HM Revenue & Customs

Simplifying tax for unincorporated businesses

Consultation document
Publication date: 15 August 2016
Closing date for comments: 7 November 2016

Subject of this consultation:	At Budget 2016, the government announced that it would explore options to simplify the tax rules for businesses, self-employed people and landlords. This consultation covers four discrete areas of simplifying tax paid by unincorporated businesses: extending the cash basis; reforming basis periods; simplifying reporting requirements; and re-examining the capital/revenue divide within the cash basis.
Scope of this consultation:	The government has developed propositions for change in a number of areas, and is seeking views to inform the detailed policy design.
Who should read this:	We would like to hear from unincorporated businesses and their advisers and representative bodies.
Duration:	The consultation will run for 12 weeks from 15 August 2016 to 7 November 2016.
Lead officials:	James Ewington and Sean Rath, HMRC
How to respond or enquire about this consultation:	Any queries about this consultation should be directed to James Ewington or Sean Rath, on 03000 553788 or by email to businessincometaxsimplification.consultation@hmrc.gsi.gov.uk. You may provide responses by email, or by post to the following address: HM Revenue and Customs Business Income Tax Consultation Small Business Team Room 3/64 100 Parliament Street London SW1A 2BQ
Additional ways to be involved:	HMRC officials are willing to meet with interested parties to discuss any aspect of this consultation and will be organising stakeholder events following publication. Written responses will be accepted until 7 November 2016.
After the consultation:	The government will consider whether to publish a summary of responses alongside any decision on these options, which will be announced at Autumn Statement, accompanied by draft legislation for Finance Bill 2017.
Getting to this stage:	The government announced at Budget 2016 that it would consult on a number of simplification measures to support and enable regular reporting under Making Tax Digital for Business, the transformational digital programme which will take effect from 2018/19 onwards.
Previous engagement:	This consultation represents the first engagement with external stakeholders on these issues but builds on previous engagement with industry around simplification measures such as the cash basis.

Contents

1	Executive summary	4
2	Increasing the entry threshold for the cash basis	6
3	Reforming basis periods	10
4	Simplified reporting	17
5	Reforming the capital/revenue divide within the cash basis	21
6	Assessment of impacts	24
7	Summary of consultation questions	26
8	The consultation process: how to respond	28
Annex A	Basis period rules	30
Annex B	Relevant (current) government legislation	33
Annex C	Reforming the capital/revenue divide: Draft legislation and explanatory note	34

On request this document can be produced in Welsh and alternative formats including large print, audio and Braille formats

1. Executive summary

1.1 During this Parliament, HMRC will make fundamental changes to the way the tax system works – transforming the administration of tax so it is more effective, more efficient, and easier for taxpayers to use. The government is also committed to simplifying tax, making it easier for businesses to comply with their reporting obligations and deliver accurate information to HMRC and providing tools to allow them to budget for their tax bills and manage their cash flow. Making Tax Digital is at the heart of these reforms, which will see the introduction of simple, secure and personalised digital tax accounts for businesses and individuals.

1.2 There is still a lot to design and develop before 2020 and it is important for us to do this hand in hand with our customers and those impacted by these changes, to hear their views and concerns and to work with them to understand how we can make these changes work for everyone. We want to design the tax administration around the people it affects and we welcome your input about how we can best achieve that. To this end we have launched a package of which this is one. To see the others, please go to MTD consultations.

1.3 As part of these changes, the government announced at Budget 2016 that it would explore options to simplify the tax rules for businesses, focusing particularly on the self-employed and those with the most straightforward tax affairs.

1.3 This consultation opens up discussion of a package of options intended to reduce reporting burdens on business and facilitate the introduction of Making Tax Digital. These proposals respond to representation made by small businesses and their representatives. They should also make it easier for businesses to capture a real-time view of their profitability.

1.4 Increasing the turnover **threshold for the cash basis** (Chapter 2) will give more businesses access to a simpler reporting framework, making it easier for them to provide information and get a real-time overview of their tax affairs. As the Office for Tax Simplification has commented, cash basis is a natural fit with Making Tax Digital. Over one million businesses already benefit and this would allow more to be eligible.

1.5 **Reforms to basis periods** for the self-employed (Chapter 3) will simplify computational rules, removing complexity when these sole traders start up in business or change their accounting dates, and providing flexibility to allow their accounting date to fit with other reporting obligations and individual preferences. Individuals will have the freedom to choose – if they wish – to align tax accounting periods with monthly reporting obligations such as Universal Credit income assessment periods. If they wish to treat each period for which they update their tax affairs to HMRC under Making Tax Digital as a separate tax accounting period, they will be free to do so and there will be no need for a further annual process. Those who wish to remain on an annual accounting period for tax may continue to do so.

1.6 **Simplifying reporting requirements** (Chapter 4) will offer small businesses options to reduce their reporting requirements, potentially eliminating complex accounting adjustments required at period ends and making a more frequent reporting framework less work. For example, a shop which values its stock at the end of the year will not have to value its stock more frequently for Making Tax Digital.

1.7 Modifying **the capital revenue divide within the cash basis** (Chapter 5) will simplify the rules for reporting capital and revenue expenditure. It will reduce complexity - assets which are bought for use in the business and which lose their value over time, for example a computer, furniture or protective clothing, will, as now, qualify for immediate up front tax relief. The effect of the proposed change will be that businesses do not need to decide whether or not these are capital items. This will make it easier to categorise expenditure under Making Tax Digital.

1.8 Together, the changes will simplify the reporting requirements for small businesses and help Making Tax Digital easier to use for more customers. This will reduce administrative burdens on business, freeing up more time for business owners to concentrate on running their business.

1.9 The government welcomes responses from all interested parties on any aspect of these simplifications, to ensure that they can be delivered in the most effective and appropriate way.

1.10 This consultation should be read alongside other related consultations on Making Tax Digital: Bringing business tax into the digital age and Business Income Tax: Simplified cash basis for unincorporated property businesses.

2 Increasing the entry threshold for the cash basis

Background

2.1 Cash basis accounting ('the cash basis') is a simplified method for calculating taxable profits for trading businesses (as opposed to investment and property businesses) with straightforward tax affairs[1]. The cash basis requires businesses only to keep records of their income and expenditure, whereas the records required for accruals accounting include the accounting records showing how they arrive at their income and expenditure figures. Cash accounts are therefore simpler to prepare and work better with Making Tax Digital as there are fewer adjustments to make and they may give a clearer picture of tax to be paid.

2.2 With the exception of businesses listed in paragraph 2.5 below, businesses may choose to start using the cash basis if their turnover is below the VAT threshold (currently £83,000). The cash basis was introduced from April 2013 and has proved very popular with over 1 million small businesses choosing to report to HMRC on this basis.

2.3 This popularity has led to calls from stakeholders for an increase to the turnover threshold. This section of the consultation explores the case for such a change, and asks you to comment on a suitable threshold.

2.4 Any decisions on expanding the cash basis will need to be taken in light of overall government finances to ensure the reform is both affordable and sustainable. Giving businesses the option to use the cash basis has an impact on government's tax receipts because it allows certain expenditure to be offset against income earlier. More detail on possible options, and associated costs, is set out later in this Chapter.

Cash basis: an outline

2.5 Currently, the cash basis can be used to report business income to HMRC by:

- unincorporated businesses and partnerships (except limited liability partnerships and partnerships where there is a member who is not an individual) with trading income below the VAT threshold, and
- self-employed Universal Credit claimants with business income up to twice the VAT threshold.

A business cannot use the cash basis if its receipts exceed double the VAT threshold (currently £166,000) in any tax year. Companies, limited liability partnerships,

---

[1] The legislation for cash basis accounting is in Part 2 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005), with detailed guidance in HMRC Business Income Manual (BIM) 70005 to 700075 http://www.hmrc.gov.uk/manuals/bimmanual/BIM70000.htm

partnerships where there is a member who is not an individual, and some other small businesses are excluded from using the cash basis[2].

2.6 Eligible businesses are allowed to account for their trading income when income is received and to account for expenses when payment is made within the period of account. Businesses using the cash basis do not need to prepare detailed profit and loss accounts as there will be no need to apportion income or expenses between different accounting periods.

2.7 Certain capital expenditure, such as plant and machinery used for business purposes, is taken into account in calculating the taxable profits of a business using the cash basis.

2.8 There are also transitional provisions available for businesses using the accruals basis (accounting for income and expenses when earned and incurred) who switch to the cash basis the following tax year or vice versa, to ensure accurate tax treatment of income, expenses and assets.

2.9 Unincorporated businesses also have the option of using a flat rate to calculate their motoring expenses, use of home for business, and use of business premises for private use.[3] These 'simplified expenses' rules are not considered by this consultation.

Rationale for change

2.10 The original cash basis entry threshold was set by reference to the VAT registration threshold (currently £83,000) ensuring consistency across taxes and reducing complexity for businesses. This threshold is reviewed annually and has been increased by more than inflation.

2.11 However, the popularity of the cash basis has led to calls for its expansion, including to larger businesses. The government is also consulting separately on a proposal to expand the cash basis to property businesses.

2.12 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. However, the government is considering the case for increasing the cash basis entry threshold to allow more small businesses to benefit from the simplification.

2.13 In addition, the government is committed to simplifying the tax system and making it easier for taxpayers to fulfil their tax obligations. By 2018, Making Tax Digital will

---

[2] The full list of those excluded from using the scheme is set out at Part 2 of the Income Tax (Trading and Other Income) Act 2005, Para 31C, and BIM 70010.

[3] A simpler way of calculating some business expenses was introduced by Schedule 5 of the Finance Act 2013.

transform the ways in which unincorporated businesses can interact with HMRC. More frequent updating of their tax affairs will mean businesses are better able to forecast their tax liabilities and plan ahead.

2.14 The government believes that regular updates will align more easily with the cash basis accounting method. Businesses who account this way will simply enter the details of their income and expenses as they actually receive payment or pay for an expense, throughout the period covered by their update to HMRC. While businesses with annual turnover below £10,000 will not be mandated to keep their business records digitally or provide regular updates to HMRC, they will continue to be able to use the cash basis. Details about quarterly updates can be found in the Making tax digital: Bringing business tax into the digital age consultation.

Options for change

2.15 Any decisions on expanding the cash basis will need to be taken in light of overall government finances, as the reform must be both affordable and sustainable. Giving businesses the option to use the cash basis carries Exchequer cost, because it accelerates access to relief for certain expenditure.

2.16 With this caveat, the government is prepared to consider constructive suggestions for appropriate thresholds.

2.17 The number of additional eligible businesses for a range of thresholds are:

Threshold	Number of additional eligible businesses
£100,000	65,000
£125,000	120,000
£150,000	155,000
Double the VAT threshold (£166,000)	175,000

2.18 These options are expected to have a cumulative transitional cost to the Exchequer of about £40m to £145m depending on the threshold and final policy design. The final costing, which will be scrutinised by the Office of Budget Responsibility, will be published when the changes are finalised and formally introduced. These are cumulative transitional costs and there are no ongoing costs to government.

2.19 The government is generally of the view that the benefits of the cash basis decline with turnover as businesses with higher turnovers are more likely to have more complex tax affairs and are also more likely to require accruals accounts for other purposes.

Question 1a: What level do you consider to be an appropriate turnover entry threshold?
Question 1b: For a threshold not linked to the VAT threshold, should it be reviewed annually in the light of inflation or less frequently (please state recommended interval)?

2.20 If the cash basis entry threshold were raised significantly, there would also be a need to consider what consequential changes might be needed to other aspects of the cash basis structure.

2.21 In particular, the exit threshold – the level of turnover at which businesses are required to leave the cash basis – and the modified entry threshold for Universal Credit claimants, are both currently set at twice the entry threshold.

2.22 The higher exit threshold is intended to avoid businesses moving in and out of the cash basis if turnover fluctuates, and to allow for some business growth within the cash basis. However, an exit threshold set at twice the entry threshold could, under the options being considered above, allow businesses with a turnover of more than £300,000 to continue to use cash basis accounting.

2.23 The cash basis remains optional and businesses are able to choose to move to accruals if this becomes more appropriate. However the legislation[4] specifies that the choice to use the cash basis can only cease to have effect if there is a change in circumstances, for example where the business expands and they decide it is more appropriate to use generally accepted accountancy practice to calculate profits.

2.24 The government would propose that both the exit threshold, and the modified threshold for Universal Credit claimants, continue to be set at twice the entry threshold.

Question 2a: If the entry threshold were to be increased, do you agree that the exit threshold should continue to be set at twice the entry threshold?
Question 2b: If the entry threshold were to be increased, do you agree that the UC threshold should continue to be set at twice the entry threshold?

[4] Section 31D(a)(3) ITTOIA 2005

3 Reforming basis periods

Background: introduction of Making Tax Digital

3.1 Making Tax Digital represents transformative change in the way that businesses interact with HMRC around their tax affairs. Although the rules are being introduced on a phased basis, and the very smallest businesses will be able to choose whether or not to update HMRC quarterly and digitally, the long-term vision is for businesses to have sophisticated control of their tax affairs, enabling businesses to choose payment patterns that suit them, allow them a better understanding of their tax position and their cash flow.

3.2 In the context of this move towards increasingly real-time reporting, and more flexible, user-driven tax accounts, the complexity and inflexibility of the basis period system is outdated. Businesses should be confident that what they report to HMRC is used to provide them with an up to date view of their tax affairs, without the need for complex rules governing how their profits are allocated into tax years if they need to change accounting dates.

3.3 The structural issues with the generation of overlap taxation, particularly in the case of changes to accounting dates, mean that the current rules do not provide sufficient flexibility to fit with digital tax accounts. Businesses wishing to change their accounting date, or choose periods of account which are shorter than twelve months (for example seasonal businesses), are not well-served by the current rules.

3.4 It is also reasonable for businesses to expect that in providing more real-time information and updating their details more regularly, HMRC will in return give them an up to date view of their tax affairs.

3.5 The design of any new rules must take into account this need for flexibility and less complexity, and should make it easier for businesses to manage their own tax account.

3.6 Of course, any new system must be affordable and sustainable, and would also need to ensure that there is no gap in the taxability of business profits.

3.7 This section of the consultation considers only self-employed sole traders, and does not cover partners and partnerships.

Overview of basis period rules

3.8 When a person starts to carry on a trade, there are specific rules which govern the calculation of profits and tax due.

3.9 Individuals are free to choose an accounting date which suits their business but tax is paid for a tax year (i.e. 6 April to 5 April) and so the profits from a chosen period of account must be translated to taxable profits for a tax year.

3.10 This is achieved by use of “basis periods”. The basis period rules ensure that tax is calculated for all tax years in which the business trades, and also make sure that there are no profits which fall between years and fail to be taxed.

3.11 In order to cover a wide range of circumstances and to achieve these aims, the rules are somewhat complex. For some businesses, the rules may result in part of their profits from the first year of trade being taxed twice. These “overlap” profits are usually given tax relief when the business ceases, but this may be some years later.

3.12 The detailed rules, and a number of examples to illustrate their application, are set out in Annex A.

Options for change

3.13 The policy aim is to simplify the rules around basis periods with a view to eliminating the “overlap” period and ensuring that the rules provide sufficient flexibility to allow businesses to choose accounting periods which suit them, including periods shorter than a year.

3.14 Currently businesses account on an annual basis because this is what HMRC requires. Making Tax Digital will enable people to report more regularly, at least quarterly. The ability to choose shorter tax accounting periods will allow the option of concluding an accounting period each time they make such a report, without needing to undertake any annual process. This might suit those with relatively simple business affairs, or those who need or want to use short accounting periods for other purposes, such as Universal Credit claimants whose income is assessed monthly for the purposes of establishing entitlement to Universal Credit.

3.15 One option would be for HMRC to remove the concept of basis periods altogether. Under this scenario, a business would remain free to choose its period of account, but would be required to apportion this period to provide reports to HMRC of its taxable profit for a given tax year.

3.16 This option has complexities: it might require accounting adjustments to split profits between tax years, and in the year of introduction many businesses would need to pay tax for previous years’ profits now becoming taxable, as well as for current year profits now being taxed on a real-time basis.

3.17 In practice, HMRC believes that this would lead to many businesses adopting the tax year as their accounting year, to minimise the need for accountancy adjustments.

3.18 As an alternative, HMRC could mandate use of the tax year as the period of account for all businesses. This would eliminate overlap periods but does not provide flexibility for shorter periods of account or for businesses to choose periods which suit them better.

3.19 Both of these options are predicated on the assumption that the default reporting period remains annual. However, as discussed above, the introduction of Making Tax Digital will offer businesses significantly more visibility over their reporting, and they may wish to move to shorter periods of account to fit in with seasonal or fixed-term sources of income, for example, or to align with other reporting such as for Universal Credit.

3.20 With this in mind, HMRC has developed an option based on “accounting periods”, and this is described in further detail below.

3.21 However, constructive suggestions for alternative approaches would also be welcomed, bearing in mind the policy aim of simplification as outlined above and taking into account the Making Tax Digital reforms.

3.22 Equally, if the broad approach of using accounting periods is welcomed, then there will be further considerations which are also outlined and on which comments are invited. These include transition from the existing rules to the new rules and the proposed approach to relief for existing overlap profits.

Accounting periods: background and design

3.23 The proposed accounting periods would be similar to those used within the Corporation Tax rules[5], which define an accounting period as:

- beginning when the company starts to carry on business, or immediately after the end of the previous accounting period; and
- ending on the earliest of: 12 months from the beginning of the accounting period; an accounting date of the company; or on the date the company ceases to trade.

3.24 For the self-employed, a similar rule would open up much greater flexibility and choice over tax accounting periods, because unlike for companies – which must prepare accounts for Companies House – there may be no specific requirement to prepare annual accounts.

3.25 As such, the self-employed would be able to choose short accounting periods where this was a more appropriate fit with their circumstances. The taxable profits for a given tax year would be reached by aggregating the taxable profits for all accounting periods ending in that tax year.

3.26 Such a rule would also eliminate any overlap period (as accounting periods would not be able to overlap, and each period would only be taxed once) while ensuring that there is no gap in taxable status (as there can be no gap between accounting periods).

[5] CTA2009 Part 1, Chapter 2

Example 1: Annual accounting period

Kyle is a self-employed plumber. He starts to trade on 1 October 2015, making up his accounts to 31 December 2015 and then annually thereafter.

Year 1: Accounting period is 1 October 2015 to 31 December 2015
(2015/16)

Year 2: Accounting period is 1 January 2016 to 31 December 2016
(2016/17)

Year 3: Accounting period is 1 January 2017 to 31 December 2017
(2017/18)

Example 2: Individual B: Shorter periods of account

Bernadette is a self-employed music teacher. She teaches in schools during term time, and also over the summer holidays. Bernadette decides that it makes sense to have accounting periods which coincide with the half term dates, with a separate accounting period covering summer. The exact dates vary from year to year, but Bernadette would like to close off an accounting period at the end of each half term and then at the end of the summer holidays.

Bernadette starts to trade on 1 September 2015, and her half term end dates are as follows:

- 23 October 2015
- 18 December 2015
- 12 February 2016
- 24 March 2016
- 27 May 2016
- 20 July 2016

The summer holidays end on 2 September 2016.

Bernadette's accounting periods fall into tax years as follows:

2015/16: 1 September 2015 – 23 October 2015
24 October 2015 – 18 December 2015
19 December 2015 – 12 February 2016
13 February 2016 – 24 March 2016

2016/17: 25 March 2016 – 27 May 2016
28 May 2016 – 20 July 2016
21 July 2016 – 2 September 2016

(For 2016/17, there will be further accounting periods based on the term dates for the next academic year).

The taxable profits for these periods are aggregated to reach the overall taxable profit for the tax year in question.

3.27 As the rules would operate by reference to the definition of an accounting period, there would not be a need for a further specific rule to deal with changes in accounting date. In the example of Bernadette, she can simply end an accounting period whenever it suits her and there will be no complex rules to consider.

3.28 For some individuals, choice of accounting period would be a matter of convenience based on the way their business operates. For those who are required to make reports for other reasons (for example, for Universal Credit) these rules provide flexibility to align tax reporting. Others may choose to treat the regular updates in Making Tax Digital as the end of accounting periods.

Example 3: Judith

Judith started claiming Universal Credit on 9 January 2018 while unemployed. She then became self-employed on 9 May 2018.

As part of claiming Universal Credit, Judith has to report her income on the 8th of each month to allow her award to be calculated. Judith has therefore calculated her income for the following periods:

9 January 2018 – 8 February 2018
9 February 2018 – 8 March 2018
9 March 2018 – 8 April 2018
9 April 2018 – 8 May 2018
9 May 2018 – 8 June 2018
9 June 2018 – 8 July 2018
9 July 2018 – 8 August 2018
9 August 2018 – 8 September 2018
9 September 2018 – 8 October 2018
9 October 2018 – 8 November 2018
9 November 2018 – 8 December 2018
9 December 2018 – 8 January 2019
9 January 2019 – 8 February 2019
9 February 2019 – 8 March 2019
9 March 2019 – 8 April 2019
9 April 2019 – 8 May 2019
9 May 2019 – 8 June 2019

Under existing rules, Judith would work out how much of this income falls into his traditional accounting year, using apportionments where necessary. Basis period rules would then translate this year of profits into a tax year. However, as Judith already reports monthly, she would prefer a system that uses the information she has already calculated and which taxes what she has actually earned during the tax year.

Using accounting periods, Judith treats each individual report for Universal Credit as an accounting period, aggregating those which end in a given tax year to reach her taxable profits for that tax year. In the example above, the periods falling into 2018/19 are italicised.

3.29 The new rules would also provide flexibility where traders were reporting on a quarterly basis and wanted to set four accounting dates each year so that they can finalise each quarter without having to revisit and adjust it based on subsequent events.

Example 4: David

David is a florist. He trades on a calendar year basis, making up accounts from 1 January to 31 December each year. David uses the cash basis, calculating taxable profits based on amounts actually received and spent in the period.

Following the introduction of Making Tax Digital, David is providing quarterly updates to HMRC. To check his tax position is correct, David adds up his income and outgoings each quarter and has a good idea of his real time tax position.

Effectively, David is accounting on a quarterly basis, but the current basis period rules would make it unattractive for him to change his accounting date, and mean that tax payments often lag behind the reality of his business. Although this delays when he has to pay tax on profits, it's confusing, and David finds it hard to manage his cash flow because the timing of his payments can bear little relation to when they are earned.

David decides to have an accounting date at each quarter end. For 2020 he has four accounting periods ending 31 March, 30 June, 30 September and 31 December. The first of these falls within the 2019/20 tax year and profits from this period are added to those from previous accounting periods ending in 2019/20. Similarly, the profits for the quarters ended 30 June, 30 September and 31 December are added to those for any further period/s ending in 2020/21, to reach the total taxable profit for that year.

3.30 Ultimately, these rules would provide businesses with complete flexibility in their choice of periods of account. The government recognises that different businesses have different requirements, and believes that the proposed system of accounting periods would reduce complexity, particularly for new businesses.

Question 3: Do you agree with the proposed approach of following accounting periods? If not, what alternative approach would you support?

Question 4a: Are there any other events or situations which would require additional rules?
Question 4b: Would it be helpful to make any changes to tax accounting periods for any other types of income?

Accounting periods: interaction with other income

3.31 The concept of accounting periods is derived from Corporation Tax where liability can be calculated purely by reference to taxable profits in that one period. For income tax, it is recognised that there may be a need to consider the interaction of several different sources of income, together with reliefs and allowances, before a liability for a year can be calculated.

3.32 To some extent, this should be mitigated by aggregating all periods ending within a tax year. However, if you have specific concerns about certain scenarios then comments on these would be welcomed.

Accounting periods: commencement and other issues

3.33 This consultation is at an early stage, and there are no firm timelines in place for any changes to be made. However, changes to basis periods would facilitate regular updates under Making Tax Digital, and so it would make sense for the rules to commence at the same time as this element of the Making Tax Digital reform takes effect.

3.34 Because the rules are relatively straightforward to operate, and allow for flexibility in choice of accounting period, the government does not anticipate that there will need for complex commencement rules. The definition of an accounting period would be applied, by reference to the date of commencement, to determine the first accounting period of a business.

3.35 Many businesses will have accumulated overlap profits from commencement under the current rules. Relief for these profits will continue to be available on cessation. However, as the new rules will provide significantly more flexibility around changes in accounting date, it is not envisaged that there will be any need for overlap relief to be given on changes to accounting date.

4 Simpler business reporting

Simpler business reporting: background

4.1 As part of its commitment to making tax easier for small businesses, the government is considering how to reduce the burden involved in calculating profits. This proposal relates to businesses liable to Income Tax. It will not apply to businesses liable to Corporation Tax.

4.2 Calculation of profits can be done on the cash basis (for Income Tax) or in accordance with generally accepted accounting practice (GAAP). The cash basis recognises income when received and expenditure when paid. GAAP uses the accruals basis which recognises income earned and the expenses incurred in earning that income (whether or not the amounts have been received or paid).

4.3 Chapter 2 of this consultation document considers expanding the size of business eligible for the cash basis. The government is also consulting separately on proposals to extend the cash basis to property. This chapter does not consider the cash basis further.

4.4 Whether profits are calculated on the accruals basis under GAAP or on the cash basis they remain subject to any adjustments required by specific legislation such as the specific disallowance of tax deductions for expenditure on business entertaining.

4.5 This chapter of the consultation considers whether the burden of calculating profits in accordance with GAAP can be reduced by removing some accounting requirements. The proposal would not be to make changes to GAAP itself, but rather to consider a reduced version of GAAP under which an acceptable profit calculation may be made for the purposes of reporting profits to HMRC.

4.6 This proposal would mainly be relevant to customers who only produce GAAP accounts for HMRC. Customers who produce GAAP accounts for other reasons (e.g. as required by their bank) are less likely to want to make use of this proposed simpler business reporting.

Simpler business reporting: proposition outline

4.7 The proposal is to develop a reduced reporting framework under which businesses may choose to make fewer adjustments than would be required under GAAP. This could reduce the administrative burden of reporting taxable profits whether the business uses an annual accounting period or a self-employed person chooses to use the flexibility provided by reform of basis periods. It should also mean that unincorporated businesses using the standard tax rules would be able to operate Making Tax Digital reporting without any need to make accounting adjustments.

4.8 The requirements being relaxed are set out in more detail in the following sections, but in general reflect expenditure or income which has not yet arisen in cash terms but which may be said to have accrued in accounting terms. For example, when a shop values its stock at the year end, it may conclude that the stock has decreased in value and record an expense, even though there has been no cash cost to the business.

4.9 As such, under a simpler reporting framework, businesses would have a choice: they could carry out adjustments at every period end, to reach a GAAP-compliant calculation of profit; or they could choose to defer these adjustments, either making them in a later period or when an underlying asset or liability is realised or an underlying transaction unwinds.

4.10 There is no intention for these simplifications to lead to a reduction in the tax payable over the lifetime of a business. Any advantage or disadvantage arising from these rules will be restricted to changes in the timing of profits arising.

4.11 Similarly, any change would ensure that for businesses using these simplifications, no business income would be taxed twice and no expenditure relieved twice.

4.12 There may be a case for restricting either the time or financial scope of the use of the simplifications. Similarly, the government may consider restricting the size of businesses able to use the simplifications.

Simpler business reporting: scope and design

4.13 The areas where simplifications to the calculation of profits at the end of a period have been identified are:

- adjustments to the **closing stock** figure;
- adjustments for **profits where contracts span the period end**;
- adjustments in respect of **provisions for bad debts;** and
- adjustments for **prepayments and accruals.**

4.14 If there are other areas where the end of year adjustments required by GAAP could be simplified then the government would also be interested in your views on these.

Question 5: Are there other end of year adjustments not listed in paragraph 4.13 which could be simplified within a reduced reporting framework?

i. Closing stock

4.15 Profits of a business may be adjusted to take into account the value of the stock held at the end of the year. This adjustment requires that the stock is reviewed to see whether it has fallen in value below the price paid for it.

4.16 If such an adjustment were required, it would result in the stock being impaired and a deduction being available in calculating the profits of the trade.

4.17 It would be possible to remove the requirement to value stock at a period end. The effect of this would be that businesses choosing not to undertake a stock valuation at a period end would not take a deduction up front for the change in value of the stock. Instead, this change in value would be reflected in the profit or loss when it is sold in a future period.

4.18 In practice, this might allow a shop with an annual period of account to undertake time-consuming stocktakes only once every other year, for example, rather than on an annual basis; or a factory reporting quarterly under Making Tax Digital to perform an annual stock valuation and simply carry that value across the four quarters rather than having to revalue every three months.

ii. Adjustments to contracts which span the reporting period end

4.19 Where a contract spans a period end, an adjustment may be required to allocate some of the profit derived from the contract to the period that is to end. These adjustments may be made to income or to expenses and can reflect a wide range of factors.

4.20 Such adjustments are most relevant to complex or long-term contracts, but it is inevitable that even businesses with straightforward affairs will at times have contracts which span reporting period ends.

4.21 The government therefore believes that there is a case for examining whether the requirement to make these adjustments could be relaxed.

4.22 Relaxing this requirement is intended to reduce the need for businesses to make adjustments which in practice move only a small amount of income or expenditure from year to year. For longer term contracts, this effect would be more pronounced and the government does not believe that it would be appropriate for businesses entering into multi-year contracts to be able to defer recognition of the income for a number of years under this relaxation.

4.23 The government is therefore proposing that only contracts with a maximum length of one year may be subject to this relaxation, and any business with a contract lasting longer than one year will still need to make these adjustments at period ends.

iii. Provisions for bad debts

4.24 At a period end (or more frequently for some businesses), a provision is made for bad debts. This is done by reviewing the amounts that are owed to a business and the likelihood that these amounts will be paid.

4.25 Where amounts are thought unlikely to be recovered, a provision may be made by the business in respect of these debts.

4.26 These provisions require a business to make judgements about the ability of debtors to repay debts. There is an inherent subjectivity to these judgements.

4.27 However, the judgement made at a period end does not change the overall accounting treatment of the debt: if it is written down and then recovered, a corresponding credit will be recognised in a later period. Conversely if it is not written down but later proves to be irrecoverable, a debit will be recognised in that later period.

4.28 As a result, bad debt provisions are purely timing adjustments. The government considers that there is a case for removing the requirement to assess bad debts to simplify reporting at a period end.

4.29 Such a relaxation could allow a business to write off a bad debt only once recovery action had failed rather than assessing the likelihood of recovery each year that payment was not made.

iv. Accruals and prepayments

4.30 To calculate the profits of a business, a business needs to ensure that the income and expenditure of that period are recognised in the period. Accruals and prepayments are adjustments that are made so that income and expenses are recognised in the correct accounting period. According to the accruals concept, expenses should be recognised when incurred rather than when paid and income should be recognised when earned, not received.

4.31 Accrued expenses are when an expense is incurred but not yet paid, prepayments refer to amounts that are paid in advance. Accrued income is where work has been done but no invoice has been raised. Deferred income arises when income has been received before work is done.

4.32 In these cases, a relaxation would mean that a business could simply recognise the expenses and income which have been invoiced in the period, with no need to apportion invoiced amounts spanning the end of the accounting period.

4.33 As with adjustments for contracts spanning a period end, the government believes it is necessary to ensure that any relaxation is not used inappropriately. For example, were a business to receive a prepayment of income but ultimately never invoice for the work, it would not be appropriate for this amount never to be recognised for tax purposes.

4.34 The government is therefore proposing that income or expenditure adjustments would only be optional where the timing impact is less than a year: in other words, that a business would still need to make adjustments in the unusual circumstance that income had not otherwise been recognised more than a year after being earned, or an expense would otherwise be recognised more than a year in advance of it being due.

Question 6: Would you welcome the four relaxations proposed?

Question 7: Do you think that the restrictions proposed are appropriate? If not, what restrictions would you suggest?

5 Reforming the capital/revenue divide within the cash basis

Background

5.1 Current tax rules for calculation of profits under the cash basis do not allow a deduction for expenditure of a capital nature unless such expenditure would qualify for plant and machinery capital allowances under the ordinary tax rules.

5.2 This means that taxpayers still need to consider firstly whether an item of expenditure is capital in nature, and secondly whether the expenditure would qualify for capital allowances (for example furniture or a printer for use of a business is classed as capital and qualifies for plant and machinery allowance, whereas a door handle which is also classed as capital does not).

5.3 It is therefore only a limited simplification, and businesses may still require advice to determine which expenditure is allowed or disallowed.

5.4 The cash basis taxes cash flow, rather than accounting profits; and it does not provide relief for the cost of borrowing money to finance capital (apart from a £500 sum allowed for administrative reasons).

5.5 As a result, the traditional divide between capital and revenue is less necessary within the cash basis. The cash basis can provide a coherent tax result by making a different distinction, between expenditure on assets which store value, and those which are used up in the course of conducting the business.

5.6 This chapter of the consultation considers the case for reforming the capital revenue divide within the cash basis to reduce reporting burdens for small businesses in a way that retains economic coherence in the context of the overall cash basis policy.

Detailed design

5.7 It is proposed that the current general disallowance of capital expenditure would be replaced by a more limited disallowance of capital expenditure incurred in relation to assets which are not used up in the business over a limited period.

5.8 Specifically, capital expenditure in relation to the following types of assets would continue to be disallowed:

a) real property (including any fixtures bought as part of or with a property), and newly constructed buildings or structures;

b) intangible assets other than any with a definite, fixed life of 20 years or less (for example, capital expenditure on a trademark would be disallowed, but expenditure on 10 year licence to use a trademark would be allowed);

c) another business (including goodwill);
d) financial instruments and equivalent assets; and
e) any other asset which does not have a limited effective life or cannot reasonably be expected to decline in value over the time it is used.

5.9 Although not falling within this general scope, capital expenditure on cars would also be excluded, to be consistent with the similar exclusion from the scope of the Annual Investment Allowance.

5.10 The disallowed expenditure would include expenditure on the provision, improvement, or disposal of these assets, as well as abortive expenditure which was intended to result in such an asset.

5.11 To assist stakeholders in considering this proposal, a draft clause and explanatory note are attached in Annex C below to illustrate how this distinction could be made in legislation.

5.12 The intention in specifying capital expenditure that would continue to be disallowed is mainly to identify expenditure for which it is not appropriate to provide 100% immediate relief. This is generally because the specified assets do not depreciate or depreciate only relatively slowly.

5.13 In relation to fixtures acquired as part of a property, a further consideration is that the ordinary tax rules (in particular the capital allowances regime) provide a regime which takes into account the complexity involved in valuing such fixtures, apportioning expenditure and matching the position of the property vendor and purchaser. Businesses wishing to obtain tax relief for this element of a property purchase should use the ordinary rules. Expenditure on a new fixture being installed in a property will be allowable providing the fixture has a limited effective life and is expected to decline in value over the period it is used.

5.14 The government believes that these proposals represent a simple, workable definition which will simplify the rules for deductions within cash basis and provide a coherent policy framework. The government would welcome views from you on whether this simplification would reduce reporting complexity.

Question 8: Do you believe that simplifying the capital/revenue distinction as suggested in paragraphs 5.7 to 5.13 would simplify reporting for businesses within the cash basis?

Commencement and other provisions

5.15 As with other simplification measures being considered within this consultation, the government believes that it would be beneficial to businesses for changes to be made in time for the introduction of Making Tax Digital in 2018.

5.16 There are existing provisions in the cash basis (and in the capital allowance regime) to deal with the subsequent disposal or change of use of assets in relation to which tax relief has been given for expenditure. These will need to be adapted to ensure they continue to operate appropriately in relation to the new boundary.

5.17 The government would welcome comments from you on any potential areas of difficulty, including where there might be a need for specific provisions to ensure that the rules do not contain scope for manipulation at the new boundary between allowable and disallowed capital expenditure.

Question 9: Can you identify any specific caveats which might be needed to ensure that the new rule operates as intended? Are there any potential tax planning opportunities which the current draft rules would not prevent?

6 Assessment of impacts

Impacts on business

6.1 The government is interested in your views on the extent to which these proposals offer administrative simplification for business. HMRC has been set challenging targets to reduce administrative burdens and would welcome views of any qualitative or quantitative assessment on the extent to which the proposals will reduce businesses' administration costs.

6.2 The government recognises that these changes will impact both on businesses in respect of their own tax affairs, and on advisers, agents and representative bodies and the services they provide. Evidence from both groups is welcome.

Question 10a: If the cash basis entry threshold is raised would you consider using the cash basis, or advising your clients or members to use it? If so please provide details of anticipated impacts, including both one-off and ongoing benefits and costs.

Question 10b: If the proposed basis period reform is taken forward, how do you think this would impact on business admin burdens? If possible, please provide details of anticipated impacts, including both one-off and ongoing benefits and costs.

Question 10c: If the reduced reporting framework is introduced, please provide details of how this will affect your business or your clients or members, including details of both the expected one-off and ongoing benefits and costs for:
- Familiarisation with the new scheme and updating software or systems
- Having to make fewer adjustments than would be required under UK GAAP

Question 10d: If the revenue / capital divide is simplified as suggested do you believe that this would simplify reporting for businesses within the cash basis? If so please provide details of anticipated impacts, including both one-off and ongoing benefits and costs.

Question 10e: Please tell us if you think there are any other impacts, benefits or costs not covered above.

Summary of impacts

Exchequer impact (£m)	The estimated costs for the extension of cash basis will depend on the threshold chosen. Some options are given in the table in 2.17, for which the estimate Exchequer costs range from £40m to £145m. The basis period proposal is estimated to cost about £50m per year. These estimates are subject to final policy design. The final costing will be subject to scrutiny by the Office for Budget Responsibility if and when this measure is introduced.
Economic impact	The proposal to reform basis periods will have some economic impact, as removing the burden of double taxation on new businesses will support growth and job creation. The other proposals are not expected to have an economic impact.
Impact on individuals, households and families	All of the options affect only the business income tax customer group. Many of these customers are individuals running small businesses by themselves. The options will reduce complexity and administrative burden within the tax system, with a positive impact on individuals. The measure is not expected to impact on family formation, stability or breakdown.
Equalities impacts	The proposals are not expected to impact on equalities.
Impact on businesses and Civil Society Organisations	Self-employed individuals and small businesses are expected to benefit from these proposals on the basis that these businesses will have the flexibility to report on the basis which suits them best. The number of businesses affected and impacts on them will be reviewed in light of consultation responses.
Impact on HMRC or other public sector delivery organisations	These measures would require some changes to HMRC systems.
Other impacts	No other impacts have been identified.

7 Summary of consultation questions

Chapter 2: Increasing the trading cash basis entry threshold

Question 1a: What level do you consider to be an appropriate turnover entry threshold?
Question 1b: For a threshold not linked to the VAT threshold, should it be reviewed annually in the light of inflation or less frequently (please state recommended interval)?

Question 2a: If the entry threshold were to be increased, do you agree that the exit threshold should continue to be set at twice the entry threshold?
Question 2b: If the entry threshold were to be increased, do you agree that the UC threshold should continue to be set at twice the entry threshold?

Chapter 3: Reforming basis periods

Question 3: Do you agree with the proposed approach of following accounting periods? If not, what alternative approach would you support?

Question 4a: Are there any other events or situations which would require additional rules?
Question 4b: Would it be helpful to make any changes to tax accounting periods for any other types of income?

Chapter 4: Simplified reporting

Question 5: Are there other end of year adjustments not listed in paragraph 4.12 which could be simplified within a reduced reporting framework?

Question 6: Would you welcome the four relaxations proposed?

Question 7: Do you think that the restrictions proposed are appropriate? If not, what restrictions would you suggest?

Chapter 5: Reforming the capital/revenue divide within cash basis

Question 8: Do you believe that simplifying the capital/revenue distinction as suggested in paragraphs 5.7 to 5.13 would simplify reporting for businesses within the cash basis?

Question 9: Can you identify any specific caveats which might be needed to ensure that the new rule operates as intended? Are there any potential tax planning opportunities which the current rules would not prevent?

Chapter 6: Assessment of impacts

Question 10a: If the cash basis entry threshold is raised would you consider using the cash basis, or advising your clients or members to use it? If so please provide details of anticipated impacts, including both one-off and ongoing benefits and costs.

Question 10b: If the proposed basis period reform is taken forward, how do you think this would impact on business admin burdens? If possible, please provide details of anticipated impacts, including both one-off and ongoing benefits and costs.

Question 10c: If the reduced reporting framework is introduced, please provide details of how this will affect your business or your clients or members, including details of both the expected one-off and ongoing benefits and costs for:
- Familiarisation with the new scheme and updating software or systems
- Having to make fewer adjustments than would be required under UK GAAP

Question 10d: If the revenue / capital divide is simplified as suggested do you believe that this would simplify reporting for businesses within the cash basis? If so please provide details of anticipated impacts, including both one-off and ongoing benefits and costs.

Question 10e: Please tell us if you think there are any other impacts, benefits or costs not covered above.

8 The consultation process

This consultation is being conducted in line with the Tax Consultation Framework. There are 5 stages to tax policy development:

Stage 1 Setting out objectives and identifying options.

Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.

Stage 3 Drafting legislation to effect the proposed change.

Stage 4 Implementing and monitoring the change.

Stage 5 Reviewing and evaluating the change.

This consultation is taking place during stage 2 of the process. The purpose of the consultation is to seek views on the detailed policy design and a framework for implementation of a specific proposal, rather than to seek views on alternative proposals.

How to respond

The deadline for responding to this consultation is 7 November 2016.

Responses may be sent electronically to:

businessincometaxsimplification.consultation@hmrc.gsi.gov.uk

or by post to the following address:

HM Revenue and Customs
Business Income Tax Consultation
Small Business Team
Room 3/64
100 Parliament Street
London
SW1A 2BQ

Any telephone enquiries should be directed to James Ewington or Sean Rath on 03000 553 788 (from a text phone prefix this number with 18001).

A summary of the questions in this consultation is included at chapter 7.

Please do not send consultation responses to the Consultation Coordinator.

Paper copies of this document or copies in Welsh and alternative formats (large print, audio and Braille) may be obtained free of charge from the above address.

This document can also be accessed from HMRC's GOV.UK pages. All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentially can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Revenue and Customs (HMRC).

HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Consultation principles

This consultation is being run in accordance with the Government's Consultation Principles.

The Consultation Principles are available on the Cabinet Office website: http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance

If you have any comments or complaints about the consultation process please contact:

John Pay, Consultation Coordinator, Budget Team, HM Revenue & Customs, 100 Parliament Street, London, SW1A 2BQ.

Email: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

Please do not send responses to the consultation to this address.

Annex A: Basis period rules

This annex sets out an overview of the current basis period rules, together with some illustrative examples to explain their use.

The basis period rules can be found in Chapter 15 of the Income Tax, Trading and Other Income Act (ITTOIA) 2005. HMRC's published guidance is in the Business Income Manual, from BIM81010 onwards.

The basis period rules are as below.

Box 1:	**Basis period rules**
Year 1:	Begins with the date of commencement and ends with the following 5 April
Year 2:	If the accounting date in year 2 is less than 12 months from commencement, basis period is 12 months from commencement If the accounting date in year 2 is more than 12 months from commencement, basis period is 12 months ending with accounting date in year 2 If there is no accounting date in year 2, basis period is the 12 months beginning with 6 April in year 2 – i.e. the tax year
Year 3:	12 months ending with the accounting date in the tax year

There are also specific rules for cessations, and changes of accounting date.

Often, these rules can result in the individual paying tax and Class 4 National Insurance (NIC) twice on a portion of the profits made in the first year, or possibly first two years, of trade. Typically, this overlap will be for the period from the commencement of trade to the end of the tax year. This period is known as the "overlap period".

Although relief is available for the profits taxed twice ("overlap profits"), this relief is not normally given until the business ceases to trade. The value of the relief also erodes due to inflation over the life of the business.

The examples below illustrate a typical overlap scenario for a new trader.

Example 1: Person A

Person A starts to trade on 1 January 2015, and makes up accounts to 31 December each year. The business makes a profit of £1000/month

Year 1: (2014/15) Basis period is 1 January 2015 to 5 April 2015

Tax is payable on 3 months' profit i.e. £3,000.

Year 2: Accounting date in year 2 is 31 December 2015. This is 12 (2015/16) months from commencement, so the basis period is 1 January 2015 to 31 December 2015

Tax is payable on 12 months' profit i.e. £12,000

Year 3: (2016/17) Basis period is 1 January 2016 to 31 December 2016

Tax is payable on 12 months' profit i.e. £12,000

Note that the basis periods for years 1 and 2 overlap and part of the profit (that made between 1 January 2015 and 5 April 2015) will be subject to both tax and Class 4 NIC twice.

Example 2: Person B

Person B starts to trade on 1 June 2015, and makes up accounts to 30 September each year. The business makes a profit of £2000/month

Year 1: (2015/16) Basis period is 1 June 2015 to 5 April 2016

Tax is payable on 10 months' profit i.e. £20,000

Year 2: (2016/17) Accounting date in year 2 is 30 September 2016. This is more than 12 months from commencement, so basis period is 12 months to accounting date in year 2 i.e. 1 October 2015 to 30 September 2016.

Tax is payable on 12 months' profit i.e. £24,000

Year 3: (2017/18) Basis period is 1 October 2016 to 30 September 2017

Tax is payable on 12 months' profit i.e. £24,000

Note that the basis periods for years 1 and 2 overlap and part of the profit (that made between 1 October 2015 and 5 April 2016) will be subject to both tax and Class 4 NIC twice.

Although this problem occurs most often for new businesses, the same issue can be encountered for those changing accounting date, where in some cases the rules will generate new basis periods and additional overlap.

The rules in these cases are analogous to those for new businesses, and the example below illustrates how they apply.

Example 3: Business C

Business C has traded for many years, and makes up annual accounts to 31 December. It makes £1500 of profit each month.

In 2014, the business decides to change its accounting date to 30 June and makes up accounts for the 6 month period from 1 Jan 2014 to 30 June 2014.

2013/14: Accounting period is 12 months ended 31 December 2013.
Basis period is 12 months to 31 December 2013.
Tax is payable on 12 months' profit i.e. £18,000

2014/15: The accounting period ending in the tax year is 6 months ended 30 June 2014.

The new accounting date falls less than 12 months after the end of the basis period for 2013/14 so the basis period for 2014/15 is the 12 month period ending with the new accounting date; 1 July 2013 to 30 June 2014.

Tax is payable on 12 months' profit i.e. £18,000

The basis periods for years 2013/14 and 2014/15 overlap. The overlap period is 1 July 2013 to 31 December 2013. Profits of that period are assessed in 2013/14 and 2014/15. The overlap profit is £9,000 over a 6 month period.

2015/16: Basis period is 12 months to 30 June 2015

Tax is payable on 12 months' profit i.e. £18,000

It is also important to note that although periods of account are often 12 months long, they can be longer or shorter than this. Sole traders are free to choose, and change, their periods of account.

The rules outlined above are complex to operate, and have consequences for new traders and those changing to an earlier accounting date, as they will be taxed more than once on the same profits, with relief not available until they cease trading or on certain changes of accounting date.

Annex B: Relevant (current) government legislation

Cash basis: Chapter 3A, Part 2 of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA)

Basis period rules: Chapter 15, Part 2, ITTOIA

Generally Accepted Accounting Practice (GAAP): Section 25, Part 2, ITTOIA

Capital/revenue: Section 33, Part 2, ITTOIA

Annex C: Reforming the capital/revenue divide: draft legislation and explanatory note

These drafts are provided to assist stakeholders in understanding how the legislation would be expected to operate. The government is not seeking detailed views on the drafting at this stage.

Subject to the outcomes of this consultation, legislation will be published for comment in the autumn.

Draft legislation

Cash basis: treatment of capital

For section 33A of ITTOIA 2005 (cash basis: capital expenditure) substitute—

"33A Cash basis: capital expenditure

(1) This section applies in relation to the calculation of the profits of a trade on the cash basis.

(2) No deduction is allowed for an item of a capital nature incurred on, or in connection with, the acquisition or disposal of a business or part of a business.

(3) No deduction is allowed for an item of a capital nature incurred on, or in connection with, the provision, alteration or disposal of —

(a) any asset that is not a depreciating asset (see subsections (5) and (6)),
(b) any asset not acquired or created for use on a continuing basis in the trade,
(c) a car (see subsection (13)),
(d) land,
(e) a non-qualifying intangible asset (see subsections (7) to (10)), or
(f) a financial asset (see subsection (11)).

(4) But subsection (3)(d) does not prevent a deduction being made for expenditure that—

(a) is incurred on the provision of a depreciating asset which, in being provided, is installed or otherwise fixed to land so as to become, in law, part of the land, but
(b) is not incurred on, or in connection with, the provision of—

(i) a building,
(ii) a wall, floor, ceiling, door, gate, shutter or window or stairs,
(iii) a waste disposal system,
(iv) a sewerage or drainage system, or
(v) a shaft or other structure in which a lift, hoist, escalator or moving walkway may be installed.

(5) An asset is a "depreciating" asset if, on the date the item of a capital nature is incurred, it is reasonable to expect that before the end of 20 years beginning with that date—

(a) the useful life of the asset will end, or
(b) the asset will decline in value by 90% or more.

(6) The useful life of an asset ends when it could no longer be of use to any person for any purpose as an asset of a business.

(7) "Intangible asset" means anything that is capable of being an intangible asset within the meaning of FRS 105 and, in particular, includes—

(a) an internally-generated intangible asset, and

(b) intellectual property.

(8) An intangible asset is "non-qualifying" unless, by virtue of having a fixed maximum duration, it must cease to exist before the end of 20 years beginning with the date on which the item of a capital nature is incurred.

(9) An intangible asset is "non-qualifying" if it consists of a right, whether conditional or not, to obtain an intangible asset without a fixed maximum duration by virtue of which that asset must, assuming the right is exercised at the last possible time, cease to exist before the end of 20 years beginning with the date on which the item of a capital nature is incurred.

(10) Where—

(a) the trader has an intangible asset, and

(b) the trader grants a licence or any other right in respect of that asset to another person,

any intangible asset that consists of a licence or other right granted to the trader in respect of the intangible asset mentioned in paragraph (a) is "non-qualifying".

(11) A "financial asset" means any right under or in connection with—

(a) a financial instrument, or

(b) an arrangement that is capable of producing a return that is economically equivalent to a return produced under any financial instrument.

(12) A reference to acquisition, provision, alteration or disposal includes potential acquisition, provision, alteration or (as the case may be) disposal.

(13) In this section—

"arrangement" includes any agreement, understanding, scheme, transaction or series of transactions (whether or not legally enforceable);

"car" has the same meaning as in Part 2 of CAA 2001 (see section 268A of that Act);

"building" includes any fixed structure;

"financial instrument" has the same meaning as in FRS 105;

"FRS 105" means Financial Reporting Standard 105 (the Financial Reporting Standard applicable to the Micro-entities Regime), issued by the Financial Reporting Council in July 2015;

"intellectual property" means—

(a) any patent, trade mark, registered design, copyright or design right, plant breeders' rights or rights under section 7 of the Plant Varieties Act 1997,

(b) any right under the law of a country or territory outside the United Kingdom corresponding or similar to a right within paragraph (a),

(c) any information or technique not protected by a right within paragraph (a) or (b) but having industrial, commercial or other economic value, or

(d) any licence or other right in respect of anything within paragraph (a), (b) or (c);

"provision" includes creation, construction or acquisition;

"the trader" means the person carrying on the trade."

Draft Explanatory Note

Summary

This clause replaces a general prohibition on deductions for capital expenditure in calculating taxable profits using the cash basis, with a more focused and limited prohibition on deductions for certain specified capital expenditure.

Details of the clause

1. *<u>Subsection 1</u> provides for the clause to have effect for calculating taxable trading profits using the cash basis.*
2. *<u>Subsection 2</u> prevents any deduction for capital expenditure to acquire or dispose of a business.*
3. *<u>Subsection 3</u> prevents any deduction for capital expenditure on the provision, alteration or disposal of certain types of assets: land, financial assets, "non-qualifying" intangible assets, cars, and assets that are not "depreciating assets" or which are not for use in the trade.*
4. *<u>Subsection 4</u> limits the application of subsection 3 to land so that it does not prevent a deduction for the provision and installation of a depreciating property fixture.*
5. *<u>Subsection 5</u> provides that an asset should be regarded as a "depreciating asset" unless it is expected to have a useful life of over 20 years and to still be worth more than ten percent of its original value.*
6. *<u>Subsection 6</u> provides that the useful life of an asset should be regarded as ending when the asset is of no use as a business asset.*
7. *<u>Subsection 7</u> provides a definition of "intangible asset", for the purposes of the clause.*
8. *<u>Subsection 8</u> provides that an intangible asset should be regarded as "non-qualifying" unless the asset expires within 20 years of expenditure being incurred.*
9. *<u>Subsection 9</u> provides that an intangible asset should also be regarded as "non qualifying" if there is a right to renew or replace it so that an asset can continue to exist more than 20 years after expenditure is incurred.*
10. *<u>Subsection 10</u> provides that an intangible asset should also be regarded as "non qualifying" if it is a licence or other right in respect of an intangible asset which the taxpayer already holds.*
11. *<u>Subsection 11</u> provides a definition of "financial asset", for the purposes of the clause.*
12. *<u>Subsection 12</u> ensures that the provisions in the clause apply to abortive capital expenditure.*
13. *<u>Subsection 13</u> provides definitions of various terms used in the clause.*