Simpler Income Tax for the Simplest Small Businesses
HM Revenue & Customs consultation response document and draft legislation for inclusion in Finance Bill 2013

Comments by the Low Incomes Tax Reform Group

Executive summary

1. We generally welcome proposals to make accounting and tax simpler for small businesses. We do though have concerns that the mechanics of the draft legislation will result in small businesses having to make annual 'better off' calculations in order to decide which accounting basis they should use and also how they should account for certain expenses. Our concern is that the cash basis has become far too complex for unrepresented small businesses to understand and may result in some unrepresented taxpayers being seriously disadvantaged if they do not fully understand the differences between the cash basis and the accruals accounting basis.

2. We strongly urge both HM Revenue & Customs (HMRC) and the Department for Work and Pensions (DWP) to reconsider their proposed cash accounting bases and attempt to align the two systems (the HMRC cash basis and the DWP Universal Credit cash accounting) as much as possible; failure to do so will result in Universal Credit claimants having to prepare monthly cash accounting calculations for their Universal Credit and a different cash basis calculation for their annual tax return. This is a serious business burden and one which the smaller businessman is unlikely to cope with well or at all.

3. Although we welcome the decision to allow rather than disallow any deduction for interest and costs of cash borrowings, we remain concerned that only allowing a flat rate expense

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for amounts up to £500 may result in a high number of small businesses not opting for the cash basis.

4. Clear and detailed guidance must be provided to small businesses as soon as possible explaining the new cash basis and the differences compared to the accruals basis in order for businesses to make an informed decision. This guidance should be provided both on line and as printed copies for digitally excluded businesses.

Who we are

5. 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.

6. LITRG works extensively with 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.

7. 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.

General comments

8. We welcome the principle of a simpler tax system for small businesses. These businesses are often unable to afford professional tax representation and may not understand the complex business tax rules, for example claiming capital allowances. We remain gravely concerned that the draft legislation has produced a set of complicated rules which although are well-intended by providing small businesses a variety of choices (ie using the simplified expenses) the result is that the small business is faced with an even more complicated set of rules and decisions to make.

9. For example, each year the business owner will need to decide if he will be using the cash basis and if this is the case then the business owner must make an election on his tax return. The businessman will then be required to make a decision on whether to use the simplified rules or the current rules for various expenses. In order to make these decisions, the business owner will have to make various 'better off' calculations to decide what would be

the best tax option. We do not think this is a satisfactory outcome for what is supposed to be a simplified tax system; this additional complexity could result in errors being made when completing Self Assessment returns. Also we are concerned that businesses who can least afford to pay for professional tax advice will feel forced to do so or will not seek appropriate advice, which may result in them not choosing the most tax advantageous option.

10. Our concerns are manifested by the fact that the proposed turnover limit is so high when compared to the original OTS recommendations.[1] In our response to the original consultation dated 22 June 2012, we considered the most appropriate turnover threshold to be £30,000 with an exit level of £40,000; we were disappointed to note that the turnover threshold has remained at the VAT registration limit of £77,000 and there is a separate threshold for Universal Credit claimants of £154,000.

11. We understand that there will be some flexibility for businesses using the cash basis to decide on the timing of receipts and payments. This means that as long as a consistent approach is used businesses can use the date that a cheque payment is written or received or the date a cheque is cleared through the bank. We acknowledge that this flexibility will enable small businesses to use a system which is best suited to their needs but we would strongly recommend that the different approaches are explained fully in the guidance on the cash basis.

12. We welcome the decision to allow small businesses using both the accruals basis and the cash basis to have an active decision whether to use the existing rules for apportioning certain expenses or to use the flat rate amounts of the proposed simplified expenses (with the exception of mileage costs for cars and motorcycles).

13. The main concerns LITRG have with the proposed simpler income tax rules relate to the following areas: interaction with Universal Credit, loss relief, payments for interest and other cash borrowings and the guidance and communications to small businesses.

Interaction with Universal Credit

14. HMRC's initial consultation stated that it was 'working with the Department for Work and Pensions to identify how it may be possible to align aspects of the cash basis for tax and self-employment income reporting for Universal Credit'[2]. Assuming this is still the case, the table below shows the differences between the cash accounting required under the proposed Universal Credit regulations and the accounting under the proposed cash basis.

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[1] Office of Tax Simplification- Small business tax review: Simpler income tax for the smallest business, paragraph 2.15.

[2] HMRC Consultation document: Simpler Income Tax for the Simplest Small Businesses, paragraph 1.8.

15. The recent consultation response document states 'Because Universal Credit claimants will have to use the cash basis to report their income for Universal Credit purposes, the entry limit for Universal Credit claimants will be the higher limit of £154,000. This will make it easier for the self-employed to meet their obligations if within both systems'[1]. This implies that HMRC expect the two systems to be working together to assist the self-employed. However we consider that there is a serious lack of alignment which then makes the simpler income tax proposals fundamentally flawed for self-employed Universal Credit claimants. We understand that there are concerns within HMRC that Universal Credit claimants will provide HMRC with the same accounting profits they provide to the DWP to ensure consistency as claimants will not understand that the accounting rules differ and this could result in incorrect tax returns.

Table comparing accounting under Universal Credit with accounting under HMRC's cash basis		
	Accounting under Universal Credit	**Accounting under HMRC's proposed cash basis**
Reporting time frame	Monthly reporting within 7 days of the end of the assessment period.	Annually by January 31 after the end of the tax year
Mandatory or optional use of accounting basis	There is no choice on how the monthly accounts are prepared for DWP – they must conform to the Universal Credit regulations.	The cash basis is optional and businesses can elect to use it on an annual basis. Alternatively businesses can use the 'accruals basis' (generally accepted accountancy practice).
Thresholds	There are no thresholds – all self-employed Universal Credit claimants must use the same accounting basis.	Universal Credit claimants must leave the cash basis if their annual turnover is greater than £154,000 (twice the VAT registration limit)

[1] HMRC Consultation document: Simpler Income Tax for the Simplest Small Businesses- Summary of responses, page 6.

Transitional rules	There are no transitional rules; when completing their self-assessment tax returns Universal Credit claimants must adjust their annual accounts to ensure that income and expenses are only declared once.	On switching to the cash basis (and from it to the accruals basis), transitional rules ensure that income and receipts are accounted for only once.
Income	Income receipts include refunds of income tax and national insurance **(UC regulation 57 (4))**	Income receipts do **not** include refunds of income tax and national insurance.
Loss position	Trading losses are unable to be carried forward to the next monthly period, they are unable to be utilised and are simply disregarded. **(UC regulation 58 (3b))**	Trading losses (cash deficits) can be carried forward and utilised against business profits (cash surpluses) in the future.
Minimum Income Floor (MIF)	If the business makes a loss in a monthly period then this artificial income level will apply to some 'gainfully self-employed' businesses (after the 12 month start-up period). **(UC regulation 62)**	Only **actual** income earned by the business is accounted for, losses can be carried forward.
Expenses	Most business expenses are allowed by the Universal Credit regulations, but not interest on cash borrowings (see below). Income Tax and National Insurance are allowable expenses within the monthly assessment period in which they are paid. **(UC regulation 57 (2a))**	Expenses are usually allowed for business costs only, the exception being interest on cash borrowings (see below). Income Tax and National Insurance are **not** allowable expenses.
Cost of borrowings expenses	No interest is allowed as a business expense. **(UC regulation 58 (3c))**	Interest on cash borrowings is allowable up to an annual limit of £500. It is not a condition that the interest is wholly and exclusively for

		the purposes of trade.
Option of using simplified expenses (except for cars and motorcycles)	Businesses have to use the regulations governing expenses. There is no choice between using the Universal Credit regulations and the actual cost of the business expense. This affects expenses such as motor vehicles (including vans), business use of home and the private use of business premises. **(UC regulation 59)**	Businesses can choose whether to use the new simplified expenses rules relating to business use of home and the private use of business premises. Depending on the business it may be beneficial to claim the actual proportion of allowable costs rather than use the new simplified rules.

16. We strongly recommend that further discussions and work is carried out by both the DWP and HMRC to ensure that the two bases are similar because the small business owners who are also Universal Credit claimants are the people who will most benefit from a simplified accounting and tax system.

17. Our view is that full alignment will be impossible unless Universal Credit claimants are able to carry forward losses from one assessment period to the next. Even then, the operation of the minimum income floor and the monthly assessment period, contrasted with a yearly accounting period under the proposed HMRC rules, will create the need for adjustments. Any purported advantages of Universal Credit claimants adopting the cash basis for tax purposes rather than the accruals basis may therefore prove illusory.

Losses

18. We are very disappointed to note that sideways loss relief will not be available to small businesses electing to use the cash basis. We are further concerned that these changes to the legislation will bring about yet another different set of rules for loss relief for the taxpayer to comprehend and this cannot be described as a simplification measure.

19. Our main concern is that many start-up businesses experience losses in the first few years of trading; it is these businesses which would benefit from being able to use the sideways loss relief rules.

20. HMRC's reasoning for not allowing the sideways loss relief under the cash basis is 'that most businesses for which the cash basis is suitable are less likely to make losses'[1]. We strongly disagree with this reasoning as in the current economic environment many small businesses, especially new businesses, are struggling to survive and many will potentially find themselves in a loss-making position. It is the unrepresented low income taxpayer who will be most vulnerable in missing out on sideways loss relief by unknowingly electing for the cash basis when completing their Self Assessment tax return in the belief that the simplified income tax rules would always be the most appropriate basis. This of course is also misleading and may have unfortunate implications later on in a business cycle.

21. As explained below, it is vital that HMRC guidance makes clear the differences between the cash basis and the accruals basis so that businesses can make an informed decision on an annual basis and not potentially lose out on loss reliefs.

Payments for interest and other cash borrowings

22. We are pleased that the cash basis proposals have been amended to make an allowance for interest and costs of cash borrowings rather than none. We do though remain very concerned that the low amount of allowable interest and cash borrowing expenses (a flat rate for amounts up to £500) may result in a high number of small businesses not opting for the cash basis at all which defeats the intention.

23. We welcome the inclusion of section 57B (4) of the Cash basis for small businesses draft legislation which will enable the Treasury to raise the limit from £500 but it is unable to be lowered without Parliamentary consent.

24. We understand that HMRC will be confirming whether the £500 limit will be amended for varying lengths of accounting periods, which could affect both small businesses opting to transfer to the cash basis from the accruals basis and new businesses.

Guidance and communication with small businesses

25. It is planned to implement the cash basis from the tax year 2013/14 onwards. With such a major change to the way that businesses can decide to prepare their accounts and tax return, we consider it critical that very clear detailed guidance is provided as soon as possible.

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[1] HMRC Consultation document: Simpler Income Tax for the Simplest Small Businesses- Summary of responses page 9

26. As the draft legislation proposes a choice whether to use the cash basis and whether to use simplified rules for certain expenses, the guidance must be detailed enough to enable unrepresented taxpayers to be able to make an informed decision on what accountancy basis would be most appropriate for them. It will be important for example for the guidance to fully explain that the cash basis will not allow the use of sideways relief, the approved mileage allowance payments must be used for cars and motorcycles, interest and cash borrowing costs of only up to £500 can be claimed, timing of receipts and payments, and the transitional rules from changing from the accruals basis to the cash basis and vice versa.

27. All guidance must clearly stipulate that certain small businesses are unable to use the cash basis, these include the 'Excluded persons' detailed in clause 31C of Cash basis for small businesses.

28. We believe that this guidance (or at the very least a summary of the guidance) must be provided every tax year, with the notice to file a Self Assessment return. Because an election for the cash basis is required every tax year it is only fair that small businesses are provided with the relevant facts each year to enable them to make an appropriate decision. For example, a business may elect to use the cash basis in the tax year 2013/14 but may have large business interest costs in the tax year 2014/15 and decide it would be beneficial not to elect for the cash basis and to instead use the accruals basis.

29. We understand that HMRC faces a challenge informing businesses of the cash basis and we reiterate our offer to assist in the development of appropriate guidance for unrepresented small businesses.

30. The timing of providing the information is important; if possible guidance should be available before the beginning of the 2013/14 tax year to enable businesses to keep the appropriate accounting records from the beginning of the tax year.

31. We would also recommend that all new businesses should have the guidance sent to them when they register for self-employment, the submission of Form CWF1- 'Registering for Self Assessment and National Insurance Contributions if you are a self-employed sole-trader', should act as a trigger for HMRC to send the guidance.

32. We would expect that HMRC staff will be familiar with the proposed new legislation before the start of the 2013/14 tax year in order to assist with any questions small businesses could have. Ideally, HMRC should encourage small businesses to consider the appropriate accounting basis during the tax year as it may be too late after the accounting year end to ensure that the correct information has been recorded.

LITRG
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