

Cash basis for calculating taxable profits

(Lecture P1238 – 10.28 minutes)

Normally, a business (both an unincorporated trader or a limited company) must prepare accounts under the 'going concern' accruals basis, as detailed in the accounting standards. This takes account of amounts paid and received, as well as future amounts payable and receivable by the business which relate to the current year.

However, eligible unincorporated businesses can also elect to use the 'cash basis' to calculate their taxable trading profits. Limited companies may not use the cash basis.

Eligibility and making of election

Individuals working as unincorporated businesses can elect to use the cash basis if their total business receipts for that tax year do not exceed £150,000 or £300,000 for Universal Credit recipients. In a year in which your tax basis period is less than 12 months long e.g. the year in which you start to trade, this limit is proportionately reduced. If you therefore commence trading on 1 January, the limit will be reduced to £37,500 (being 3/12th of £150,000).

It is necessary to consider all self-employed income of an individual to see if they are eligible to enter the cash basis. If you are considering partnerships, if there is a controlling partner, then the partnership receipts must be added to the receipts of any other businesses carried on by the controlling partner to see if the limit is exceeded.

Once an election is made, it will apply for the tax year for which it is made and all subsequent tax years, until such times as the business receipts exceed £300,000.

In order to make an election to use the cash basis, the relevant box must be ticked on the self-assessment return.

Certain persons cannot elect to use the cash basis (called by the legislation 'excluded persons':

- Partnership which has a partner who is not an individual
- An LLP
- An individual who is a Lloyd's underwriter
- A person who has made a herd basis election
- A person who has made a claim for profit averaging
- A person who has within the previous seven years obtained a BPRA
- A person who carries on a mineral extraction trade
- A person who has at any time obtained a research and development allowance

Effect of making the election

If an election is made for the cash basis to apply, it applies for income tax and Class 4 NIC purposes.

The profits of the trade for an accounting period are then calculated simply as income actually received, less allowable expenses actually paid.

The tax treatment of costs is generally governed by the same rules as applying to those businesses not using the cash basis, however there are some exceptions.

Capital allowances – the only assets which qualify for capital allowances are cars purchased by the business. All other plant and machinery is treated as deductible in full in the year it is paid, if used wholly for business purposes. Any private usage will reduce the allowances given. If the private proportion increases, then a notional receipt must be brought in when calculating the profit. Sales proceeds will also be brought into the tax computation in full when received. For assets being acquired under hire purchase, a deduction would be allowed for each payment as it falls to be paid.

No deduction is permitted for capital expenditure:

- to acquire or dispose of a business or part of a business or
- in connection with education or training
- or on the acquisition, alteration or disposal of an asset which is not a depreciating asset, is not used in the trade, is a car, is land, is an intangible asset or a financial asset.

Goods taken for own use – if goods are removed for your own use, the cost of the goods is disallowed in the tax computation, rather than making an adjustment to include the sales price of the goods.

Interest costs – a maximum of £500 of loan/overdraft interest and related costs can be deducted each period for any loans obtained. The limit also includes the incidental costs of obtaining loan finance. This does not impact hire purchase interest.

Car leasing costs – all car leasing costs are deductible without any restriction based on emissions.

It is possible to claim simplified expenses as part of a cash basis calculation but it is not obligatory. There are restrictions though as motoring expenses under the cash basis cannot be calculated using the simplified expenses mileage rates if the vehicle has been subject of a capital allowances claim before entering the cash basis.

If the business makes losses, these losses may only be carried forward against future trading income. They cannot be used against other income in the same way as non-cash basis trading losses can be.

Entering the cash basis

Where a person enters the cash basis, there are various rules to ensure that there is no advantage or disadvantage accruing:

- if income has already been taxed as accrued income it is not taxed again when it is received;
- If expenses have already been allowed on an accrued basis, they will not be allowed again when paid;

- any expenditure that is unrelieved qualifying expenditure for capital allowances purposes at the start of the period in which the cash basis election is made (other than cars) is allowable as a deduction in the first year of using the cash basis.

For assets being purchased on hire purchase, it is necessary to check the amount on which capital allowances have been claimed as against the amount of payments made. If capital allowances claimed exceed payments (for example because the entire cost has been covered by annual investment allowance) then there will need to be a receipt of the amount by which the AIA exceeds payments. If it is the other way around, then a deduction is allowed in the first cash basis period for the excess payments.

Leaving the cash basis

Where a person leaves the cash basis, there are various rules to ensure that there is no advantage or disadvantage accruing as well. So income which has earned but not received would have to be brought into account when received and costs which have been accrued but not paid would be allowed when paid. If there is any adjustment income on leaving the cash basis, it can be spread evenly over the following six tax years although the individual can elect to accelerate that charge if they wished to do so.

For capital expenditure, there is unlikely to be a significant number of adjustments since capital costs are deductible as incurred. The most obvious exception is where assets are being purchased under hire purchase agreements. Any amount unpaid at the time of leaving the cash basis would be allocated to a capital allowance pool in the first chargeable period the person used the accruals basis.

Property businesses

The default for property businesses is that they will be calculated on the cash basis unless any of the five conditions below are met:

Condition A: the business is carried on at any time in the tax year by:

- (a) a company,
- (b) a limited liability partnership,
- (c) a partnership with a non-individual member,
- (d) the trustees of a trust.

Condition B: the cash basis receipts for the tax year exceed £150,000 (or pro-rata amount thereof if the property business is carried on for only part of the tax year).

Condition C: that:

- (a) the business is carried on by an individual ('P'),
- (b) a share of joint property income (see below) is brought into account in calculating the profits of the business for the tax year,
- (c) a share of that joint property income is brought into account in calculating the profits of the business for the tax year of a property business carried on by another individual ('Q's property business'), and

(d) the profits of Q's property business for the tax year are calculated in accordance with GAAP.

Condition D: that:

(a) an allowance under the BPRA rules has been made in calculating the profits of the property business, and

(b) if the profits of the business were to be calculated on a GAAP basis, there is a day in the tax year on which the occurrence of a balancing event under the BPRA rules would give rise to a balancing adjustment for the tax year

Condition E: that a valid election is made to disapply the cash basis. An election must be made on or before the first anniversary of the normal self-assessment filing date for the tax year for which it is made.

Contributed by Ros Martin