

## Expanding the cash basis for the self-employed – HMRC consultation<sup>1</sup>

### Response by the Chartered Institute of Taxation

#### 1 Executive Summary

- 1.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 19,000 members, and extensive volunteer network, in providing our response.
- 1.2 We agree that it is an appropriate time to review the income tax cash basis now that the regime is 10 years old. Despite the cash basis not being introduced in exactly the way that the Office of Tax Simplification (OTS) had recommended in its 2012 report, it does provide some simplification for those businesses that have chosen to use it. However, we agree with HMRC that there are aspects of the current rules that can deter otherwise eligible businesses from using the cash basis, particularly the loan interest and loss relief restrictions. There is scope for removing some of the inherent complications and restrictions so as to simplify the rules which may encourage more businesses to use them.
- 1.3 Any changes to the current rules must go hand-in-hand with improving and updating the guidance for the cash basis on GOV.UK. Even if, following this consultation, no changes are forthcoming to the rules, existing guidance should still be improved. It should be updated, for example, to reflect that many small businesses now trade online or operate via online digital platforms. We suggest that the cash basis guidance should be included in the Small Business Guidance Transformation Project which was announced by the Chancellor in the March 2023 Budget.<sup>2</sup>
- 1.4 It is likely that there is a significant lack of understanding and awareness of the cash basis particularly amongst unrepresented businesses (those without an accountant to help them prepare accounts). The quantity and quality of guidance currently provided by HMRC is inadequate considering that the total population of taxpayers eligible to use the cash basis is very significant (over 4.2 million businesses according to paragraph

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<sup>1</sup> <https://www.gov.uk/government/consultations/expanding-the-cash-basis/expanding-the-cash-basis-for-the-self-employed--2>

<sup>2</sup> Paragraph 4.92 of the 'Red Book'.

- 1.6 of the consultation document). If guidance is improved, this may help increase understanding and awareness and lead to more businesses taking advantage of the simplifications offered by using the cash basis.
- 1.5 Ultimately the cash basis, even an expanded and less restrictive version, is still likely to be suitable only for small businesses with very straightforward financial affairs. In other words, unrepresented taxpayers, with no employees, and without, or with very low, levels of stock, debtors, creditors and fixed assets.
  - 1.6 Our impression is that the cash basis is not widely used by taxpayers represented by an agent. This may partly be due to the complexity of the rules, in particular the interest and loss restrictions and the entry and exit transitional rules. However, there is likely to be more to it than that. This is because preparing accounts on a cash basis really only satisfies the need to report to HMRC, whereas reporting on an accruals basis will serve several purposes, including accurately measuring profitability and providing evidence for loan applications. This supersedes any simplification benefits from preparing accounts using the cash basis. One of the benefits of the accruals basis is that it can help improve general financial literacy for the small business owner, including the need for budgeting and identifying and understanding the true profitability of their business. In encouraging the cash basis, HMRC are arguably encouraging weaker financial controls and worse financial literacy more generally.
  - 1.7 HMRC acknowledge that by extending the cash basis for trading income, this may reduce the need for businesses to use an agent. This may well be the result because the expansion of the cash basis could encourage taxpayers to handle their own accounting and tax affairs (rather than appoint an agent to help them), particularly if (as is likely) the availability of cheap accounting software increases. We are concerned, however, that this could have adverse consequences if taxpayers fail to take professional advice and make inappropriate and / or costly choices as a result. Further, typical small business errors, such as the failure to adjust for private elements of expenditure, may remain.
  - 1.8 We would like to see the current restrictions on loss relief and finance costs relaxed. In our view, these are the most significant barriers to use of the cash basis. There seems to us to be little evidence of avoidance to justify them. The current restrictions undoubtedly influence a business's decision not to join the cash basis. In fact, during the original 2012 consultation on introducing the cash basis, we noted that there was little explanation why HMRC wanted to weigh it down with conditions that were likely to reduce the ability to claim proper allowance for business costs; particularly as they were not recommended by the OTS.
  - 1.9 If a decision is made to increase or remove the entry threshold, removal of the restrictions referred to above becomes even more pressing because otherwise there would be an increased risk that a business might enter the cash basis when it would be inappropriate to do so, because for example it has interest costs in excess of £500 (or whatever new limit is chosen). Increasing or removing the entry and exit thresholds should not be done without also addressing the loss relief and finance cost restrictions.
  - 1.10 Similarly, the cash basis should not be made the default without addressing the loan interest and loss relief restrictions. More generally, we are concerned that HMRC are proposing making the cash basis the default without investigating and thereby fully understanding why eligible businesses are not currently using it. As mentioned, we think it is likely that there is a significant lack of understanding and awareness of the cash basis particularly amongst unrepresented businesses. Making the cash basis the default could lead to businesses using it 'by accident' even though the accruals basis may be more suitable for their needs. In our

view, businesses should not be effectively forced into using the cash basis by default by HMRC, even if HMRC think it might formalise what some businesses are already doing in practice.

## **2 About us**

- 2.1 The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.
- 2.2 The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.
- 2.3 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.
- 2.4 Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

## **3 Introduction**

- 3.1 The consultation seeks views and feedback on proposals to increase eligibility and use of the income tax cash basis scheme for the self-employed. The proposals aim to increase the number of businesses eligible to use the regime and make the rules easier to apply and understand.
- 3.2 The cash basis is a simplified regime for calculating taxable profits for unincorporated businesses with straightforward tax affairs which was introduced in 2013. It allows businesses to calculate their taxable profit as the difference between income and expenditure when money is actually received or paid out, rather than in accordance with generally accepted accounting practice (GAAP accounting), provided certain criteria are satisfied.
- 3.3 The Government has identified a number of potential areas to simplify and expand the regime:
  - reviewing the turnover threshold for the cash basis to expand the regime to larger unincorporated businesses, allowing more businesses to choose whether to use the cash basis.
  - setting the cash basis to the default basis for eligible businesses to calculate taxable profits, thereby encouraging more businesses to use it.
  - relaxing the interest restriction for businesses in the cash basis to widen access to the cash basis to businesses that have interest costs above £500 per year.

- removing the restrictions on loss relief in the cash basis to allow new businesses to use the cash basis while setting loss relief against other sources of income.

The consultation notes that these proposals have the potential to widen eligibility for the cash basis to almost all small self-employed businesses.

3.4 The CIOT's stated objectives for the tax system, which are all relevant to the proposals in this consultation document, include:

- A legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.

## 4 Turnover restriction

4.1 **Question 1a: Under either of the options, would businesses within the newly eligible population consider moving to the cash basis?**

The two options outlined at para 2.4 of the consultation document are:

- to align the threshold with that used for the VAT cash accounting scheme, allowing businesses into the cash basis if they have turnover below £1.35 million, and being required to leave the basis if they have turnover above £1.6 million.
- to remove the turnover threshold entirely, allowing any size of business to use the cash basis as long as it is not otherwise prevented from joining.

HMRC estimate that for both options the eligible population for the cash basis would increase by around 26,000 businesses.

In our view it is unlikely that many of these newly eligible businesses would want to change from accruals accounting to cash basis accounting. As the consultation document notes, *'these businesses may be more complex, so more likely to prefer accruals accounting'*. We agree with this. We would expect that most businesses with a turnover of over £150,000 are likely to be relatively complex businesses that will want to prepare accounts based on GAAP accounting in order to accurately reflect their financial position and performance for the accounting period concerned (and for example to obtain loans, mortgages and so on, and to provide management information on profitability). Most businesses in this population, due to their size, are also more likely to use a professional accountant to help prepare their financial statements so are not likely to consider it particularly complicated, or onerous, to use GAAP accounting.

Given the numbers involved, there seems little point in increasing the entry threshold. Further, increasing the threshold to businesses with higher receipts could lead to increased burdens on businesses, at least initially. This is because it would mean that a good proportion of them would need to think about whether the system was the right one for them. This could lead to more businesses seeking professional advice, and to advisers needing to do additional calculations in order to inform the business on the impact of adopting the cash basis.

**4.2 Question 1b: What are the benefits/disbenefits of aligning the threshold to the VAT cash accounting scheme, and what are the benefits/disbenefits of removing the threshold entirely?**

They are likely to be similar, whichever option is chosen. As a general comment, if a threshold is going to be aligned to another threshold, then, for simplicity, it is helpful if that link is retained going forwards. Otherwise in a few years' time we could end up with one threshold for the cash basis and another for VAT cash accounting.

As noted above, there seems little point in increasing or removing the entry threshold given that HMRC estimate that for both options the eligible population for the cash basis would increase by only 26,000 businesses, and given that many of these would probably choose not to use it because of their size. On the other hand, this may mean there is little downside to increasing or removing it – it may not increase the numbers of businesses using it, but it would simplify the rules.

However, if the scheme allows larger businesses to use it, HMRC may perceive a need for some measures to prevent abuse, thus making the scheme more complicated and defeating the simplification objective. If this were to be the case, we would expect further consultation to take place before any such measures were introduced.

There may be a small risk that a business in the newly eligible population, perhaps one without a professional adviser, changes to the cash basis when it is inappropriate to do so, ie without fully understanding the consequences for the business.

If an exit threshold is retained, the existing complication of needing to follow the transitional rules when exiting the cash basis would continue. There is therefore potentially an argument for removing the exit threshold (currently £300,000) entirely, even if the entry threshold were retained. At the time the OTS first prepared its report into the income tax cash basis in 2012, there was some evidence that some businesses would be put off from using it because of the exit threshold. Even those which had no plans to grow to the extent that they would ever reach the threshold were concerned about it, still viewing the transitional rules as a complication they would rather avoid. Removing the exit threshold could therefore encourage some more businesses which are already in the eligible population to use the cash basis.

**4.3 Question 1c: Would increasing the cash basis threshold encourage businesses currently below the threshold to move into the cash basis, knowing that they would be able to stay in it for longer if their business grew? Would this have a significant or minor effect on businesses?**

We found it difficult to answer these questions for the reasons stated below.

Currently, a business must leave the cash basis the year after its turnover exceeds £300,000. The consultation document, at para 2.2, says that *'increasing the threshold would also reduce the number of businesses that*

*are forced to make transitional adjustments as they grow out of the cash basis, allowing them to make their own decisions on when is best to move to accruals accounting'* However, there is no indication in the document how many businesses are forced to move out of the cash basis and adopt accruals accounting because of an increase in their turnover above £300,000. There is also no indication how many businesses with a turnover of between £150,000 and £300,000 are currently using the cash basis, including how many are near the £300,000 turnover threshold. It is difficult, therefore, to understand the scale of the problem and what effect increasing or removing the exit threshold might have in practice.

We would expect that a business with a turnover near £300,000 is more likely than not to use a professional adviser who should be able to guide them through the transitional process of moving from cash accounting to GAAP accounting.

Overall, our feeling is that increasing the threshold on its own would have minimal impact on encouraging businesses currently below the threshold to move into the cash basis. This is based on our understanding that (as far as we can tell from the data in the consultation document) the vast majority of businesses within the eligible population are below the VAT registration threshold and so well below the current exit threshold of £300,000.

However, as noted above, there is some evidence that businesses can be deterred from using the cash basis because of the exit threshold. Even those which have no plans to grow to the extent that they would ever reach the threshold may be concerned about it, still viewing the transitional rules as a complication they would rather avoid. Removing the exit threshold could therefore encourage some more businesses which are already in the eligible population to use the cash basis, although it would probably need to be combined with relaxing the interest and loss restrictions to make any real difference (see below).

#### 4.4 **Question 1d: Are there any alternative changes to the entry or exit thresholds that would also increase the eligible population and encourage businesses to join the cash basis?**

We have no further alternative suggestions.

Currently, an estimated 1.2 million businesses use the cash basis out of an eligible population of 4.2 million businesses. It appears that the doubling of the entry and exit thresholds in April 2017 (see para 1.2 of the consultation document) did not markedly increase the number of businesses using the cash basis. At that time, over 1 million small businesses used the cash basis, a similar figure to now, and HMRC estimated that the entry threshold would have to be doubled to increase the number of eligible businesses by 175,000<sup>3</sup>. This suggests that it is businesses which are below the VAT threshold (and which have been able to use the cash basis since it was first introduced in 2013) that are choosing to use it. It implies that increasing the thresholds even further or removing them altogether will not necessarily achieve HMRC's desire to increase the number of businesses using the cash basis, particularly if the existing interest and loss restrictions are not relaxed or removed.

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<sup>3</sup>Simplifying tax for unincorporated businesses – HMRC consultation – see para 2.2 and the table at para 2.17.  
[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/545708/Business\\_Income\\_Tax-Simplifying\\_tax\\_for\\_unincorporated\\_businesses-consultation.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/545708/Business_Income_Tax-Simplifying_tax_for_unincorporated_businesses-consultation.pdf)

## 5 Cash basis default

### 5.1 Question 2a: Many businesses that would benefit from the cash basis currently do not use it, and many use it without electing to do so. Do you have any insight into why many businesses in the eligible population do not use the cash basis?

There are many reasons why an eligible business may choose not to use the cash basis. The consultation document speculates what some of them might be. Amongst them are:

- Many eligible businesses find the accruals basis more suitable or appropriate for their own business needs (para 2.7).
- Some businesses may have started trading on the accruals basis and are simply carrying on with the method they started with (para 2.8).

However, HMRC do not provide any firm evidence to support these views. We suggest HMRC conduct some research to try to identify the precise reasons why businesses which are eligible to use the cash basis choose not to, before making a decision on whether to make it the default basis. We would be willing to facilitate some research into this point.

The question asks, '*Many businesses that would benefit from the cash basis currently do not use it*'. The question seems to be assuming that there is a benefit to using the cash basis for those businesses that are eligible to use it, but that will not necessarily be the case. Each business is different, so it is impossible, and potentially unhelpful, to generalise. That is why some research appears to us essential.

We would expect that many businesses, particularly those represented by an accountant, will use GAAP (accruals) accounting because accounts prepared using the accruals basis will be more useful since they will serve several purposes beyond HMRC, including providing a more accurate picture of the business's financial position and profitability, and evidence for loan / mortgage applications. This supersedes any simplification benefits from preparing accounts using the cash basis.

We think it is likely that there is a significant lack of understanding and awareness of the cash basis amongst unrepresented businesses, which may lead to them not using it or using it without ticking the appropriate box on the SA103 self-employment pages of the Self-Assessment Tax Return (SATR). Similarly, there will be many unrepresented businesses who tick the 'cash basis' box without necessarily understanding what it means and whether they have in fact prepared their return in conformity with it. It is also likely that many businesses use a mixture of cash basis and accruals accounting due to a lack of understanding of the rules.

To help address this, HMRC could consider changing the return so as to provide two alternative boxes (one for 'cash basis' and one for 'accruals basis') and making it mandatory to tick one or the other. This would require the taxpayer to make a positive decision between the two options and encourage them to think more carefully about which option would be more beneficial for them to use. It would clearly be essential to provide guidance about the two accounting bases in the SATR explanatory notes, on GOV.UK and via the use of nudges and prompts in the SA return software. It would also provide HMRC with a better evidence base on which to make decisions about the scheme. However, we recognise that making the choice between the two bases mandatory on the tax return will not necessarily work well in practice because some people will not understand the difference between the two and be unable to make the choice without help – either from their family, a friend, a professional or from HMRC. And people could still end up making an inappropriate

choice for their business due to lack of understanding. A default position for taxpayers who tick neither (or both) boxes, even if there are two boxes on the return, will still be required.

The taxpayer's online tax return could be pre-populated with a note to say which choice the person made the previous year to help avoid the problems identified in para 2.9 of the consultation document (people apparently switching to and from the cash basis).

Another suggestion is that the cash basis should only be the default for those businesses which do not have their accounts drawn up professionally – and vice versa the accruals basis should be the default for those who have their accounts drawn up professionally. Arguably a better box on the tax return would be to ask, 'Do you have professional help in the drawing up of your accounts?' and then, depending on the answer, explaining which default applies and asking the person if they wish to change it.

It is concerning that, according to para 2.9, apparently 1.3 million businesses appeared to move from the cash basis to the accruals basis between 2019/20 and 2020/21 (more than the current population of cash basis users). It is impossible to know if these businesses made a positive choice to leave the cash basis or not, or whether it was simply a case of forgetting to tick the 'cash basis' box. Given the numbers involved, it appears to indicate a widespread level of misunderstanding and confusion amongst taxpayers, which expanding the cash basis would not on its own address. It could reflect a wider lack of awareness and understanding of how the UK tax system works for self-employed taxpayers, which could be addressed by the Government providing more education about tax in schools and better, more easily accessible guidance and support.

The current restrictions around interest deductions and losses (paras 1.17 and 1.18) will also no doubt deter some businesses from using the cash basis. We have in the past called for these to be relaxed.

Lastly, as noted above, the exit threshold can act as a barrier to some businesses using the cash basis, even those with no intention of growing to that size.

**5.2 Question 2b: Would changing the cash basis to the default for trading income have an impact on whether businesses use the cash basis or accruals basis? What are the benefits or drawbacks of setting the cash basis as the default?**

We are concerned that HMRC are proposing making the cash basis the default without investigating and thereby fully understanding why eligible businesses are not currently using it. It could lead to businesses using it 'by accident' (because they do not understand the question and do not tick the box to opt out) even though the accruals basis may be more suitable for their needs. In our view, businesses should not be effectively forced into using the cash basis by default by HMRC, even if HMRC think it might formalise what is already happening in practice.

It also seems odd to make the cash basis the default for the 71% of business that currently do not use it (see para 1.6 of the consultation document). Admittedly, they will be able to opt out, but if a business inadvertently does not opt out (perhaps due to a lack of understanding or awareness of the difference between it and the accruals basis), it could mean it makes errors in its tax return, which could potentially lead to penalties and interest. Indeed, making the cash basis the default could increase the level of error across the self-employed population, particularly if any change is not adequately publicised, and guidance made available. Paragraph



2.10 envisages that businesses could ‘switch between the 2 methods’ depending on their needs, but that introduces significant complexity in the period of transition.

The cash basis should not be made the default without addressing the loan interest and loss relief restrictions at the same time.

Para 2.10 of the consultation document suggests that HMRC consider that only ‘some’ businesses find the accruals basis more suitable for their needs, but no evidence is provided to support this claim. Indeed, the only evidence seemingly available is that 71% of businesses apparently use the accruals basis – a significant majority. As set out above, research is necessary to understand what the accurate take-up rate is, and why.

We do not think the fact that the cash basis is the default for property businesses is a reason to make it the default for trading income (para 2.12 of the consultation document). Whilst it would align the rules, so is in theory an attractive proposition from a simplification standpoint, property businesses are significantly different to trading businesses and what is suitable for one type of business is not necessarily suitable for the other.

Further, most small businesses owners will not have income from property, so the rules for taxing property income will be unfamiliar to them<sup>4</sup>. Those that do may have always prepared their rental accounts on a cash basis anyway. In addition, there are likely to be fewer adjustments required under GAAP accounting for property income, so it will often make little difference which basis they are prepared under. This will not necessarily be the case for trading income – either comparative calculations will need to be done to identify which basis is more suitable or it will be simply easier to stick with the existing basis that is being used.

Our concern is that, like now, an unrepresented taxpayer will not have sufficient knowledge or information to make an informed choice as to which basis is more appropriate for their own circumstances. A business could opt out (or not), without understanding the consequences, which could mean they pay more tax than they otherwise would have done. We do not think it unusual for unrepresented taxpayers to have no comprehension of the difference between the accruals and the cash basis and not know which basis they are using.

### 5.3 **Question 2c: Under a cash basis default, what proportion of businesses would you expect to opt-out and use the accruals basis?**

At para 2.11 of the consultation document HMRC say that they expect that a proportion of the 3 million remaining eligible businesses would not opt-out and so stay in the simpler regime. However, no figure is provided so it is not clear what proportion of eligible businesses HMRC think will use the cash basis if it were made the default. It would have been helpful if HMRC had done some research to try to ascertain what the take-up might be rather than relying on what appears to be speculation.

There are then, what we consider to be, some quite sweeping assumptions made about the benefits of using the cash basis and its suitability for some of these eligible businesses. No doubt some of these businesses will

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<sup>4</sup> The OTS’s 2021 report ‘The UK tax year end date: exploring the potential for change’ found that in the 2018/19 tax year the number of individuals with both self employment income and property income was 469,000, out of a total number of self employed businesses of 5,346,000 (ie just under 9% of the total) (indicative figures only) – see Annex F on page 64. [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1016718/Tax\\_year\\_end\\_date\\_report\\_web\\_copy.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1016718/Tax_year_end_date_report_web_copy.pdf).

have straightforward financial affairs that would make the cash basis a more suitable option for them than the accruals basis, but it is by no means certain that the cash basis will be of benefit to all who choose not to opt-out (particularly if the loan interest and loss relief restrictions are retained). That is why we favour providing the taxpayer with a choice on the tax return – see our response to Question 2a.

We would also expect that most businesses that have an accountant will continue to use the accruals basis, with the cash basis recommended only for small businesses with exceptionally straightforward affairs (as now). In other words, making the cash basis the default will make little difference to represented taxpayers. and the biggest impact of the change will fall on unrepresented taxpayers who are likely to require more guidance and support from HMRC in understanding and navigating the impact of the change. It is possible that it may lead to some unrepresented taxpayers appointing an agent to help them make the right choice.

**5.4 Question 2d: Would you expect there to be a transition administrative burden for businesses brought into the cash basis by the default, and are there any changes to the transition process for entering the cash basis that could help to smooth any burdens?**

We would expect the main issue to be that many unrepresented businesses will not recognise that they might need to make transitional adjustments, or not understand how to make them, because of a lack of understanding of the rules and/or awareness of what guidance might be available on gov.uk. We note that there are some examples in the Business Income Manual<sup>5</sup>, but it is quite hard to find them if you do not know they are there. It would be helpful if more prominence was given on the basic gov.uk guidance page<sup>6</sup> to where to find the more detailed manuals guidance, and what it contains.

Some businesses may already be using the cash basis without ticking the box on the SA103, so transitional adjustments would not be required in any event (although HMRC will not know that unless they make enquiries or open a compliance check). HMRC should not automatically conclude that if a taxpayer has not previously ticked the cash basis box, they must do transitional adjustments if it becomes the default and they do not choose to opt out.

**5.5 Question 2e: To what extent would businesses need help and support with understanding the change from the default accruals basis to the cash basis?**

We agree with HMRC's assessment of changing the default accounting basis, as set out in para 2.13 of the consultation document. However, we would caution HMRC against 'overselling' the benefits of using the cash basis in any communications and guidance they issue for business. In our opinion, there is an implied narrative throughout the consultation that the cash basis is 'better' and is what HMRC want as many businesses as possible to use. In reality, the cash basis may not be suitable for many businesses, and it would not be in their best interests to switch-over to using it. Any communications material and guidance need to make this clear.

HMRC would need to ensure that they have enough adequately trained staff to deal with the large number of queries they are likely to receive if this change were to go ahead.

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<sup>5</sup> BIM paragraphs 70065 – 70069 – see <https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim70000>.

<sup>6</sup> <https://www.gov.uk/simpler-income-tax-cash-basis>

## 6 Interest restriction

### 6.1 **Question 3a: What would be an appropriate level to set the interest restriction to? Are any of the 3 options proposed an appropriate level, considering the balance between allowing up-to-date costs of financing and the distortive effects of allowing private borrowing costs as deductions?**

The consultation document says at para 2.16 that approximately 98,000 businesses are eligible to use the cash basis but use the accruals basis and deduct interest costs above £500. But it does not indicate if there are any statistics available on what level of interest deductions the 98,000 businesses claim, and thus how many might benefit if the limit is raised to each of the proposed thresholds. It is therefore difficult for us to form an opinion on which of the three proposed thresholds would be most appropriate, if any. It is worth noting, however, that when the cash basis was introduced in 2013 the Bank of England base rate was just 0.5%. It is currently nine times that rate, at 4.5%.

It is possible that the cash basis may not be suitable for some or many of these 98,000 businesses regardless of whether they could deduct their interest costs (for example, because they are loss-making or because their affairs are not straightforward so the accruals basis of accounting is more suitable for their needs).

### 6.2 **Question 3b: To what extent would increasing the interest restriction in the cash basis have an effect on whether businesses choose to use the cash basis or not? Does the interest restriction influence decisions to join the cash basis where a business has interest costs below the £500 limit?**

It is possible that increasing the interest restriction along the lines suggested in the consultation document might affect whether a business chooses to use the cash basis, but we have no insight on what level of effect it would have. The current restriction undoubtedly influences a business's decision not to join the cash basis.

### 6.3 **Question 3c: To what extent would you expect businesses currently using the cash basis to increase their interest deductions, either through further borrowing or not being limited by the current £500 maximum?**

Decisions about further borrowing and increasing interest deductions are typically business decisions so we would not expect them to be influenced by whether the business can use the cash basis or not.

### 6.4 **Question 3d: Is the form of the current interest restriction appropriate for the cash basis? Are there any changes to the interest restriction rule itself, aside from changes to the limit, that would help to increase the number of businesses that are able to use the cash basis while allowing appropriate deductions for interest costs?**

### 6.5 We would like to see more evidence that any restrictions and special rules for finance costs in the cash basis are necessary at all. It is not clear to us what concerns HMRC had when the cash basis was introduced in 2013 that caused them to introduce the restriction and special rules in the first place. It was not one of the OTS's recommendations. We would have thought that most business owners will find it reasonably straightforward

to identify what interest they have paid on a credit card or bank loan, and to determine the extent to which this was incurred for the purposes of their trade.

We have heard that, because businesses using the cash basis would not necessarily prepare a balance sheet, HMRC thought it would be difficult for them to identify capital introduced into the business and from that assess if the level of loan interest deductions claimed made sense. If this was the case, have these concerns been borne out? Unless there is compelling evidence that the restriction should be retained, we would like to see a more fundamental change and the same rules for deduction of finance costs be applied to the cash basis as to the accruals basis of accounting (ie the restriction removed entirely). This could encourage more businesses to join the cash basis, and it would simplify the rules.

There is a risk that simply tweaking the amount of interest that can be claimed will only have a marginal effect on take-up of the cash basis.

If HMRC are concerned about abuse, some specific rules could be considered to address them (for example by restricting the amount of interest that can be deducted in one year on loans from family members and connected parties).

If the restriction were to be removed, HMRC guidance on private use adjustments and how to calculate them would need to be increased and improved. This would be of benefit generally since previous HMRC activity at the time of their Business Records Checks programme identified that the most common cause of error by small businesses was in recognising and calculating private use adjustments.

## **7 Loss restrictions**

### **7.1 Question 4a: Would removing or relaxing the cash basis trade loss relief restrictions have an effect on whether businesses with losses choose to use the cash basis?**

Yes, it might do. For example it might affect whether new businesses that have budgeted for early years losses choose to use the cash basis, since the cash basis then becomes a viable alternative to be considered.

### **7.2 Question 4b: Is the burden of moving out of, and then back into, the cash basis to claim sideways loss relief currently having an effect on businesses' decisions to use the cash basis?**

We would expect represented taxpayers with fluctuating profits to use the accruals basis to avoid issues around moving into and out of the cash basis to claim sideways relief. Some of these businesses may choose to use the cash basis instead if the loss restriction were to be removed.

What is unclear is whether unrepresented taxpayers are aware of sideways loss relief in the first place, and if so whether they are aware of the restriction on relief if using the cash basis. As noted above, it is questionable as to how many unrepresented taxpayers know the exact basis on which they are preparing tax statements. We suspect few unrepresented taxpayers would understand the adjustments required to switch from a cash basis to an accruals basis in order to claim sideways loss relief. As with the interest restriction, we question whether there is any evidence that a restriction on sideways loss relief is justified for cash basis users.

**7.3 Question 4c: Are the restrictions on loss relief under the cash basis dissuading new businesses, that may be making losses in their early years of trade, from using the cash basis?**

Potentially. As above, if the business 'plan' recognises the potential for losses in the early years of trade then 'what to do with those losses' is a relevant question for the taxpayer (and their advisers). Where there is other income against which losses could be used, that could well rule out the cash basis as an option for that business.

**7.4 Question 4d: What changes to the loss relief restrictions for the cash basis do you think would have the greatest effect on the number of businesses that would be eligible for, and use, the cash basis?**

7.5 We would like the current restrictions on loss relief removed. It is unclear to us what evidence there is that the loss relief restrictions are necessary. There seems to us to be little evidence of avoidance to justify them. If a decision is made to increase (or remove) the entry threshold, removal of the restriction becomes more pressing as larger businesses become eligible to use the cash basis.

It would have been helpful if the consultation had explained the concerns HMRC had when the cash basis was introduced in 2013 that caused them to introduce the loss restriction in the first place. Have their concerns been borne out by evidence in the ten years since then or not? If not, then there would seem to be no reason to retain them, particularly if HMRC want to encourage more businesses to use the cash basis.

Removing the restrictions so that the loss rules are aligned with businesses which do not use the cash basis would introduce consistency and be a welcome simplification. It would remove the inequitable situation that currently exists between businesses that use the cash basis and those that use the accruals basis. The current rules unfairly penalise loss-making businesses that use the cash basis and as a consequence cannot access sideways loss relief when it might be advantageous to do so.

We also note that the consultation options suggest '*...allowing new businesses to use the cash basis while setting loss relief against other sources of income...*' Clearly, the greatest effect on eligibility would arise if all (not just new) businesses were entitled to loss relief.

**8 Question 5: Are there any specific interactions, benefits, or issues that could arise from a combination of some or all of the options outlined in this consultation document?**

8.1 There is likely to be a link between turnover, interest and losses. Increasing the turnover threshold without changing the restrictions on interest deductions and sideways loss relief is likely to have very little effect on the numbers of businesses choosing the cash basis. This said, use of the cash basis in any event is likely to be of little interest to businesses with higher turnover due to all the reasons set out above.

8.2 As already noted, we do not think increasing or removing the entry and exit thresholds, or making the cash basis the default, should be done without also removing the restrictions on interest deductions and sideways loss relief. In our view, these restrictions are likely to be discouraging eligible businesses from using the cash basis which might otherwise use it.

**9 Question 6: Are there any other areas of the cash basis that could be modified or improved to increase eligibility, take up, or simplicity?**

9.1 Farming businesses and creative artists are not able to use the profit averaging rules if they are using the cash basis to prepare their accounts. We can see that there could be a rationale for having profits for the averaged years calculated on the same basis (ie both cash or both accruals basis) but otherwise it seems an odd restriction. We have received feedback that creative artists with modest profits would find it helpful to be able to use the cash basis.

**10 Question 7: Would allowing an optional end of year adjustment for stock in the cash basis be a feasible or helpful addition, and would it encourage more businesses to use the cash basis?**

10.1 We have no specific insight whether this would make a significant impact on the numbers of businesses using the cash basis, particularly without removing some of the other restrictions.

10.2 However, it would add complexity to the existing rules (by combining an aspect of accruals accounting into the cash basis) which would make it less attractive from a simplification viewpoint and perhaps increase the likelihood of errors. We do not believe that adding a third potential basis of taxation (a cash basis 'plus') would be helpful.

**11 Question 8: Are there any opportunities to more closely align the rules for measuring self-employment income under Universal Credit with the self-employed cash basis? Would closer alignment encourage more people to use the cash basis, or provide simplification benefits for people already using the cash basis?**

11.1 We would support closer alignment with the Universal Credit rules. Please refer to the comments made by the CIOT's Low Incomes Tax Reform Group in their response to the consultation document, which we endorse.

**12 Question 9: Are there any non-legislative changes that could be made to improve understanding and use of the cash basis for eligible businesses? Would an education campaign to inform small businesses of the cash basis encourage more to use it, even without changes to the cash basis itself?**

12.1 Yes, there does seem the potential to increase understanding and use of the cash basis by eligible businesses by non-legislative means. Some of the statistics provided in the consultation document (for example at para 2.9) would suggest that an educational campaign and improved guidance would be of benefit to a significant number of taxpayers in helping them decide if the cash basis is suitable for their business or not and, if so, how to use it.

12.2 The current GOV.UK guidance is only a few pages long, and only provides a cursory overview.

12.3 The interaction with simplified expenses is also confusing, and it is not (easily) possible to navigate from the high-level GOV.UK guidance, to the more detailed explanations in the Business Income Manual. Further, the link 'make some adjustments' in the section 'Changing from traditional accounting to cash basis' simply takes you to a page of guidance and worksheets which is likely quite daunting for the unrepresented.

12.4 Considering there are approximately 4.2m businesses entitled to use the cash basis, the amount and accessibility of guidance is poor.

**13 Question 10: Could any of the proposals or ideas in this consultation document for reforming the cash basis be applied to income from property businesses? Would increasing or maintaining alignment between the trading income cash basis and property income cash basis have an effect on simplicity or take up?**

13.1 As noted in our response to Question 2b above, we do not think that there is much practical benefit in increasing or maintaining alignment between the trading income cash basis and the property income cash basis even though the overlap of 469,000 individuals (see footnote 4 above) is a reasonably significant figure. We think the two bases should be kept separate. Although the taxation of property income and trading income can 'look' similar in some ways, there is in fact a divergence of treatment (for example, in broad terms, deductions for property improvements and repairs for property compared to capital allowances for a trade), so it is not perhaps practical or expected that the legislation and the associated guidance etc is the same for both.

**14 Question 11: Any changes to the trading income cash basis would automatically apply to partners in partnerships that use the cash basis; are there any particular issues that should be taken into account when considering the impact of these changes on partnerships, and should any of these proposed changes not apply to partnerships?**

14.1 It is logical for the rules to apply equally to sole traders and partnerships. However, we would have thought that most partnerships would not want to adopt the cash basis, because they would normally need to prepare accruals basis accounts – particularly in the case of large professional partnerships and farming partnerships. The nature of a partnership is different from that of a sole trader in that it is important to ensure fairness between the partners when profits are determined for sharing between them. This is more likely to be achieved by drawing up commercial accounts using the accruals basis. If commercial accounts are drawn up there is no saving from doing tax on a cash basis. Consequently in our view any changes that are made to the cash basis following this consultation are unlikely to have a significant effect on partnerships.

**15 Question 12: What other interactions between reforms to the cash basis and MTD for ITSA should the government take into consideration?**

15.1 We accept that under Making Tax Digital (MTD) for Income Tax Self Assessment (ITSA) as currently proposed businesses which use the cash basis may find it easier to finalise their annual position, as this should largely be just a sum of the four quarterly reports. We do not, however, consider it will make quarterly reporting under MTD for ITSA significantly easier than the invoice basis, since no 'accruals-type' adjustments are required in the quarterly reports.

15.2 For quarterly updates, it is intended that the taxpayer must specify whether they are using the cash basis or accruals basis. However, as the cash basis has an annual threshold, it may not be clear for quarterly filing which basis will ultimately be used for the tax year until part way through the year, or until the end of the year. The only solution, if quarterly updates were prepared on one basis but the final position is determined on the other

basis, seems to be to re-file each previous quarterly report, which would be an extra administrative burden. Removing the threshold would remove that uncertainty and burden.

- 15.3 We understand that any changes to the cash basis are expected to be introduced before MTD for ITSA becomes compulsory in April 2026. It will be necessary to ensure that MTD software can adequately cope with the cash basis, and the ability to opt out and use the accruals basis. There is a risk that software could be a restricting factor if someone chooses cheap / free software because it works on the cash basis, but it cannot adapt to the accruals basis which would in fact be more beneficial to the business.
- 15.4 Another interaction that should be considered is basis period reform and the interaction of a tax year basis of assessment with the cash basis. We believe that the interaction of the tax year basis period for assessing profits from self-employment and electing into and out of the cash basis potentially introduces some complexity for taxpayers with periods of account that do not coincide with the tax year end. In particular, since a cash basis election currently applies for a tax year rather than a period of account, clarity will be required as to how the adjustments on entering or leaving the cash basis are to be applied where the tax year basis assesses part of a period of account in one tax year and the remainder in another. We have provided further elaboration of this point in the appendix.

**16 Question 13: What is your view on whether encouraging/expanding the cash basis will improve sole traders' experience of MTD for ITSA, particularly for very small businesses, and why?**

- 16.1 In accordance with, and subject to, the comments set out in response to question 12, above, the cash basis would, prima facie, help smaller businesses to comply with MTD for ITSA when or if these businesses are eventually required to sign up.
- 16.2 However, as stated in other submissions and engagement with HMRC, we have significant reservations about bringing such small businesses into MTD for ITSA regardless of whether the cash basis might improve their experience of it.

**17 Acknowledgement of submission**

- 17.1 We would be grateful if you could acknowledge safe receipt of this submission and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

The Chartered Institute of Taxation

6 June 2023



## Appendix

### Interaction of Cash Basis and Basis Period Reform (see paragraph 15.4 above)

ITTOIA 2005, section 25A(1) provides that:

*'A person who is or has been carrying on a trade may elect for the profits of the trade to be calculated on the cash basis (instead of in accordance with generally accepted accounting practice).'*

ITTOIA 2005, section 31D(1)(a) provides that an election for the cash basis under section 25A:

*'An election made by a person under section 25A has effect-*

*(a) For the tax year for which it is made, ...'*

The basis period for a tax year has (until the current tax year) usually been the 12 months to the date the accounts were made up to in that tax year. For example, under the current year basis, for a business with an accounting period ending on 30 September, the basis period for the 2021/22 tax year would have been the period of account from 1 October 2020 to 30 September 2021.

Where a taxpayer first elects to use the cash basis, after previously using the accruals basis, certain adjustments are required to calculate the profit or loss for tax purposes. Similarly, where a taxpayer ceases to qualify to use the cash basis or wishes to calculate profits using the accruals basis – then, again, adjustments are required to calculate the profit or loss for tax purposes.

Usually, under a current year basis of assessment, these transitional adjustments on entering or leaving the cash basis are applied to the profits or losses arising in the 12 month period of account ending in the relevant tax year. For example, for a business with a 30 September year end, if a taxpayer elects to use the cash basis for the 2021/22 tax year, transitional adjustments will be applied to the accounting period beginning on 1 October 2020 and ending on 30 September 2021.

It is, however, unclear how these transitional adjustments will apply under the tax year basis of assessment where the business's period of account does not coincide with the tax year end.

For example, under the tax year basis of assessment a business with a 30 September year end will be assessed for the 2025/26 tax year on 6/12ths of the profit for the accounting period ended on 30 September 2025 plus 6/12ths of the profit for the accounting period ended on 30 September 2026.

Since the effect of an election for the cash basis is that it has effect for a tax year, the accounts for both the year ended 30 September 2025 and those for the year ended 30 September 2026 will as things stand need to be prepared on the cash basis.

What then happens if, say, for the 2026/27 tax year the taxpayer either no longer qualifies to use the cash basis or there is a change of circumstance and the taxpayer elects to use the accruals basis? Transitional adjustments will be required to the profits to be taxed under the tax year basis of assessment, but it is not clear how those adjustments are to be calculated.

Currently the two steps to the transitional adjustment calculation are:

Step 1

1. Add together amounts that customers had owed to the business at the end of the last cash basis period, and add to this the amounts paid for any stock of goods held at the end of the last cash basis period;
2. Add together amounts that the business had owed to suppliers at the end of the last cash basis period. Add to this any amounts of income that the business received, in the last cash basis period, where the work for the customer had not been done as at the end of that period.

## Step 2

Deduct the total of 2 from the total of 1.

Following on from the previous example, the profits to be assessed for 2026/27 on the accruals basis are 6/12ths of the profit for the accounting period ended on 30 September 2026 plus 6/12ths of the profit for the accounting period ended on 30 September 2027. However, 6/12ths of the profits for the accounting period ended on 30 September 2026 have already been assessed under the cash basis for the 2025/26 tax year.

Do the accounts for the year ended 30 September 2026 have to be restated on an accruals basis and the transitional provisions applied as if the end of the last cash basis period was the end of the 2025/26 tax year (ie 5 April 2026)? Or do the accounts for the year ended 30 September 2026 remain on the cash basis and the transitional provisions applied as if the end of the last cash basis period was 30 September 2026 and, in effect, any adjustments are included in the accounts for the period for the year ended 30 September 2027?

Our assumption would be that the accounts for the year ended 30 September 2026 would remain on the cash basis, that the accounts for the year ended 30 September 2027 would be prepared on the accruals basis, and that any adjustment income or expense arising from an effective transition from the cash basis to the accruals basis on 1 October 2026 would be included as either income (spread for tax over 6 years) or as a one-off expense in the self-assessment tax return for the 2026/27 tax year. Does HMRC agree with this approach?