Low Incomes Tax Reform Group.
A voice for the unrepresented.

Expanding the cash basis for the self-employed
Response from the Low Incomes Tax Reform Group (LITRG)

1. Executive Summary

1.1. We broadly support the expansion of the cash basis as set out in the consultation document.

1.2. We consider that the formal cash basis is a straightforward way of calculating profit for businesses for whom it is suitable. We also believe it will make complying with Making Tax Digital for income tax (MTD) easier in due course.

1.3. In our experience, many low-income unrepresented businesses do not give much consideration to the basis on which they work out their accounts for tax purposes and are often unaware that there is a choice of two different methods. This means there are likely to be many people using the cash basis without ticking the box on their tax return confirming that they are doing so and therefore take-up is likely to be higher than shown by the official statistics.

1.4. The proposal to make the cash basis the default option would:

- Formalise what is happening in reality – that many unrepresented businesses are likely to be using it in practice even though they are not ticking the box on the form.
- Mean people do not need to make an active decision to elect to use it. This decision making can be off-putting to someone unfamiliar with accounting and tax terminology.
- Align with the default approach for preparing rental property accounts.

1.5. Targeted communications on a default cash basis will be very difficult as some businesses will have been using the cash basis without realising it or electing to do so, and therefore will not be required to make any transition adjustments.

1.6. A default cash basis will not make more people eligible to use the scheme but increasing the interest restriction threshold (providing it was sufficiently uprated) and relaxing loss relief restrictions may increase take-up of the cash basis. Sideways loss relief is especially valuable for new businesses.

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1.7. We think the loss restriction rules should be removed for businesses using the cash basis as we are unclear why HMRC consider there would be a greater risk of tax avoidance or errors when making losses using the cash basis compared to the accruals basis.

1.8. If the government's goal is to encourage more businesses to use the cash basis, we strongly recommend HMRC improves its general communications and guidance on the cash basis including additional guidance to help growing sectors in self-employment such as those trading through online platforms to improve understanding on areas such as 'net receipts' and 'timing of payments from platforms'. This improvement in guidance should be a priority even if changes to expanding the cash basis do not proceed. We think the name itself ('cash basis') is likely to be off-putting as it gives the impression that the business must be dealing in cash for it to be used – stronger guidance earlier in the process could help people's understanding.

1.9. There are differences between the cash basis for tax and cash accounting for Universal Credit (UC), and the proposals for interest and losses could increase these disparities. However, we think there could be an opportunity for greater procedural alignment in the reporting processes for UC and for tax purposes under Self Assessment and potentially under MTD.

1.10. We consider the timing of introducing any change to the default basis is important. In particular, if the default was changed to the cash basis it would be helpful if it does not coincide with other significant changes for the self-employed such as Basis Period Reform in the 2024/25 tax year or the start of the roll-out of MTD in the 2026/27 tax year.

2. About Us

2.1. The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998, LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low-income workers, pensioners, migrants, students, disabled people and carers.

2.2. LITRG works extensively with HM Revenue & Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind, and this often makes life difficult for those we try to help.

2.3. The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3. General comments

3.1. We welcome the opportunity to respond to this consultation on expanding the cash basis. Our response to this consultation is based on our experience of dealing with low profit-making, unrepresented self-employed individuals and partnerships and their experiences with the tax system.

3.2. By way of context to our comments, our experience suggests many unrepresented businesses do not give much consideration to the basis on which they work out their accounts for tax purposes as they are often unaware that there is a choice of two different methods. Many unrepresented businesses will tend to look at their bank account transactions to work out what has been received and paid out and this will form the basis for their accounting figures for their tax returns. So although it may seem that the uptake in the cash basis is modest, based on the numbers who elect to use it on the tax return form, in reality we believe many unrepresented businesses will be using a more informal 'cash basis' approach. Guidance on the two methods and the rules under each is currently not detailed enough or sufficiently clear which means we also think that some people may well be using a hybrid of the two methods without realising. This can have consequences such as potentially incorrectly claiming sideways loss relief when using the cash basis without making the appropriate election. See our detailed comments on using a default cash basis at paragraph 5 below.

3.3. Please note that for the four proposed changes (turnover restriction, cash basis default, interest restriction and loss restrictions) we have answered the relevant questions which focus on the impact to low-income, unrepresented businesses only.

4. Turnover restriction

4.1. **Question 1a) Under either of the options, would businesses within the newly-eligible population consider moving to the cash basis? Question 1b: What are the benefits/disbenefits of aligning the threshold to the VAT cash accounting scheme, and what are the benefits/disbenefits of removing the threshold entirely? Question 1c: Would increasing the cash basis threshold encourage businesses currently below the threshold to move into the cash basis, knowing that they would be able to stay in it for longer if their business grew? Would this have a significant or minor effect on businesses? Question 1d: Are there any alternative changes to the entry or exit thresholds that would also increase the eligible population and encourage businesses to join the cash basis?**

4.1.1. As LITRG's remit is to help low-income individuals and businesses we do not consider raising the entry and exit threshold will specifically impact on the majority of people we aim to help. Therefore, our comments below relate to all the questions 1a- 1d.

4.1.2. We note from the consultation that increasing the turnover thresholds would mean that an additional 26,000 businesses may be eligible to use the cash basis, this is only 0.6% of the total self-employment population. Our understanding is that businesses with higher turnover often require more traditional accounts for various commercial reasons as well as additional management accounting controls in areas such as stock, debtors and creditors. These businesses would usually engage professional advisors and use the accruals basis to prepare their accounts. For these types of businesses, we anticipate there would not be a change from using the accruals basis to using the cash basis following an increase or relaxation to the turnover entry and exit thresholds.

4.1.3. Additionally, some businesses will need to prepare their accounts using the accruals basis if they need to produce balance sheets or specific management accounting information. This may be the case for certain conditions attached to loan agreements or grant applications.

4.1.4. Under the current cash basis rules, the turnover entry threshold is doubled for universal credit (UC) claimants (from £150,000 to £300,000). If the turnover thresholds were to increase, then HMRC should consider whether there is still a need to have such a disparity on the entry threshold between UC and non-UC claimants. We would expect that it would no longer be required for UC claimants. If it is decided not to change the turnover entry threshold then there could be merit in HMRC researching how many UC claimants take advantage of the UC threshold by having turnover between £150,000 and £300,000 when joining the cash basis. This information would be helpful for HMRC to consider whether this additional complexity for UC claimants is needed and, if so, is it at the right level.

5. Cash basis default

5.1. **Question 2a: Many businesses that would benefit from the cash basis currently do not use it, and many use it without electing to do so. Do you have any insight into why many businesses in the eligible population do not use the cash basis?**

5.1.1. Although the consultation document states that the take-up rate for the cash basis is 29%, we suspect that in reality this figure is likely to be considerably higher. Based on our own experiences of the low-income self-employed and information in the consultation document [1] we strongly believe that many unrepresented, unincorporated businesses do not understand the term 'cash basis' and how it applies to them. This means that consequently they do not tick the relevant box to make the cash basis election on their Self Assessment tax return despite actually preparing their accounts using it.

5.1.2. One of the reasons we think this occurs is that many unrepresented small businesses prepare their accounts primarily using information from their bank statements by looking at the income and expenses they have received and paid. We consider this is a natural intuitive method of calculating accounting figures especially if there has been no experience or training in accounting or book-keeping. This results in a set of accounts prepared by using the cash basis or perhaps a hybrid version of it. As the accounts are often prepared before the tax return is completed, when they fill in their tax return they do not consider in depth the cash basis election question because they have already worked out their accounting information. This results in some taxpayers not understanding there is a choice of accounting basis and that if appropriate they need to confirm they are using the

[1] Paragraph 2.9 on Expanding the cash basis for the self-employed (https://www.gov.uk/government/consultations/expanding-the-cash-basis/expanding-the-cash-basis-for-the-self-employed--2) states that 'between the 2019 to 2020 and 2020 to 2021 tax year, 1.3 million businesses appeared to move from the cash basis to the accruals basis'.

cash basis. We comment further below about the need for better guidance and education for taxpayers about cash basis and accruals basis and the rules under each of them.

5.1.3. Based on anecdotal evidence, we think the name 'cash basis' may be putting off some businesses from electing to use it, even if they are actually preparing their accounts using the cash basis. This is because most of their business transactions are not in the form of actual cash and so they do not think the cash basis election applies to them. There are also connotations that the cash basis may refer to 'cash in hand' work. We also think this potential issue could be helped with more targeted communications and enhanced guidance to eligible businesses (see our comments under paragraph 8.5).

5.2. **Question 2b: Would changing the cash basis to the default for trading income have an impact on whether businesses use the cash basis or accruals basis? What are the benefits or drawbacks of setting the cash basis as the default?**

5.2.1. One of the benefits in making the cash basis the default option is that it would formalise what is probably happening with many unrepresented eligible businesses in practice even though they have not ticked the relevant box on their return. Therefore, we do not think this proposal would expand eligibility to the cash basis unlike two of the options (relaxations to the interest restriction and loss relief rules). Instead, the benefits of using a cash basis default position would be to improve accuracy of tax information for a number of taxpayers, which in turn could help with general tax compliance and future tax policy decision-making.

5.2.2. In addition to our comments above, we think making a specific election to use the cash basis may be off-putting to some unrepresented taxpayers who struggle with accounting and tax terminology and therefore do not feel confident to elect to use the cash basis because it is an active decision on something they do not fully comprehend. Making the cash basis the default option could help with this as we assume it will only be necessary to make an election if a taxpayer wants to use accruals accounting. We would expect a large majority of represented businesses may wish to continue with accruals accounting and so will need to make the opt-out election. Clear guidance would be needed to ensure people understand the accruals basis in full and how it differs from the cash basis to inform this decision.

5.2.3. A default cash basis also has the benefit of aligning with the default approach for preparing rental property accounts as noted in the consultation document. However, this would be a different scenario to when the cash basis default was introduced for rental property because the position of the default has reversed, rather than being introduced for the first time. Therefore, there would need to be a clear warning about this change on the relevant section of the Self Assessment tax return as well as general communications highlighting this new default (see further comments on communications and guidance at paragraph 8.5).

5.2.4. If a cash basis default position is not taken forward, then it may be useful if HMRC online services could roll forward the choice of accounting basis from the previous tax year. This should improve consistency between tax years, yet still provide an option for the taxpayer to change their accounting basis if they can and wish to do so. We also think that even if this option is not taken, work should be undertaken to help those who are currently using the cash basis in practice but not ticking the relevant box to understand their position and encourage them to do so.

5.3. **Question 2c: Under a cash basis default, what proportion of businesses would you expect to opt-out and use the accruals basis?**

5.3.1. As explained at paragraph 4.1.2 above, we anticipate that many represented and/or larger businesses will continue to use the accruals basis and so will opt-out of a default cash basis. For low-income, unrepresented businesses it is difficult to answer this question in isolation from the other proposals outlined in this consultation, as we consider relaxing the restrictions on loss reliefs and interest would encourage an active decision to use the cash basis amongst informed businesses who understand the different rules of the accruals basis and cash basis. If the proposals for loss relief and interest do not go ahead, then we would anticipate a higher proportion of opt-outs from the cash basis to use the accruals basis.

5.4. **Question 2d: Would you expect there to be a transition administrative burden for businesses brought into the cash basis by the default, and are there any changes to the transition process for entering the cash basis that could help to smooth any burdens?**

5.4.1. Our comments for question 2e below explain our concerns about the transition process with respect to what help and guidance will be required from HMRC.

5.5. **Question 2e: To what extent would businesses need help and support with understanding the change from the default accruals basis to the cash basis?**

5.5.1. We are concerned that understanding the transition rules may be difficult for some low-income unrepresented eligible businesses. Additionally, this is further complicated for some businesses as their accounting position may be different from what has been formally declared, for example where self-employment accounts and tax returns have been prepared using the cash basis but no cash basis election made. We assume this means that HMRC's records show the taxpayer as using the accruals basis but in reality, they are using the cash basis and so no transition adjustments will actually be required if a default cash basis is introduced. This added complication will make it very difficult for any targeted communications about the move to a default cash basis.

5.5.2. There is a risk that a too high-level or detailed approach to explaining transition adjustments may put off some people from using the cash basis, even if it is the new default approach. It may also result in some taxpayers putting through transition adjustments which are unnecessary as they are keen to use the new default basis. Potentially this could result in over or under tax payments particularly in the first tax year of the change to the default basis.

5.5.3. Guidance explaining the transition adjustments must be carefully worded to try to ensure 'informal' cash basis users do not make errors when adjusting to a default cash basis approach and should include lots of examples to aid understanding. Perhaps the use of a calculation worksheet would be helpful in assisting whether any adjustments to, say, sales or stock are required. HMRC should be mindful that any changes to the cash basis are coming at a time when there are also other significant changes to the tax system for unincorporated businesses such as Basis Period Reform and Making Tax Digital for income tax.

6. Interest restriction

6.1. **Question 3a: What would be an appropriate level to set the interest restriction to? Are any of the 3 options proposed an appropriate level, considering the balance between allowing up-to-date costs of financing and the distortive effects of allowing private borrowing costs as deductions?**

6.1.1. The consultation indicates that approximately 98,000 are eligible to use the cash basis based on their turnover but use the accruals basis and deduct interest expenditure above £500. Relaxing the interest restriction is therefore likely to mean more people may actively choose to use the cash basis. It is difficult to quantify how many this may be as there may be other reasons why they use the accruals basis but notwithstanding that point, this change would likely directly impact the number of people opting to use the cash basis (compared to say making the cash basis the default option).

6.1.2. The amount of the restriction has not been increased since its introduction in 2013. Since then the base rate has increased and those with lower incomes may be less able to negotiate better rates. Unless any change reflects this reality, it is unlikely to lead to any change in the number of people opting for the cash basis.

6.2. **Question 3b: To what extent would increasing the interest restriction in the cash basis have an effect on whether businesses choose to use the cash basis or not? Does the interest restriction influence decisions to join the cash basis where a business has interest costs below the £500 limit?**

6.2.1. It is not easy to quantify the extent to which this restriction alone influences the decision to not use the cash basis vs its impact in conjunction with other restrictions (particularly losses). With increasing interest rates and high inflation leading to a higher demand for bank loans and overdraft facilities, the £500 restriction will act as a deterrent from using the cash basis in some cases. In particular, this may be the case for certain businesses such as new and growing businesses or for those still recovering from the effect on trade of the coronavirus pandemic. As noted above, newer businesses in the lower-income population are less likely to be able to access the better rates.

6.2.2. The extent to which increasing the interest restriction would have an effect on whether a businesses chooses the cash basis or not depends on the level which it is increased to. A small increase is unlikely to have a big impact, but a more significant increase will.

6.3. **Question 3c: To what extent would you expect businesses currently using the cash basis to increase their interest deductions, either through further borrowing or not being limited by the current £500 maximum?**

6.3.1. No comment.

6.4. **Question 3d: Is the form of the current interest restriction appropriate for the cash basis? Are there any changes to the interest restriction rule itself, aside from changes to the limit, that would help to increase the number of businesses that are able to use the cash basis while allowing appropriate deductions for interest costs?**

6.4.1. From our experience, some low-income small businesses do not have a separate business bank account, often due to not wanting to incur banking fees or because they start their business on an ad-hoc or informal basis so initially use their own personal bank account and do not change their systems when their business expands. For this reason, we urge HMRC to have a simple way of allowing tax relief for interest and finance costs as it may be onerous for unrepresented businesses to calculate a split of, say overdraft interest and charges, for a bank account used for both personal and business purposes.

6.4.2. There is also a potential issue if a business is using three-line accounts so are only providing information on their total sales and expenses as they may be using the cash basis without realising they are ineligible to do so, because they have interest and finance costs above £500. Additional guidance and tools may be needed to ensure that the cash basis rules on the interest restriction are understood (see paragraph 8.5 below).[1]

6.4.3. Also, some businesses do not appreciate that loan repayments are usually made up of capital and interest elements and therefore they consider the interest limit in the context of their total loan repayments as a whole and not just the interest element. Better guidance on this area may help taxpayers to identify exactly what any restrictions relate to.

7. Loss restrictions

7.1. **Question 4a: Would removing or relaxing the cash basis trade loss relief restrictions have an effect on whether businesses with losses choose to use the cash basis?**

7.1.1. The consultation states that 94,000 businesses are eligible to use the cash basis based on turnover but claim some sideways loss relief. It is possible some of those businesses may still want to use the accruals basis for other reasons even if changes were made to sideways loss relief in the cash basis. However, the figure implies that making this change could apply to more businesses than the change in the turnover entry and exit thresholds so would be a sensible option for HMRC to fully pursue.

7.2. **Question 4b: Is the burden of moving out of, and then back into, the cash basis to claim sideways loss relief currently having an effect on businesses' decisions to use the cash basis?**

7.2.1. No comment.

7.3. **Question 4c: Are the restrictions on loss relief under the cash basis dissuading new businesses, that may be making losses in their early years of trade, from using the cash basis?**

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[1] The main GOV.UK guidance on the cash basis (https://www.gov.uk/simpler-income-tax-cash-basis) states that the cash basis might not suit you if you 'want to claim interest or bank charges of more than £500 as an expense' but HMRC Manuals (BIM 70040: https://www.gov.uk/hmrc-internal-manuals/business-income-manual/bim70040 states 'Payments of interest on purchases are not subject to the £500 limit, provided the purchase itself is an allowable expense, as this is not cash borrowing.' It would be helpful if this distinction was made on the main GOV.UK guidance.

7.3.1. For a new self-employment, sideways loss relief can be a very valuable relief where another source of income is essentially being used to fund a start-up. If this loss relief was available to cash basis users too, this may encourage more start-ups which could be potentially loss-making in their early years to use cash basis accounting from the outset.

7.3.2. We do not have any statistical evidence regarding loss-making new businesses and their choice of accounting basis. From our experience, we would expect any loss-making business to currently be advised to use the accruals basis, if possible, as it provides more choice when utilising losses. However, as discussed in paragraph 5.5.1 above it is difficult to know if loss relief claims currently being made are correct. For example, if some unincorporated businesses are effectively preparing their accounts using the cash basis but not electing to do so on their tax return and still claiming sideways loss relief due to a lack of understanding of the different rules under each basis.

7.4. **Question 4d: What changes of the loss relief restrictions for the cash basis do you think would have the greatest effect on the number of businesses that would be eligible for, and use, the cash basis?**

7.4.1. We think the loss restriction rules should be removed for businesses using the cash basis as we are unclear why HMRC consider there would be a greater risk of tax avoidance or errors when making losses using the cash basis compared to the accruals basis. If loss restrictions are removed, existing legislation will automatically apply a cap[1].. Understanding the different options available if you make losses can be complex for unrepresented small businesses without the additional consideration of which accounting basis you have used to prepare your accounts. Of all of the changes proposed we think removing this restriction, along with changes to the interest restriction, would be the simplest option and potentially have most impact on expanding the opportunity to use the cash basis.

8. Interactions and other improvements to the cash basis

8.1. **Question 5: Are there any specific interactions, benefits, or issues that could arise from a combination of some or all of the options outlined in this consultation document?**

8.1.1. Under the current cash basis rules, it is possible to move from the cash basis to the accruals basis if there are commercial reasons to do so[2]. Examples used as commercial reasons often include having interest costs above £500 or wanting to use sideways loss relief. Therefore, if these proposed changes to the cash basis are introduced and this requirement remains it would be helpful if HMRC

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[1] S24A Income Tax Act 2007

[2] Under ITTOIA 2205 Chapter 3A 31D (3) states 'An election made by a person under section 25A ceases to have effect if (a)there is a change of circumstances relating to any trade, profession or vocation carried on by the person which makes it more appropriate for its profits for a subsequent tax year to be calculated in accordance with generally accepted accounting practice'.

provide revised guidance on what remaining commercial reasons may be appropriate to leave the cash basis.

8.1.2. It is possible that anything that ultimately changes the amount of profit or loss declared could have knock-on effects with other systems. For example, Tax-Free Childcare eligibility is based on expected income from self-employment being above a certain level. Any changes should be fully explored with the relevant officials to ensure there are no unintended consequences or if there are any impacts these are properly explained so affected people can make informed decisions about whether to use the cash basis or the accruals basis.

8.2. **Question 6: Are there any other areas of the cash basis that could be modified or improved to increase eligibility, take up, or simplicity?**

8.2.1. As mentioned in paragraph 5.1.1 above, it is difficult to get an understanding of the number of businesses who are using the cash basis but not officially informing HMRC by making the relevant election. We anticipate that making the cash basis the default method of preparing accounts will increase the 'official' numbers of businesses using the cash basis and some of the proposals outlined in this consultation, in particular relaxing the interest restrictions and loss relief rules, would increase eligibility. However, it is imperative that these changes are made alongside a good communication strategy and clear, updated guidance and we discuss this in more detail at paragraph 8.5.

8.3. **Question 7: Would allowing an optional end of year adjustment for stock in the cash basis be a feasible or helpful addition, and would it encourage more businesses to use the cash basis?**

8.3.1. Businesses with significant stock levels could have commercial reasons to use a management accounting stock control system and so be more suited to the accruals basis than the cash basis. In general, we would expect most of these types of business to be outside the scope of the people LITRG aim to help understand their tax affairs.

8.4. **Question 8: Are there any opportunities to more closely align the rules for measuring self-employment income under Universal Credit with the self-employed cash basis? Would closer alignment encourage more people to use the cash basis, or provide simplification benefits for people already using the cash basis?**

8.4.1. In our 2017 report on Universal Credit (UC) and the self-employed[1] we raised the issue of differences between the cash basis for tax purposes and UC cash accounting required for monthly assessments. There are clear differences between the two approaches but how much these differences affect UC claimants depends on their actual business transactions and the timing of these transactions. For example, £41 per month is allowed for interest and finance costs for UC purposes, this equates broadly with the current interest restriction of £500 per annum under the 'tax' cash basis. However, it is possible that a UC claimant may have a finance cost expense of over £41 in some monthly assessment periods so the full expense would not be allowed when calculating UC, but during the

[1] Self-employed claimants of universal credit – lifting the burdens: https://www.litrg.org.uk/latest-news/reports/171030-self-employed-claimants-universal-credit-%E2%80%93-lifting-burdens

tax year the claimant has a total finance cost of less than £500 which would be allowable under the cash basis for tax purposes. It should be noted that any changes to increase the interest restriction limits will increase this disparity unless the Department for Work and Pensions (DWP) also change the monthly amounts to remain broadly consistent.

8.4.2. Under UC, self-employment losses go against self-employment income earned in future assessment periods so any relaxation of the loss relief rules under the 'tax' cash basis, such as allowing sideways relief, will increase the differences between the calculations of profits for UC and those for tax purposes.

8.4.3. We appreciate the purpose of providing monthly information to the DWP is different to the reasons to complete and submit a Self Assessment tax return, so therefore, it may not be possible to fully align the cash basis/cash accounting rules due to these different objectives. An example of a conflicting objective is the UC rule on allowing business expenses which are wholly, exclusively, necessarily and reasonably incurred as opposed to the tax rules which state that expenses must be wholly and exclusively for the purpose of the trade. This means that DWP may refuse to allow a deduction for an expense, that they deem not reasonably incurred, that may be an allowable deduction for tax purposes.

8.4.4. However, we think there could be an opportunity for greater procedural alignment in the reporting processes for UC and for tax purposes under Self Assessment and potentially under Making Tax Digital for income tax (MTD). This would be with a view to making things simpler for self-employed UC claimants rather than increasing take-up of the cash basis. We consider it would benefit and encourage more formalised usage of the cash basis if the monthly assessment forms for UC were in the same format as the questions used for self-employment on the Self Assessment tax return.

8.4.5. We suggest further work is undertaken into the feasibility of aligning the UC monthly assessment periods[1] to the tax year and MTD quarterly reporting periods as we consider this will be a significant issue for UC claimants if they fall into the MTD for income tax (see our comments on 8.8.1 on MTD and UC claimants).

8.5. **Question 9: Are there any non-legislative changes that could be made to improve understanding and use of the cash basis for eligible businesses? Would an education campaign to inform small businesses of the cash basis encourage more to use it, even without changes to the cash basis itself?**

8.5.1. We consider the guidance for the cash basis could be expanded and improved, especially in respect of explaining the differences between the cash basis and accruals basis. Clear but detailed guidance signposted from the notes to the tax return and help button on HMRC online services should help reduce the risk of an error being made by people either using the cash basis without realising or using a hybrid method of both the accruals basis and the cash basis.

[1] UC monthly assessment periods start from the date an initial claim for UC is made.

8.5.2. We would like to see current guidance enhanced[1] to ensure there is more accessible guidance within the main body of GOV.UK rather than 'hidden away' in the HMRC manuals. For example, currently there is no information on pre-trading expenditure and the cash basis, an issue which can be very relevant to start-ups.

8.5.3. Also, it is important that the guidance covers changes to trading income which may not have been as significant or developed when the cash basis was first introduced. Two areas where new guidance needs to be included are 'net receipts' and 'timing of payments from platforms'. Guidance in these areas would also assist with the introduction of Making Tax Digital for income tax.

8.5.4. **Net receipts**- many low-income unrepresented taxpayers prepare their accounts using information directly from their bank accounts. This can result in inaccurate business records if using an online platform to facilitate sales, as platforms usually pay the trader after deducting their selling fees. For example, if you are trading using an online platform who deduct their 15% commission fee before paying the balance directly into your bank account then the correct tax position would to be record the gross income as turnover and the 15% deduction as a business expense selling fee. However, we suspect many unrepresented businesses who are using platforms would incorrectly record the net amount (85%) as turnover instead and although the correct taxable profit would be recorded, the sales and expenses amounts would be incorrect. Unfortunately, it could be argued that using the cash basis reinforces this error therefore clear guidance on the main GOV.UK pages is needed.

8.5.5. **Timing of payments from platforms**- some platforms allow the trader to decide when they want to receive their net income (after their selling fee has been deducted) or only transfer income when a certain net threshold has been reached. For businesses choosing to use the cash basis this can cause confusion on when the income is actually received; for example, is it when the sale goes through or when you request and receive the income from the platform. Although guidance on GOV.UK states 'You can choose how you record when money is received or paid (for example the date the money enters your account or the date a cheque is written) but you must use the same method each tax year'[2] we think additional clear guidance is needed as more businesses are using platforms.

8.5.6. The issue discussed at paragraph 8.5.4 above, is further compounded by the function available on some platforms to hold sales proceeds which can be used to subsequently purchase goods on the same platform. For self-employed traders (rather than hobby-traders or people selling unwanted items occasionally) this means that these funds may not actually leave the platform and so may not be accounted for or taxed correctly.

[1] See our March 2023 report: Good guidance – the importance of effective guidance for unrepresented taxpayers (https://www.litrg.org.uk/latest-news/reports/230404-good-guidance-%E2%80%93-importance-effective-guidance-unrepresented-taxpayers)

[2] GOV.UK website: https://www.gov.uk/simpler-income-tax-cash-basis/income-and-expenses-under-cash-basis

8.5.7. We are concerned that some platforms may provide inconsistent and incorrect guidance on using the cash basis. We recommend that platforms are encouraged to link to enhanced and updated guidance on GOV.UK to reduce the number of potential errors.

8.5.8. As explained at paragraph 5.1.2, we think most people have drafted their accounts or compiled a list of their business income and expenses before filling in their tax return and so do not consider which accounting basis they are using when reaching the question on the cash basis election. Therefore, we think communication on changes to the cash basis which contain links to enhanced guidance, needs to be made before businesses start completing their tax return. This could be achieved by including information on the statutory annual notice to file a tax return, or linking to relevant guidance when people register their self-employment with HMRC or perhaps by having a pop-up warning on the tailored questions section at the start of the online tax return where it asks if you are self-employed. Additionally, an interactive tool could help unrepresented businesses decide which basis of accounting would be most appropriate for them to use and/or the use of a pop-up checklist on the online tax return listing the eligibility criteria. These interactive tools would fit with the recent Budget announcement to transform HMRC guidance aiming to 'ensure guidance is clear, simple and easy to find, introduce step-by-step interactive guidance'[1] as long as they were accurate and included links to relevant guidance[2].

8.5.9. Additionally, in our experience there can be confusion by businesses thinking if they use the cash basis then they have to use the simplified expenses fixed amounts. This is probably because both simplification changes were introduced during the same tax year. However, it would be helpful if revised guidance clarified the position on simplified expenses to reduce any misunderstanding in this area.

8.6. **Question 10: Could any of the proposals or ideas in this consultation document for reforming the cash basis be applied to income from property businesses? Would increasing or maintaining alignment between the trading income cash basis and property income cash basis have an effect on simplicity or take up?**

8.6.1. The complete alignment of the trading income cash basis and the property income cash basis would require significant changes to areas such as the use of losses and the restriction on tax relief for interest and finance costs for residential landlords. If such alignments are being considered, then we would anticipate early consultation with relevant stakeholders on any proposed changes.

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[1] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1144441/Web_accessible_Budget_2023.pdf paragraph 4.92

[2] See the recommendations in the recent LITRG report: Good guidance – the importance of effective guidance for unrepresented taxpayers (https://www.litrg.org.uk/latest-news/reports/230404-good-guidance-%E2%80%93-importance-effective-guidance-unrepresented-taxpayers)

8.6.2. We consider it would be helpful for unrepresented businesses if the wording for the default cash basis, included on tax returns and any related guidance, was consistent between the trading income and property income sections.

8.7. **Question 11: Any changes to the trading income cash basis would automatically apply to partners in partnerships that use the cash basis; are there any particular issues that should be taken into account when considering the impact of these changes on partnerships, and should any of these proposed changes not apply to partnerships?**

8.7.1. When considering the cash basis threshold, the turnover restriction looks through the partnership to include additional trading activities of any controlling partners. Increasing (or removing) the entry turnover threshold would make this easier and simpler for larger partnerships to join the cash basis but they may have other reasons to remain in the accruals basis as outlined at paragraphs 4.1.2 and 4.1.3.

8.8. **Question 12: What other interactions between reforms to the cash basis and MTD for ITSA should the government take into consideration? Question 13: What is your view on whether encouraging/expanding the cash basis will improve sole traders' experience of MTD for ITSA, particularly for very small businesses, and why?**

8.8.1. We have participated in discussions with HMRC regarding the MTD review for smaller businesses (those with turnovers/ rental income between £10,000 and £30,000) and we are currently awaiting the outcome of the review. Depending on this, we understand there could be a significant number of people in the £10,000- £30,000 MTD cohort who could also be claiming Universal Credit (UC) when migration from tax credits has completed. UC claimants who are required to report tax information under MTD will report their trading income and expenses 17 times for a tax year (this comprises of: 12 monthly assessments for UC purposes, four quarterly digital returns and one End of Period Statement for MTD purposes). We consider this an onerous administrative burden for those who can least afford professional help. There are areas where we think this burden could be reduced by making the procedural processes more consistent and we discuss these at paragraphs 8.4.4 and 8.4.5. However, this is an area that needs more detailed consideration and perhaps its own consultation, it would also require the DWP to be open and willing to make potential changes to UC legislation and/or its systems.

8.8.2. As many record-keeping software packages use information imported from bank accounts and so automatically record transactions on a cash basis, we consider that cash basis accounting may be easier than the accruals basis, for low-income unrepresented businesses who are confident in choosing and using appropriate digital record-keeping software. Assuming the software package generates the quarterly updates required under MTD, then using the cash basis should minimise any end of year adjustments that might be necessary to the information submitted in the quarterly updates to create the taxable profit. However, there are issues with this approach such as platform fees already being deducted so net income rather than gross income is shown on the bank statements, which is a potential problem for both the MTD and cash basis thresholds (see paragraph 8.5.4) and the timing of transactions from platforms (see paragraph 8.5.5).

8.8.3. The government is keen to use information provided by regular digital reporting for MTD to enable taxpayers to see what their 'real time' tax liability could be. For some businesses using the cash basis could provide a more accurate 'real time' tax calculation as there may be fewer tax adjustments required for the End of Period Statement than if they were using the accruals basis. However, accurate in-year tax calculations will depend on a number of variables and not just the choice of accounting basis, these variables include the quality of digital record-keeping, decisions to make any relevant elections at the end of the tax year and having regular patterns of income and expenditure.

LITRG
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