

**Simplified cash basis for unincorporated property businesses
HM Revenue & Customs (HMRC) consultation document
Response from the Low Incomes Tax Reform Group (LITRG)**

1 Introduction

- 1.1 LITRG welcomes the opportunity to comment on all the Making Tax Digital (MTD) consultations issued on 15 August 2016. In this response relating to the simplified cash basis for unincorporated property businesses, we refer to such businesses as ‘landlords’, for simplicity’s sake. Our response concentrates only on the potential effects on low-income taxpayers or other vulnerable groups whom we seek to represent, such as retired people on low incomes who rent out property instead of having a pension, or who may have to rent out their home to pay for residential care, or an employee having to relocate because of their job.
- 1.2 This consultation response should be read in conjunction with our responses to the other consultations on MTD.
- 1.3 We begin though with some general comments on the MTD policy.

2 Making Tax Digital programme

- 2.1 We generally support the HMRC digital strategy and recognise that many benefits may be possible in the digital world. We are though hugely concerned that much of the detail of the MTD programme is still to be considered and finalised, and as a result implementation of MTD for unincorporated businesses from April 2018 is totally unrealistic and unachievable in the timescale.
- 2.2 The current timetable does not allow sufficient time for:

- HMRC to properly publicise and educate the public about MTD;
- businesses to prepare for these very significant changes, both in terms of practical impacts and the additional costs which will result;
- the software – which is crucial to the success of MTD – to be anything like fully developed and tested.

- 2.3 We strongly urge HMRC to delay the commencement of MTD until the design has been completed and fully tested. This should substantially reduce the massive risk of the project going seriously wrong with the damage done to HMRC reputation but also the inevitable ‘teething problems’ that will without doubt occur. A more relaxed introduction will therefore lessen the chances of the public quickly losing faith in the system, reduce the chance of naturally compliant taxpayers making mistakes due to having to rush into unfamiliar territory, and protect HMRC from reputational damage.
- 2.4 We do not support the principle of mandating MTD and are wholly opposed to this approach. If we compare it to self assessment (SA) online filing which has been very successful without being mandatory, we can see that if a product is good and beneficial, taxpayers will naturally migrate to it. Mandation is very likely to have the opposite effect to that which it is intended to foster: instead of increasing tax receipts, it may act as a disincentive to businesses to trade legitimately and encourage some into the hidden economy.
- 2.5 Many businesses with low incomes will find it extremely difficult to comply with the requirements of MTD for a number of reasons, being cost, extra administrative time, lack of IT knowledge, and lack of financial literacy. To make the system work as smoothly as possible, we would strongly recommend that the exemption level is raised very substantially above the proposed limit of £10,000 annual turnover. In our view we consider that the exemption limit should initially be set at an amount equivalent to the current VAT registration threshold. This should at least mean that MTD for business will be more successful from the outset as potentially problematic traders will be below the exemption limit. In turn, fewer resources will be required to provide digital and perhaps financial support to those who will need assistance. This should result in a much smaller group than would otherwise be the case. But if MTD is as good as HMRC promise, traders will almost certainly wish to join it voluntarily.
- 2.6 The success of the MTD programme depends heavily on the use of good software. It is the responsibility of Government to provide free software where it is a requirement to have software to be able to comply with legal obligations. In respect of MTD HMRC should ideally provide good, free software to small businesses. Relying on commercial businesses to make free software available is, in our view, fraught with very significant problems and is wholly unsatisfactory. Free software provided from commercial sources will have only limited functionality, thus those unable to afford upgraded packages could be excluded from many of the purported benefits of MTD and free software providers will constantly be bombarding their customers with update requests.

- 2.7 Finally, there will always be some taxpayers who are digitally excluded for a variety of reasons such as lack of broadband due to remote location, or age, or disability. The service and support available to this group of taxpayers must be of at least the same level as that available to digitally enabled taxpayers. Regrettably, the detail of what this support will likely be has not yet been made clear.

3 Simplified cash basis for unincorporated property businesses: Executive Summary

- 3.1 The option to use a simplified accounting basis may be helpful with the introduction of digital tax reporting, provided it is not too complex to understand, detailed guidance is available to assist unrepresented landlords and it will not result in an overall tax disadvantage.
- 3.2 We understand that HMRC want to provide unincorporated property businesses with choices which enable flexibility when completing their digital tax reporting. While we welcome this choice, we are concerned that many unrepresented landlords will simply not understand the choice they will have between accounting under the cash basis or the accruals basis (and, most importantly, the implications of making one choice).
- 3.3 We recommend that software nudges and prompts are used to flag up the different tax treatments, this proactive support might assist taxpayers in determining which basis is most appropriate for them to use and prevent errors being made.
- 3.4 Although not entirely clear from the consultation document, it appears that the cash basis for landlords could be introduced from April 2017.¹ We are very concerned that this measure alone presents a significant change for landlords and would seem to come in at the same time during which MTD processes will be being piloted and tested. It is difficult to see how a meaningful test of MTD for landlords will be undertaken at the same time as they are getting used to other significant change and this reinforces our concerns and worry that the current proposed timescale to launch MTD is totally unrealistic. We do not think there will be sufficient time to consider these very significant changes in enough detail, to write comprehensive guidance and publicise the choices unincorporated businesses will have from April 2017 and this lack of planning time could in turn totally undermine the transition to digital reporting.

¹ The consultation document outlines that legislation is to be put forward in Finance Bill 2017, but an introduction date of the measure is not specified, except that it is implied to be April 2017 (for instance Example 2 on page 9 refers to the cash basis being used in the 2017/18 tax year).

4 About Us

- 4.1 The 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.
- 4.2 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.
- 4.3 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.

5 General comments

- 5.1 We welcome the extension of the cash basis to landlords as it may provide some landlords with greater simplicity in understanding how to account for and calculate their taxable rental profits. However, any changes introduced which may affect low income or vulnerable groups must not result in further costs to them, such as having to take professional advice to understand the new rules.
- 5.2 We consider it important that this proposed extension of the cash basis is a voluntary option, and it is good that the consultation recognises the importance of such a choice. Any guidance should explain the difference between the two bases using examples, so that unrepresented landlords can clearly see how both the accruals basis and the cash basis will work. We recommend that the guidance reassures landlords who have simple tax affairs that if their income and expenses are reasonably consistent and are paid at regular intervals then the overall tax result will probably not vary regardless of which accounting basis they use. We anticipate that there will be many unrepresented landlords who currently use the cash basis without realising that they should be using the accruals basis.
- 5.3 Current HMRC guidance¹ explains that the cash basis will be accepted provided there would be no significant variations from the accruals accounting basis and that gross rental receipts are less than £15,000. It would be helpful for HMRC to confirm whether this guidance will continue to stand if these proposals are introduced as it may be the case that some

¹ Property Income Manual (PIM 1101) 'Use of cash basis': www.gov.uk/hmrc-internal-manuals/property-income-manual/pim1101

landlords are not aware that they will need to make a formal decision so as to continue preparing their property accounts in this way.

- 5.4 Guidance and free software must also be written for landlords who use the accruals basis in preference to the cash basis. It would be wrong and unfair if a landlord is effectively forced to change their accounting basis at the risk of being non-compliant if they do not – for example because the digital tax reporting systems or ‘apps’ do not support the accruals basis to the same extent as the cash basis.
- 5.5 We are very concerned that the timescale to bring in these changes, which appear to come in from April 2017 – a year ahead of the launch of MTD – is too short so as to ensure that landlords have time to adjust. HMRC will need to write guidance and publicise the choices landlords will have as a matter of urgency. This lack of planning time could in turn undermine the transition to digital reporting, as there is unlikely to be adequate time to pilot MTD for landlords and fully test how it will work with these new rules.
- 5.6 Landlords using the cash basis may come across problems in obtaining the information required for their digital reporting. For example, most landlords only receive their mortgage statement on an annual basis, however this information is required for the split of capital and interest costs. Would HMRC expect landlords to contact their mortgage provider on a quarterly basis for this information, or will there be an opportunity to make annual adjustments when this information becomes available?
- 5.7 We believe that landlords who rent out their home to pay for residential care fees should be specifically exempt from MTD. We discuss this further in the exemptions section of our response to the consultation document ‘Making Tax Digital: Bringing business into the digital age’.

6 Question 1 – Do you feel there should be a relevant maximum limit imposed for eligibility for the cash basis for unincorporated property businesses? If so, what should this limit be and why?

- 6.1 The move to digital reporting will be a significant change for many taxpayers and it is important that accounting for income and expenses is simplified for those landlords who cannot afford professional advice. The option to use a simplified accounting basis is useful and we welcome the proposal provided it is not too complex to understand, detailed guidance is available to assist unrepresented landlords and it will not result in a tax disadvantage (for example, the proposed rules under the cash basis regarding lease premiums).
- 6.2 Additional rental income does not necessarily indicate any greater degree of complexity in a property business and therefore a maximum limit may have less relevance in this sector when compared with trading businesses. However, as we represent low-income taxpayers we have no comment on a maximum limit other than to suggest that any accounting basis which reduces the administration burden on small unincorporated property businesses

should be widely available.

7 Question 2 – Do you feel there is any reason why the cash basis should not be optional for all eligible unincorporated property businesses?

- 7.1 When considering low-income landlords, we agree that the cash basis should be available on an optional basis. However, for landlords to make an informed choice about which accounting basis would be the most suitable for their individual circumstances there needs to be sufficient guidance available. Unrepresented businesses need detailed and practical advice. An example of this is the date on which to record a transaction such as a rent receipt; is it when the business is presented with a cheque, or deposits the cheque in their bank, when the bank processes the cheque or when the cheque clears? In addition, we think that the prompts and nudges that will be incorporated in software could assist in-year with regards to decisions about the appropriate basis. This could be done by letting the taxpayer know what the tax treatment should be of a particular item under each basis.

8 Question 3 – Would you want to opt in for each of their property businesses separately (for example, UK property business and overseas property business) or would they prefer to choose whether to opt in for all their business income or none of it?

- 8.1 There may be some situations in which a low-income landlord has different property businesses, for example renting out a room in their main residence and sub-letting a garage or parking space. We note that one of the main purposes of introducing the cash basis to landlords is to assist with digital reporting to HMRC. To fulfil this objective, the cash basis (supported by clear and detailed guidance) should therefore be open to as many unincorporated property businesses as possible.
- 8.2 The additional flexibility that would be offered by allowing taxpayers to opt in for each property business separately means more complexity and possibly higher risk of confusion in terms of accounting for each property business. However, flexibility may be an advantage if for example some property held overseas needs reporting using a different basis (this may be to help align with information already gathered for reporting to an overseas tax authority). By allowing landlords a choice, it will allow them to make a decision about what suits their reporting needs best.
- 8.3 One approach which could simplify this option for landlords is that the first choice of an accounting basis is used as a default basis for all other sources of rental income, however landlords can opt out of this default if they choose to. This would have the benefit of keeping the choice of accounting basis simpler for unrepresented landlords but provides flexibility if it would be more appropriate to use different accounting bases.
- 8.4 We recommend that the personal tax account clearly states which accounting basis is being used for each rental property source.

9 Question 4 – Does the above advice give you enough information to decide whether or not to use the cash basis with/without (please indicate) professional advice? If not, what else would you need to know about the new rules?

- 9.1 There have been changes to the tax treatment of property income and expenses recently (such as tax relief on mortgage interest and the reform of the wear and tear allowance). While these changes may not affect many low-income landlords, they may have been aware of them due to reports in the media and they may have been concerned about what the changes mean for them. It is promising that the proposed rules will not result in many further changes other than the timing differences of when to account for rental income and expenses. It is important that guidance clearly explains not only what changes are being made but also what the existing rules are, such as only (some) interest and not capital is a tax deductible expense.
- 9.2 We understand that HMRC want to provide landlords with choices which enable flexibility when complying with their digital tax reporting obligations. However, we are concerned that many unrepresented landlords will not understand the choice and differences between accounting under the cash basis or the accruals basis. Some low-income taxpayers will find themselves in the unplanned position of being a landlord, for example due to having to re-locate because of their job, being a couple separating or a pensioner having to rent out their home to cover care costs. Unfortunately, because of this, it will be unrepresented taxpayers who – through lack of awareness – may lose out on the potential benefits these choices may provide.
- 9.3 Paragraph 3.16 of the consultation states ‘It is intended that guidance would be provided through the GOV.UK website and other channels to help new and existing businesses understand whether the cash basis would be suitable for them and to inform their choice about whether to use the cash or accruals accounting basis rules.’ This is encouraging, as long as the guidance referred to is comprehensive and clear, so that landlords can make an informed decision. It may be helpful if guidance from ‘other channels’ could include leaflets provided to landlords identified from either the property income disclosure scheme or from SA tax returns or given to letting agents to pass to their clients.
- 9.4 It is important that any guidance covers how accounting for the cash basis would work and the differences between the cash basis for a non-property trade and for a property business (as a landlord may also be a self-employed trader, for instance). It would be helpful if there were specific examples of how the cash basis would work with common scenarios that unrepresented taxpayers may find themselves in, such as with rent-a-room relief and the proposed property income relief of £1,000 announced in the last budget.
- 9.5 There is no mention in the consultation of whether there need be a commercial reason to change from the cash basis to the accruals basis. If there is such a requirement then we think it should be sufficiently flexible to allow landlords to move to the accruals basis if they require full rental accounts for personal reasons as well as commercial reasons such as obtaining a mortgage for their own residence or if required as part of a divorce settlement.

9.6 Part way through a tax year, it may become apparent that a taxpayer has adopted, say, the cash basis, but it would be better to use the accruals basis. We think it should be possible to make a final decision about which basis to use at the end of the tax year, notwithstanding quarterly reports for MTD having been made on a different basis. In this regard, it would be helpful if nudges and prompts built into MTD software provide indications to the taxpayer of the different tax treatment under each basis for particular items, for example, lease premiums, particularly where this could materially affect the decision as to which basis is most appropriate.

9.7 The consultation does not clarify whether upon leaving the cash basis there will be the option to spread any tax adjustments over six years. This adjustment may seem to be too complex for some unrepresented landlords to understand but they still need to be aware of it in order to make an informed choice about which accounting method to use.

10 Question 5 – Does a regime that allows for individuals letting jointly, not in partnership, to separately opt to report using the cash basis present particular difficulties or issues?

10.1 We consider it will be more problematic if individuals letting jointly have a requirement to agree to opt to use the cash basis. For example, there could be difficulties if a separating couple who are letting out their former home had to discuss and agree the tax treatment of their property income or if one of the party failed to report the joint tax information on time.

10.2 There is an issue regarding individuals letting jointly who opt for different accounting basis, as it may be the case that HMRC become concerned if they are unable to reconcile the cash basis information reported by one with the accruals basis information reported by the other and this then results in a higher risk of a compliance enquiry.

10.3 It should be noted that this proposal (to allow joint landlords to each report income on different bases) is not consistent with the proposal at 4.45 of the consultation document 'Making Tax Digital: Bringing business into the digital age' which suggests that one of the joint landlords would be the 'nominated individual' and they would be obliged to comply with all the requirements of MTD on behalf of all those who have an interest in the property. Therefore, HMRC need to clarify their thinking in this area as soon as possible.

11 Question 6 – Should eligibility for the trading cash basis affect eligibility for the cash basis for unincorporated property businesses? If so, do you have any suggestions on what this interdependence should be?

11.1 As per our answer to question one (paragraph 6.1), it would be helpful if accounting for income and expenses could be simplified for those landlords who cannot afford professional advice. We think landlords should be able to use the cash basis for their properties even if they have a trade which is ineligible to use the cash basis. (Although it may well be the case

that businesses which must use the accruals basis for their trade will also do so to report their rental profits.)

- 11.2 We are concerned that as the rental property profits will be taxed on a tax-year basis and self-employment income can be taxed at different quarterly, or more frequent, periods (as suggested in the consultation document ‘Making Tax Digital: Simplifying tax for unincorporated businesses’) the situation may arise that a taxpayer could have at least eight different digital reports to complete each year. This administrative burden and the potential confusion would also increase if monthly reports are required by the Department for Work and Pensions (DWP) for universal credit (UC) claimants.

12 Question 7 – Would only recognising deposits that landlords are entitled to keep at the end of a tenancy create unnecessary complexity?

- 12.1 We consider it more important to only recognise income that belongs to the landlord rather than risk being taxed on an amount which does not and may never belong to them, even if this is unwieldy to convey. Aiming for simplification is generally a good idea, but sometimes complexity is necessary if it would otherwise result in an unfair position on the taxpayer.
- 12.2 There may be complexity in understanding the treatment of deposits, especially for landlords who cannot afford professional advice, but it is up to HMRC to provide plain language guidance – yet with sufficient detail so that landlords are clearly able to understand this accounting treatment. Often HMRC guidance on the GOV.UK website oversimplifies complex situations to the detriment of the unrepresented taxpayer. But it should not be impossible to convey to taxpayers that they should not have to pay tax on deposits – after all, these are now largely required to be held in the ‘deposit protection scheme’,¹ out of the landlord’s reach. It would be iniquitous to expect a landlord therefore to include deposits amongst their income and pay tax on them, as they are unable to access the funds. HMRC may want to consider putting a checklist and examples on the digital tax accounts of people who record property income to highlight the correct tax treatment of deposits. In addition, prompts and nudges built into software could provide guidance on the treatment of deposits if a taxpayer selects this item when making an update.
- 12.3 There is also a risk to UC claimants, as they need to consider the treatment of any deposit when reporting their monthly income to the DWP. If UC claimants include deposits as ‘earnings’ then this will affect their UC entitlement for a particular month even though this should not (as far as we can tell under the UC rules) be treated as actual income, they do not have access to the funds, and indeed all of it may be returned to the tenant in due course. It is important that HMRC adopt a consistent approach with the DWP and that only actual

¹ See <https://www.gov.uk/deposit-protection-schemes-and-landlords/overview>

income 'earned' be accounted for. The same must be said for tax credit claimants. Clarity and consistency of the rules here is very important.

13 Question 8 – Do you feel there is anything which has not been considered which could make the cash basis as simple as possible for landlords?

- 13.1 We would recommend that the digital tax accounts contain a checklist or decision tree which is flagged up each time a taxpayer enters rental property information. The taxpayer could then click on further information to assist with the tax treatment of certain items such as the treatment of deposits or lease premiums. This checklist could contain links to the following information: the choice of accounting basis, when you can use each accounting basis, how you can transition between each accounting basis, the treatment of expenses such as mortgage interest and capital equipment, how losses can be utilised, and how lease premiums are accounted for.
- 13.2 Software nudges and prompts could also be used to flag up different tax treatment of particular items, so if a taxpayer is using the cash basis, a nudge could indicate what the accruals basis treatment is for a particular item, if this is materially different. This might assist taxpayers in determining which basis it is most appropriate for them to use.
- 13.3 We accept that the usual, accruals basis rules regarding lease premiums are too complex to use under the cash basis. The consultation proposes, however, that premiums should be taxed in full on receipt and that no deduction should be provided in respect of premiums paid, due to their capital nature. This will result in unrepresented landlords who opt to use the cash basis being at a possible tax disadvantage when compared to using the accruals basis. Unrepresented taxpayers would benefit from an option to amend submitted reports so as to use a different accounting basis if it was realised at the end of the tax year a tax planning error had been made.
- 13.4 In addition to these proposed changes and the introduction of digital tax reporting, there have been recent changes to the law which affect the calculation of rental profits. It is easy to envisage a situation whereby an unrepresented landlord could make genuine errors and it would be helpful to have reassurance from HMRC that they will take a lenient approach to taxpayers who are trying to report their tax affairs correctly but may make honest mistakes as they attempt to understand any new rules. We would like to reiterate the proposal in our response to the consultation 'Making Tax Digital: Tax administration' where we state that a 'light touch' approach should be taken to penalties initially but that no penalties should be introduced until MTD has been running for three years (as was the case when RTI was introduced).
- 13.5 Many unrepresented landlords have only one property which is managed by a letting agent. It would be useful if HMRC could work alongside letting agents to help them understand what information will be required by their clients so that landlords receive accurate, relevant information in a timely manner. In our response to 'MTD: Transforming the tax system

through the better use of information' we discuss the potential pitfalls, however, of HMRC using information direct from letting agents to prepopulate digital tax accounts.

14 Question 9 – Are you aware of any risks that the cash basis for unincorporated property business could present which could lead to the avoidance or reduction of liability to income tax? If so please provide details.

- 14.1 We understand that HMRC want to provide landlords with flexibility to choose between the two accounting bases, however there is a balance to be drawn between simplicity and flexibility (as flexibility can increase complexity). As there are no conditions proposed on when to exit the cash basis or accruals basis, this could result in landlords changing the way they account for their property income on an annual basis. This may result in accounting errors such as double-counting or failing to recognise taxable income or deductible expenses. The risk of these errors could be mitigated by having detailed guidance available or considering the use of certain conditions or restrictions which apply when moving from one basis to another.

15 Question 10 – Do you have any comments, not already provided, on any aspect of the proposal?

- 15.1 Only to reiterate the need for clear, unambiguous guidance to enable unrepresented landlords to make informed choices on their tax affairs.

16 Question 11 – If the government introduces a simpler tax system for unincorporated property businesses, please provide details of how this will affect your business. This should include details of both the expected one-off and ongoing benefits and costs of:

- a) Familiarisation with the new basis and updating your software or systems.**
- b) Not having to keep accruals accounts and prepare calculations in accordance with UK GAAP.**

- 16.1 As a charity providing information to help unrepresented, low-income and vulnerable people understand the tax system, any such changes will result in additional work due to the need for writing and presenting new material for our websites and other third sector advisers so they can assist their 'clients'. There will therefore be a cost in writing and presenting any new material.
- 16.2 Although we do not offer tax advice to individuals we regularly receive questions from people struggling to understand their tax position. In our experience, changes to the tax system, especially where a taxpayer has a choice of approaches, can result in confusion and requests for further help. We anticipate that such significant changes to the tax system, as proposed in all six of the MTD consultations, will result in more questions and requests for

assistance to the voluntary organisations which specialise in tax.¹ We are concerned that these voluntary organisations will have inadequate funding to cope with these proposed changes which will affect so many low-income and vulnerable taxpayers, and so we would like reassurance that additional resources will be made available to them should they prove to be necessary.

17 Question 12 – Please tell us if you think there are any other benefits or costs not covered in the summary of impacts.

- 17.1 The additional complexity for UC and tax credit claimants is not addressed in the consultation. Although there may only be a limited scope for UC claimants to receive rental property income because of the capital rules, there may be some UC claimants who are affected, for example, claimants living in a care home, going through a separation or living in job-related accommodation. We reiterate our concerns discussed at paragraphs 11.2 and 12.3 and the additional time burden claimants will face, especially if rental income is received sporadically throughout the year which may result in claimants not fully understanding their digital reporting obligations.
- 17.2 Tax credit claimants who only report their property income annually will also have to prepare and report at quarterly intervals, as under the current UC rollout timetable they may not move from tax credits to UC until 2022.

LITRG
7 November 2016

¹ The tax charities which provide direct advice to low-income people are TaxAid (www.taxaid.org.uk) and Tax Help for Older People (www.taxvol.org.uk).