

Response to 'Expanding the cash basis for the self-employed' consultation

Association of Accounting Technicians (AAT)

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About AAT

- AAT is the UK's leading qualification and professional body for technical accountants and bookkeepers. We have around 51,000 members in over 100 countries and approximately 75,000 students studying our qualifications.
- Founded in 1980, AAT is a registered charity committed to increasing the availability of high-quality accountancy education and raising professional standards. We aim to advance public education, promote the study of accountancy, prevent crime, and promote and enforce standards of professional conduct for accountants.
- Over 600,000 small businesses are supported by more than 6,000 AAT licensed members to help build the businesses' financial capabilities.
- An AAT Accountant is a qualified accounting professional with the practical and technical skills needed to support businesses with their accounting activities. Typical job roles include: Financial Accountant, Commercial Analyst, Senior Finance Officer, Payroll Manager, VAT Accountant, and Tax Supervisor.

Executive Summary

- **AAT is not convinced the proposed changes will do much to encourage businesses to switch to the cash basis.** While the changes may go some way to encourage businesses to switch, there is ultimately not enough of a financial incentive for businesses to change their accounting method.
- **The cash basis is not suitable for every sector so making the cash basis the default is not an effective solution.** HMRC should acknowledge that for some sectors, like construction, the cash basis is not suitable and should not be encouraged. Making the cash basis the default would unlikely have much impact in any case.
- **Accountants prefer the accruals basis which can sometimes be easier than the cash basis.** Businesses with accountants will therefore be unlikely to change from the accruals basis, especially if there is no discernible financial benefit.
- **If HMRC wanted to drive up use of the cash basis, it should remove interest restrictions for legitimate borrowing.** This would offer a significant financial incentive for businesses to switch to the cash basis, despite the administrative burden that comes with transferring to the basis.
- **HMRC's own admission that these changes could impact MTD and customer services is concerning.** There are already significant issues and delays with MTD and HMRC service levels are the major source of frustration with AAT members currently. HMRC must consider fully whether any of these changes are worth the risk of further disruption.
- **Government needs to set out clearly what it means by simplification.** The proposals follow a list of other reforms which have inconsistent interpretations of what the goal of simplification actually means. There needs to be a clearer guiding principle set out by government on what simplification is that tackles the root problem of the current complexity in the tax rules.

If you have any queries, require any further information or would like to discuss any of this consultation response in more detail, please contact Jack Withrington, Head of Public Affairs & Public Policy at AAT: jack.withrington@aat.org.uk.

Turnover restriction

Question 1a: Under either of the options, would businesses within the newly-eligible population consider moving to the cash basis?

Several AAT members acknowledged that the cash basis can be a simple way for some small business owners to understand the way their profit is calculated. However, while easing turnover restrictions may encourage some businesses to join, they are likely to be small in number. Businesses will only change if there is a significant financial advantage in doing so and there are certain sectors (like construction) where the cash basis will never be suitable, regardless of eligibility criteria.

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?

Some AAT members support aligning the threshold to the VAT cash accounting scheme noting it would help reduce abuse of the scheme and that there would be few instances where someone who is eligible for the cash basis is not VAT registered. It could also help a business plan ahead as once it left the threshold of the VAT cash accounting scheme, that would also indicate a move to the accrual basis.

However, other members noted that this would add complexity with another constantly changing threshold and that removing the cash basis threshold altogether would be a simpler and fairer solution. Removing the threshold may also benefit landlords with one or two properties and market traders.

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?

While AAT members believe that it may possibly see such a result, the volume of businesses that would move to the cash basis would be minimal. One member said any move would be accountant driven, with most clients following the advice of their accountant.

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?

As with Q1a, financial outcomes will be the main driver of a business's decision to join the cash basis so while the cash basis may be simpler and easier to use, ultimately most businesses will only move if savings can be identified.

Cash basis default

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?

One reason may be how a business keeps records and whether they use an accountant. For an accountant, the accruals basis is well-known and is not typically any more time consuming than the cash basis. In fact, it sometimes can be quicker and easier. There may also be a lack of awareness and knowledge of the two bases that means small businesses without an accountant do not know which one to declare or may even prepare accounts using a hybrid of the two schemes.

Accounts prepared on the cash basis method only show the income and expenses paid, however this does not reflect the true accounts as under the accrual basis. If using the accrual basis it shows all the debtors and creditors that are due and provides useful information for credit control as to which invoices need chasing more urgently than others. It also shows the actual amount of monies owed to suppliers and loans which can then be budgeted for and for the business owner to ensure that there are sufficient funds in the bank account.

As in answer to Q1a, there must also be an acknowledgement from HMRC that the cash basis is not a 'silver bullet' for all businesses and that there are some sectors which should always choose the accruals basis and not be encouraged to choose the cash basis.

Construction is one such sector where most works are carried out on an interim basis and a 5% retention is withheld until six months after completion when 2.5% is released and then the final 2.5% retention is released after one year. This can cause several problems with cash accounting as businesses will only enter the amounts paid and will not account for the retentions. Without being able to account for retentions, the contractor will not know the amount of monies being withheld or when the retentions are due to be paid which can amount to sizeable sums of money. The same applies to the CIS deductions on labour which are not paid in full as they are also included in the withheld retentions.

In contrast, it is much easier to use the accruals basis for the construction industry as you can keep track of retentions and withheld CIS deductions as well as recover all the interest from purchasing large equipment via hire purchase.

As such, AAT would not support making the cash basis the default for trading income.

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?

The benefits would suit some smaller businesses, helping them make a straightforward calculation of profits. However, several AAT members were doubtful of the positive impact a cash basis default would have, especially for existing businesses. In most cases, the underlying figures will be prepared exactly the same as now and it may just see an increase in errors of returns not ticking the right box. As with Question 2a, the cash basis can be a significant problem for construction businesses and so setting a default to the cash basis would be more disruptive.

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

For the reasons stated above, we would suspect that there would be minimal change in the use of the cash basis, with most sticking with the basis they currently use. Any sole trader business over the VAT threshold would opt out and use the accruals basis as at this level of income there are several factors in working out their profit and tax liability which will make the accruals basis more attractive.

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?

Yes, AAT members believed this would incur a greater administrative burden. One such example is the cost of having to realign the prior year financial statements so they can be used for comparison. Businesses may also need to keep different records or have them in a different format which would deter them from moving, especially if there was no financial benefit. Lastly, businesses that use an accountant will most likely opt not to change and stick with the accruals basis.

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

Businesses without an accountant would need a lot of support and time to ensure the figures are accurate for the basis specified. This would be less of a risk if the business had a properly qualified accountant who should have the relevant knowledge to explain the cash basis to the client.

Interest restriction

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?

The preference of most AAT members was to remove the interest restriction entirely, with others preferring the maximum of the options given (£1,000). In both cases, members strongly felt that the pandemic and cost-of-living crisis have seen greater costs and borrowing levels that makes the interest restriction unrepresentative of the current economic climate. Offering much higher or full relief for borrowing costs would offer a proper financial incentive to move to the cash basis. Without that, it is unlikely to persuade many businesses to change.

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?

Many businesses will not consider a change if there is no significant financial benefit. If the increased restriction does not affect them, they will most likely stick with the accruals basis. A complete removal of the restriction could have a significant pull factor for many small businesses.

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?

AAT members believed the likelihood of businesses increasing borrowing costs for the sake of receiving further tax relief on them would be low.

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?

As above, several AAT members believe the restriction should be lifted altogether but this would still require rules on allowing only legitimate borrowing costs to be considered for deductions.

Loss restrictions

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?

AAT members were not wholly convinced this would have much effect either way on choosing to use the cash basis, although some said it might be possible it increases usage.

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?

It is difficult to determine but certainly any measures that make the process more difficult for businesses seem counterintuitive to HMRC's desire to encourage more use of the cash basis.

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?

See response to Q4b.

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?

AAT members suggested cash basis could be treated the same as accruals basis for loss relief, like carrying forward or back losses, thereby avoiding penalising businesses that choose the cash basis. Another suggestion was to remove the relief restriction altogether.

Interactions and other improvements to the cash basis

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?

There was concern among some AAT members that too many changes could have the countereffect of the intention behind the proposals for more simplification. Adding more rules and new guidance to an already complicated system could make things more complex for businesses and result in a poorer understanding of what basis would best suit their needs.

AAT would reiterate previous answers that for some sectors and businesses, no amount of changes will have the intended effect as the cash basis is simply not suitable. Moreover, there does need to be a financial incentive for businesses to change their accounting method, especially given the administrative burden of transferring from the accruals basis.

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

There does not appear to be a consistent view of what 'simplification' actually means across the various tax reforms proposed by government and HMRC. Simplification efforts have tended to look at digitisation or removing the need for accountancy support rather than addressing the root problem of the current complexity inherent in the tax rules. Having multiple different options for different bases with different thresholds and restrictions (all of which need separate guidance) does not aid simplification nor encourage businesses to switch from a tried and tested method they are familiar with.

AAT would be in favour of a clearer idea from government on what exactly its ambitions for simplification are so that it could be used more consistently by HMRC as a guiding principle for its tax reform.

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?

Several AAT members said this would not be helpful, arguing it would only add further complexity for limited benefit. One member took the opposing view, believing it would encourage more use of the cash basis.

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?

N/A

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?

More education and awareness targeted at smaller businesses would be beneficial, especially those who do not use an accountant, so that there is a greater understanding of both the cash and accruals bases. This should also note when the cash basis is not suitable for a particular sector, like construction. However, without demonstrating discernible financial benefits of using the cash basis, any further education or guidance is unlikely to change eligible businesses' accounting behaviour.

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?

Most AAT members who responded were against this proposal, preferring that trading and property income have the same basis, given they are both business income, which should only be the accruals basis. One member said that keeping alignment between all types of income for cash basis would improve simplicity and that sideways loss relief would benefit landlords.

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?

In keeping with the principle of tax simplification, all thresholds should apply to all businesses to ensure that no one type of business has special consideration.

Question 12: What other interactions between reforms to the cash basis and MTD for ITSA should the government take into consideration?

If the threshold for the cash basis was the same as the VAT threshold, it would make sense to keep this consistent with the threshold for MTD for ITSA.

The consultation's impact assessment notes that the proposed changes may impact HMRC's IT systems and contact centres. If this risk was realised, this would be very concerning given the problems and delays with MTD so far and the declining customer service levels currently provided by HMRC. AAT members have faced increasing frustrations in dealing with HMRC and the continual change of tax policy without a long-term strategy. Before taking any action, HMRC should fully consider whether the benefits of expanding the use of the cash basis outweigh the potential added complexity and uncertainty that any changes would cause. AAT would welcome further information from HMRC on this specific impact and the likelihood of disruption or delays that each proposal would cause.

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?

AAT members did not think expanding the cash basis use will have much effect on sole traders' experience of MTD for ITSA. There was concern expressed for very small businesses who will face added costs with MTD for ITSA compliance and who probably already use the cash basis anyway.