R WALTERS & Co

Chartered Certified Accountants
Business and Taxation Advisors

R Walters & Co
E mail@rwalters.co.uk   www.rwalters.co.uk
LinkedIn: www.linkedin.com/company/rwaltersco/
Twitter: @TeamRwalters
Address: Suite A, 4-6 Canfield Place, London NW6 3BT. Tel No: 020 7328 0412

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Using cash basis accounting

There are important changes to the rules on cash basis accounting, aimed at driving many more businesses into using the scheme.

As a result, most unincorporated businesses will need to decide what to do next. We look at the factors involved, and what moving to the cash basis might mean for you.

In outline

Change from 6 April 2024 makes cash basis the default method of calculating profits for trading income for Income Tax, rather than the traditional accruals basis. The move turns the previous position upside down. Businesses now have to opt out of cash basis, whereas previously, they had to opt in.

In a second major move, the cash basis regime itself has been given a considerable makeover. Key restrictions under the old regime have been lifted, making cash basis more viable for a wider range of businesses.

For the avoidance of confusion: the cash basis rules used by landlords, and the cash accounting scheme for VAT are separate regimes, and there are no changes to either of these.

Your choices

Essentially, your business will now need to use the cash basis, unless you opt out. Note, though, that companies cannot use cash basis, and some businesses are excluded. Some of the main exclusions are:

- partnerships which have a corporate member
- limited liability partnerships
- Lloyd's underwriters
- those using the special profit averaging rules for farmers, and creators of literary or artistic works
- farming businesses with a current herd basis election
- businesses that have claimed business premises renovation allowance
- ministers of religion
- businesses that have claimed research and development allowances.

Apart from these groups, all other unincorporated businesses should use cash basis from the 2024/25 tax year, unless they opt out.

Opting out requires a formal election, which is made on the tax return. The election has effect from the tax year in which it's made, and doesn't need to be made again. You can, however, revoke the election, and move back onto the cash basis, if you choose.

What difference does it make?

The basis on which accounts are taxed matters for two key reasons.

1. It impacts the information available to help you control and run the business.
2. It can impact cash flow and the timing of your tax liabilities.

We look at these in more detail below.

Changes to cash basis rules

Turnover limits: Turnover restrictions, previously governing entry and exit from the scheme, are removed from 6 April 2024. Businesses of any size can now use cash basis.

Interest costs: Previously, no more than £500 in interest costs could be deducted from taxable profits each year. This restriction is removed. Businesses can now deduct any amount of interest incurred wholly and exclusively for the purposes of trade. This gives parity with the accruals basis.

Loss relief: Previous restrictions to loss relief are removed. Cash basis losses can now be used in the same way as accruals basis losses: they can be set sideways against general income of the same period; or carried back to earlier years, subject to the same general loss relief rules as accruals losses.

More than one business: Previously, if you used cash basis for one business, you had to use it for any other business you ran. This does not now apply; you can decide on a business by business basis.

Interaction with Making Tax Digital for Income Tax (MTD ITSA)

One reason the cash basis is being expanded is to provide a better user experience when MTD ITSA is rolled out. MTD ITSA is expected to apply to landlords and sole traders with qualifying income over £50,000 from April 2026, and for those with qualifying income over £30,000 from April 2027. No start date for partnerships has been given yet, but they are expected to join eventually.

MTD ITSA involves quarterly reporting, coupled with end of year adjustments, and either accruals or cash basis can be used. For small businesses, the cash basis could potentially sit well alongside the MTD regime, as they are expected to have to make fewer end of year adjustments.

Note, however, if you join the MTD ITSA pilot, to get a dry run before mandation, you can't then switch from cash basis to accruals, or vice versa. You have to stay with the basis you have chosen for the duration of the pilot.

Cash basis and accruals basis compared

Accruals basis: The accruals basis is more complex, but provides more comprehensive information to run a business.

With the accruals basis, income and expenditure are matched to the period in which they are earned and incurred, rather than when they are received or paid.

Your invoices may not be paid for some time after they're raised: but your credit sales are included in your income tax computation regardless of whether or not customers have paid for the goods or services by the end of the accounting period. Likewise, you may not pay the bills you receive for 30 days after you receive them, but you get the tax relief straightaway. In due course, your tax liability is based on this complex mixture of debtors and creditors.

In terms of management information, the larger the business, the more important up to date financial information and control will be. This is where the accruals basis comes into its own. By recognising income when it's earned and expenditure when it's incurred, the accruals basis gives a business a real-time picture of how it's performing. This is likely to be necessary in any case where a business applies for finance or grant funding.

Cash basis: Cash basis is simpler. It just tracks cash movement. Businesses are taxed on the basis of receipts, less allowable payments made during the basis period. Receipts are recognised as income of the period in which received, and expenses are outgoings of the period in which they're paid.

All money received by the business is taxed when received. This includes proceeds from the sale of any plant and machinery, as well as trading income. Credit sales are accounted for and taxed in the year that the customer pays.

To be eligible for deduction, expenses must be paid in the accounting period: and be incurred wholly and exclusively for the purposes of the trade. Interest costs under the cash basis are generally deductible.

The costs of most plant and machinery can be included as deductions from trading profits. Car purchase is the main exception, and relief for this comes via capital allowances. Particularly significant, however, is the fact that cash basis involves complex adjustments for capital assets — such as vans, for example — with both business and private use; and this can impact tax bills. If non-business use of such assets goes up materially, it falls to be treated as a sale of part of the asset at current market value.

HMRC Example

Hugo buys a van for his business. Initially, private use is 10%. Hugo's wife later starts to use the van for weekly supermarket trips, and private use increases to 30%. An amount based on market value at the time of the change has to be taken into account as a cash basis receipt as a result. This will impact Hugo's tax bill.

Using cash basis takes out a raft of adjustments which would otherwise be needed, such as debtors, creditors, stock and work in progress adjustments. It means the business can — in theory — keep simpler accounting records.

But it is important to bear in mind that this doesn't provide the same solidity for management purposes. Knowing what your stock levels are; having a clear picture of debtors and creditors — these are big tools for business control, and you may not want to do without them — even if you are eligible to use cash basis.

Moving in or out of the cash basis

If you join (or later leave) the cash basis, transitional adjustments to the taxable profit figure are needed so that business income is taxed once and only once; and similarly, that business expenses are relieved once, and only once.

Using the accruals basis, your last taxable profit figure might have included amounts that the business had earned, but not yet received by the year end. When you join the cash basis, this has to be adjusted. The adjustment could look something like this:

Example

Root and Branch, a business selling logs for firewood, joins the cash basis. In its first year on the cash basis, it receives £32,000 from customers. Of this total, £1,750 represents sales made last year and owing at the end of the last tax year. When Root and Branch joins the cash basis, it has already been taxed on this £1,750 in the previous tax year, so an adjustment is made so that it is not taxed a second time.

Transitional adjustment

Total cash receipts from customers	£32,000
Less: last year's year end debtors	(£1,750)
Adjusted cash basis receipts	£30,250

Other areas which could require adjustment include: amounts owed to suppliers; trading stock; accruals and prepayments; and income received in advance. The calculations to make sure that relief is given appropriately for capital expenditure on the transition to the cash basis can be particularly complicated, for example where there are any remaining capital allowances pools, and we can advise further here.

Cash flow and timing of liabilities

If your business operates with customers paying at point of sale (as would be the case in retail, for example), and you use trade credit on what you buy in for the business, moving to the cash basis is likely to accelerate your Income Tax and National Insurance payments.

On the other hand, if the amounts owing to you are usually more than the amounts you owe, moving to the cash basis is initially likely to have a positive effect on your tax bills. This might be the case, for example, if you are a freelance consultant, invoicing in arrears for work done, and having fairly minimal overheads.

What happens next?

A decision is needed as to whether to use cash basis or not. Which option will work best for you will depend on your individual circumstances.

As discussed, in the short term, moving onto the cash basis could mean various adjustments to your figure for taxable profit — which, in turn, may accelerate the Income Tax and National Insurance liability involved. There may also be implications for the records you keep.

We can explore all this with you and help you plan the best way forward. In the meantime, if you have any questions about the issues raised here, please do not hesitate to get in touch.