Simpler Income Tax for the Simplest Small Businesses
Technical Note

Technical Note
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Contents

Foreword

The Government has announced the introduction of a couple of simpler income tax measures for small businesses. From the 2013/14 tax year self employed individuals or partnerships carrying on the smallest trading businesses will be able to choose to be taxed on the basis of receipts less payments. All unincorporated businesses will be able to use simpler rules for some business expenses.

This technical note accompanies draft clauses and explanatory notes published today 28 March 2013 and replaces the Technical Note issued on 11 December 2012.

This note provides an overview of the legislation and, in broad terms, describes how the policy objectives are delivered by the legislation.

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Chapter 1: Introduction

Purpose of the simpler income tax - cash basis and simplified expenses

1. The Government wants to make it easier for the smallest businesses, whether self-employed sole traders or those in partnership with other individuals, to calculate their taxable income as well as providing them with more certainty over their tax affairs.

An overview of the cash basis

2. The cash basis is a simpler tax system designed for unincorporated businesses which do not need or want to prepare accruals accounts for business purposes. Small businesses using the cash basis will be taxed on their receipts less payments of allowable expenses rather than being asked to spend their time making accounting adjustments and doing other calculations designed for larger or more complex businesses. However, it will not be appropriate for every small business.

3. The key aspects of the cash basis are that:

- it is an optional scheme which small unincorporated businesses can choose to use

- businesses can enter the cash basis if their receipts for the year do not exceed the amount of the VAT registration threshold (currently £79,000) or twice that (currently £158,000) for recipients of Universal Credit. Businesses must leave the cash basis after their receipts exceed twice the amount of the VAT registration threshold (currently £158,000)

- businesses can leave the cash basis if their commercial circumstances change such that it is no longer appropriate for them

- it will work on a cash flow basis. For income, it's what the business receives, when it is received; for outgoings it's what the business pays, when it pays it. Income includes all means of payment be it cash, card, cheque, or any other form of payment

- a business' income includes all amounts received in connection with the business including those from the disposal of non-durable assets, for example plant and machinery.

- allowable expenses must be amounts paid wholly and exclusively for the purposes of the trade, including for non-durable assets. Generally, it will no longer be necessary to calculate and claim capital allowances. Interest payments are also allowed up to a limit of £500

- business losses may be carried forward to set against the profits of future years but cannot be carried back or set off ‘sideways’ against other sources of income

- rules on entering or leaving the cash basis are intended to ensure that income is taxed once and once only and expenses are relieved once and once only.

An overview of simplified expenses

4. Simplified expenses are easier to follow rules that can be used when calculating some business expenses. These simplified expenses are all optional. They are:

- fixed allowances for business mileage (rather than deductions for actual expenditure on purchasing, maintaining and running a motor vehicle or motor cycle, apportioned between business and private use)

- a flat rate to calculate expenses relating to business use of home (rather than deductions for actual amounts, apportioned between business and private use)

- a 3 tier banded rate to calculate the adjustment for private use of business premises (rather than deductions for actual amounts, apportioned between business and private use)

5. Simplified expenses can be used by any unincorporated business whether or not they have also chosen to use the cash basis.

Draft legislative structure of the cash basis

6. Legislation will be introduced in Finance Bill 2013 to amend the Income Tax (Trading and Other Income) Act (ITTOIA) 2005 to allow for a cash basis for small businesses and simplified expenses.

7. These amendments comprise:

- a new chapter 3A: Trade Profits: Cash Basis for ITTOIA 2005

- amendments and additions to existing legislation to provide for the operation of the cash basis and simplified expenses

- a new chapter 5A: Trade Profits: Flat-Rate Deductions for ITTOIA 2005

- consequential amendments and transitional arrangements for entering and leaving the cash basis.

Chapter 2: Simpler Income Tax - the cash basis

Introduction

1. The draft legislation provides the necessary legislative framework for the cash basis by making amendments to existing rules and inserting some additional sections.

Eligibility

2. The key principles determining eligibility are:

- the cash basis is optional. Once in the cash basis businesses will remain in it unless their circumstances change such that it is no longer appropriate for them, in which case they can choose use the accruals basis instead
- businesses can enter the cash basis if their business receipts for the year do not exceed the VAT registration threshold (currently £79,000)
- Universal Credit recipients can enter the cash basis if their business receipts for the year do not exceed twice the amount of the VAT registration threshold (currently £158,000)
- all businesses must leave the cash basis the year after their business receipts for a year exceed twice the amount of the VAT threshold (currently £158,000), unless receipts in that later year fall back below the entry limits
- the existing cash basis arrangements for barristers will be withdrawn, except for barristers using the current special rules for the 2012/13 tax year.

3. **The cash basis is an optional regime**: the rules that provide for the election are in section 25A. This allows an eligible business to elect to calculate its taxable profits on the cash basis instead of in accordance with generally accepted accountancy practice.

4. In practical terms an “election” will be made in the tax return when it is filed. From 2013/14 onwards it is anticipated that a ‘cash basis’ tick box will be added to Self Assessment tax returns.

5. The existing cash basis for barristers (section 25(3) of ITTOIA 2005) is being replaced with the more general option for businesses to use the cash basis, as set out in Chapter 25A of the draft legislation. (Though, the existing special rules for barristers will continue for those barristers who use the current special rules for the 2012/13 tax year).

6. In the case of a partnership the election for the cash basis must be made by the person responsible for making the partnership return (such as a nominated partner).

7. Section 31A introduces four conditions relating to:

- receipts limits
- what to do if there is more than one business to take into account
- specific exclusions from the cash basis
- accounting dates and basis periods.

8. **The receipts limits for using the cash basis**: The legislation refers to the receipts limits in terms of the 'relevant maximum' for a tax year. They are:

- for those joining the cash basis, the amount of the VAT registration threshold (currently £79,000)
- for those in receipt of Universal Credit (who must use the cash basis for income assessment for UC), twice the amount of the VAT registration threshold (currently £158,000).

9. In subsequent years businesses can continue in the cash basis even though they exceed these limits, but once their receipts exceed twice the amount of the VAT registration threshold (currently £158,000) then for the following year the business must stop using the cash basis and start using the ordinary rules (unless receipts in that later year fall below the entry limits).

10. **Leaving the cash basis**: section 31D provides that a business can leave the cash basis if it has a change in commercial circumstances which means that the cash basis is no longer appropriate for it. Examples of such changes include a business that is expanding and wishes to claim more than £500 interest deductions, a business that wishes to claim "sideways" loss relief or a business that decides to register for VAT.

11. **More than one business to take into account**: section 31A provides that a cash basis election applies to all the businesses carried on by a person in the year for which an election is made. So, for example, if two separate trades are carried on in parallel during the year it is the combined receipts of the two trades that needs to be considered when applying the eligibility test.

12. **Specific exclusions from the cash basis**: limited companies are excluded from the cash basis by virtue of the legislation being contained in ITTOIA 2005 only. Section 31C provides the rules on which specific persons are excluded from using the cash basis. They are:

- limited liability partnerships
- Lloyd's underwriters
- businesses with a current herd basis election
- persons with a section 221 ITTOIA profit averaging election
- businesses that have claimed business premises renovation allowance
- businesses that carry on a mineral extraction trade

- businesses that have claimed research and development allowance.

13. Additionally, section 148K provides that the rules concerning the tax treatment of some specific trades are also disapplied. These are:

- dealers in securities
- relief for mineral royalties
- lease premiums
- ministers of religion
- pool betting duty
- intermediaries treated as making employment payments
- managed service companies
- waste disposal
- cemeteries and crematoria.

Taxable cash basis profit

14. The rule for determining taxable profit under the cash basis is in section 31E. This provides that the taxable business profits under the cash basis are the total amount of receipts less the total payments of allowable expenses, subject to adjustments required or allowed by tax law.

Tax Year

15. The cash basis does not change the date that businesses will able to make their books up to for a tax year.

VAT

16. The cash basis does not change the way a business should account for VAT. If you are registered for VAT you may enter details of your business income and expenses either:

- excluding VAT (that is, with the VAT taken off), or
- including VAT. If you choose to include the VAT in your income and expenses totals then you will also need to include your net VAT payments to HMRC as an expense and your net VAT repayments from HMRC in your receipts.

NICs

17. Profits calculated under the cash basis constitute profits used to calculate NICs.

Capital Gains Tax

18. Section 47A of TCGA 1992 provides that for a disposal of business assets while in the cash basis, the disposal does not give rise to a chargeable gain or allowable loss.

19. Section 47B TCGA 1992 provides that for disposals after leaving the cash basis, capital gains tax rules to apply as though the expenditure had qualified for capital allowances.

Receipts

20. The key principles are that:

- receipts include all amounts received in connection with the business, when they are received
- amounts received include those from the disposal of assets that would give rise to an allowable deduction when acquired in the cash basis
- receipts include all forms of payment be it cash, card, cheques and ‘payments in kind’ as well as monetary receipts
- additions will be required to be made in respect of non-commercial transactions.

21. **Specific types of receipt**: receipts under the cash basis include amounts received for selling or leasing capital assets or rights. Additionally, on cessation of a trade while in the cash basis, the value of trading stock and work in progress are counted as receipts of the business.

22. Capital receipts: section 96A provides the rules concerning capital receipts in the cash basis and confirms that the following receipts are included:

- proceeds from the disposal of any asset that was, or would have given rise to, an allowable deduction in the cash basis
- grant of any right or any interest in the asset
- receipt of any amount in respect of damages or insurance claims in respect of assets.

23. Subsection (3) provides for an adjustment when only part of the expenditure incurred in acquiring, creating or improving an asset has been brought into account.

24. Subsections (4)–(7) provide the rules to be used when the non-business use of assets changes that a relevant proportion of the asset’s market value must be taken into account in computing profits. The intention is to make reasonable adjustments when the use of assets changes materially.

25. Section 97A provides that when trade ceases the value of the trading stock is included as a receipt, and section 97B does the same for work in progress.

26. Section 106C provides that just and reasonable additions must be made in respect of non-commercial transactions, if other specific provisions referenced in sections 106D-E do not deal with the transaction.

27. **Changes in trading stock:** section 172AA provides that the adjustments to trading stock taken for own use (*'Sharkey v Wernher'*) in Chapter 11A ITTOIA 2005 are disapplied in calculating the profits of a trade on the cash basis.

28. The intention is to simplify the treatment of stock taken for own use by small businesses using the cash basis. Current rules require stock taken for own use to be valued at market value, which may be more than was paid for the stock, and this places a burden on businesses both to determine a market value and make an adjustment.

Expenses

29. The key principles are that:

- expenses are only allowable when they are paid
- allowable payments are those made wholly and exclusively for the purposes of the trade (including capital expenditure on non-durable assets such as plant and machinery), subject to a small number of specific rules and exceptions (for example if motoring expenses are calculated using the simplified expenses mileage rate)
- motoring expenses for motor cycles and goods vehicles may be calculated using either actual expenditure or the simplified expense mileage rates
- motoring expenses for cars can be calculated using either existing Capital Allowances rules and actual expenditure or the simplified expenses mileage rates
- interest on cash borrowing is only allowable up to £500. It is not necessary to establish that the borrowing is financing capital employed in the business because it is not a condition of this deduction that the interest is wholly and exclusively for business purposes.

30. Section 32A prevents existing sections of ITTOIA 2005 from applying under the cash basis, to ensure that particular deductions that do not reflect payments and receipts are excluded from the cash basis:

- section 33 capital expenditure
- section 35 bad and doubtful debts

- sections 36 & 37 unpaid remuneration
- section 43 employee benefit contributions
- sections 48-50B car hire.

31. **Capital expenditure excluding cars**: section 33A provides for the treatment of capital expenditure in the cash basis. The general proposition is that expenditure on assets used in a business is an allowable deduction in the cash basis where for the purchase or improvement of assets that would be qualifying expenditure within Part 2 of CAA 2001 (Plant and machinery allowances).

32. **Capital Expenditure on Cars:** motoring expenditure on cars can be calculated using existing Capital Allowances rules and expenditure on actual running costs or, alternatively, the mileage rate can be used.

33. **Loan interest:** in order to reduce complexity for businesses, section 57B provides that interest is allowable up to £500. This allows modest amounts of interest to be deducted without, for example, having to establish that the borrowing is financing capital employed in the business.

34. The general rule is in section 51A which provides that, apart from section 57B, no deduction is allowed for interest paid on a loan. The intention is to allow the interest components of purchase costs where the purchase cost is allowable, such as the interest element of hire purchase, but not to allow the interest costs on cash borrowing.

Losses

35. The key principle is that:

- negative results (losses) under the cash basis can only be carried forward to the next year.

36. This is provided for by section 74E in Income Tax Act 2007. ‘Sideways’ loss relief against other income, including the carry back of losses to the previous year, or capital gains relief is not allowed under the cash basis.

Chapter 3: Simplified expenses

Introduction

1. The draft legislation includes three types of simplified expenses: expenditure on motor vehicles, use of home for business purposes, and premises used for both home and for business purposes.

2. The key principles underlying the simplified expenses are that:

- these types of allowable expenses may be calculated using a simple flat rate allowance, rather than a potentially complex apportionment of actual expenditure
- they are entirely optional for those using the cash basis and for those outside the cash basis.

Expenditure on motor vehicles

3. The primary rule for vehicles is in section 94D. The business may use the appropriate mileage amount to calculate the allowable expenditure for each vehicle and cannot make any other deductions in respect of such vehicles.

4. **Excluded vehicles**: section 94E provides that a business cannot use the mileage rate for a vehicle if:

- it has previously claimed capital allowances in respect of that vehicle
- it is a goods vehicle or a motorcycle and any expenditure incurred on acquiring the vehicle has been deducted in calculating profits under the cash basis.

5. The mileage rate calculation is set out in section 94F along with the rates and associated definitions. The deduction is calculated as follows:

- Number of business miles x rate for the vehicle

6. The rates are as follows:

- for cars 45p per mile for the first 10,000 miles, 25p per mile after that
- for motor cycles 24p per mile.

7. Vehicle definitions are set out in section 94G.

8. The intention is that business have the following options for the vehicles that they use:

- **Cars**: businesses may use the mileage rate for cars, or alternatively may use the existing capital allowances rules and actual expenditure. If a business has previously claimed capital allowances on a car then it must continue to do so and cannot use the mileage rate for that particular vehicle

- **Goods vehicles and motorcycles**: businesses may use the mileage rate, or alternatively may claim the full purchase cost as a deduction and actual running costs. If a business has previously claimed capital allowances on a motorcycle or goods vehicle then it must claim actual expenditure and cannot use the mileage rate.

Use of home for business purposes

9. Businesses that use the home for business purposes can opt to use a standard deduction based on the amount of time spent working at home.

10. The amount allowable per month is set out in section 94H and is as follows:

• 25-50 hours per month	£10
• 51-100 hours per month	£18
• 101 hours or more per month	£26

11. Alternatively businesses can choose to claim any allowable portion of actual expenses.

Premises used both as a home and for the business

12. Where business premises are used partly for private purposes as a home an adjustment can be made based on the number of occupants using the premises as a home each month. This adjustment is subtracted from actual expenses so that personal costs are excluded.

13. Section 94I provides the necessary conditions. It also sets out the way the adjustment is calculated each month, which is as follows:

• 1 occupant	£350 per month
• 2 occupants	£500 per month
• 3 or more occupants	£650 per month

14. Alternatively businesses can choose to identify the allowable portion of actual costs if they prefer.

Chapter 4: Transitional rules

Introduction

1. The draft legislation provides the necessary legislative framework for transitional rules by providing amendments to existing rules and some additional sections.

2. The key principles underlying the transitional rules are that

- receipts are taxed once and once only
- payments are deducted once and once only
- adjustment income can be spread over the each of the 6 tax years beginning with the year a business leaves the cash basis.

3. **Adjustment income**: section 227A confirms that chapter 17 (adjustment income) of ITTOIA applies to the cash basis. This ensures that no receipt is taxed twice or not at all, and that no allowable payment is deducted twice or not at all.

Entering the cash basis

4. **Capital Expenditure**: chapter 17A provides for the treatment of assets and adjustments for Capital Allowances.

5. Section 240C confirms that when entering the cash basis the amount of unrelieved qualifying expenditure carried forward from the previous basis period is allowable as a deduction under the cash basis. Section 240D restricts this allowable deduction to the amount actually paid.

6. Section 38ZA provides that where mileage rate allowances have been claimed, any expenditure incurred in respect of a vehicle is not qualifying expenditure.

7. Section 240E applies where an election has been made under the Capital Allowances legislation. It determines the amount of unrelieved qualifying expenditure allowable where a successor acquires a business from a connected person.

Leaving the cash basis

8. **Spreading**: section 239A provides that when leaving the cash basis any adjustment income can be spread over each of the 6 tax years beginning with the year a business leaves the cash basis, 1/6th being treated as arising and charged to tax in each year.

9. Section 239B allows a person to accelerate the charge under section 239A.

10. **Capital Expenditure:** section 66A provides that on leaving the cash basis any unrelieved qualifying expenditure can be allocated to a new capital allowances pool in the subsequent chargeable period.

11. The intention is that where an asset has been acquired but has not been fully paid for, such as under a hire purchase arrangement, the amount still unpaid can be allocated to an appropriate pool when leaving the cash basis.