

7 June 2023



Expanding the cash basis for the self-employed

Response from ICAS



About ICAS

The Institute of Chartered Accountants of Scotland ('ICAS') is the world's oldest professional body of accountants and we represent over 23,600 members working across the UK and internationally. Our members work in all fields, predominantly across the private and not for profit sectors.

ICAS has a public interest remit, a duty to act not solely for its members but for the wider good. From a public interest perspective, our role is to share insights from ICAS members in the many complex issues and decisions involved in tax and financial system design, and to point out operational practicalities.

ICAS was created by Royal Charter in 1854. The ICAS Charter requires its Boards to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Our response

1. The following submission has been prepared by the ICAS Tax Board. The Tax Board, with its five technical Committees, is responsible for putting forward the views of the ICAS tax community; it does this with the active input and support of over 60 committee members.

Background comments

2. ICAS is grateful for the opportunity to contribute its views on this HMRC [consultation](#), entitled "Expanding the cash basis for the self-employed".

General comments

3. ICAS recognises the need to assess the effectiveness of the cash basis for the self-employed.
4. Aside from any tax considerations, businesses are required to prepare accounts for different purposes, including for banks, external investors and other stakeholders. Those stakeholders may require accounts to be prepared using accruals accounting and it would create additional costs for unincorporated businesses to prepare different accounts for tax purposes.
5. ICAS strongly supports measures which help facilitate greater tax simplification and avoid unnecessary costs and complexities when navigating the tax system. By effectively reforming the cash basis, this could help facilitate greater simplification for many unincorporated businesses.

Turnover restriction (Questions 1a to 1d)

6. The consultation is currently considering the alignment of the entry and exit thresholds for the cash basis with those for the VAT cash accounting scheme (currently an entry threshold of £1.35 million and exit threshold of £1.6 million). An alternative option being considered is to remove the turnover thresholds for the cash basis completely.
7. ICAS believes that the benefits of the cash basis are mostly felt by micro unincorporated businesses, for whom the timing of the Income Tax and Class 4 National Insurance liability could play a significant impact on the cash flow of the business. For such businesses, being able to report income and expenditure using the cash basis is incredibly valuable, particularly in the early stages when a significant element of turnover could be included in debtors as a year end. Those benefits would particularly be felt in the early years of trading.
8. We believe that unincorporated businesses with turnover of £150,000 or above are more likely to have more complex affairs and would generally find accruals accounting more suited to their needs and accruals accounting may more accurately reflect the profitability of the business. There would appear to require to be a specific justification for an existing business trading at that level to be minded to opt for the cash basis. Indeed, the administrative costs for making such a transition could outweigh the benefits of making such a move.
9. ICAS does not believe that a significant number of existing businesses with turnover of £150,000 or above are likely to move to the cash basis if the threshold is increased or even removed completely. Indeed, we note that paragraph 2.5 of the consultation notes that HMRC estimates an increase in population of only 26,000.
10. There could nevertheless be advantages in increasing the threshold in terms of ensuring those businesses currently in the cash basis can continue to use that basis for longer should they so wish. We can understand the rationale behind the logic in aligning the turnover threshold with the VAT cash accounting scheme, although Income Tax and VAT are assessed differently and do not generally share similar characteristics.
11. In view of the likely number of businesses affected, ICAS does not consider there to any particular merit of the VAT cash accounting scheme thresholds being used. Indeed, it may facilitate greater tax simplification of the rules to remove the turnover thresholds altogether.
12. By giving unincorporated businesses of all sizes the option to use the cash basis, this would enable those businesses with straight-forward affairs to continue to do so. This would be whilst those businesses with more complex affairs could, at the same time, decide that accruals accounting would be more suitable for their business.
13. ICAS believes that the turnover threshold in itself is unlikely to have a material impact on the decision of a business to elect for the cash basis, or remain to be assessed on the cash basis. Indeed, reform to the interest and loss restrictions are more likely to influence the decision.

Cash basis default (Questions 2a to 2e)

14. Whilst the cash basis may be helpful for smaller unincorporated businesses, both in terms of simplicity and the timing of Income Tax and Class 4 National Insurance liabilities, ICAS does not believe that it is necessary to make the cash basis apply as default. Indeed, greater awareness of the cash basis and its potential advantages could improve its use by those businesses who would find it beneficial.

15. We would suggest that there are several non-tax reasons why a business would choose to adopt accruals accounting. Indeed, larger unincorporated businesses will be expected to prepare accounts for other external stakeholders who will wish for accounts to be prepared using accruals accounting. This will particularly be relevant where external lending is required for the business or the owner in a personal basis (such as a mortgage application). Businesses may see the need to prepare separate accounts on a cash basis as an unnecessary expense.
16. The cash basis is not ideally suited for those businesses which hold high levels of stock. There are also practical challenges for unincorporated businesses in the farming sector, who cannot use the cash basis if they prepare their accounts using the herd basis. Farming businesses are also unable to average their profits using the cash basis, a feature of the tax system that is particularly helpful to those farming businesses with fluctuating profits, often outwith the control of the business owner(s).
17. Notwithstanding the suggestion in paragraph 2.6 that only 29% of eligible businesses use the cash basis, the actual number of businesses using the cash basis could potentially be in excess of this, particularly where taxpayers are unrepresented and may not be fully aware of the need to tick a box on their tax return to denote that they are using that status. For some taxpayers, the difference between accruals accounting and cash basis may not be significant in overall terms.
18. For those businesses currently using accruals accounting, any move to the cash basis as a default would require significant increased awareness and guidance to be provided so that taxpayers were able to understand their obligations and fulfil those obligations accurately.
19. ICAS does not believe that any changes would be needed to the transitional rules from moving from accruals accounting to cash basis. We do however believe that a significant proportion of businesses currently using accruals accounting will wish to continue to do so.
20. Before any moves in the direction of cash basis being default are further considered, we would strongly recommend that the proposed changes to the rules on interest deductibility and loss relief are explored in more detail. Unincorporated businesses may be more easily persuaded of the merits of the cash basis if these tax reliefs were more generous than they are currently.

Interest restriction (Questions 3a to 3d)

21. Unincorporated businesses using the cash basis are currently entitled to claim up to £500 of finance costs per tax year. Alternatives of £625, £750 or £1,000 are currently suggested.
22. ICAS believes that all of the above suggestions do not reflect the increase in borrowing costs since the £500 limit was set and that even a limit of £1,000 would not reflect the genuine borrowing costs that unincorporated businesses may be facing. It goes against the concept of fairness to taxpayers, but would also discourage participation in the cash basis by those businesses who may otherwise benefit.
23. We believe that setting a monetary limit to restrict tax relief for interest is unnecessary. Indeed, in these times of increased interest rates, it does not make sense to have a situation where an unincorporated business would receive full relief if they use accruals accounting but would be restricted in the tax relief that they can obtain if they use the cash basis.
24. If HMRC is minded to set a monetary limit on interest relief, a more significant figure of at least £10,000 would seem more appropriate. It would seem desirable for this to be reviewed to take account of changing interest rates on an ongoing basis.
25. The absence of a more ambitious monetary limit is likely to act as a barrier for a business choosing to use the cash basis and would significantly reduce the desirability for a business currently using accruals accounting to move to the cash basis.

Loss restrictions (Questions 4a to 4d)

26. ICAS believes that the existence of the specific loss restrictions for the cash basis is acting as a direct deterrent for unincorporated businesses to use cash basis.
27. Whilst it seems unlikely that unincorporated businesses would switch between accruals accounting and the cash basis purely to take advantage of loss relief, a more level playing field between the schemes would seem sensible. Indeed, the removal of what is currently a disincentive of using the cash basis can only improve the attractiveness of using that basis.
28. As noted earlier, those unincorporated businesses in the early years of trading are those likely to benefit from the cash basis in general terms. However, being able to utilise loss relief in the early years of trade is likely to be beneficial and avoid the need for new unincorporated businesses to choose between being assessed on income and expenses physically received and paid during a year and securing tax relief where the result of that is a loss.
29. The cash basis rules, as they currently apply, disadvantage those businesses making a loss in their early years. Indeed, depending on the timing of cash flows, using accruals accounting may give rise to a profit, whereas cash basis may give rise to a loss. But the ability to secure tax relief on that loss is limited by the existing loss restrictions.
30. By removing these loss restrictions, unincorporated businesses are more likely to use the cash basis. Ensuring the existing restrictions under Section 66 ITA 2007 (for businesses being required to operate on a commercial basis) and Section 24A ITA 2007 (for the general losses cap) are maintained will ensure that unincorporated businesses are treated more fairly and consistently in terms of loss relief.

Interactions and other improvements to the cash basis (Questions 5 to 11)

31. ICAS believes that the best way to encourage greater participation in the cash basis is to reform the interest restriction and loss restriction rules. These currently act as a deterrent for those businesses whose affairs are relatively straight-forward to adopt, or continue to use, the cash basis.
32. We feel that a business should be able to choose the most appropriate method to reflect its circumstances. We do not think the suggestion to include an optional end of year adjustment for stock is necessarily helpful. It makes the system more complex in nature and this is likely to increase the likelihood of errors arising. If stock is a material consideration for an unincorporated business, the cash basis is less likely to be advantageous and we feel that the use of accruals accounting should just be accepted as the best way forward for that business.
33. Alignment with the Universal Credit rules would make sense. For the smaller unincorporated businesses who are likely to benefit from using the cash basis, this will help achieve greater simplification of the taxpayer's filing obligations for both their Income Tax and Universal Credit. Avoiding unnecessary complexity for those taxpayers will increase understanding and reduce the likelihood of errors occurring under both regimes.
34. So that unrepresented taxpayers can fully understand the merits of accruals accounting versus the cash basis, improved HMRC guidance would be helpful. This will allow taxpayers to make the right decision for their circumstances, considering all the facts as they apply to their business. An improved education campaign would most definitely be beneficial.

Interactions with MTD ITSA (Questions 12 and 13)

35. ICAS feels that the possible changes to the cash basis may not significantly impact on the burdens that MTD ITSA will bring on unincorporated businesses. Should quarterly reporting under MTD ITSA proceed as has currently been announced, we anticipate that the cash basis may make this more straight-forward given the lack of adjustments that would be needed to each submission.
36. For those unincorporated businesses whose profits fluctuate, using the cash basis could mean that the quarterly returns under MTD ITSA would more accurately reflect the in-year position.
37. Whilst this may offer opportunities for smaller businesses in the scope of MTD ITSA, this does not eliminate the challenges posed by the additional reporting requirements and need to make submissions using MTD compliant software. The additional admin burden, along with associated costs, could be particularly significant for micro unincorporated businesses, something that using the cash basis would not alter.

Summary

38. Overall, ICAS believes that there should be improvements in terms of the design of the cash basis, so that more businesses who would benefit from the cash basis are able to do so and better understand why the cash basis may be the best option for their business. We feel that unincorporated businesses should be able to 'opt in' to the cash basis rather than 'opt out' as those businesses with more complicated affairs are likely to find accruals accounting more relevant to them and are more likely to be required to prepare accounts using accruals accounting for other purposes.
39. By reforming the interest restriction and loss restriction rules so that they are more consistent with those for accruals accounting, HMRC would encourage more taxpayers to secure the benefit of cash basis when they may not be currently.
40. An set turnover threshold is probably unnecessary. By removing this, HMRC can help ensure that unincorporated businesses can decide what is best for their particular circumstances. Improved education and HMRC guidance will help businesses to understand and appreciate the difference between the systems and how to decide on the best method for their particular situation.



CA House, 21 Haymarket Yards, Edinburgh, UK, EH12 5BH
+44 (0) 131 347 0100
connect@icas.com
[icas.com](https://www.icas.com)

 @ICASaccounting

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