

# Simpler income tax for the simplest small businesses

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## Who is likely to be affected?

Individuals carrying on a trade or profession as self employed sole traders or in partnership with other individuals.

## General description of the measures

The first measure will allow eligible unincorporated businesses to calculate taxable income figures on a simpler cash basis if this suits the business. Such businesses will not have to compute figures of debtors, creditors and stock, or distinguish between 'capital' and 'revenue' expenditure and will not have to compute capital allowances to arrive at taxable income.

The second measure will allow all unincorporated businesses to choose to use flat rate expenses for particular items of business expenditure.

## Policy objective

The objective is to simplify the calculation of taxable income for small unincorporated businesses. The policy aim is to give these small businesses greater certainty over the preparation of taxable income figures for their Self Assessment return and to clarify and simplify self assessment of business income.

The measures are intended to reduce the concerns, uncertainty and administrative burden of preparing a taxable income figure for these businesses. The measures will allow customers to choose the method of computing taxable income that best suits their business. They will not be suitable for all small businesses.

## Background to the measures

The simpler income tax measures respond to proposals made by the Office of Tax Simplification (OTS). The OTS found that small businesses are concerned about the difficulty and uncertainty involved in preparing a taxable income figure. The OTS published their report *Simpler income tax for the smallest businesses* in February 2012.

At Budget 2012 the Government announced that from April 2013 the Government will introduce a new cash basis for calculating tax for small unincorporated businesses.

HM Revenue & Customs (HMRC) issued a consultation document in March 2012 and workshops were undertaken with interested parties.

HMRC has considered all the responses to the consultation as detailed in the summary of responses published on 11 December 2012.

Further draft legislation will be published shortly on the transition to and from the cash basis.

## Detailed proposal

### Operative date

The measures will apply from the tax year 2013 -14.

## Current law

The current legislation requires that the profits of a trade are calculated on an accruals basis in accordance with Generally Accepted Accountancy Practice (Section 25 Income Tax (Trading and Other Income) Act 2005 (ITTOIA)).

Capital expenditure is not an allowable deduction for tax purposes (Section 33 ITTOIA). While capital expenditure is not an allowable deduction a business can claim capital allowances in respect of certain capital expenditure, for example plant and machinery. The capital allowances legislation is in the Capital Allowances Act 2001.

In calculating taxable profit, deductible expenses have to be for the purpose of the business (Section 34 ITTOIA). Where there is both a business and a private use element to expenses they are apportioned to arrive at the appropriate amount to be deducted for tax purposes.

Barristers can use a cash basis in the early years of trading (Section 160 ITTOIA), and on moving to profit figures prepared under GAAP can have any adjustment to profits arising on the change of accounting basis spread over a number of years (Section 238 ITTOIA).

## Proposed revisions

Legislation will be introduced in Finance Bill 2013 to allow eligible small businesses to calculate their taxable income by taking business cash received in a year and deducting business cash expenses paid in a year. This will mean they will generally not have to distinguish between revenue and capital expenditure.

For flat rate expenses, legislation will be introduced in Finance Bill 2013, with effect for the tax year 2013-14, to allow all unincorporated businesses to deduct certain expenses on a simplified flat rate basis. Businesses that choose to adopt the cash basis will be required to use simplified expenses for business mileage but use of the other flat rate expenses will be optional.

Eligible barristers will be able to choose either to use the new cash basis and simplified expenses or the current accruals basis. The existing cash basis legislation for barristers will be repealed (except for barristers already using it, for the remainder of their qualifying period).

## Summary of impacts

Exchequer impact (£m)	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
	-	nil	-165	+25	-5	negligible
	These figures are set out in Table 2.1 of the Autumn Statement and have been certified by the Office for Budget Responsibility. More details can be found in the policy costings document published alongside the Autumn Statement.					
<b>Economic impact</b>	The measure is not expected to have any significant economic impacts.					
<b>Impact on individuals and households</b>	Individuals and households claiming Universal Credit or other benefits are expected to be able to use a compatible cash basis, and the flat rate expenses of Simpler Income Tax measures, when preparing their income figures for the Department for Work & Pensions (DWP).					
<b>Equalities impacts</b>	The proposals relate to a voluntary simplified scheme to compute business profits for tax purposes. No impact on equality of protected groups has been identified.					

<b>Impact on business including civil society organisations</b>	<p>This measure is likely to result in a small on-going annual admin saving to businesses due to simplification of the calculations needed to complete tax returns combined with greater certainty and understanding of those calculations. In addition the change is likely to incur a one off cost to business due to familiarisation with this new approach. Initial calculations estimate that approximately 3 million businesses could take advantage of this measure.</p> <p>Estimates of the impacts on the total business population will be established once the business design for this policy has been finalised and the impact fully evaluated. At this time a revised Tax Information and Impact Note will be published.</p>
<b>Operational impact (£m) (HMRC or other)</b>	<p>Potential options for changes to paper and online tax returns are being considered. Initial estimates of the external IT costs of these options are in the range of £80,000 to £1.9 million, depending on the extent of the changes.</p>
<b>Other impacts</b>	<p><u>Small firms impact test:</u> The measure is targeted at small firms and steps have been taken to consult with them and their representative bodies. Certain design changes have been made as a result of their responses. The changes and associated guidance are to be road tested before implementation, this is to ensure the process is easier and enables small businesses to calculate their own tax.</p> <p>Other impacts have been considered and none have been identified.</p>

### Monitoring and evaluation

These measures will be monitored by the numbers of businesses using the scheme as reported either in their tax returns or using a survey to identify take up.

### Further advice

If you have any questions about this change, please contact Robert Nott (email: robert.nott@hmrc.gsi.gov.uk) or contact Alison Bull on 020 7147 2595 (email: alison.bull@hmrc.gsi.gov.uk).

## **1 Cash basis for small businesses**

Schedule 1 contains provision enabling the profits of a trade, profession or vocation to be calculated on the cash basis.

## SCHEDULE 1

Section 1

## CASH BASIS FOR SMALL BUSINESSES

## PART 1

## MAIN PROVISIONS

*Introductory*

- 1 Part 2 of ITTOIA 2005 (trading income) is amended as follows.

*Eligibility to calculate profits on cash basis*

- 2 Chapter 3 (trade profits: basic rules) is amended as follows.
- 3 In section 25(3) (exception to requirement to use generally accepted accounting practice), for “section 160 (barristers and advocates in early years of practice)” substitute “section 25A (cash basis for small businesses)”.
- 4 After section 25 insert –

**“25A Cash basis for small businesses**

- (1) A person who is or has been carrying on a trade may elect for the profits of the trade to be calculated on the cash basis (instead of in accordance with generally accepted accounting practice).
- (2) References in this Part to calculating the profits of a trade on the cash basis are references to doing so in accordance with this section.
- (3) Chapter 3A contains provision about –
- (a) when a person may make an election under this section, and
- (b) the effect of such an election.
- (4) Where an election under this section has effect in relation to a trade, sections 27, 28 and 30 do not apply in relation to the calculation of the profits of the trade.”
- 5 After Chapter 3 insert –

**“CHAPTER 3A**

## TRADE PROFITS: CASH BASIS

*Eligibility***31A Conditions to be met for profits to be calculated on cash basis**

- (1) A person may make an election under section 25A (cash basis for small businesses) for a tax year if conditions A to C are met.

- (2) Condition A is that the aggregate of the cash basis receipts of each trade, profession or vocation carried on by the person during that tax year does not exceed any relevant maximum applicable for that tax year (see section 31B).
- (3) Condition B is that, in a case where the person is either an individual who controls a firm or a firm controlled by an individual –
  - (a) the aggregate of the cash basis receipts of each trade, profession or vocation carried on by the individual or the firm during that tax year does not exceed any relevant maximum applicable for that tax year, and
  - (b) the firm or the individual (as the case may be) has also made an election under section 25A for that tax year.
- (4) Condition C is that the person is not an excluded person in relation to the tax year (see section 31C).
- (5) For the purposes of this section, the “cash basis receipts” of a trade, profession or vocation, in relation to a tax year, are any receipts that –
  - (a) are received during the basis period for the tax year, and
  - (b) would be brought into account in calculating the profits of the trade, profession or vocation for that tax year on the cash basis.

### **31B Relevant maximum**

- (1) For the purposes of section 31A there is a “relevant maximum” applicable for a tax year in relation to a trade, profession or vocation carried on by a person if any of conditions A to C is met.
- (2) Condition A is that an election under section 25A did not have effect in relation to the trade, profession or vocation for the previous tax year.
- (3) Condition B is that the aggregate of the cash basis receipts of each trade, profession or vocation carried on by the person during the previous tax year is greater than an amount equal to twice the VAT threshold for that previous tax year.
- (4) Condition C is that, in a case where the person is either an individual who controls a firm or a firm controlled by an individual, the aggregate of the cash basis receipts of each trade, profession or vocation carried on by the individual or the firm during the previous tax year is greater than an amount equal to twice the VAT threshold for that previous tax year.
- (5) If there is a relevant maximum applicable for a tax year, the amount of the relevant maximum is –
  - (a) the VAT threshold, or
  - (b) in the case where the person is an individual who is a universal credit claimant in the tax year, an amount equal to twice the VAT threshold.
- (6) For the purposes of this section, where the basis period for a tax year is less than 12 months, the VAT threshold is proportionately reduced.

- (7) In this section –
- “universal credit claimant”, in relation to a tax year, means a person who is entitled to universal credit under Part 1 of the Welfare Reform Act 2012 for an assessment period (within the meaning of that Part) that falls within the basis period for the tax year, and
  - “the VAT threshold”, in relation to a tax year, means the amount specified at the end of that tax year in paragraph 1(1)(a) of Schedule 1 to VATA 1994.
- (8) The Treasury may by order amend this section.
- (9) A statutory instrument containing an order under subsection (8) that restricts the circumstances in which an election may be made under section 25A may not be made unless a draft of the instrument containing the order has been laid before, and approved by a resolution of, the House of Commons.

### **31C Excluded persons**

- (1) A person is an excluded person in relation to a tax year if the person meets any of conditions A to E.
- (2) Condition A is that –
- (a) the person is a firm, and
  - (b) one or more of the persons who have been partners in the firm at any time during the basis period for the tax year was not an individual at that time.
- (3) Condition B is that the person was a limited liability partnership at any time during the basis period for the tax year.
- (4) Condition C is that the person is an individual who has been a Lloyd’s underwriter at any time during the basis period for the tax year.
- (5) Condition D is that the person has made an election under Chapter 8 (trade profits: herd basis rules) that has effect in relation to the tax year.
- (6) Condition E is that the person has made a claim under section 221 (claim for averaging of fluctuating profits) in relation to the tax year.
- (7) The Treasury may by order amend this section.
- (8) A statutory instrument containing an order under subsection (7) that restricts the circumstances in which an election may be made under section 25A may not be made unless a draft of the instrument containing the order has been laid before, and approved by a resolution of, the House of Commons.

#### *Elections under section 25A*

### **31D Effect of election under section 25A**

- (1) An election made by a person under section 25A has effect –
- (a) for the tax year for which it is made, and

- (b) in relation to every trade, profession or vocation carried on by the person during that tax year.
- (2) For provision prohibiting a person who has made an election under section 25A from claiming any capital allowances, see section 1(4) of CAA 2001.

*Calculation of profits on cash basis*

**31E Calculation of profits on cash basis**

- (1) This section applies to professions and vocations as it applies to trades.
- (2) To determine the profits of a trade for a tax year on the cash basis –
  - Step 1*  
Calculate the total amount of receipts of the trade received during the basis period for the tax year.
  - Step 2*  
Deduct from that amount the total amount of expenses of the trade paid during the basis period for the tax year.
- (3) Subsection (2) is subject to any adjustment required or authorised by law in calculating profits for income tax purposes.”

*Rules restricting deductions*

- 6 Chapter 4 (trade profits: rules restricting deductions) is amended as follows.
- 7 After section 32 insert –

*“Cash basis accounting*

**32A Overview of rules for calculating profits on cash basis**

- (1) The following sections do not apply in calculating the profits of a trade on the cash basis –
  - section 33 (capital expenditure),
  - section 35 (bad and doubtful debts),
  - sections 36 and 37 (unpaid remuneration),
  - section 43 (employee benefit contributions: profits calculated before end of 9 month period),
  - sections 48 to 50B (car hire).
- (2) For rules restricting deductions that apply only where profits are calculated on the cash basis, see the following –
  - section 33A (cash basis: capital expenditure),
  - section 51A (cash basis: interest payments on loans),
  - section 55C (cash basis: rental payments).”

- 8 After section 33 insert –



### **“33A Cash basis: capital expenditure**

- (1) In calculating the profits of a trade on the cash basis, no deduction is allowed for items of a capital nature falling within any of the Heads set out in –
  - (a) subsection (2) (land),
  - (b) subsection (4) (cars and motor cycles),
  - (c) subsection (5) (intellectual property),
  - (d) subsection (7) (shares etc),
  - (e) subsection (8) (other businesses),
  - (f) subsection (10) (investment assets),
  - (g) subsection (11) (non-depreciating assets).
- (2) Head 1 is expenditure on –
  - (a) acquiring or improving any land, and
  - (b) acquiring or improving any fixture acquired at the same time as, and as part of, any land.
- (3) In subsection (2) “fixture”, in relation to any land –
  - (a) means anything that is so installed or otherwise fixed in or to the land as to become, in law, part of that land, and
  - (b) includes any boiler or water-filled radiator installed in a building as part of a space or water heating system.
- (4) Head 2 is expenditure on acquiring or improving cars or motor cycles.
- (5) Head 3 is expenditure on acquiring, creating or improving intellectual property.
- (6) In subsection (5) “intellectual property” has the same meaning as in section 579 (charge to tax on royalties and other income from intellectual property).
- (7) Head 4 is expenditure on acquiring shares or other securities.
- (8) Head 5 is expenditure on acquiring another business.
- (9) In subsection (8) “business” means something which is –
  - (a) a trade, profession or vocation for the purposes of the Income Tax Acts or the Corporation Tax Acts,
  - (b) a property business (within the meaning of section 263(6)), or
  - (c) an investment business (that is, a business consisting wholly or partly of making investments).
- (10) Head 6 is expenditure on acquiring, creating or improving any asset which –
  - (a) is acquired or created as an investment, or
  - (b) generates income that is chargeable to tax under Part 4 (savings and investment income).
- (11) Head 7 is expenditure on acquiring, creating or improving any asset which, at the time of its acquisition or creation, could not reasonably be expected to decrease significantly in value with the passage of time.”

- 9 In section 38 (restriction of deductions in respect of employee benefit contributions), after subsection (2) insert –
- “(2A) In calculating for income tax purposes the profits of a trade on the cash basis, this section has effect as if –
- (a) in subsection (1), the words “or to be made” were omitted, and
  - (b) in subsection (2), the words “or within 9 months from the end of it” were omitted (in both places).”
- 10 Before section 52 (and after the heading “*Interest payments*”) insert –
- “51A Cash basis: interest payments on loans**
- (1) In calculating the profits of a trade on the cash basis, no deduction is allowed for the interest paid on a loan.
  - (2) This is subject to section 57B.”
- 11 (1) Section 55A (expenditure on integral features) is amended as follows.
- (2) The existing provision becomes subsection (1).
  - (3) After that subsection insert –
- “(2) But section 33A(3) of CAA 2001 does not apply in calculating the profits of a trade on the cash basis.”
- 12 After section 55B insert –

*“Cash basis: rental payments*

**55C Cash basis: rental payments**

- (1) This section applies if, in calculating the profits of a trade on the cash basis for the basis period for a tax year, a deduction would otherwise be allowable for the period in respect of any expenses paid in renting, leasing or hiring an asset that is used for the purposes of the trade.
- (2) No deduction is allowed for the expenses unless condition A or condition B is met.
- (3) Condition A is that, if the asset had been acquired for the purposes of the trade, the expenditure on acquiring the asset would have been allowable as a deduction in calculating the profits of the trade on the cash basis.
- (4) Condition B is that the expenses relate to the use of the asset in –
  - (a) the basis period mentioned in subsection (1), or
  - (b) the period of 3 months beginning immediately after the end of that basis period.”

*Rules allowing deductions*

- 13 Chapter 5 (trade profits: rules allowing deductions) is amended as follows.
- 14 After section 56 insert –

*“Cash basis accounting*

**56A Overview of rules for calculating profits on cash basis**

- (1) The following sections do not apply in calculating the profits of a trade on the cash basis –
  - sections 60 to 67 (tenants under taxed leases),
  - section 68 (replacement and alteration of trade tools).
- (2) For rules allowing deductions that apply only where profits are calculated on the cash basis, see the following –
  - section 57B (cash basis: interest payments on loans),
  - section 94B (cash basis: VAT payments).
- (3) In calculating the profits of a trade on the cash basis –
  - (a) any reference in this Chapter to the incurring of expenses is to be read as a reference to the paying of expenses, and
  - (b) any reference in this Chapter to a period of account is to be read as a reference to a basis period.”

15 After section 57A insert –

*“Cash basis: interest payments*

**57B Cash basis: interest payments on loans**

- (1) This section applies if a person carrying on a trade in a period pays any interest on a loan during the period and –
  - (a) a deduction for the interest would not otherwise be allowable in calculating the profits of the trade because of section 51A, or
  - (b) in the absence of section 51A, a deduction for the interest would not otherwise be allowable in calculating the profits of the trade because (and only because) it was not an expense incurred wholly and exclusively for the purposes of the trade.
- (2) In calculating the profits of the trade on the cash basis, a deduction is allowed for the interest.
- (3) But the maximum amount that may be deducted by virtue of this section or section 58 (incidental costs of obtaining finance) in calculating the profits of a trade for any period is £500.
- (4) The Treasury may by order amend the figure for the time being specified in subsection (3).
- (5) A statutory instrument containing an order under this section that amends that figure so as to substitute a lower figure may not be made unless a draft of the instrument has been laid before, and approved by a resolution of, the House of Commons.”

16 In section 58 (incidental costs of obtaining finance), in subsection (5), after “with” insert “–

- (a) section 57B(3) (which imposes a limit on the total amount that may be deducted by virtue of this section or section 57B), and
- (b) ”.

- 17 In section 72 (payroll deduction schemes: contributions to agents' expenses), after subsection (2) insert –
- “(2A) In calculating the profits of the employer's trade on the cash basis, subsection (2) has effect as if paragraph (b) were omitted.”
- 18 In section 94A (costs of setting up SAYE option scheme or CSOP scheme), after subsection (4) insert –
- “(5) But subsection (4) does not apply in calculating the profits of a trade on the cash basis.”
- 19 After section 94A insert –

*“Cash basis: VAT payments*

**94B Cash basis: VAT payments**

- (1) This section applies if a person carrying on a trade in a period is a taxable person for the purposes of VATA 1994.
- (2) In calculating the profits of the trade for the period on the cash basis, a deduction is allowed for any amount of value added tax paid by the person.
- (3) This section is subject to section 34 (no deduction allowed for expenses not incurred wholly and exclusively for the purposes of a trade).  
Accordingly, section 31 (relationship between rules prohibiting and allowing deductions) is subject to this subsection.”

*Receipts*

- 20 Chapter 6 (trade profits: receipts) is amended as follows.
- 21 After section 95 insert –

*“Cash basis accounting*

**95A Overview of rules for calculating profits on cash basis**

For rules about receipts that apply only for the purpose of calculating profits on the cash basis, see the following –  
section 96A (cash basis: capital receipts),  
section 97A (cash basis: value of trading stock on cessation of trade),  
section 106A (cash basis: VAT receipts),  
section 106B (cash basis: repayments of rent etc).”

- 22 After section 96 insert –

**“96A Cash basis: capital receipts**

- (1) This section applies if the cost of acquiring, creating or improving an asset has been brought into account in calculating the profits of a trade of a person on the cash basis (or would have been so brought into account if an election under section 25A had had effect in relation to the trade at the time the asset was acquired or created).

- (2) The following amounts are to be brought into account as a receipt in calculating the profits of the trade on the cash basis –
- (a) any proceeds arising from the disposal of the asset or any part of it;
  - (b) any proceeds arising from the grant of any right in respect of, or any interest in, the asset;
  - (c) any amount of damages, proceeds of insurance or other compensation received in respect of the asset.
- (3) In a case where the amount of any proceeds within subsection (2)(a) or (b) is less than the market value amount, the amount to be brought into account under subsection (2) is an amount equal to the market value amount.
- (4) If –
- (a) at any time the person ceases to use the asset or any part of it for the purposes of the trade, but
  - (b) the person does not dispose of the asset (or that part) at that time,
- the person is to be regarded for the purposes of this section as disposing of the asset (or that part) at that time for an amount equal to the market value amount.
- (5) If at any time there is an increase in the person’s non-business use of the asset or any part of it, the person is to be regarded for the purposes of this section as disposing of the asset (or that part) at that time for an amount equal to the relevant proportion of the market value amount.
- (6) For the purposes of subsection (5) –
- (a) there is an increase in a person’s non-business use of an asset (or part of an asset) if the person’s use of the asset (or that part) for the purposes of the trade decreases and the person’s use of the asset (or that part) for other purposes (the “non-business use”) increases, and
  - (b) “the relevant proportion” is the difference between –
    - (i) the proportion of the person’s use of the asset (or part of the asset) that is non-business use, and
    - (ii) the proportion of the person’s use of the asset (or that part) that was non-business use before the increase mentioned in subsection (5).
- (7) In this section “the market value amount” means the amount that would be regarded as normal and reasonable –
- (a) in the market conditions then prevailing, and
  - (b) between persons dealing with each other at arm’s length in the open market.
- (8) In a case where only part of the cost of acquiring, creating or improving an asset has been brought into account as mentioned in subsection (1), the amount brought into account under subsection (2) is proportionately reduced.”

*“Cash basis: value of trading stock on cessation*

**97A Cash basis: value of trading stock on cessation of trade**

- (1) This section applies if –
    - (a) a person permanently ceases to carry on a trade in a tax year, and
    - (b) an election under section 25A (cash basis for small businesses) has effect in relation to the trade for the tax year.
  - (2) The value of any trading stock belonging to the trade at the time of the cessation is brought into account as a receipt in calculating the profits of the trade for the tax year.
  - (3) The value is the value determined in accordance with sections 175 to 178.
  - (4) In this section “trading stock” has the meaning given by section 174(1).”
- 24 In section 98 (acquisition of trade: receipts from transferor’s trade), after subsection (2) insert –
- “(2A) For the purpose of calculating the profits of the transferee’s trade on the cash basis, the reference in subsection (2) to the period of account in which the sums mentioned in that subsection are received is to be read as a reference to the basis period in which those sums are received.”
- 25 In section 102 (reverse premiums: arrangements not at arm’s length), after subsection (5) insert –
- “(6) In calculating the profits of a trade on the cash basis, this section has effect as if any reference to a period of account were a reference to a basis period.”
- 26 (1) Section 105 (industrial development grants) is amended as follows.
- (2) In subsection (2), at the end of paragraph (a) insert “(but see subsection (2A))”.
  - (3) After that subsection insert –
- “(2A) Subsection (2)(a) is to be disregarded in calculating the profits of a trade on the cash basis.”
- 27 After section 106 insert –

*“Cash basis: VAT receipts*

**106A Cash basis: VAT receipts**

- (1) In calculating the profits of a trade for a period on the cash basis, the following amounts are to be brought into account as receipts of the trade –
  - (a) any amount of VAT paid to the person carrying on the trade,
  - (b) any amount received by the person by way of a refund of VAT, and

- (c) where the person has paid any amount by way of VAT that was not VAT due to the Commissioners for Her Majesty’s Revenue and Customs, any amount received by the person by way of a repayment of that amount.

- (2) In this section “VAT” means value added tax.”

28 After section 106A (inserted by paragraph 27) insert –

*“Cash basis: repayments of rent etc*

**106B Cash basis: repayments of rent etc**

- (1) This section applies for the purpose of calculating the profits of a trade of a person on the cash basis.
- (2) Subsection (3) applies if any expenses paid in renting, leasing or hiring an asset have been brought into account in calculating the profits of the trade on the cash basis (or would have been so brought into account if an election under section 25A had had effect in relation to the trade at the time the expenses were paid).
- (3) Any amounts received by the person in connection with the rental, lease or hire of the asset are to be brought into account as receipts of the trade.”

*Amounts not reflecting commercial transactions*

29 After Chapter 6 insert –

**“CHAPTER 6A**

TRADE PROFITS: AMOUNTS NOT REFLECTING COMMERCIAL TRANSACTIONS

**106C Professions and vocations**

The provisions of this Chapter apply to professions and vocations as they apply to trades.

**106D Application of Chapter**

This Chapter applies in calculating the profits of a person’s trade for a period on the cash basis.

**106E Amounts not reflecting commercial transactions**

- (1) This section applies if –
- (a) the person does anything in relation to the trade (“the relevant act”),
- (b) there is a difference between –
- (i) the amount (if any) that, as a result of the relevant act, would (apart from this section) be brought into account in calculating the profits of the trade for the period, and
- (ii) the amount (if any) that would have been so brought into account had the relevant act occurred between the person and another person dealing with each

- other at arm's length in the open market ("the arm's length amount"), and
- (c) the profits for the period are less than they would have been if the arm's length amount had been so brought into account.
- (2) The amount to be brought into account in calculating the profits of the trade for the period is an amount that is just and reasonable in all the circumstances.

#### **106F Capital receipts**

Section 106E does not apply in relation to the relevant act if any of subsections (3) to (5) of section 96A (cash basis: capital receipts) applies in relation to that act.

#### **106G Gifts to charities etc**

Section 106E does not apply in relation to the relevant act if any of the provisions of Chapter 7 (trade profits: gifts to charities etc) applies in relation to that act.

#### **106H Changes in trading stock**

Section 106E does not apply in relation to the relevant act if any of the provisions of Chapter 11A (trade profits: changes in trading stock) applies in relation to that act."

#### *Herd basis rules*

- 30 In Chapter 8 (trade profits: herd basis rules), after section 111 insert –

#### **"111A Herd basis rules not to apply where cash basis used**

Nothing in this Chapter applies in calculating the profits of a trade on the cash basis."

#### *Sound recordings*

- 31 In Chapter 9 (trade profits: sound recordings), after section 130 insert –

#### **"130A Chapter not to apply where cash basis used**

Nothing in this Chapter applies in calculating the profits of a trade on the cash basis."

#### *Telecommunication rights*

- 32 In Chapter 10 (trade profits: certain telecommunication rights), before section 145 insert –

#### **"144A Chapter not to apply where cash basis used**

Nothing in this Chapter applies in calculating the profits of a trade on the cash basis."



*Long funding leases*

- 33 In Chapter 10A (leases of plant and machinery: special rules for long funding leases), before section 148A (and the italic heading preceding it) insert –

*“Application of Chapter*

**148ZA Chapter not to apply where cash basis used**

Nothing in this Chapter applies in calculating the profits of a trade on the cash basis.”

*Specific trades*

- 34 In Chapter 11 (trade profits: other specific trades), before section 149 (and the italic heading preceding that section) insert –

*“Cash basis accounting*

**148K Overview of rules for calculating profits on cash basis**

The following sections do not apply in calculating the profits of a trade, profession or vocation on the cash basis –

sections 149 to 154A (dealers in securities etc),  
 section 157 (relief in respect of mineral royalties),  
 section 158 (lease premiums etc: reduction of receipts),  
 section 159 (ministers of religion),  
 section 162 (payments by persons liable to pool betting duty),  
 sections 163 and 164 (intermediaries treated as making employment payments),  
 section 164A (managed service companies),  
 sections 165 to 168 (waste disposal),  
 sections 169 to 172ZE (cemeteries and crematoria).”

*Unremittable amounts*

- 35 In Chapter 13 (deductions from profits: unremittable amounts), after section 188 insert –

**“188A Chapter not to apply where cash basis used**

Nothing in this Chapter applies in calculating the profits of a trade on the cash basis.”

*Disposal and acquisition of know-how*

- 36 In Chapter 14 (disposal and acquisition of know-how), before section 192 insert –

**“191A Chapter not to apply where cash basis used**

Nothing in this Chapter applies in calculating the profits of a trade on the cash basis.”

*Basis periods*

- 37 Chapter 15 (basis periods) is amended as follows.
- 38 (1) Section 198 (general rule) is amended as follows.
- (2) In subsection (2), omit the “and” before “section 216” and at the end insert –  
“section 220E (first tax year after using cash basis),  
section 220F (second tax year after using cash basis).”
- (3) After that subsection insert –  
“(3) Where an election under section 25A (cash basis for small businesses) has effect for a tax year, the basis period for the tax year is given by section 220A (and not by subsection (1) or any of the sections mentioned in subsection (2)).”
- 39 In section 203 (apportionment etc of profits to basis periods), after subsection (1) insert –  
“(1A) But nothing in this section applies in calculating the profits of a trade on the cash basis.”
- 40 (1) Section 205 (deduction for overlap profit in final tax year) is amended as follows.
- (2) Before subsection (1) insert –  
“(A1) This section applies if –  
(a) a person permanently ceases to carry on a trade in a tax year, or  
(b) an election under section 25A (cash basis for small businesses) has effect in relation to the trade for the tax year.”
- (3) In subsection (1), for the words from “If” to “a deduction” substitute “A deduction”.
- (4) The heading of the section becomes “**Deduction for overlap profit**”.
- 41 In section 206 (restriction on bringing losses into account twice) –  
(a) the existing provision becomes subsection (1), and  
(b) after that subsection insert –  
“(2) This section does not apply in calculating the profits of a trade on the cash basis.”
- 42 In section 207 (treatment of business start-up payments received in an overlap period), after subsection (1) insert –  
“(1A) But nothing in this section applies in calculating the profits of a trade on the cash basis.”
- 43 In section 208 (when the late accounting date rules apply), after subsection (2) insert –  
“(2A) But nothing in section 209 or 210 applies in calculating the profits of a trade on the cash basis.”
- 44 In section 220 (deduction for overlap profit on change of accounting date), after subsection (1) insert –

“(1A) But nothing in this section applies in calculating the profits of a trade on the cash basis.”

45 After section 220 insert –

*“Special rules if cash basis used*

**220A Rule if cash basis is used for a tax year**

- (1) This section applies in relation to a trade if an election under section 25A (cash basis for small businesses) has effect in relation to the trade for a tax year.
- (2) The basis period for the tax year is the period –
  - (a) beginning immediately after the end of the basis period for the previous tax year, and
  - (b) ending with the chosen date for that tax year.
- (3) This applies unless a different basis period is given by one of the following sections –
  - section 220B (no chosen date),
  - section 220C (first tax year in which trade carried on),
  - section 220D (final tax year in which trade carried on).
- (4) The “chosen date”, in relation to a tax year, is a date chosen by the person carrying on the trade which falls within the period –
  - (a) beginning with the 31st March in that tax year, and
  - (b) ending with the 30th April immediately following the end of that tax year.

**220B No chosen date**

- (1) This section applies if a person carries on a trade in a tax year and –
  - (a) an election under section 25A has effect in relation to the trade for the tax year,
  - (b) the person does not start or permanently cease to carry on the trade in the tax year, and
  - (c) there is no chosen date for the tax year for the purposes of section 220A(4).
- (2) The basis period for the tax year is the period –
  - (a) beginning immediately after the end of the basis period for the previous tax year, and
  - (b) ending with the 5th April in the tax year.

**220C First tax year in which trade carried on**

- (1) This section applies if –
  - (a) a person starts to carry on a trade in a tax year, and
  - (b) an election under section 25A has effect in relation to the trade for the tax year.
- (2) The basis period for the tax year –
  - (a) begins with the date on which the person starts to carry on the trade, and
  - (b) ends with the chosen date for that tax year.

- (3) But if a person starts and permanently ceases to carry on a trade in the same tax year, the basis period for the tax year is that given by section 220D(3).
- (4) If there is no chosen date for the tax year, the basis period for the tax year –
  - (a) begins with the date on which the person starts to carry on the trade, and
  - (b) ends with the 5th April in that tax year.
- (5) If the person starts to carry on the trade after 31st March –
  - (a) the profits or losses of the trade of the tax year are treated as nil, and
  - (b) the actual profits and losses of the trade of the tax year are treated as arising in the basis period for the following tax year.

#### **220D Final tax year in which trade carried on**

- (1) This section applies if –
  - (a) a person permanently ceases to carry on a trade in a tax year, and
  - (b) an election under section 25A has effect in relation to the trade for the tax year.
- (2) The basis period for the tax year –
  - (a) begins immediately after the end of the basis period for the previous tax year, and
  - (b) ends with the date on which the person permanently ceases to carry on the trade.
- (3) But if a person starts and permanently ceases to carry on a trade in the same tax year, the basis period –
  - (a) begins with the date on which the person starts to carry on the trade, and
  - (b) ends with the date on which the person permanently ceases to carry on the trade.

#### **220E First tax year after using cash basis**

- (1) This section applies if –
  - (a) a person carries on a trade in a tax year (“the current tax year”),
  - (b) the person does not permanently cease to carry on the trade in the current tax year,
  - (c) an election under section 25A had effect in relation to the trade for the previous tax year, and
  - (d) no such election has effect in relation to the trade for the current tax year.
- (2) The basis period for the current tax year –
  - (a) begins immediately after the end of the basis period for the previous tax year, and
  - (b) ends with the relevant date in the current tax year.

- (3) If there is an accounting date in the current tax year and that date is 31st March or 1st, 2nd, 3rd or 4th April, the relevant date is the accounting date.
- (4) In any other case, the relevant date is the 5th April in the current tax year.

### **220F Second tax year after using cash basis**

- (1) This section applies if—
  - (a) a person carries on a trade in a tax year (“the current tax year”),
  - (b) the person does not permanently cease to carry on the trade in the current tax year, and
  - (c) section 220E (first tax year after using cash basis) had effect for the previous tax year.
- (2) The basis period for the current tax year is the period of 12 months beginning immediately after the end of the basis period for the previous tax year.”

#### *Averaging profits of farmers and creative artists*

- 46 In Chapter 16 (averaging profits of farmers and creative artists), after section 221 insert—

#### **“221A Claim not available where cash basis used**

Nothing in this Chapter applies in calculating the profits of a trade on the cash basis.”

#### *Compensation for compulsory slaughter of animal*

- 47 In Chapter 16ZA (compensation for compulsory slaughter of animal), after section 225ZA insert—

#### **“225ZAA Chapter not to apply where cash basis used**

Nothing in this Chapter applies in calculating the profits of a trade on the cash basis.”

#### *Oil activities*

- 48 In Chapter 16A (oil activities), before section 225A (and the italic heading preceding it) insert—

#### *“Application of Chapter*

#### **225ZH Chapter not to apply where cash basis used**

Nothing in this Chapter applies in calculating the profits of a trade on the cash basis.”

#### *Adjustment income*

- 49 In Chapter 17 (adjustment income), after section 227 insert—

### “227A Application of Chapter where cash basis used

- (1) This Chapter applies if –
  - (a) an election under section 25A (cash basis for small businesses) has effect in relation to a trade for a tax year but no such election has effect in relation to the trade for the following tax year, or
  - (b) no such election has effect in relation to a trade for a tax year but such an election has effect in relation to the trade for the following tax year.
- (2) But this Chapter does not apply to income which is charged in accordance with section 832.
- (3) In calculating the profits of a trade on the cash basis, any reference in any subsequent provision of this Chapter to a period of account is, in relation to a time when an election under section 25A has effect in relation to the trade, to be read as a reference to a basis period.”

#### *Post-cessation receipts*

- 50 (1) Chapter 18 (post-cessation receipts) is amended as follows.
- (2) In section 246 (basic meaning of “post-cessation receipt”), after subsection (2) insert –

“(2A) If, immediately before a person permanently ceases to carry on a trade, an election under section 25A (cash basis for small businesses) has effect in relation to the trade, a sum is to be treated as a post-cessation receipt only if it would have been brought into account in calculating the profits of the trade on the cash basis had it been received at that time.”
  - (3) In section 254 (allowable deductions), after subsection (2) insert –

“(2A) If, immediately before a person permanently ceases to carry on a trade, an election under section 25A (cash basis for small businesses) has effect in relation to the trade, assume for the purposes of subsection (2) that such an election has effect in relation to the trade.”

#### *Rent-a-room relief*

- 51 In Chapter 1 of Part 7 of ITTOIA 2005 (rent-a-room relief), in section 786 (meaning of “rent-a-room receipts”), after subsection (4) insert –
- “(5) Subsections (6) and (7) apply if –
    - (a) the receipts would otherwise be brought into account in calculating the profits of a trade, and
    - (b) an election under section 25A (cash basis for small businesses) has effect in relation to the trade.
  - (6) Any amounts brought into account under section 96A (capital receipts) as a receipt in calculating the profits of the trade are to be treated as receipts within paragraph (a) of subsection (1) above.
  - (7) The reference in subsection (1)(b) to receipts that accrue to an individual during the income period for those receipts is to be read

as a reference to receipts that are received by the individual during that period.”

*Qualifying care relief*

- 52 Chapter 2 of Part 7 of ITTOIA 2005 (qualifying care relief) is amended as follows.
- 53 In section 805 (meaning of “qualifying care receipts”), after subsection (3) insert –
- “(4) Subsections (5) and (6) apply if –
- (a) the receipts would otherwise be brought into account in calculating the profits of a trade, and
- (b) an election under section 25A (cash basis for small businesses) has effect in relation to the trade.
- (5) Any amounts brought into account under section 96A (capital receipts) as a receipt in calculating the profits of the trade are to be treated as receipts within paragraph (a) of subsection (1) above.
- (6) The reference in subsection (1)(b) to receipts that accrue to an individual during the income period for those receipts is to be read as a reference to receipts that are received by the individual during that period.”
- 54 In section 820 (periods of account not ending on 5th April) –
- (a) the existing provision becomes subsection (1), and
- (b) after that subsection insert –
- “(2) Where an election under section 25A (cash basis for small businesses) has effect in relation to the trade, any reference in this section or sections 821 to 823 to the period of account in which receipts accrue is to be read as a reference to the basis period in which receipts are received.”

PART 2

CONSEQUENTIAL AMENDMENTS

*TMA 1970*

- 55 In section 42 of TMA 1970 (procedure for making claims etc), in subsection (7)(e), after “sections” insert “25A,”.

*CAA 2001*

- 56 In section 1 of CAA 2001 (capital allowances), after subsection (3) insert –
- “(4) But a person is not entitled to any allowance or liable to any charge under this Act in calculating the profits of a trade, profession or vocation of the person in relation to which an election under section 25A of ITTOIA 2005 (cash basis for small businesses) has effect.”

ITTOIA 2005

- 57 Omit section 160 of ITTOIA 2005 (cash basis of calculation for barristers and advocates in early years of practice).

ITA 2007

- 58 In Part 4 of ITA 2007 (loss relief), in Chapter 2 (trade losses), after section 74D insert –

*“Restriction on sideways relief and capital gains relief where cash basis applies*

**74E No relief where cash basis used to calculate losses**

- (1) This section applies if –
- (a) a person makes a loss in any trade in a tax year, and
  - (b) an election under section 25A of ITTOIA 2005 (cash basis for small businesses) has effect in relation to the trade for that tax year.
- (2) No sideways relief or capital gains relief may be given to the person for the loss.
- (3) For the purposes of this section –
- (a) capital gains relief is, in relation to a loss, the treatment of a loss as an allowable loss by virtue of section 261B of TCGA 1992 (use of trading loss as a CGT loss), and
  - (b) capital gains relief is given for a loss when it is so treated.”
- 59 (1) Chapter 1 of Part 8 of ITA 2007 (relief for interest payments) is amended as follows.
- (2) In section 383(5), after paragraph (a) insert –
- “(aa) section 384B (restriction on relief where cash basis applies),”.
- (3) After section 384A insert –

**“384B Restriction on relief where cash basis applies**

- (1) Relief is not to be given under this Chapter for a tax year for interest paid by a person on a relevant loan if the partnership to which the loan relates has made an election under section 25A of ITTOIA 2005 (cash basis for small businesses) for the tax year.
- (2) A loan is a “relevant loan” if –
- (a) it is a loan to which section 388 applies (loan to buy plant or machinery for partnership use), or
  - (b) it is a loan to which section 398 applies (loan to invest in partnership) and which is not used for purchasing a share in a partnership.”

PART 3

COMMENCEMENT

- 60 The amendments made by this Schedule have effect for the tax year 2013-14 and subsequent tax years.





**EXPLANATORY NOTE**

**CASH BASIS FOR SMALL BUSINESSES**

**SUMMARY**

1. This schedule provides that eligible individuals carrying on a trade or profession as self employed sole traders or in partnership with other individuals can choose to use a cash basis to calculate taxable income.

**DETAILS OF THE SCHEDULE**

2. Paragraph 3 amends section 25(3) Income Tax (Trading and other Income) Act 2005 (ITTOIA). Section 25(1) provides that profits of a trade are calculated in accordance with Generally Accepted Accounting Practice. Section 25(3) is amended so that section 25 is subject to new section 25A which provides for calculation of profits on a cash basis for small businesses. The new cash basis legislation replaces the alternative basis for barristers in the early years of practice allowed by section 160.
3. Paragraph 4 inserts a new section 25A of ITTOIA.
4. New subsection 25A(1) provides that a person carrying on a trade profession or vocation can elect to use the cash basis.
5. New subsection 25A(4) provides that sections 27, 28 and 30 of ITTOIA do not apply to those using the cash basis. These sections deal with receipts and expenses under Generally Accepted Accounting Practice and animals kept for trade purposes.
6. Paragraph 5 introduces a new Chapter 3A to Part 2 of ITTOIA dealing with when a person is eligible to make an election to use the cash basis under section 25A and the effect of an election.
7. New Section 31A details conditions A to C which a person must meet to be eligible to elect to use the cash basis.
  - Condition A is that the aggregate of cash basis receipts of each business carried on by the person in the tax year does not exceed any applicable relevant maximum. (New section 31B deals with when a relevant maximum applies and what that amount is).
  - Condition B sets out how the aggregate receipts condition applies in the case of a partnership controlled by an individual and of an individual who controls a partnership. It also requires that where a person is a partnership controlled by an individual, the

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individual must have elected to use the cash basis for calculating his trading income, and where a person is an individual who controls a firm, the partnership must also have made a cash basis election for the tax year.

- Condition C is that the person does not fall within any of the “excluded persons” categories set out in new section 31C.
8. New subsection 31A(5) provides that cash receipts in a tax year means any receipts that are received in a tax year or would be included in calculating the profits of the trade for that tax year.
  9. New section 31B details the conditions regarding the ‘relevant maximum’. There is a relevant maximum if any of three conditions is met.
  10. New subsection 31B(2) provides Condition A which is that the business was not in the cash basis in the previous tax year.
  11. New subsection 31B(3) provides Condition B which is that the aggregate of cash basis receipts for each business carried on is greater than twice the VAT threshold in the previous tax year.
  12. New subsection 31B(4) provides Condition C which is that the person is an individual who controls a partnership or a partnership controlled by an individual, and the aggregate of cash basis receipts in the previous tax year exceeded double the VAT threshold.
  13. New subsection 31B(5) provides that the ‘relevant maximum’ that applies if any of conditions A-C is met is the VAT threshold and double the VAT threshold where the person is a Universal Credit claimant.
  14. New Section 31C sets out the categories of person that are excluded from electing to use the cash basis, for example, a partnership where any of the partners is a company.
  15. New section 31D provides that an election under section 25A has effect for the tax year in which it is made and for all the trades professions or vocations carried on by the person in the tax year. New section 31D also signposts the amendment to the Capital Allowances Act 2001 which precludes a person using the cash basis from claiming capital allowances.
  16. New section 31E provides for how profits are determined on the cash basis. There are two steps, firstly calculate the total trade receipts received in the basis period for the tax year and secondly, from that figure deduct the total amount of expenses of the trade paid during the basis period of the tax year (subject to any adjustments required or authorised by law).

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17. Paragraphs 6 to 12 amend Chapter 4 Part 2 ITTOIA, dealing with trade profits: rules restricting deductions.
18. New section 32A gives an overview of how this Chapter applies when calculating profits on a cash basis.
19. New section 33A details the types of capital expenditure not allowed as a deduction for those using the cash basis to calculate the profits of a trade. Capital expenditure not allowed includes expenditure on land, cars and motorcycles. Capital expenditure not within new section 33A is allowable as an expense in computing taxable income under the cash basis. Under the normal rules, section 33 ITTOIA disallows any capital expenditure as a deduction in calculating the profits of a trade.
20. Paragraph 9 amends section 38 which provides that where an employee benefit contribution is made, a deduction is available to the trader only if certain qualifications are met. This section is amended with the effect that for calculating taxable income on the cash basis the employee benefit contributions have to be made in the taxable period.
21. Paragraph 10 inserts new section 51A which provides that in calculating profits of a trade on a cash basis no deduction is allowed for interest paid. This section is subject to new section 57B.
22. Paragraph 11 amends section 55A. Section 55A provides that no deduction is available for integral features of a building or structure as detailed in section 33A(3) Capital Allowances Act 2001. As amended, section 55A signposts that s.33A(3) does not apply in the cash basis.
23. Paragraph 12 inserts new section 55C into ITTOIA. This section provides that where an asset is rented leased or hired then the expense of renting leasing or hiring is not an allowable expense in calculating the profits of a business on the cash basis unless the acquisition costs of the asset would have been an allowable expense for cash basis purposes and that the expenses relate to the use of the asset in the current or following basis periods.
24. Paragraphs 13 to 19 amend Chapter 5 Part 2 ITTOIA dealing with 'trade profits: rules allowing deductions'.
25. New section 56A provides an overview of the rules in Chapter 5 for calculating profits on the cash basis.
26. Paragraph 15 inserts a new section 57B. This allows that, in calculating profits of a trade under the cash basis, where a deduction would otherwise be disallowed under new section 51A, or where in the absence of section 51A a deduction would not be allowable only

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because it was not an expense wholly and exclusively for the trade, a deduction is allowed for interest paid of up to £500.

27. Paragraph 16 amends section 58 which allows incidental costs of finance so that on the cash basis, the maximum deduction which may be made for those costs when taken together with interest allowable under new section 57B is £500.
28. Paragraph 17 amends section 72 which deals with payroll expenses so that contributions to agents expenses are only allowed as a deduction when the expenses have been incurred.
29. Paragraph 18 amends section 94A which allows expenses of setting up a SAYE or CSOP option scheme. The amendment ensures that only expenses paid in respect of such schemes are allowable deductions for computing income under the cash basis.
30. Paragraph 19 inserts new section 94B. New section 94B provides that where a person using the cash basis is a taxable person under the Value Added Tax Act 1994 then the value added tax paid is allowed as a deduction in calculating profits for the period on the cash basis.
31. New section 94B(3) restricts the deduction of VAT to expenses that are incurred wholly and exclusively for the purposes of a business and is subject to section 34.
32. Paragraph 21 inserts new section 95A. This provides that rules about receipts which apply only for the purposes of calculating profits under the cash basis can be found at new sections 96A, 97A, 106A and 106B.
33. Paragraph 22 inserts new section 96A which provides how capital receipts are to be treated under the cash basis.
34. New section 96A(1) provides that section 96A applies where an asset has been brought into account in calculating profits under the cash basis, or would have done if the cash basis had been elected for when the asset was acquired.
35. New subsection (2) provides that the amounts to be brought into account as a receipt of the cash basis are any proceeds arising from disposing of the asset or part of the asset, any proceeds arising from the grant of any right or interest in the asset or any damages, insurance or compensation received in respect of the asset.
36. New subsection (3) provides that where the proceeds from disposal are less than market value then market value is the amount to be brought to account for the cash basis.
37. New subsection (4) provides that where a person ceases to use an asset but does not dispose of it an amount equal to market value is

brought into account for the cash basis at the time that use of the asset ceases.

38. New subsection (5) provides that where there is an increase in the proportion of non business use of an asset then an amount is brought into account by treating the asset as disposed of and for the relevant proportion of the market value amount relating to the increase.
39. New subsection (6) provides the mechanism by which changes in the proportion of non business use before disposal are dealt with.
40. New subsection (7) defines market value for the purpose of section 96A. That is an amount that would be regarded as normal and reasonable in the prevailing market conditions at arm's length in the open market.
41. New subsection (8) provides that where only part of the cost of the asset has been brought into account under subsection (1) the amount brought into account under subsection (2) is reduced accordingly.
42. Paragraph 23 introduces new section 97A provides that where a cash basis business ceases the value of stock on hand at cessation is brought into accounts as a receipt of the business.
43. Paragraph 26 amends section 105 ITTOIA which deals with particular grants received and treats them as trading income. One of the exceptions to this is where the grant is towards the cost of capital expenditure. The new subsection (2A) disapplies this exception when calculating profits under the cash basis.
44. Paragraph 27 inserts new section 106A into ITTOIA. This new section provides that where a person using the cash basis is a taxable person under the Value Added Tax Act 1994 then the value added tax paid to the person including repayments of VAT are receipts to be brought into account in calculating profits for the period on the cash basis.
45. Paragraph 28 inserts new section 106B into ITTOIA. This section provides that where an asset is rented leased or hired and the expense of renting leasing or hiring has been brought into account in calculating the profits of a business on the cash basis then any income received in connection with the rental lease or hire of the asset are to be brought into account as receipts of the trade.
46. Paragraph 29 inserts new chapter 6A which applies only in relation to the cash basis and which deals with bringing into account amounts which do not reflect commercial transactions.
47. New section 106E of chapter 6A provides that where there is a difference between the amount brought into account in respect of a transaction and the amount that would be brought into account if the

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transaction was at arm's length then the amount which must be brought into account is a just and reasonable amount.

48. New section 106F disapplies new 106E where the transaction involves a capital receipt (new section 96A covers this situation).
49. New section 106G disapplies new 106E where the transaction involves a gift to charity.
50. New section 106H disapplies new 106E where Chapter 11A applies to the transaction. Chapter 11A concerns changes in trading stock.
51. Paragraph 30 inserts new section 111A into ITTOIA which disapplies the 'herd basis rules' (a tax treatment where a person has a production herd) for those using the cash basis.
52. Paragraph 31 inserts new section 130A which disapplies chapter 9 Part 2 ITTOIA (sound recordings), for the purposes of calculating profits under the cash basis.
53. Paragraph 32 inserts new section 144A which disapplies chapter 10 Part 2 ITTOIA (telecommunication rights), for the purposes of calculating profits under the cash basis.
54. Paragraph 33 inserts new section 148ZA into ITTOIA which disapplies Chapter 10A (regarding long funding leases) for those using the cash basis.
55. Paragraph 34 inserts new section 148K into ITTOIA which disapplies legislation relating to specific trades for those using the cash basis.
56. Paragraph 35 inserts new section 188A into ITTOIA which disapplies Chapter 13 Part 2 ITTOIA (deductions from profits: unremittable amounts) for those using the cash basis.
57. Paragraph 36 inserts new section 191A into ITTOIA which disapplies Chapter 14 Part 2 ITTOIA (Disposal and Acquisition of know-how) for those using the cash basis.
58. Paragraph 37 introduces amendments to Chapter 15 Part 2 ITTOIA which concerns basis periods.
59. Paragraph 45 inserts new sections 220A-E which provide for special rules on basis periods where the cash basis is used or has been used.
60. New section 220A introduces special rules where the cash basis is used for a tax year.
61. New section 220A(2) provides that the basis period for a tax year is the period beginning immediately after the end of the previous basis period and ends on the chosen date for that tax year.

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62. New section 220A(3) provides that subsection (2) applies except for where there is no chosen date (in which case new section 220B applies), in the first tax year in which the trade is carried on (in which case new section 220C will apply), or in the final tax year in which trade is carried on (in which case new section 220D will apply).
63. New section 220A(4) provides for the 'chosen date'. This is a date chosen by the trader that falls in the period beginning with the 31 March in the tax year and ending with the 30 April following the end of that tax year.
64. New section 220B provides that for a person who has elected to use the cash basis but not chosen an end date then the basis period ends with 5 April of the tax year.
65. New section 220C provides the basis period for a person electing to use the cash basis for a trade that starts in the tax year. The basis period will be from the date the trade started to the chosen date unless the trade also ceases in the tax year in which case the basis period is provided for in new section 220D. If there is no chosen date the basis period ends on 5 April in that tax year.
66. New section 220D provides for the basis period when a business using the cash basis ceases. The basis period will begin immediately after the end of the previous basis period and end on the date the business is permanently ceased. If a person using the cash basis starts and ceases his business in a year then the basis period runs from the date the person starts the business to the date the person ceases the business.
67. New section 220E provides for what happens when a continuing business stops electing to use the cash basis. The basis period will begin immediately after the end of the basis period of the previous tax year and end on the relevant date in the current year. The relevant date is the accounting date in that tax year, and in the absence of an accounting date the relevant date will be 31 March.
68. Paragraph 46 inserts new section 221A into ITTOIA to disapply chapter 16 which allows for averaging of profits of farmers and creative artists. New section 221A disapplies the averaging provisions for those using the cash basis.
69. Paragraph 47 inserts new section 225ZAA into ITTOIA to disapply chapter 16ZA which provides for the treatment of compensation when animals treated as trading stock are compulsorily slaughtered. New section 225ZAA disapplies this treatment for those using the cash basis.
70. Paragraph 48 inserts new section 225ZH into ITTOIA to disapply chapter 16A which applies to oil activities. New section 225ZH disapplies the chapter for those using the cash basis.



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71. Paragraph 49 Paragraph 49 amends Chapter 17 which deals with adjustment income where a person changes the basis on which he calculates the profits of the trade. The insertion of new section 227A provides that Chapter 17 applies to businesses moving to and from the cash basis.
72. Paragraph 51 to 54 make changes to allow the cash basis to work with rent a room relief (amending section 786 ITTOIA) and qualifying care relief (amending sections 805 and 820 ITTOIA).
73. Part 2 of the Schedule deals with consequential amendments.
74. Paragraph 55 amends section 42 of the Taxes Management Act 1970 so that in the case of a business carried on by a partnership, the general rule is that an election to use the cash basis must be made on the partnership return by the person required to make that return.
75. Paragraph 56 makes an amendment to the Capital Allowances Act 2001 inserting a new subsection (4) to section (1) CAA2001. The new subsection provides that persons using the cash basis are not entitled to any allowance or liable to any charge under the capital Allowances Act.
76. Paragraph 57 omits section 160 of ITTOIA which provides that barristers in the early years of business can use a cash basis of calculating profits.
77. Paragraph 58 amends the Income Tax Act 2007 (ITA 2007) by inserting a new section 74E which prevents a person using the cash basis from using a loss arising from the business either as sideways relief or capital gains relief.
78. Paragraph 59 amends the provisions of ITA 2007 dealing with relief for interest payments. New section 384B inserted in ITA 2007 restricts relief for interest on loans where the cash basis is used for loans to buy plant and machinery for partnership use or to buy an interest in a partnership.
79. Paragraph 60 provides that the amendments made by the schedule have effect for the tax year 2013-14 onwards.

## BACKGROUND

80. Existing income tax legislation requires the taxable profits of a business to be calculated in accordance with Generally Accepted Accounting Practice.

## **FINANCE BILL**

81. This means that profits are computed on the accruals basis so that income is the income earned in a tax year and not the amounts received in a year; expenses are those incurred in a tax year not the expenses paid out in a tax year.
82. The cash basis introduced by this schedule allows eligible small businesses to choose to use a simpler cash basis to work out their taxable income with effect from the tax year 2013-14.
83. If you have any questions about this change, or comments on the legislation, please contact Tony Linehan 020 7147 0527 (email: [tony.linehan@hmrc.gsi.gov.uk](mailto:tony.linehan@hmrc.gsi.gov.uk)) or Alison Bull on 020 7147 2595 (email: [alison.bull@hmrc.gsi.gov.uk](mailto:alison.bull@hmrc.gsi.gov.uk)).

**1 Trade profits: deductions allowable at a fixed rate**

Schedule 1 contains provision enabling persons carrying on a trade, profession or vocation to claim deductions for certain expenses at a fixed rate.

SCHEDULE 1

Section 1

TRADE PROFITS: DEDUCTIONS ALLOWABLE AT A FIXED RATE

1 In Part 2 of ITTOIA 2005 (trading income), after Chapter 5 insert –

**“CHAPTER 5A**

TRADE PROFITS: DEDUCTIONS ALLOWABLE AT A FIXED RATE

*Introduction*

**94C Professions and vocations**

The provisions of this Chapter apply to professions and vocations as they apply to trades.

**94D Provisions not applicable to certain firms**

The provisions of this Chapter do not apply in calculating the profits of a trade carried on by a firm for a period if one or more of the persons who have been partners in the firm at any time during the period was not an individual at that time.

*Expenditure on vehicles*

**94E Expenditure on vehicles**

- (1) This section applies if, in calculating the profits of a trade for a period –
  - (a) a deduction would otherwise be allowable for the period in respect of qualifying expenditure incurred in relation to a relevant vehicle (see subsection (2)), or
  - (b) a deduction would be so allowable in respect of such expenditure but for the fact it is capital expenditure.
- (2) In this section “relevant vehicle” means a car, motor cycle or goods vehicle that –
  - (a) is used for the purposes of the trade, and
  - (b) is not an excluded vehicle (see section 94F).
- (3) A deduction is allowed for the period in respect of the qualifying expenditure.
- (4) If any of the mandatory deduction conditions in section 94G is met in relation to the relevant vehicle, the only deduction that is allowed for the period in respect of the qualifying expenditure is a deduction under this section.
- (5) If a deduction for a period is made under this section –

- (a) no other deduction is allowed (for that or any other period) in respect of the qualifying expenditure, and
  - (b) this section applies in relation to the relevant vehicle for every subsequent period for which the vehicle is used for the purposes of the trade.
- (6) The amount of the deduction is the appropriate mileage amount in relation to the relevant vehicle for the period (see section 94H).
- (7) In this section “qualifying expenditure”, in relation to a vehicle, means any expenditure incurred in respect of the acquisition, ownership, hire, leasing or use of the vehicle, other than incidental expenses incurred in connection with a particular journey.
- (8) For provision preventing capital allowances from being claimed in respect of qualifying expenditure incurred in relation to a relevant vehicle, see section 38ZA of CAA 2001.

#### **94F Excluded vehicles**

- (1) A car, motor cycle or goods vehicle that is used for the purposes of a trade is an “excluded vehicle” for the purposes of section 94E if condition A or B is met in relation to the vehicle.
- (2) Condition A is that –
- (a) the person who is or has been carrying on the trade has at any time –
    - (i) claimed an annual investment allowance under section 51A of CAA 2001 in respect of any expenditure incurred in relation to the vehicle, or
    - (ii) claimed a first-year allowance under section 52 of that Act in respect of any such expenditure, and
  - (b) the vehicle is not –
    - (i) a car that has low CO<sub>2</sub> emissions (within the meaning of section 45D of CAA 2001), or
    - (ii) a car that is electrically-propelled (within the meaning of section 268B of that Act).
- (3) Condition B is that –
- (a) the vehicle is a goods vehicle, and
  - (b) any of the expenditure incurred on acquiring the vehicle has been deducted in calculating the profits of the trade for a period on the cash basis (see section 25A).

#### **94G The mandatory deduction conditions**

- (1) This section applies for the purposes of determining for the purposes of section 94E whether any of the mandatory deduction conditions is met in relation to a relevant vehicle (within the meaning of that section).
- (2) Mandatory deduction condition A is met in relation to a relevant vehicle if –
- (a) it is a car or a motor cycle, and
  - (b) an election under section 25A (cash basis for small businesses) has effect in relation to the trade.

- (3) Mandatory deduction condition B is met in relation to a relevant vehicle if –
- (a) an election under section 25A has at any time had effect in relation to the trade, and
  - (b) at that time mandatory deduction condition A was met in relation to the vehicle.

#### 94H The appropriate mileage amount

- (1) In calculating the profits of a trade for a period, the appropriate mileage amount in relation to a relevant vehicle for the period is –

$$M \times R$$

where –

M is the number of miles of business journeys made by a person (other than as a passenger) using that vehicle in the period, and

R is the rate applicable to that kind of vehicle.

- (2) The rates applicable are as follows –

Table

<i>Kind of vehicle</i>	<i>Rate per mile</i>
Car or goods vehicle	45p for the first 10,000 miles 25p after that
Motor cycle	24p

- (3) In a case where the total number of miles of relevant business journeys made in the period is greater than 10,000, the rate of 45p per mile is available only in relation to 10,000 of those miles.
- (4) “Relevant business journey” means any business journey made in the period by a car or goods vehicle –
- (a) that is used for the purposes of the trade, and
  - (b) in relation to which section 94E applies for the period.
- (5) In this section –
- “business journey”, in relation to a vehicle used for the purposes of a trade, means any journey, or any identifiable part or proportion of a journey, that is made wholly and exclusively for the purposes of the trade, and
- “relevant vehicle” has the same meaning as in section 94E.
- (6) The Treasury may by regulations amend subsection (2) so as to alter the rates or rate bands.
- Regulations under this subsection may also make consequential amendments to subsection (3).

#### 94I Definitions of types of vehicle

- (1) This section applies for the purposes of sections 94E to 94H (and this section).

- (2) “Car” means a mechanically propelled road vehicle which is not—
  - (a) a goods vehicle,
  - (b) a motor cycle,
  - (c) an invalid carriage, or
  - (d) a vehicle of a type not commonly used as a private vehicle and unsuitable to be so used.
- (3) “Goods vehicle” means a mechanically propelled road vehicle which—
  - (a) is of a construction primarily suited for the conveyance of goods or burden of any description, and
  - (b) is not a motor cycle.
- (4) “Motor cycle” has the meaning given by section 185(1) of the Road Traffic Act 1988.
- (5) For the purposes of this section “invalid carriage” has the meaning given by section 185(1) of the Road Traffic Act 1988.

*Use of home for business purposes*

**94J Use of home for business purposes**

- (1) This section applies if, in calculating the profits of a trade of a person for a period, a deduction (“the standard deduction”) would otherwise be allowable for the period in respect of the use of the person’s home for the purposes of the trade.
- (2) The person may, instead of making the standard deduction, make a deduction for the period under this section.
- (3) The amount of the deduction allowable for the period is the sum of the applicable amounts for each month, or part of a month, falling within the period.
- (4) The applicable amount for a month, or part of a month, is given by the following Table—

Table

<i>Number of hours worked</i>	<i>Applicable amount</i>
25 or more	£10.00
51 or more	£18.00
101 or more	£26.00

where the “number of hours worked” in a month (or part of a month) is the number of hours spent wholly and exclusively on work done by the person, or any employee of the person, in the person’s home wholly and exclusively for the purposes of the trade.

- (5) If the person has more than one home, this section has effect as if those homes were a single home.

- (6) The Treasury may by regulations amend subsection (4) so as to alter the rates or rate bands.

*Premises used both as home and business premises*

**94K Premises used both as a home and as business premises**

- (1) This section applies if—
- (a) a person carries on a trade at any premises,
  - (b) the premises are used mainly for the purposes of carrying on the trade, but are also used by the person as a home,
  - (c) the person incurs expenses in relation to the premises,
  - (d) the expenses are incurred mainly (but not wholly and exclusively) for the purposes of the trade, and
  - (e) in calculating the profits of the trade for a period, a deduction (“the standard deduction”) would otherwise be allowable for the period in respect of a part or proportion of the expenses in accordance with section 34(2).
- (2) The person may, instead of making the standard deduction, make a deduction for the period under this section.
- (3) The amount of the deduction allowable for the period is the amount of the expenses less the non-business use amount.
- (4) The non-business amount is the sum of the applicable amounts for each month, or part of a month, falling within the period.
- (5) The applicable amount for a month, or part of a month, is given by the following Table—

Table

<i>Number of relevant occupants</i>	<i>Applicable amount</i>
1	£350
2	£500
3 or more	£650

- (6) For the purposes of subsection (5), “relevant occupant”, in relation to a month (or part of a month), means an individual who, at any time during that month (or that part of a month)—
- (a) occupies the premises as a home, or
  - (b) stays at the premises otherwise than in the course of the trade.
- (7) The Treasury may by regulations amend subsection (5) so as to alter the rates or rate bands.”

- 2 In Part 2 of CAA 2001 (plant and machinery allowances), in Chapter 3 (qualifying expenditure), after section 38 insert—



**“38ZA Vehicles for which deductions allowed at fixed rate under Part 2 of ITTOIA 2005**

Expenditure is not qualifying expenditure if –

- (a) it is incurred in respect of a vehicle, and
- (b) a deduction is allowed in respect of the expenditure under section 94E of ITTOIA 2005<sup>1</sup> (trade profits: deduction for expenditure on vehicles).”

- 3 The amendments made by this Schedule have effect for the tax year 2013-14 and subsequent tax years.

**EXPLANATORY NOTE**

**TRADE PROFITS: DEDUCTIONS ALLOWABLE AT A FIXED RATE**

**SUMMARY**

1. This clause introduces the schedule which provides that individuals carrying on a trade or profession as self employed sole traders or in partnership with other individuals can choose to use certain simplified expenses when calculating their profits for income tax purposes.

**DETAILS OF THE SCHEDULE.**

2. Paragraph 1 inserts new Chapter 5A 'Trade Profits: Flat Rate Expenses' into the Income Tax (Trading and other Income) Act 2005 (ITTOIA). The new chapter comprises new sections 94C-K.
3. New section 94D excludes a partnership where one of the partners is not an individual (for example a company) from using the fixed rates provided for in new chapter 5A.
4. New section 94E sets out the circumstances in which a fixed rate deduction is allowable for expenditure on vehicles.
5. New section 94E(1) provides that new section 94D applies where a deduction would be allowed under the normal trading income rules for expenditure on a relevant vehicle. In some cases the only deduction allowed for vehicle expenditure is that provided under new section 94E. These are cases where any of the mandatory conditions (as set out in new section 94G).
6. New section 94E(5) provides that where a deduction is made under new section 94E then no other deduction can be made and that only a deduction under new section 94E is allowed in respect of the relevant vehicle in any later period.
7. New section 94E(7) provides a definition of qualifying expenditure as being amounts incurred on acquisition and ownership of a vehicle.
8. New section 94F(1) provides that a vehicle is an excluded vehicle if either of two conditions are met.
9. New section 94F(2) provides the first condition which is that if the car is not a low emission car and the person carrying on the trade has claimed an annual investment allowance in respect of expenditure on

the vehicle or a first year allowance, then the vehicle is an excluded vehicle.

10. New section 94F(3) provides the second condition which is that if the vehicle is a van and expenditure incurred on acquiring the van has been deducted in calculating profits of the trade on a cash basis the vehicle is an excluded vehicle.
11. New section 94G provides the mandatory conditions referred to in new section 94D with the effect that if either of the conditions is met the fixed rate deduction is to be used.

Condition A (new section 94G(2)) is that the vehicle is a car or motorcycle and the business is using the cash basis.

Condition B (new section 94G(3)) is that at any time there has been an election to use the cash basis and at that time condition A was met in respect of the vehicle.

12. New section 94H provides the means of calculating the ‘appropriate mileage amount’, the amount allowable as an expense of the business.
13. New section 94H(1) provides that the rate for a vehicle is computed by multiplying the number of miles of business journeys made by a person (other than as a passenger) by the rate appropriate to that vehicle.
14. New section 94H(2) provides the rates for vehicles. For cars or vans the rate for the first 10,000 miles is 45p, after which the rate is 25p. For motorcycles the rate is 24p.
15. New section 94H(4) provides that in calculating the rate of the fixed rate deduction where a business has more than one car or van, the number of miles of business journeys of each of the cars and vans must be taken together in calculating the first 10, 000 miles.
16. New section 94H(5) provides that in new section 94H that a business journey is a journey or an identifiable part of that journey that is wholly and exclusively for the purposes of the trade.
17. New section 94J deals with a fixed rate deduction for the business use of a home. Where the section applies (as set out in subsection (1), a person may make a fixed deduction instead of making a deduction under the normal trading income rules.
18. New section 94J(3) provides that the deduction allowable is the sum of the applicable amounts for each month or part of a month falling within a period.

19. New section 94J(4) provides the monthly rates at which a deduction will be allowed being £10.00 per month where business use is 25 hours or more, £18.00 where business use is 51 hours or more and £26.00 where business use is 101 hours or more. The hours worked have to be wholly and exclusively for the purposes of the business.
20. New section 94K provides for a fixed rate deduction where premises are used both as a home and for business purposes. Where the section applies (as set out in subsection (1), a person may make a fixed deduction instead of making a deduction under the normal trading income rules.
21. New section 94K(3) provides that the amount of the deduction allowed is the amount of the expenses reduced by the non-business use amount.
22. New section 94K(4) provides that the non-business amount is the sum of the monthly “applicable amounts” computed in accordance with the table in new subsection 94K(5). The level of the applicable amount depends on the number of people occupying the premises in a month. Where one person occupies the premises the rate is £350 per month, where two people occupy the premises the amount is £500 per month and where more than two people occupy the premises the amount is £650 per month.
23. New section 94K(6) provides that for the purposes of the fixed rate deduction, the relevant persons occupying the premises are those who occupy the premises as a home or who stay at the premises otherwise than as part of the trade.

## **BACKGROUND**

24. Existing tax legislation requires that where expenses are incurred that are partly for business purposes and partly for private purposes that an apportionment of these expenses is made.
25. New Chapter 5A inserted by this schedule provides that for certain expenses an apportionment will not be required. A business can choose to make fixed rate deductions for vehicle expenditure, expenses arising from business use of home and in relation to premises used both as a home and as business premises.
26. If you have any questions about this change, or comments on the legislation, please contact Tony Linehan 020 7147 0527 (email: [tony.linehan@hmrc.gsi.gov.uk](mailto:tony.linehan@hmrc.gsi.gov.uk)) or Alison Bull on 020 7147 2595 (email: [alison.bull@hmrc.gsi.gov.uk](mailto:alison.bull@hmrc.gsi.gov.uk)).