ICAEW
REPRESENTATION 50/23

EXPANDING THE CASH BASIS

Issued 30 May 2023

ICAEW welcomes the opportunity to comment on the Expanding the cash basis published by HMRC on 15 March 2023, a copy of which is available from this link.

For questions on this response please contact Richard Jones at richard.jones@icaew.com quoting REP 50/23.

This response of 30 May 2023 has been prepared by the ICAEW Tax Faculty. Internationally recognised as a source of expertise, the ICAEW Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business. ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark the tax system and changes to it, are summarised in Appendix 1.

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KEY POINTS

1. We believe the cash basis is likely to be most relevant for the smallest of businesses (eg those with turnover of no more than £30,000) but we also acknowledge that some larger businesses would benefit from the simplification provided by extending the turnover limit.
2. Having any form of turnover limit provides a level of complexity, especially for those businesses with annual profits oscillating around the limit. There is therefore an argument for removing the turnover limit altogether, although we believe that this could have a detrimental effect on the accuracy of accounting records in some cases.
3. Aligning the turnover thresholds with the VAT cash accounting scheme would provide an element of simplification as businesses would have just one turnover limit to consider. We therefore support extension of the turnover threshold to align it with the VAT cash accounting scheme.
4. We also support relaxation of the restrictions relating to finance costs and loss relief and believe these should be removed entirely.
5. We would only support a *default* use of the cash basis for trades up to £30,000 of annual turnover. Above that level, accruals accounting based accounts are likely to be required for other purposes and therefore could result in duplication of requirements for businesses.
6. We believe that the cash basis for trades and property businesses should be aligned as far as possible so that taxpayers with both sources of income do not need to apply two different sets of tax rules.
7. We agree that cash accounting would help to align the tax result for quarterly updates prepared for the purposes of Making Tax Digital for Income Tax but only for businesses with accounting periods that align with the tax year.

ANSWERS TO SPECIFIC QUESTIONS

8. We have included below responses to those questions on which we have received feedback from our members.

TURNOVER RESTRICTION

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

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?

9. In its consultation document entitled "Simplifying tax for unincorporated business" published on 15 August 2016, which explored raising the turnover threshold beyond the value of the VAT registration threshold, HMRC stated at paragraph 2.12 that "The government believes that for the largest businesses, who will be required to prepare accruals accounts for other reasons, a cash basis reporting system for tax is unlikely to be the right approach". Indeed, the current consultation document continues to express this at paragraph 1.12 where it says: "the government recognises that the cash basis may not be appropriate for all businesses, such as those with significant stock purchases or large debtor and creditor balances."
10. We are therefore surprised by the suggestion to increase the turnover threshold to align with the VAT cash accounting scheme or to remove the turnover threshold altogether.
11. Feedback from our members suggests that many agents do not believe there is an appetite or need to increase the entry level threshold as they do not generally advise their clients to use the cash basis. When asked why, agents responded that their clients did not prepare

accounts purely for tax purposes and accounts prepared under the accruals basis were more meaningful and often required by providers of finance.

12. Having said that, we also support any measure that would help to reduce the administrative burden faced by clients of our members. For many, preparing cash basis accounts would be a significant simplification compared to accruals-based accounts. Especially since the greater proliferation of digital accounting records, the former should be capable of being produced automatically in some cases.
13. In its response to the 2016 consultation, ICAEW's Tax Faculty also stated that the cash basis was generally supported by the accounting profession to allow those businesses with the most straight forward affairs to spend less time preparing accounts and more time pursuing their business endeavours. The Faculty continues to share this view and believes that this is the primary benefit to retaining the option of preparing tax computations on a cash basis.
14. Alignment of the turnover threshold with the VAT cash accounting scheme would also provide an element of simplification for those businesses with annual turnover around this threshold as they would only have one threshold amount to consider and would ensure that a consistent approach was taken to accounting under the two different taxes. We therefore support extension of the turnover threshold to this level so that it is available to be used by those businesses which do not need the information provided by accruals-based accounts.
15. However, we continue to be of the view that the cash basis is unlikely to be appropriate for businesses with turnover in excess of the VAT cash accounting threshold and therefore would not support removing the turnover threshold entirely.
16. It is also worth remembering that the cash basis of accounting is much more susceptible to manipulation than the accruals basis such as through businesses deferring cash receipts or accelerating cash payments. Accruals accounting also almost inevitably forces a bank reconciliation which acts as a check on whether cash in and out records are accurate. HMRC's stated aim in introducing MTD ITSA is to promote better accounting record keeping and so should bear this mind when considering whether to open up the cash basis to more businesses.

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?

17. The need to swich in and out of regimes would certainly be disruptive for businesses, especially where they need to apply transitional adjustments and may therefore dissuade them from joining the cash basis. Increasing the turnover threshold reduces the number of businesses affected by this.

CASH BASIS DEFAULT

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?

18. Some of the potential reasons why eligible businesses are not electing into the cash basis include:
    - They would prefer to prepare accruals-based accounts - this could be because they consider this to be good practice and achieves a more accurate position of their financial affairs, or they are required to prepare them for other parties, such as banks and other financial institutions.
    - They are using cash accounting but not electing to do so because they don't understand the difference between this and accruals accounting or they forget to make the election.

- They have simple tax affairs and so their cash basis accounts and their accruals basis accounts would produce the same result and it is therefore irrelevant whether they elect into the cash basis or not.
- While meeting the turnover threshold, some businesses are deterred from using the cash basis due to the restriction it places on their ability to deduct interest costs or claim loss relief.
- Accruals based accounting gives much better management information. It facilitates the identification of seasonal and non-seasonal business trends; and is often required by external lenders or investors.

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?

19. Setting the cash basis as the default might send a message (rightly or wrongly) that the government considers cash accounting to be sufficient in determining a fair and accurate result for taxable profits. This might then lead to a fall in the discipline of some businesses to maintain accurate accounting records because the cash in/out position is not checked through the process of determining accruals. For that reason, we are of the view that cash accounting should remain an option that needs to be elected into, except perhaps for the smallest of businesses (eg those with annual turnover not exceeding £30,000).
20. As some businesses may already be using a cash basis of accounting for income tax (without electing to do so), the impact for them would be to make them compliant with the tax rules.

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?

21. All transitional adjustments required on entering the cash basis (having previously applied the accruals basis) are sensible and seek to ensure that no amounts are taxed or relieved twice. As such, it is hard to see how these transitional adjustments can be avoided without producing an unfair tax result (for the taxpayer or HMRC).

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

22. The only population we consider would require significant help with the transition to the cash basis would be those who currently use an accountant to prepare their results and on transitioning to the cash basis, decide to prepare their own accounts going forwards to save money, for example. If a business is already preparing accruals accounts, a cash version can only be simpler, though there may be some complications with transitioning from one version to the other.

INTEREST RESTRICTION

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?

23. Evidence we have received from members suggests that the restriction on finance costs is not a significant factor in determining whether to use the cash basis. If it were a factor, then any affected business owner would want the limit to be set at a rate more than its own finance costs.

24. The most appropriate level is largely determined by the size of business the government would like to have the cash basis available for. We have estimated that a cost limit of £500 is equivalent to £8,000 of third-party borrowing. Doubling the limit to £1,000 would still not support a sizeable borrowing amount for businesses with turnover more than £150,000. If the government is concerned that the finance cost restriction is discouraging businesses from using the cash basis, it should consider removing the restriction altogether.

25. There also does not seem to be a logic in having a limit if the issue that the rules are trying to address is mixed personal and business use as this is surely a problem under accruals basis accounting too.

Question 3b: To what extent would increasing the interest restriction in the cash basis influence 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?

26. As mentioned above, we do not believe that the interest restriction has historically been a significant impact on the decision for many businesses to use an accruals basis of accounting. Most will do so for other reasons eg to meet the requirements of their bank or other lender. However, now that UK interest rates are significantly higher than they were when the cash basis was introduced, the restriction could have a much bigger impact on whether the accruals basis is used.

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?

27. We are sceptical about the possibility that businesses are holding back on obtaining more finance because they are not able to claim the cost of deductions under the cash basis. We believe that most businesses would obtain the amount of financing they need and are able to obtain from third parties. If the inability to claim the interest costs associated with this finance is having a material effect, we would expect such businesses to move out of the cash basis and obtain the tax deductions available. Transitioning to the accruals basis can be challenging and complex for some businesses and so allowing such businesses to stay within the cash basis and claim the deductions they would not otherwise be entitled to constitutes a simplification of the tax system.

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?

28. The main situation in which a maximum flat rate interest deduction might be advantageous is where the taxpayer makes both business and personal use of a loan facility, and it is difficult to split out those two elements in determining the proportion of the cost that is allowable for tax purposes. Hence, users could have the choice of deducting their actual business finance cost or claiming the flat rate deduction where this is easier.

LOSS RESTRICTIONS

Question 4a: Would removing or relaxing the cash basis trade loss relief restrictions influence whether businesses with losses choose to use the cash basis?

29. We believe that this potential change would have a significant impact on businesses choosing to use the cash basis. Especially in the early years of trading, small business owners frequently make losses that they could not off-set against other income were they to use the cash basis. Often these business owners are continuing to work part-time in an employed position and therefore have other income against which the losses could be set.

Question 4b: Is the burden of moving out of, and then back into, the cash basis to claim sideways loss relief currently influencing businesses' decisions to use the cash basis?

30. It can be complex and confusing to switch between different modes of accounting from one year to the next and transitional adjustments may be required. For these reasons, businesses typically tend to stick to one method of tax accounting. If they expect to oscillate between being in a profit and loss position, they will probably opt out of the cash basis to avoid this.

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?

31. Yes, we believe that this accounts for a significant proportion of loss-making businesses that would otherwise adopt the cash basis were the loss relief restrictions not in place.

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?

32. Removing all restrictions on the use of losses under the cash basis would make the biggest impact in simplifying the tax system and making this basis available to the widest group of businesses. If HMRC is concerned about abuse of loss reliefs, it should be remembered that s24A 2007 is still in place to restrict sideways relief in all cases to the higher of £50,000 and 25% of adjusted total income each year.

INTERACTIONS AND OTHER IMPROVEMENTS TO THE CASH BASIS

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?

33. The main impact we would like to see avoided is a complete removal of the turnover restriction and reverting to make cash basis the default. As all but the smallest businesses (eg those with turnover below £30,000) are likely to need accruals-based accounts for other purposes, this would mean they would need to produce two sets of accounts, unless they opted out of the cash basis.

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?

34. We are not aware of any specific advantages for having an end of year adjustment for stock. If adjusting for stock would give a more accurate reflection of the business' financial position, we cannot see why adjustments for prepayments and accruals wouldn't also be useful.

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?

35. It is likely that a large proportion of the smallest businesses (if they don't engage an accountant) will be using cash accounting by default, either because they don't have any pre-payments or accruals or because they aren't aware that such adjustments are necessary. It would be useful to educate such taxpayers that they ought to be electing into the cash basis. This would probably be most effective to include in communications with taxpayers in the early period of their business eg as soon as they have registered for self-employment. A

guide could be developed which sets out the differences between cash and accruals accounting and the implications of choosing one over the other.

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?

36. For simplification purposes, it makes sense for the cash basis rules for trades and landlords to be aligned as much as possible. We do not see a problem with the cash basis being the default for property businesses (and not for trades) because most property businesses have receipts below the current turnover threshold for trades. In addition, the accounts for property businesses tend to be more straightforward than for trading businesses as the rental income tends to be fixed month-on-month and there is less variety in expenses. As such, the cash basis seems more appropriate for property businesses than trading businesses.

37. Two particular areas where the rules could be aligned are as follows:

- Allowing loss relief under both the property and the trade cash basis
- Finance costs- the current rules around deductibility of loan interest on rental properties are complex and could be moved to a simpler regime based on the proportion of the loan taken out for property business purposes.

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?

38. There is no reason, in principle, why the proposed changes should not also apply to partnerships. There are specific rules which restrict the tax relief available for losses derived from partnerships which should address any avoidance concerns the government may have.

39. However, the cash basis is unlikely to be suitable to the largest of unincorporated businesses (which will predominately be partnerships) and so we recommend further consultation could consider whether extending the existing turnover threshold beyond its existing limit is appropriate.

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

40. Adopting the cash basis could give some businesses less incentive to use sophisticated software to calculate their taxable profit and report it to HMRC. Such businesses my therefore be less prepared for MTD ITSA, although if they were already carrying out accruals accounting, they may continue using pre-existing software. If HMRC wishes to encourage uptake of MTD ITSA, it should perhaps focus more on ensuring that cheap and easy-to-use software options are available that would apply whether the business uses cash or accruals accounting.

41. As a result of basis period reform, for businesses with accounting years that do not correspond to the tax year, the method of calculating taxable profits will be different to those for making quarterly reports under MTD ITSA. For the former, this will be a pro-rata of the results over two different accounting periods whereas for MTD ITSA this is based on the cash transactions carried out in each quarter of the tax year.

42. However, moving to the cash basis would reduce the number of end-of-year adjustments required to reconcile the quarterly report results to the accounting result. Therefore, businesses that have an accounting year end between 31 March and 5 April may find the cash basis useful.

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?

43. We do not think that the cash basis should be promoted as a preferred system of reporting just to support MTD ITSA but rather that MTD ITSA should be designed to support the most appropriate choice of accounts preparation for any business. MTD ITSA as currently designed, is struggling with year-end adjustments and where/how to make these. This MTD ITSA problem would be resolved for many businesses if they adopt the cash basis but would leave many businesses with less informative accounts.

44. As above, if a business has a 31 March – 5 April year end the removal of end of year adjustments would mean that the quarterly reports required under MTD for ITSA should provide the taxable result for the year. However, this does not apply for every business, and it is not clear yet when, or if, businesses with a turnover below £30,000 will be required to adopt MTD for ITSA (which are the businesses which are most likely to use the cash basis).

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see https://goo.gl/x6UjJ5).