



HM Revenue  
& Customs

# Simplifying tax for unincorporated businesses

**Summary of responses**  
31 January 2017

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# 1. Introduction

## Background to the consultation

- 1.1 On 14 December 2015, HM Revenue and Customs (HMRC) published the Making Tax Digital (MTD) roadmap which sets out how we will transform the tax system so that it is more effective, more efficient and easier for customers.
- 1.2 MTD will be introduced in phases: April 2018 for Income Tax and Class 4 National Insurance obligations; April 2019 for Value Added Tax (VAT) obligations; and April 2020 for Corporation Tax obligations.
- 1.3 This consultation was published in August 2016 as one of six consultations focusing on the government's MTD transformation programme.
- 1.4 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. This consultation opened up discussion on a package of options intended to reduce reporting burdens on business and facilitate the introduction of MTD for Business.
- 1.5 Increasing the turnover threshold for the cash basis aims to 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, the cash basis is a natural fit with MTD for Business. Over one million businesses already benefit from the cash basis of accounting and increasing the turnover threshold would allow more to be eligible.
- 1.6 Reform to the basis period rules for the self-employed aims to simplify computational rules, removing complexity when sole traders start up in business or change their accounting dates. The reform provides more flexibility to allow accounting dates to fit with other reporting obligations and individual preferences. Individuals would have the freedom to choose shorter accounting periods which would allow alignment with monthly Universal Credit requirements or quarterly updates under MTD for Business.
- 1.7 Simplifying reporting requirements offers small businesses the choice to eliminate some accounting adjustments currently required at the end of each period for which taxable profits are calculated.
- 1.8 Modifying the rules that define capital and revenue within the cash basis simplifies the rules for reporting capital and revenue expenditure. The effect of the change is that it should be more clear-cut whether expenditure is deductible or not. This will also make it easier to categorise expenditure under MTD for Business.
- 1.9 Together, the changes are intended to simplify the reporting requirements for small businesses and provide more flexibility for some customers in MTD for

Business. These reforms would reduce administrative burdens, freeing up more time for business owners to concentrate on running their business.

## General response

- 1.10 There were 114 written responses to this consultation, 75% of which were from accountants or accountancy firms. Professional bodies made up 17% of the written responses and the remainder were made by software providers or other interested parties. There were no written responses directly from small business owners or self-employed individuals who were not accountants. A full list of those who provided written responses to the consultation is given in Annex A.
- 1.11 There were 730 responses to the two questions from the 'Simplifying tax for unincorporated businesses' consultation included in the MTD online survey. Of those responding online, 58% were accountants or agents, 20% were self-employed, 10% were business owners and the remainder were made up of landlords and other individuals.
- 1.12 There were also over 65 attendees across two online webinars to discuss the consultation and 6 face to face events across the country. Officials met with a range of stakeholders including accountants, software developers and representative groups as part of the consultation process. There have also been discussions with organisations representing small businesses.
- 1.13 The vast majority of the responses supported simplification of the tax system. There was wide agreement that a simpler tax system helps small businesses and the self-employed. The responses to the specific simplification measures in the consultation were mixed. Some stakeholders were supportive of certain measures but critical of others. More details on the points raised by stakeholders will be set out in the responses section of this document.
- 1.14 An issue raised by some was the timing of these reforms in the context of MTD for Business. There was concern that businesses would not all have the capacity or capability to understand multiple changes at the same time. There were suggestions that time should be allowed for the simplifications or MTD for Business to bed in before making additional reforms.

## 2. Responses

### Increasing the entry threshold for the cash basis

- 2.1 Under the cash basis of accounting, income and expenditure is recorded when payments are received or made. This is an alternative to accruals accounting which accounts for income and expenditure when the transaction actually takes place, usually using the date of invoice or billing. Businesses with turnover below £83,000 (the current VAT registration threshold) can 'enter' the cash basis, in other words use the cash basis to calculate their taxable profits. Since it was introduced in 2013, over one million businesses have opted to use the cash basis.
- 2.2 Many of the accountants who responded to the consultation were critical of cash basis accounting. They said that businesses do not produce accounts just for tax purposes and that accounts are also used to provide information on financial performance. Accounts will inform business decisions and can also be required by providers of finance. As a result, accountants will usually encourage their clients to use accrual accounts prepared in accordance with UK generally accepted accounting practice (GAAP).
- 2.3 The government recognises that for more complex businesses, the cash basis of accounting is not usually appropriate. That is why the cash basis is targeted at smaller businesses, which often have more straight-forward affairs. These businesses usually do not need the adjustments of a complex business to assess and understand their finances.
- 2.4 Despite the general criticism towards the cash basis, there was acknowledgement that it was a simple way for businesses to report a taxable profit to HMRC. A significant number of respondents across all groups supported an increase to the entry threshold. Small business representatives also supported increasing the thresholds, provided businesses had a free choice to switch to using the ordinary rules.

#### Question 1a: What level do you consider to be an appropriate turnover entry threshold?

	<b>Increase threshold</b>	<b>Keep threshold the same</b>	<b>Decrease threshold</b>	<b>Number of respondents</b>
<b>Written Response</b>	31%	56%	13%	114
<b>Online Survey</b>	81%	19%	0%	413
<b>Webinars</b>	55%	40%	5%	53

**Table 1:** Summary of responses to Question 1a

- 2.5 This was the first of the two questions included in the MTD online survey. The majority of respondents to the online survey and webinars wanted to increase the threshold (81% and 55% respectively). The majority of written responses (56%) thought that the threshold should remain at the current level.

- 2.6 Of the self-employed who responded to the online survey, 8% wanted to maintain the existing entry threshold, 66% wanted to double the threshold, increasing it from £83,000 to £166,000. Of the accountants who responded, 24% wanted to maintain the existing level of the entry threshold and 37% wanted to double it.
- 2.7 Of all the respondents who wanted to increase the threshold, double the current threshold was the most popular option. There were a small number of responses that suggested increasing the threshold to the same level as the VAT cash accounting threshold (£1.35 million) or to abolish the entry threshold completely.

**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)?**

- 2.8 The majority of responses thought that the threshold should be reviewed annually. Some thought that it was simpler to set a threshold that did not change on such a regular basis.

**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?**

- 2.9 There was a mix of views on the level at which to set the exit threshold. Respondents suggested levels between 120% - 200% of the entry threshold. A significant number said that the exit threshold should continue to be twice (200% of) the entry threshold, but some thought that this might be too high after any future increases to 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?**

- 2.10 There were few responses to this question. Many did not see the rationale for increasing the threshold for Universal Credit (UC) claimants as it was probably already large enough for anyone who would claim UC. Some respondents said that the thresholds should be aligned in order to aid simplicity.

**Government response**

- 2.11 The government will increase the entry threshold for the cash basis to £150,000. This increases the number of businesses eligible for the cash basis by an estimated 135,000 businesses. The exit threshold will be set at double the new entry threshold, so will increase to £300,000.
- 2.12 Exit and entry thresholds for UC claimants will continue to be the same as the exit threshold for non-UC claimants and will therefore be increased to £300,000.
- 2.13 Further increases are possible, but the Government understands businesses with larger turnovers are likely to be more complex and less likely to use the cash basis of accounting.

2.14 The government will also allow businesses free choice to move from cash basis to using the accruals basis to address concerns arising from increasing thresholds.

### Reforming basis periods

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

2.16 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 makes sure that there are no profits which fall between years and fail to be taxed. In order to cover a wide range of circumstances and to achieve these aims, the rules can be complex.

2.17 For some businesses, the rules may result in part of their profits from the first years of trade being taxed twice. These “overlap” profits are usually given tax relief when the business ceases, but this may be some years later.

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

	Yes	Unsure	No	Number of respondents
Written Response	36%	39%	25%	114
Webinar	47%	27%	27%	71

**Table 2:** Summary of responses to Question 3

2.18 Many of the responses were supportive of the objective to eliminate overlap profits. They agreed that the proposed approach of following accounting periods was the best proposal presented to achieve that objective. They agreed that the existing rules could be difficult to understand.

2.19 Some respondents pointed out that overlap profits could be avoided by a new business by choosing an accounting year end date between 30 March and 5 April inclusive.

2.20 Many respondents asked for early relief on existing overlap profits. They said that a business with overlap profits would already have been taxed twice on these profits, which was unfair. As the business may not need to change accounting date or cease trading until sometime in the future, the value of the existing overlap profits was depreciating, which was also unfair.

2.21 Many responses recommended that the reform should also apply to partnerships. They said that the reasons to reform the basis period rules for sole traders also applied to partners. Some highlighted that partners were more likely

to generate overlap profits and more often. Some were critical of having different basis period rules for different tax payers.

- 2.22 Those who were unsure or negative about the proposals were concerned that the new reforms created tax planning opportunities. Others were concerned that the additional flexibility would create too much choice which would confuse businesses, particularly those that did not have an accountant.
- 2.23 Many of the attendees at the face to face events did not see the benefit of the ability to use shorter accounting periods. However small business representatives have commented that this could be helpful for the self-employed and seasonal businesses.

#### **Question 4a: Are there any other events or situations which would require additional rules?**

- 2.24 There were few responses to this question. Those that did respond raised similar concerns as above: anti-avoidance provisions may be required, up front tax relief for existing overlap profits should be given and the reform should be extended to include partnerships.
- 2.25 Further to this, some responses wanted clarification on transitional rules and how the changes would impact on National Insurance Contributions.

#### **Question 4b: Would it be helpful to make any changes to tax accounting periods for any other types of income?**

- 2.26 The responses to this question were split roughly across two groups. The first did not want to see this reform extended to other types of income. These responses were generally not supportive of the reform in the first place.
- 2.27 The second group thought that there would be benefits to allowing businesses to align the basis periods with other income. Alignment would be simpler for most taxpayers and could provide greater transparency for their tax affairs. The income source usually mentioned was property income. These respondents argued that some landlords already treat their property rental activity like a business, so they should have the same flexibility of basis period reform that would be available to the self-employed.

#### **Government response**

- 2.28 The consultation responses highlighted support for eliminating overlap profits and simplification of the basis period rules. However, there were other issues raised through the consultation, such as the tax planning risk and interactions with basis period rules for partnerships. The government will consider these issues further to ensure that the original policy objectives are met.



## Simpler business reporting

- 2.29 The simplified business reporting proposals have been developed to reduce the reporting requirements under which businesses calculate their profits for HMRC. They would allow the choice to make fewer adjustments at the end of a period than may be required under GAAP.
- 2.30 This would 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.

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

- 2.31 There were few responses to this question. These responses included adjustments for: dilapidation provisions, recognition of financial instruments, fair value accounting adjustments for financial instruments, work in progress and restricting claims for capital allowances.

### Question 6: Would you welcome the four relaxations proposed?

	Yes	Unsure	No	Number of respondents
Written Response	15%	48%	37%	114
Webinar	52%	21%	27%	67

**Table 3:** Summary of responses to Question 6

- 2.32 Support for this proposal was weak in the written responses to this question. Many did not think that there would actually be a benefit or simplification by making these period end adjustments optional. There was concern that this could lead to the creation of a third basis of accounting which would be potentially confusing for businesses.
- 2.33 Many responses said that the changes would not result in any new benefit for the businesses the change was targeted at. This was either due to those businesses not being complex enough to require the adjustment or that some of the adjustments are already not necessary under existing GAAP standards.
- 2.34 Participants in the webinar discussion tended to be more positive, and discussion with small business representatives identified support for this proposal as providing some advantages to businesses, providing it remains optional and is clearly explained.

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

- 2.35 Those that were already critical of this measure thought that the need for restrictions demonstrated that this measure would lead to complexity due to the additional rules required to reduce tax planning opportunities.

2.36 Those responses that were more positive about the measure thought that the restrictions in place were sufficient so long as the measures remained optional.

### Government response

2.37 The government wants to reduce admin burdens for small businesses and making these period end adjustments is one way which this can be achieved. However, given the concerns raised by stakeholders and the interaction of this measure with the basis period reform, the government will consider these issues further to ensure that the policy meets the objectives originally set out.

### Reforming the capital/revenue divide within the cash basis

2.38 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.

2.39 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.

2.40 This reform proposes that the current general disallowance of capital expenditure would be replaced by a more specific disallowance of capital expenditure incurred in relation to assets which are not used up in the business over a limited period. The government believes that this represents a simpler approach for capital deductions within the 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?

	Yes	Unsure	No	Number of respondents
<b>Written Response</b>	24%	44%	32%	114
<b>Online Survey</b>	27%	40%	32%	730
<b>Webinars</b>	44%	26%	30%	70

**Table 4:** Summary of responses to Question 8

2.41 This was the second question included in the MTD for Business online survey. There were mixed views on taking forward this reform. While some could appreciate the simplification that was intended through the reform, others were sceptical if it would make any appreciable difference to those in the cash basis.

2.42 This is because those using the cash basis will typically have simple affairs and will not often make capital purchases. When they do, they are likely already to be covered by the existing provisions. There is also a question as to what extent these businesses follow the existing rules around capital.

- 2.43 Some responses thought any change might result in unintended consequences, such as some unconsidered deductions no longer being allowable. They flagged that this could be bad for businesses that had previously depended on those deductions. They also thought that in some cases a capital or revenue distinction would still be required.
- 2.44 Discussion with small business representatives identified support for the proposal to define a clearer boundary, with a narrower, more specific list of excluded expenditure, provided the new boundary is clearly explained.

**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?**

- 2.45 There were very few comments to this question. Those who did provide comment asked whether the utilisation of capital losses could be allowed under the cash basis and how the expenditure would be treated if moving from the cash basis to the accruals basis.

**Government response**

- 2.46 The government understands that the rules around capital and revenue expenditure can be difficult to understand, particularly for businesses that do not have accountants. This reform will provide clarification on the majority of capital and revenue expenditure, providing greater certainty for those in the cash basis.
- 2.47 The government will address concerns regarding unintended consequences through consultation on the draft legislation for this measure. Guidance will be updated alongside the measure to ensure the changes are clearly explained.

**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.**

- 2.48 Generally the responses said that there would be little impact as a result of the increase. There was some recognition that simple businesses with larger turnovers could benefit from the increase.
- 2.49 The majority of accountants who responded to the consultation said that they would continue to advise their clients to use the accruals basis. This could be because they are not eligible for the cash basis or because the accruals basis provides better financial information for the business concerned.

**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.**

- 2.50 Some respondents thought that the impact would be minimal as the majority of continuing businesses would simply keep the same accounting dates. Others thought that the new rules could reduce admin burdens for unrepresented businesses as they would be easier to follow.
- 2.51 Many accountants were negative about the impacts of this measure. They thought the increased flexibility the measure provides would create more work as accountants would need to determine the most beneficial accounting dates for their clients.

**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

- 2.52 There were mixed views on the impacts of this measure. Some responses agreed that there would be simplifications that would have a small benefit to some small businesses. Others flagged the familiarisation costs that would be associated with having to understand the new accounting framework.

**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.**

- 2.53 There were few comments on this question; almost all the responses were from accountants. A significant number, in particular professional bodies, said that there would be no simplification from this proposal. Some accountants did think there would be a small benefit from this reform.

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

- 2.54 There were few comments made to this question. Those who did provide a response focused on concerns with MTD for Business, for example, the increased burden they foresee from providing quarterly updates.

### **Government response**

- 2.55 Many of the responses regarding the impacts of these measures came from accountants or accountancy firms. Overall they indicated that these measures would have a limited impact on their client base. This is likely to be due to them either not using the cash basis or other requirements which meant that they produced GAAP compliant accounts for their clients.
- 2.56 These measures may have more of an impact on businesses that do not have accountants. They will make it easier for them to get their taxes right, either by reducing reporting burdens or increasing certainty on certain transactions.

2.57 The measures would also provide small businesses with more flexibility. This could be particularly useful as MTD for Business is implemented. It would be easier for small businesses to choose accounting dates that suit their needs and reduce some of their reporting burdens.

2.58 The government wants to ensure that any changes that it makes for unincorporated businesses are simplifications and will benefit businesses.

## 3. Next steps

### Draft legislation

- 3.1 Following this consultation and review, the government has taken the decision to publish draft legislation on the reform of capital revenue divide in the cash basis for Finance Bill 2017. This measures will be effective for the 2017/18 tax year onwards.
- 3.2 The draft legislation is subject to consultation and review. Details on how to provide comments will be available with the draft legislation.
- 3.3 The government has also agreed to increase the entry threshold for the cash basis from the current level of £83,000 to £150,000. The exit threshold will be double the new entry threshold, so will increase to £300,000.
- 3.4 The increase to the cash basis thresholds will be effective from the 2017/18 tax year onwards.
- 3.5 The government will give continue to develop the reform of the basis period rules and simplified reporting measures and make a decision on these at a later date.

### Making Tax Digital

- 3.6 Responses to the other MTD consultations and next steps can be found online:

<https://www.gov.uk/government/collections/making-tax-digital-consultations>

## Annex: List of respondents

- Association of Accounting Technicians
- Association of Chartered Certified Accountants
- AccountingWEB.co.uk
- Accounts Direct
- Albert Goodman
- Association of Taxation Technicians
- AW Tax Service Ltd
- BDO UK LLP
- BHP accountants
- Blackadders LLP
- Brian Tilbury & Co
- British Dental Association
- Bullock Woodburn Limited
- Buzzacott
- Confederation of British Industry
- Chartered Institute of Taxation
- CKLG Limited
- Country Land and Business Association
- Clive McGovern Limited
- Copson Grandfield Limited
- Crowe Clark Whitehill
- Davies Tracey Ltd
- Deloitte LLP
- Digital Advisory Group
- Disability Dynamics
- Donaldson & Thompson Ltd
- Duncan & Toplis Ltd
- Dutchmans Chartered Accountants Ltd
- Elizabeth Whiteley Accountancy Ltd
- Equity
- Fenn Cox & Partners
- FreeAgent
- Garbetts Ltd
- Greaves West & Ayre
- Harold Smith Partnership
- Hillier Hopkins LLP
- HMRC Charter Committee
- Howsons Ltd
- HPH, Chartered Accountants
- Institute of Chartered Accountants in England and Wales
- Institute of Chartered Accountants of Scotland
- Institute of Certified Practising Accountants
- Intuit Inc.
- IRIS Software Group

- Jane Jenner Taxation & Accounting Services
- Johnston Carmichael LLP
- Kingston Smith LLP
- KPMG LLP
- Kreston Reeves LLP
- Lambert Chapman LLP
- Land Tax LLP
- Larking Gowen Ltd
- Lieberman & Co
- Llŷr James Cyf
- Longhill Accounting Ltd
- Low Incomes Tax Reform Group
- M&S Accountancy and Taxation Ltd
- Manningtons Chartered Accountants
- Menzies LLP
- MHA MacIntyre Hudson
- Moore and Smalley LLP
- Morris Owen
- Murrison & Wilson Ltd
- National Farmers Union
- National Union of Journalists
- Office of Tax Simplification
- Patricia J Arnold & Co Ltd
- PKF Francis Clark LLP
- Prentis and Co
- Price Bailey LLP
- Price Deacon Witham Ltd
- Rayner Essex LLP
- River Thames Accountancy
- Ross Martin Tax Consultancy
- Rowlands Accountants
- RSM UK Tax and Accounting Ltd
- Saffery Champness
- Sagars Accountants Ltd
- SAGE
- Saint & Co
- Sandisons Ltd
- Singletons Solicitors
- Smith & Williamson LLP
- Spurling Cannon
- Summers & Co
- TaxAid
- TaxAssist Accountants
- Thandi Nicholls Ltd
- tiintax.com
- UK200Group
- Walter Wright Chartered Accountants



- Watts Gregory LLP
- Whitefield Tax Limited
- Wolters Kluwer
- Wood & Associates LLP

13 individuals also provided written responses.