Cash basis for small business

Introduction

From April 2013, it is proposed that sole traders with a low turnover may use the cash basis for determining their taxable profits. Traders here include vocations (such as musicians, writers and artists) and professions (such as accountancy, law and medicine).

It must be stressed that these are just proposals at the moment. Many of the details have still to be worked out, following a consultation that ended on 22 June 2012. It is almost certain that the scheme will go ahead, though some details may be changed. One of the issues yet to be resolved is how this system will interact with the universal credit, the new means-tested social security benefit for low earners.

The idea originated from the Office of Tax Simplification which proposed a simple cash basis for micro-businesses with a turnover of up to £30,000 a year. In the 2012 Budget, the Chancellor accepted the proposal but proposed a limit of more than double that figure. He proposed a limit equal to the VAT threshold (currently £77,000). This threshold is also the upper limit for three-line accounts on tax returns, rather than having to detail all expenditure.

There are 3.5 million businesses in the UK. About 3 million will be able to use the cash basis.

Once a business has started to use the cash basis, it may continue to do so until its turnover exceeds £150,000. When this happens, the business must switch to the accruals basis from the start of the next tax year.

Suppose a business has these turnover figures:

2013/14	£70,000
2014/15	£90,000
2015/16	£110,000
2016/17	£130,000
2017/18	£160,000

The business may start to use the cash basis in 2013/14, and may remain in it until 2016/17, after which it must use the accruals basis.

If the business decides not to use the cash basis in 2013/14, it has lost its chance. It cannot join in a later year as its turnover has exceeded the limit.

In reality, many sole traders wrongly use cash accounting for their tax returns, unaware that they should use any other basis. The change may therefore be seen more as regularising and formalising an existing practice, rather than introducing a new practice.

The adoption of cash accounting for income tax does not affect any other reporting requirement. Any accounts must still be prepared using relevant accounting standards, and must use the same accounting conventions.

There is already a completely separate scheme of cash accounting for VAT, which has a higher threshold. If the business is registered for VAT, it may only use cash accounting for income tax if it uses cash accounting for VAT. This means that it may be possible for a business to use cash accounting for VAT but not for income tax. It is not possible to use cash accounting for income tax but not for VAT.

Before looking at the tax implications, it may be helpful to understand the underlying accountancy.

Fuller details of the proposals can be found at:
http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_031991.

Cash basis and accruals basis

There are two common methods of financial accounting that may be used by a business:

- cash accounting
- accruals accounting.

Cash accounting is simpler, but accruals accounting is considered more accurate.

The record keeping is largely the same for both methods. You keep the same documents, cash books and other records.

Under accrual accounting, some adjustments are made to the accounts, usually at the end of the accounting period.

Under cash accounting, a business simply records payments made and received. The accounts for an accounting period simply show the total payments made and payments received in that period.

Under accruals accounting, these figures for payments are adjusted so that the income and expenditure relates to the period.

This requires adjustments in three areas:

- recording when payment is received
- calculating figures for Accruals and Prepayments where payments received or

made relate wholly or partly to a different accounting period

- valuing stock
- accounting for fixed assets.

When payment is received

Consider this sequence of events:

(1) You buy £100 worth of goods to sell for £150.
(2) A customer orders those goods.
(3) You send the goods with an invoice.
(4) The invoice is paid.

At what stage have you earned the £50 profit?

Under cash accounting, the answer is (4). Under accruals accounting, the answer is (3).

Suppose you make up your accounts to 31 March. You supply goods on 1 March and the customer pays you on 1 May. Under accruals accounting, you must pay tax on the £50 profit even though the customer has not yet paid you.

If a sale is made against an invoice rather than a payment, accounting practice is to treat this as two financial transactions:

- the sale (debit Debtors, credit Sales)
- the payment (debit Cash, credit Debtors).

A similar arrangement is made when purchasing goods against an invoice:

- the purchase (debit Purchases, credit Creditors)
- the payment (debit Creditors, credit Cash).

The constantly changing figures for Debtors and Creditors are supported by a Sales Ledger and Purchase Ledger that records the sums owed by your customers or owed to your suppliers. These ledgers are memorandum accounts, which means they are not part of the double-entry bookkeeping.

Example of accurals accounting

For example, you make up your accounts to 31 March each year. In January, a customer pays you £1,200 for a year’s subscription to 31 December.

Under cash accounting, the whole £1,200 would be included as sales as it was received in that accounting period. Under accruals accounting, only one quarter would be included, as the other nine months relates to the next accounting period.

Under double entry bookkeeping, the adjustment is made by a journal entry:

Debit: £900 Sales
Credit: £900 Accruals

This journal entry is reversed at the start of the next accounting period, so the figure for Accruals immediately reverts to zero.

The accounting period will have had an accrual reversed at the start of the accounting period.

Suppose the same customer paid £1,000 for a year's subscription at last year's rate. At the start of the current accounting period, you would have reversed the journal entry made in the previous accounting period and so would have credited £750 to sales.

So the account for this sale under accruals accounting would be:

Payment received:	£1,200
plus last year's accrual reversed:	£750
minus this year's accrual	(£900)
Balance on account	£1,050

This represents nine months' subscription at £1,000 a year:	£750
plus three months' subscription at £1,200 a year:	£300
Total	£1,050

(In practice, a Sales account is likely to include many more than a single sale to one customer. However the principle is exactly the same.)

Prepayments

Just as you make an accrual when a payment *received* relates to another accounting period, so you must adjust payment you make if any of it relates to another accounting period.

The principle is the same. The journal entry is the other way round, and the balancing figure is called a Prepayment and not an Accrual.

For example, you make up your accounts to 31 March each year. In February you pay £3,000 for three months' rent from 1 March to 31 May.

Under cash accounting, the whole £3,000 is included as it was made in the accounting period. Under accruals accounting, only one third of that figure is included as two months of that period relate to the next accounting period.

This adjustment is done by a journal entry in double-entry bookkeeping. The journal entry is:

Debit: £2,000 to prepayments
Credit: £2,000 to rent.

This journal entry is also reversed at the start of the next accounting period, so that the balance of Prepayments reverts to zero.

Suppose at the same time in the previous year, you paid £2,400 for three months rent just before the rent increased from 1 May. You would have started the year by reversing an adjustment for £1,600 (two-thirds of £2,400).

The balance on the rent account would show:

Four payments of £3,000:	£12,000
Plus last year's journal reversed:	£1,600
Minus this year's journal:	(£2,000)
Total	£11,600

This represents:

Two month's rent at £2,400 a quarter:	£1,600
Ten months' rent at £3,000 a quarter:	£10,000
Total	£11,600

In each case, it can be seen that using Accruals and Prepayments gives a more accurate figure of how much expenditure has been incurred and how much sales revenue has been generated in the accounting period.

In both examples, the rates had changed from one period to the next.

Suppose the rent paid remains at £3,000 a quarter next year. A new journal for £2,000 must be made and last year's journal for £2,000 must be reversed. The two figures will cancel each other out, showing that a rent charge of £12,000 for the year. However the journals must still be made and then reversed.

Stock

Under the cash basis, all purchases are included when made.

Under the accruals basis, all stock should be counted and valued at the end of the accounting period. Stock is not limited to items that the sole trader sells. It includes all consumable items that the trader still has at the end of the year. So stock can include stationery, cleaning materials, packing materials and canteen supplies.

An adjustment is made to the accounts, similar to the accruals and prepayments previously explained.

Under cash accounting, the figure for "cost of sales" is simply purchases made during that accounting period.

Under accruals accounting, “cost of sales” is:

Opening stock (last year’s stock-take and valuation)
Plus stock bought during the year
Minus closing stock (this year’s stock-take and valuation).

Fixed assets

A fixed asset is anything a sole trader buys for the business and which is expected to last for more than one year. Examples include buildings, furniture, machinery, computers and vehicles.

Under cash accounting, the whole cost is deducted in the year of purchase.

Under accruals accounting, the cost must be spread over the asset’s expected useful life. So if you spend £2,500 on computer equipment expected to last for five years, you do not deduct the whole £2,500 in the first year. You may deduct £500 a year in each of five years.

Who may use the new cash basis?

The new cash business is intended for certain unincorporated businesses whose turnover is below the VAT limit. This is currently £77,000, but will probably be a little higher when the cash basis is introduced in April 2013.

If a person runs more than one business, the cash basis may only be used if the turnover from all businesses added together are below the threshold. Such a person must use the cash basis for all the businesses or for none of them. It is not possible for some businesses to use the cash basis and others to use the accruals basis.

Foreign residents who run a business subject to UK income tax may use the cash basis if they otherwise meet the conditions.

Companies may not use the cash basis, however small their turnover is.

A partnership may use the cash basis but an LLP may not. A partnership is only eligible if the *partnership’s* income is below the threshold.

All property businesses are excluded, though a separate scheme for very small property businesss may be introduced in another year.

Other excluded businesses are:

- any business that is claiming averaging of earnings (mainly farmers and people in creative industries, such as composers and artists)
- farmers who have made a herd basis election
- financial trading businesses

- members of Lloyd's insurance market operating an underwriting business.

It is stressed that using the new cash basis is entirely voluntary. A small business may use the accruals basis if it wishes. A business that uses the cash basis may change back to the accruals basis at any time, even if the turnover is still below the threshold.

How it works

A business that decides to use the cash basis will:

- record all cash received and paid by the business in the tax year (6 April to 5 April)
- keep a record of business journeys made in the trader's private vehicle
- keep a record of approximate time spent working
- use fixed rates of expenses for certain items of expenditure
- use the actual rate of expenditure of other items of expenditure
- indicate on the tax return that the cash basis has been used.

For completely new businesses, it is expected that they will use the cash basis unless the business elects not to.

If, unusually, payment is made in kind rather than in cash, the benefit must be valued and regarded as income or expenditure. This means that barter transactions must be included in sales and expenses, as is already the law.

If a transaction is made on a non-commercial basis, an adjustment must be made to reflect the commercial basis. For example, a shopkeeper who allows a family member to take goods for a nominal sum must adjust that sum to reflect the real value of the goods.

The following are not regarded as income and so are not subject to income tax:

- funds introduced to the business by the trader
- money which has merely changed form, such as funds in a bank withdrawn as cash
- loan capital, such as money borrowed from a bank, to fund the business,
- proceeds from the sale of "durable assets" such as intellectual property, shares or land. (These will be taxed separately)
- refunds of tax.

Expenses

Many of the small businesses comprise sole traders who operate from their homes.

It can be difficult to determine what items of expenditure relate to the business rather than to home use. Common areas of problem are:

- household expenses
- interest paid on loans
- travel, such as use of a car
- joint-use assets, such as a computer.

The proposal is such items should be allowed by means of a **fixed deduction**. This avoids the need to keep detailed records, and to support apportionment where there is both business and personal use.

Such fixed deductions are already used in employment. For example, an employer may pay tax-free an employee 45p a mile for using their car, and may pay £4 a week to an employee who works from home.

For **use of home**, consideration is being given to either a single flat rate or a three-tier system. Claiming the allowance would be an alternative to the existing system of claiming a proportion of household expenses, such as one seventh of utility bills when one room in a seven-room house is used as a study.

For **telephone and Internet,** the proposal is to allow the full cost where private use is not significant. This is not further defined. Similar provisions will apply for **stationery and computer products.**

The position for **subsistence** on business travel is yet to be resolved.

The use of the fixed deductions will be compulsory for any business using the cash basis. It will not be possible for a business to use the cash basis and claim the actual cost for these items of expenditure.

Items that are not allowable as a business expense under current law remain disallowed under the cash basis. Disallowed items include:

- personal expenditure
- entertainment of customers
- depreciation and amortization
- payments in relation to offences, such as fines and parking tickets
- interest on personal loans
- drawings taken out of the business by the trader
- payment of any tax.

Some **capital expenditure** would be allowable as if it were revenue expenditure. This means that the business does not have to bother with calculating capital allowances. It also means that full tax relief is given in the year of acquisition and not spread over many years.

Assets that have the nature of **investment** would not be deductible. Examples include land, property, shares and intellectual property.

Predictably and tiresomely, **cars and motorcycles** are also excluded. Instead the trader would claim the mileage allowance.

Other motor vehicles, such as **vans**, would be tax-deductible unless the trader chose to use a mileage allowance for those vehicles.

Normal hire charges for vehicles would be allowable, except for the hire of cars or motorcycles.

For **loans,** interest is tax-deductible if the asset to which the loan relates is tax-deductible.

Interaction with VAT

A business that is VAT-registered will only be able to use cash accounting for income tax if the trader uses cash accounting for VAT.

Using cash accounting for VAT does not oblige a trader to use cash accounting for income tax. A trader may use cash accounting for VAT and the accruals basis for income tax. As VAT cash accounting has a higher threshold, some traders using cash accounting for VAT will not be eligible for cash accounting for income tax.

It is proposed that the accounting would use VAT-inclusive figures for sales and receipts, regardless of whether the trader was VAT-registered. A registered trader could claim payments of VAT as a deductible expense. Any refunded VAT is taxable income.

Interaction with capital gains tax

A trader is liable to capital gains tax under the existing rules. The only change is that where any proceeds of a disposal have been subject to income tax, they will not also be subject to CGT.

Losses

If a loss is made, that may be carried forward for offset against future profits from the same business.

It is not possible to claim sideways relief against other income where that loss is calculated under cash accounting. A claim could be made by switching to accruals accounting for the loss-making accounting period.

Changing from one basis to another

There are some special provisions that apply when a trader switches from one basis to the other.

First, the accounts must be prepared for accounting periods of one year ending on 5 April. Under the accruals basis, a trader may make up accounts to any date he or she chooses. Many traders use 30 April as it provides a longer period between receiving income and paying tax on it.

Details have yet to be announced, but the underlying principle is that all sales are taxed once and only once, and all allowable expenditure is tax-relieved once and only once.

In practice what this is likely to mean is that in the year that a business switches from cash basis to accruals basis:

- sales must be increased by unpaid invoices to customers
- profits are reduced by invoices received from suppliers that the trader has not yet paid
- the value of stock on the date of the change must be added to turnover if tax relief has been claimed for it.
- a new capital allowances pool is created with a written down value of zero. No attempt is made to claw back the tax relief already provided.

If a trader moves from accruals basis to cash basis (which is less likely):

- sales are reduced by payments of invoices from a previous period
- profits are increased by payments of suppliers' invoices issued in the previous period
- stock on the date of the change and which has not been allowed as a tax deduction, is added to expenditure in the first year of the cash basis
- the written down value of capital allowances for assets is immediately written off against expenses.

In addition, adjustments will be needed when a business pays or receives a refund of VAT under one basis in respect of the other basis.

A trader is free to switch from one basis to another from year to year, though the guidance notes that doing so defeats the purpose of offering a simpler system.

Other provisions

There is currently a special tax provision for newly-qualified **barristers** who may use the cash basis for the first seven years. This will be withdrawn as barristers will be eligible to use the new cash accounting basis. Barristers already using the special tax provision may continue to do so.

Tax planning opportunities

Every new tax scheme throws up new problems and new tax planning opportunities.

The most obvious planning opportunity is simply for an eligible business to compare how much tax would be paid under the new cash accounting arrangements as against the existing accruals scheme. The trader may then choose the more favourable basis. This is specifically allowed for in the proposals.

Businesses that are likely to benefit are those that:

- spend significant amounts on plant and machinery
- where the fixed deductions significantly exceed the actual expenditure to which they relate.

One surprising opportunity is in relation to capital allowances. A business using the accruals basis can in effect get tax relief for the entire written down pool just by opting for the cash basis for one year. None of that relief is clawed back if the business then reverts to accruals accounting.

Another benefit is that the many small businesses that already use cash accounting anyway may now do so legally, and thus avoid the inevitable penalty when HMRC catches up with them.

There is a tax trap for loss relief. Sideways loss relief, which is very useful for loss-making businesses in their early years, is denied. As sideways loss relief cannot be carried forward, this means that many losses will in reality go unrelieved.

However the main benefit of the new cash accounting scheme is the simplicity that the scheme is designed to bring. Although a full set of rules makes the scheme complicated, most one-man bands should find the new cash basis simple to operate in practice.

For once, we may actually have a tax simplication that really does simplify tax. About time.