.

I describe this distortion as behavioural reporting noise: variation in reported figures that arises from the reporting process itself rather than from underlying non-compliance. If first-year quarterly submissions are treated as directly comparable to mature annual compliance data, HMRC may face weaker targeting accuracy, lower yield per intervention, and unnecessary case allocation during the transition period.

Two decisions should be made before quarterly submissions begin arriving. First, the initial four quarters should be treated as a compliance restraint period, with higher triage thresholds and more cases monitored rather than opened. Second, risk selection systems should distinguish quarterly submissions from annual declared liabilities and allow for the expected year end adjustment gap. Neither step requires legislation. Both are easier to put in place before the first reporting cycle begins than after avoidable case volume has already entered the system.

Priority Actions

- Designate the first four quarters as a compliance restraint period, explicit triage thresholds set higher than steady-state, cases monitored rather than opened
- Configure risk-selection systems before rollout to distinguish quarterly submission totals from annual declared liabilities and model the expected year-end adjustment gap

Supporting Actions

- Build sector-specific seasonal income profiles into risk banding before quarterly data is processed in volume
- Require mandatory pre-submission validation checks as a condition of MTD software approval
- Establish and publicise a formal within-year correction window
- Produce plain-language guidance on the relationship between quarterly and annual figures

Institutional Stakes

- Compliance yield per case will fall during the transition period if triage thresholds are not adjusted.
- Tax gap statistics reported to Parliament may be partially influenced by reporting process artefacts rather than taxpayer behaviour
- Contact centre demand from unrepresented taxpayers will spike in the first year if the quarterly-to-annual relationship is not explained proactively.

1. Basis of Observations

The observations in this paper are grounded in sustained direct engagement with small business accounting practice over several years. This includes firsthand professional advisory work with accountancy practices preparing for digital transition from single-adviser firms managing a few dozen clients to mid-sized practices handling several hundred across varied sectors, as well as ongoing professional contact with bookkeepers, sole traders, and self-employed taxpayers navigating self-assessment. That engagement has given me direct exposure to the practical decisions advisers make when managing client records under deadline pressure: how they configure software, how they handle uncategorised transaction backlogs, and how they resolve reconciliation discrepancies when time is short.

I am not presenting a formal empirical study, and I make no claim to statistical representativeness. What I offer is a pattern-based account grounded in recurring, consistent professional observation across different practice types, client profiles, and software environments. Where I describe what a taxpayer or accountant is likely to do under specific conditions, that description reflects patterns observed repeatedly across comparable situations, not inference from a single case.

I note this at the outset because the argument I am making depends on the plausibility of its behavioural claims. If HMRC's own stakeholder engagement and MTD piloting data contest those claims, the policy conclusions should be moderated accordingly. My expectation is that the patterns described here will be recognisable to anyone who has worked with this population and that the pilot programme will have surfaced evidence broadly consistent with them. These observations appear broadly consistent with themes discussed in HMRC stakeholder communications and agent updates issued during the preparation phase of MTD implementation.

2. The Central Argument

MTD policy discussions usually focus on whether quarterly reporting will improve behaviour: whether taxpayers will keep better records, claim more accurately, or engage more consistently with their finances. That is a legitimate question. But there is a prior question that receives less attention and has more immediate consequences for HMRC's operational systems:

> **MTD does not only change what taxpayers do with their finances. It changes the conditions under which they report those finances to HMRC and therefore changes the statistical properties of the data HMRC receives. The practical implication is that HMRC may temporarily misinterpret compliant reporting behaviour as elevated compliance risk if existing targeting assumptions are applied to early MTD data without adjustment. Compliance measurement reliability is affected as directly as compliance behaviour.**

The mechanism is specific. Under the current annual system, the figures submitted to HMRC have, in most cases, been through a professional review in which an accountant applies judgment, queries ambiguous items, and checks the full year's pattern before committing to a number. That review is imperfect, but it produces figures that carry a degree of deliberate calibration. Under quarterly reporting, the figures submitted at each deadline will not have been through a comparable review. They will reflect categorisation decisions made under compressed timelines, software defaults that may or may not be correct, and the practical constraints of advisers managing four submission cycles per client per year instead of one.

I have named this phenomenon because naming it allows it to be treated as a distinct policy problem rather than a general concern about data quality:

> *Behavioural reporting noise: the systematic variation introduced into reported financial data when a change in reporting requirements alters the conditions under which taxpayers and their advisers make categorisation, estimation, and reconciliation decisions. Unlike random measurement error, this reporting noise is not random. It follows recurring patterns linked to time pressure, software defaults, and adviser capacity constraints. It will be concentrated in specific taxpayer groups, specific expense categories, and specific quarters of the year.*

The consequence for HMRC is practical and immediate. **If HMRC treats first-year quarterly data as normal compliance data, investigation targeting efficiency will fall and administrative cost per case will rise.** This risk is foreseeable from the design of the reporting cycle. It is the predictable consequence of applying risk-selection models calibrated on annually reviewed data to quarterly data produced under structurally different conditions. The anomalies generated will be real anomalies in the data, but a significant proportion of them will be artefacts of the reporting process rather than indicators of non-compliance. They will enter the triage pipeline, be risk-banded, allocated to compliance officers, investigated, and closed without yield. The resource cost is built into the mismatch unless systems are adjusted in advance. It is the direct institutional cost of a mismatch between the data environment the compliance system was designed for and the data environment MTD creates.

3. How the Current Process Works and Why It Matters

To understand precisely what quarterly reporting changes, it is necessary to be specific about what the annual system currently produces and how.

Most sole traders and small landlords in the self-assessment population do not maintain continuous accounting records. They accumulate evidence, such as bank statements, receipts, mileage logs, and invoices, then hand it to an accountant or work through it themselves in the months following the tax year end. The accountant's role is not purely clerical. It involves applying professional judgment to an assembled picture: distinguishing business from personal expenditure, querying ambiguous items, deciding whether a cost is revenue or capital, adding accruals for unpaid invoices, and restricting dual-purpose costs to their business proportion. Crucially, this work is done with the full year visible. The accountant can compare this year's expense ratios against last year's, notice that vehicle costs look implausibly low, and ask before submitting.

To make this concrete: consider a self-employed electrician. I will call him Mr. A, with an annual income of approximately £48,000 from a mix of domestic and commercial work. These examples are composite illustrations drawn from recurring patterns observed across multiple taxpayers and practices rather than isolated individual cases. He uses both a business and a personal account, because materials are often purchased on whichever card is accessible on-site. He photographs receipts inconsistently. His mileage log is an estimate. At year-end, he gives his accountant, a sole practitioner managing around eighty similar clients' bank statements for both accounts, a folder of receipts and that mileage estimate.

The accountant spends three to five hours on this material. She removes duplicate transactions that appear in both account feeds. She queries two or three payments that look personal. She makes a judgment about a laptop purchased in October and adds an accrual for a March invoice not yet paid. The return that results is professionally reviewed, produced with full-year context, and carries considered judgment about every significant categorisation decision. The errors it contains tend to be small and distributed. They are not the kind of systematic, direction-consistent misclassification that repeats itself quarter after quarter.

That corrective function is structural. It exists because the annual cycle permits review before commitment. What quarterly reporting removes is not the accountant's competence; it is the conditions under which that competence can be fully applied.

4. Where Behavioural Reporting Noise Will Come From

From 6 April 2026, Making Tax Digital for Income Tax applies to taxpayers with qualifying self-employment and/or property income above £50,000 based on recent Self Assessment returns, with phased expansion to lower income thresholds planned in subsequent years. There are three distinct mechanisms through which quarterly reporting will introduce noise into HMRC's data. They are worth separating because they produce different patterns in the reported figures and have different implications for how risk models should be adjusted.

4a. Compressed categorisation under deadline pressure

From April 2026, quarterly deadlines fall in August, November, February, and May. Each covers a three-month window that must be reported within approximately one month of its close. The most common preparation response observed among accountancy practices is to migrate clients to cloud accounting software with connected bank feeds such as Xero, QuickBooks, and Sage, which are most prevalent so that transactions are captured automatically throughout the year.

Automatic capture does not mean automatic categorisation. A bank feed records that on 14 September, £340 left Mr. A's account payable to Henderson Electrical Supplies. The software assigns a default category based on the payee name. It cannot determine whether this payment was for materials for a specific job, a replacement tool, or consumable stock distinctions that matter for how the expenditure is treated. If Mr. A is not reviewing his accounts between quarters, that transaction sits in the software's default category, unverified, until the deadline arrives.

At the quarterly deadline, the accountant logs in and finds a backlog: for a client like Mr. A, perhaps two hundred transactions, of which forty or fifty remain uncategorised or carry an unconfirmed automatic categorisation. She has roughly two hours before moving to the next client. Ambiguous transactions are resolved by rapid judgment rather than careful inquiry.

A van service goes to vehicle maintenance without a conversation about whether it constitutes a capital improvement. A trade body subscription is coded to professional fees without checking whether the amount and period match the prior year. A bank reconciliation that does not close by £180 is resolved with a miscellaneous adjustment entry.

None of these decisions is necessarily wrong. But each is made with less time and less context than the equivalent decision in an annual review. The categorisation errors that result are not random: they are biased toward whatever the software default suggests and toward whatever requires the least investigation under time pressure. That is a directional, correlated pattern, the defining characteristic of behavioural reporting noise.

4b. Precautionary under-claiming by uncertain taxpayers

Consider a landlord I will call her Ms. B, who owns two buy-to-let properties and manages them without a letting agent. She is aware that some costs are allowable against her rental income but is genuinely uncertain about the borderlines: travel to inspect the properties, a proportion of her mobile phone bill, a landlord association subscription, and a new front door that she believes is a repair rather than an improvement but is not entirely sure. Under the current annual system, she raises these questions with her accountant at year-end and receives a considered answer before the return is submitted.

Under MTD, Ms. B must submit a quarterly figure before that conversation has taken place. When uncertain about whether an expense is allowable, the consistent pattern in practice is to omit the borderline item rather than claim it and risk a query. Ms. B files her quarterly return without the disputed items. She has not made a false statement. But she has understated her allowable expenditure, overstated her taxable profit, and paid more tax than she is legally required to. She has done this not once but in each quarterly submission, until the year-end conversation with her accountant corrects the position.

From HMRC's analytics perspective, the consequence is this: precautionary under-claiming creates a population of taxpayers whose expense ratios are systematically compressed relative to their actual allowable expenditure. If risk models use the distribution of expense ratios to define expected ranges for sector benchmarking, precautionary under-claimers will shift the lower end of that distribution downward. The benchmark will move. Taxpayers who correctly claim their full allowable expenses will appear, relative to the shifted benchmark, slightly more aggressive than before. This is a calibration distortion that originates not in non-compliance but in caution, and it is one that conventional anomaly detection is not designed to identify.

4c. The structural gap between quarterly totals and annual declarations

Quarterly submissions will not include year-end adjustments. Accruals, prepayments, depreciation charges, and the private-use restriction on dual-purpose assets are all calculated at year-end and applied in the annual declaration. For most businesses, the sum of the four quarterly submissions will therefore differ materially from the final declared liability. The MTD design already assumes this gap. That is why the annual finalisation process exists.

What matters for compliance operations is whether HMRC's internal systems are configured to expect and discount that difference. If a risk tool or caseworker at triage compares quarterly submission totals against the annual return and identifies a significant discrepancy without an adjustment layer that models the expected year-end correction, that discrepancy will enter the risk pipeline as an apparent unexplained change. The taxpayer whose accountant has correctly applied depreciation and accruals will find themselves allocated to a caseworker, who will investigate and close the case with no yield. The administrative cost on both sides of that exchange is real. It is also entirely predictable and therefore entirely avoidable.

5. Implications for HMRC Compliance Operations

It is worth being concrete about how behavioural reporting noise will manifest at each stage of HMRC's compliance cycle, because the effects are different at triage, at risk banding, at case allocation, and at yield tracking.

At triage, the volume of cases flagged by automated risk tools will increase in the first quarters of MTD operation. A proportion of those flags will be genuine anomaly signals. A larger proportion, particularly in the first year, will be artefacts: seasonal income variation that has become visible for the first time, expense category fluctuations driven by software defaults rather than changed behaviour, and quarterly-to-annual discrepancies generated by year-end adjustments that the quarterly figures do not include. Triage teams will need to distinguish these artefactual signals from genuine ones without established patterns to guide them.

At the risk-banding stage, some cases may receive medium or high scores on the basis of quarterly anomalies but may not warrant that classification once the annual declaration is received. If banding decisions are made before the annual return is available or if the risk model does not weight the annual return heavily enough relative to the quarterly submissions, resources will be directed toward cases that will close as compliant. That is a yield problem, and it is the kind that shows up in performance metrics as a sustained reduction in average yield per case opened and an increase in cost per intervention.

At case allocation, compliance officers reviewing flagged quarterly submissions will encounter a category of case they have not previously managed: a taxpayer whose figures are anomalous not because of deliberate misreporting but because the quarterly process has introduced categorisation inconsistency. Distinguishing these cases from genuine non-compliance requires reviewing transaction-level detail in the bank feed, the categorisation history, and the reconciliation log rather than simply comparing declared figures against sector norms. That is more time-consuming than a standard return comparison and requires familiarity with how MTD software categorises transactions by default.

At closure classification, a sustained pattern of cases closing without yield will eventually appear in management data. The question is whether that pattern is recognised early as a calibration problem and corrected, or attributed to other causes and left to accumulate. The difference between those two outcomes is partly a question of whether HMRC has been prepared to expect it.

There is also a contact centre dimension. When unrepresented taxpayers receive a compliance check arising from a quarterly anomaly they did not expect and cannot explain, the most likely response is a query to HMRC. In the first year of operation, that demand will be disproportionately high, concentrated in a period when both HMRC and the taxpayer population are still developing familiarity with the system. That is a volume pressure that can be modelled in advance and, to a significant degree, reduced by the communication actions described in the recommendations. Without adjustment, early MTD operation is likely to reduce average compliance yield per case and increase cost per intervention until risk models are recalibrated.

6. The Tax Gap Implication

The consequences extend beyond operational efficiency and affect how early MTD data may be interpreted at the system level.

HMRC's annual tax gap statistics for the self-employment and landlord population are reported to Parliament, to HM Treasury, and to the Office for Budget Responsibility. They inform revenue forecasts and policy decisions. Their credibility rests on a specific assumption: that the gap between what is reported and what is owed reflects taxpayer behaviour deliberate under-declaration, error, or avoidance rather than the characteristics of the reporting process itself. Behavioural reporting noise places pressure on that assumption during the transition period.

There are two directions of effect. First, precautionary under-claiming of the Ms. B pattern will produce a population of taxpayers whose quarterly reported profits are systematically higher than their correctly calculated liability. That is tax revenue collected in excess of legal entitlement, generated not by evasion but by caution under deadline pressure. If those overstated profits are incorporated into the dataset used to estimate the tax gap, the measured gap for this population will be artificially compressed. HMRC's statistics will show a smaller gap than actually exists, not because compliance has improved, but because the reporting process has shifted the figures in a direction that makes compliance appear better than it is.

Second, compressed quarterly categorisation where expenses are systematically resolved toward higher-tax defaults under time pressure, will produce a similar aggregate effect. The direction and magnitude of this bias are uncertain, but the mechanism is clear: when categorisation decisions are made under conditions that systematically favour one outcome over another, the reported figures will deviate from correctly calculated liability in a consistent direction.

The result is that, during the transition period, some movement in tax gap estimates may reflect reporting conditions as well as underlying taxpayer behaviour. That is a measurement reliability problem of a different order from ordinary data quality concerns. It affects the validity of official statistics, not merely their precision. HMRC's tax gap estimation methodology should be reviewed before the first full year of quarterly data is incorporated, with explicit allowance for the directional biases that behavioural reporting noise is likely to introduce. HMRC's tax gap methodology may therefore benefit from sensitivity testing of first-year quarterly data in order to separate behavioural reporting effects from genuine changes in taxpayer compliance.

7. Specific actions HMRC may wish to consider before full rollout.

The recommendations below address the operational risks identified in this paper. They are ordered by priority. The first two are critical and time-sensitive: they require decisions before quarterly submissions begin arriving, because they are substantially harder to implement after the fact. The remaining four are important but can be implemented progressively.

7a. Treat the first four quarters as a compliance restraint period.

The purpose of this restraint period is calibration of targeting accuracy rather than a reduction in enforcement activity.

This is the recommendation that follows most directly from the analysis and the recommendation least visible in current published implementation material.

The operational decision: HMRC should make an explicit internal decision before rollout that compliance enquiry intensity during the first four quarters of MTD operation will be moderated relative to the intensity applied to equivalent anomalies under the annual system. This does not mean suspending compliance activity. It means setting explicit thresholds for triage and risk banding that are calibrated to expect a higher baseline level of apparent anomalies during the transition period and applying those thresholds consistently before cases are allocated to compliance officers.

If this decision is not made: The triage pipeline in the first year will be flooded with cases reflecting learning-curve categorisation errors, software defaults, and seasonal income patterns newly visible for the first time. Caseworkers will investigate cases that close without yield at a rate substantially above historical norms. Yield tracking data for the period will conflate genuine non-compliance signals with transition-period noise, making the compliance team's performance data difficult to interpret and the risk model's early results unreliable as a calibration baseline.

If this decision is made: HMRC will be in a position to treat the first year's data as a calibration observation period rather than a production compliance target. Cases that appear anomalous can be triaged at a higher threshold, monitored rather than opened, and used to build the sector-specific seasonal profiles and year-end adjustment expectations the risk model will need for subsequent years. The compliance resource not spent on low-yield first-year cases will be available for cases that genuinely warrant investigation.

7b. Distinguish quarterly submissions from annual declared liabilities in risk selection

The operational decision: before the first quarterly submissions are received, HMRC should establish explicit rules within its risk-selection infrastructure preventing unmediated comparison between quarterly submission totals and annual declared liabilities. The expected year-end adjustment range for each business type and size should be modelled from existing Self Assessment data and built into the comparison layer so that discrepancies within the expected range are classified as normal rather than anomalous.

If this is not done, compliant taxpayers whose accountants have correctly applied year-end adjustments, depreciation, accruals, prepayments, and private-use restrictions will generate apparent discrepancies that enter the triage pipeline as unexplained changes. Those cases will consume caseworker time and close without yield. The pattern will repeat in every annual declaration cycle until the system is recalibrated.

If this is done, the compliance system will identify discrepancies that genuinely exceed what year-end adjustments would account for while filtering out the structural gap that is the designed consequence of a two-stage reporting system. This is a configuration decision, not a policy change, and it is one that is much easier to make before data arrives than after.

7c. Develop sector-specific seasonal income profiles and incorporate them into risk banding

A hospitality sole trader with near-zero Q1 income, a construction subcontractor with a large Q3 spike, and a specialist freelancer with one busy quarter and three quiet ones are each exhibiting normal trading patterns that will, under quarterly reporting, be newly visible to HMRC's risk systems. If risk banding treats these patterns as anomalous, the cases that result will be low-yield by definition; the anomaly is the business model, not the compliance record.

HMRC holds several years of Self Assessment data for this population. That data contains sufficient information about within-year income distribution by sector to build seasonal profiles that distinguish normal lumpiness from genuine irregularity. Incorporating those profiles into the risk banding framework before quarterly data is processed in volume is a data analysis task that requires planning time but not additional resources. The alternative is recalibrating the model after a year of disproportionate false positive rates, which is more expensive and more disruptive.

7d. Require pre-submission validation checks as a condition of MTD software approval

Software approved for MTD use should be required to present users with a mandatory pre-submission checklist before a quarterly return is filed: a count of uncategorised transactions with a prompt to review; a flag for automatic categorisations not confirmed by the user; a bank reconciliation status showing any unreconciled balance; and a comparison of total income and expenses against the equivalent prior-year quarter where data is available.

Several approved products already offer some of these features as optional settings. Making them mandatory as a condition of MTD-compatible status would standardise what is currently variable and reduce the volume of noise entering the compliance system. This should be reflected in the updated functional requirements before the software approval process is finalised.

7e. Establish and communicate a formal within-year correction window.

Quarterly submissions should be formally designated as provisional, with a clearly communicated window, ideally the remainder of the tax year, during which earlier submissions can be amended without generating a penalty or a compliance flag. This window should be framed as a designed feature of the provisional reporting system, not as an administrative concession to error.

Without a correction window, taxpayers and accountants who identify a categorisation error after submission face a choice between leaving it uncorrected or making an amendment that may generate a risk signal. Many will leave it uncorrected. The annual return will then require a larger adjustment, which will itself be more visible to compliance systems as an unexplained change. A correction window reduces that pressure, increases the accuracy of the final dataset, and makes the annual-to-quarterly gap smaller and more predictable.

7f. Produce and promote plain-language guidance on how quarterly and annual figures relate

A significant proportion of the MTD population does not use an accountant and will navigate the system without professional advice. Many will interpret their quarterly submissions as reasonably final statements of their tax position and will be unprepared for a year-end adjustment that produces a materially different liability. A proportion will contact HMRC to query the difference.

HMRC should produce guidance written in plain language, distributed through software interfaces and direct taxpayer communications, explaining that quarterly submissions are provisional working totals, that they will not match the final liability, and that the difference is expected and normal. This is a communication investment with a direct, measurable return in reduced contact centre demand and reduced confusion-driven amendment activity.

8. Concluding Observations

The central point of this submission is straightforward. Quarterly reporting changes the process by which figures are produced, not only the timing of submission. In the early stages of MTD for Income Tax, that process change is likely to generate reporting effects that can resemble compliance risk even where underlying behaviour has not materially changed.

For that reason, the first year of quarterly data should be treated primarily as a calibration period. If HMRC adjusts triage thresholds, separates quarterly from annual data in risk selection, and communicates more clearly that quarterly figures are provisional, much of the avoidable noise described in this paper can be contained before it enters the compliance pipeline at scale.

The taxpayers most likely to generate these effects are not those attempting to conceal income. They are ordinary sole traders and landlords trying to comply with a more demanding reporting system while their advisers, software, and record-keeping habits adjust in real time. That is precisely why the implementation phase matters.

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