These notes refer to the Finance Act 2013 (c.29) which received Royal Assent on 17 July 2013

FINANCE ACT 2013

EXPLANATORY NOTES

INTRODUCTION

Section 17, Schedule 4: Cash Basis for Small Businesses

Summary

1. Section 17 introduces Schedule 4 which provides that eligible individuals carrying on a trade or profession as self employed sole traders or in partnership with other individuals can choose to use a cash basis to calculate taxable income.

Details of the Schedule.

2. Paragraph 3 amends section 25(3) Income Tax (Trading and other Income) Act 2005 (ITTOIA). Section 25(1) provides that profits of a trade are calculated in accordance with Generally Accepted Accounting Practice. Section 25(3) is amended so that section 25 is subject to new section 25A which provides for calculation of profits on a cash basis for small businesses. The new cash basis legislation replaces the alternative basis for barristers in the early years of practice allowed by section 160.

3. Paragraph 4 inserts a new section 25A of ITTOIA which provides that a person carrying on a trade profession or vocation can elect to use the cash basis. New subsection 25A also provides that sections 27, 28 and 30 of ITTOIA do not apply to those using the cash basis. These sections deal with receipts and expenses under Generally Accepted Accounting Practice and animals kept for trade purposes.

4. Paragraph 5 introduces a new Chapter 3A to Part 2 of ITTOIA dealing with when a person is eligible to make an election to use the cash basis under section 25A and the effect of an election.

5. New Section 31A details conditions A to C which a person must meet to be eligible to elect to use the cash basis.

6. New section 31B details the conditions regarding the ‘relevant maximum’. There is a relevant maximum if any of the three conditions is met.

7. New subsection 31B(5) provides that the ‘relevant maximum’ that applies if any of conditions A-C is met is the VAT threshold and double the VAT threshold where the person is a Universal Credit claimant.

8. New subsection 31B(6) provides that the threshold is proportionally adjusted for short basis periods.

9. New subsection 31B(7) provides that for the purpose of section 31B a universal credit claimant must have a universal credit assessment period within a cash basis period.

10. New subsections 31B(8) and (9) provide that section 31B may be amended by order.

11. New Section 31C sets out the categories of person that are excluded from electing to use the cash basis, for example, a partnership where any of the partners is a company.

12. New section 31D provides that an election under section 25A has effect for the tax year in which it is made and for all the trades professions or vocations carried on by the person in the tax year. New section 31D additionally provides that a person will remain in the cash basis until their circumstances change, at which point they can choose to use the accruals basis. New section 31D also signposts the amendment to the Capital Allowances Act 2001 which precludes a person using the cash basis from claiming capital allowances other than on a car.

13. New section 31E provides for how profits are determined on the cash basis. There are two steps, firstly calculate the total trade receipts received in the basis period for the tax year and secondly, from that figure deduct the total amount of expenses of the trade paid during the basis period of the tax year (subject to any adjustments required or authorised by law).

14. Paragraphs 6 to 11 amend Chapter 4 Part 2 ITTOIA, dealing with trade profits: rules restricting deductions.

15. New section 32A gives a summary of how this Chapter applies when calculating profits on a cash basis.

16. New section 33A details the types of capital expenditure allowed as a deduction for those using the cash basis to calculate the profits of a trade. Capital expenditure allowed includes expenditure on items on which capital allowances can be given under Part 2 of the capital Allowances Act 2001 unless it is capital expenditure on a car. Under the normal rules, section 33 ITTOIA disallows any capital expenditure as a deduction in calculating the profits of a trade.

17. Paragraph 9 amends section 38 which provides that where an employee benefit contribution is made, a deduction is available to the trader only if certain qualifications are met. This section is amended with the effect that for calculating taxable income on the cash basis the employee benefit contributions have to be paid in the taxable period.

18. Paragraph 10 inserts new section 51A which provides that in calculating profits of a trade on a cash basis no deduction is allowed for interest paid. This section is subject to new section 57B.

19. Paragraph 11 amends section 55A. Section 55A provides that no deduction is available for integral features of a building or structure as detailed in section 33A(3) Capital Allowances Act 2001. As amended, section 55A signposts that s.33A(3) does not apply in the cash basis.

20. Paragraphs 12 to 17 amendChapter 5 Part 2 ITTOIA dealing with 'trade profits: rules allowing deductions'.

21. New section 56A provides a summary of the rules in Chapter 5 for calculating profits on the cash basis.

22. Paragraph 14 inserts a new section 57B. This allows that, in calculating profits of a trade under the cash basis, where a deduction would otherwise be disallowed under new section 51A, or where in the absence of section 51A a deduction would not be allowable only because it was not an expense wholly and exclusively for the trade, a deduction is allowed for interest paid of up to £500.

23. Paragraph 15 amends section 58 which allows incidental costs of finance so that on the cash basis, the maximum deduction which may be made for those costs when taken together with interest allowable under new section 57B is £500.

24. Paragraph 16 amends section 72 which deals with payroll expenses so that contributions to agents' expenses are only allowed as a deduction when the expenses have been incurred.

25. Paragraph 17 amends section 94A which allows expenses of setting up a SAYE or CSOP option scheme. The amendment ensures that only expenses paid in respect of such schemes are allowable deductions for computing income under the cash basis.

26. Paragraph 19 inserts new section 95A. This provides that rules about receipts which apply only for the purposes of calculating profits under the cash basis can be found at new sections 96A, 97A, 106A and 106B.

27. Paragraph 20 inserts new section 96A which provides how capital receipts are to be treated under the cash basis.

28. New subsection (6) provides the mechanism by which changes in the proportion of non business use before disposal are dealt with.

29. New subsection (7) defines market value for the purpose of section 96A. That is an amount that would be regarded as normal and reasonable in the prevailing market conditions at arm's length in the open market.

30. Paragraph 21 introduces new sections 97A and 97B which provide that where a cash basis business ceases the value of stock on hand or work in progress at cessation is brought into account as a receipt of the business.

31. Paragraph 22 amends section 105 ITTOIA which deals with particular grants received and treats them as trading income. One of the exceptions to this is where the grant is towards the cost of capital expenditure. The new subsection (2A) disapplies this exception when calculating profits under the cash basis.

32. Paragraph 23 inserts new chapter 6A which applies only in relation to the cash basis and which deals with bringing into account amounts which do not reflect commercial transactions.

33. New section 106C of chapter 6A provides that where there is a difference between the amount brought into account in respect of a transaction and the amount that would be brought into account if the transaction was at arm's length then the amount which must be brought into account is a just and reasonable amount.

34. New section 106D disapplies new 106C where the transaction involves a capital receipt (new section 96A covers this situation).

35. New section 106E disapplies new 106C where the transaction involves a gift to charity.

36. Paragraph 24-34 disapply particular Chapters of ITTOIA for the purpose of calculating profits of a trade under the cash basis.

37. Paragraph 36 amends Chapter 17 which deals with adjustment income where a person changes the basis on which he calculates the profits of the trade. The insertion of new section 227A provides that Chapter 17 applies to businesses moving to and from the cash basis.

38. Paragraph 37 inserts new section 239A into ITTOIA to provide that the taxation of any adjustment income arising as a result of leaving the cash basis may be spread over 6 tax years. New section 239B provides that the spreading of adjustment income may be accelerated by an election and provides a means of calculating the spreading in subsequent years.

39. Paragraph 38 inserts new Chapter 17A 'Cash basis: adjustments for capital allowances' into ITTOIA, which applies where a person enters the cash basis for a tax year (that is, he was not in the cash basis in the previous tax year).

40. New section 240C provides that where a person enters the cash basis for a tax year, any expenditure that is unrelieved qualifying expenditure for capital allowances purposes and would qualify as a deduction within the cash basis is allowable as a deduction in

calculating the profits of the trade under the cash basis unless the asset is not fully paid for.

41. New section 240D provides for the case where a person enters the cash basis for a tax year and has claimed capital allowances on plant and machinery that is not fully paid for. Then where the amount paid exceeds the capital allowances given the difference is deductible for the purposes of calculating profit under the cash basis. Where the amount paid is less than the capital allowances given the difference is a receipt. This section does not apply to expenditure on cars.

42. New section 240E deals with the circumstances where a predecessor business passes plant and machinery to a successor business and makes an election under section 266 of the Capital Allowances Act 2001. New section 240E provides that the successor is treated as though he had done everything the predecessor business had done in respect of the plant and machinery.

43. Paragraph 39 ensures that post cessation receipts and expenses for a business that was in the cash basis are treated as though the business was still in the cash basis.

44. Paragraphs 40-43 make changes to allow the cash basis to work with rent a room relief (amending section 786 ITTOIA) and qualifying care relief (amending sections 805 and 820 ITTOIA).

45. Part 2 of the Schedule deals with consequential amendments.

46. Paragraph 44 amends section 42 of the Taxes Management Act 1970 so that in the case of a business carried on by a partnership, the general rule is that an election to use the cash basis must be made on the partnership return by the person required to make that return.

47. Paragraph 45 inserts new sections 47A and 47B into the Taxation of Chargeable Gains Act 1992 which deal with capital gains on disposal of assets when a business is in, or has been in, the cash basis. Section 47A provides that while in the cash basis disposals of assets will not give rise to a chargeable gain or loss (because the proceeds are liable to income tax). Section 47B provides that where a business is no longer in the cash basis then if the disposal is of an asset which has been used in the cash basis the disposal is treated as though capital allowances had been claimed on the asset.

48. Paragraph 46 makes an amendment to CAA 2001 inserting a new subsection (4) to section (1) CAA 2001. The new subsection provides that persons using the cash basis are not entitled to any allowance or liable to any charge under that Act other than in respect of a car.

49. Paragraph 47 inserts new subsections (4) and (7) into section 59 CAA 2001. These provide that there is no unrelieved qualifying expenditure brought forward when joining the cash basis except if incurred on the provision of a car.

50. Paragraph 48 inserts new section 66A into CAA 2001 which sets out how the capital allowances regime applies on leaving the cash basis.

51. New section 66A to CAA 2001 provides for the case where a person leaving the cash basis has incurred expenditure that would have been qualifying expenditure if the election to use the cash basis had not had effect. Such expenditure that has not been relieved under the cash basis will qualify for capital allowances.

52. Paragraph 51 omits section 160 of ITTOIA which provides that barristers in the early years of business can use a cash basis of calculating profits.

53. Paragraph 52 amends section 229 to provide that adjustment income arising on leaving the cash basis can be spread.

54. Paragraph 54 amends the Income Tax Act 2007 (ITA 2007) by inserting a new section 74E which prevents a person using the cash basis from using a loss arising from the business either as sideways relief or capital gains relief.

55. Paragraph 55 amends the provisions of ITA 2007 dealing with relief for interest payments. New section 384B inserted in ITA 2007 restricts relief for interest on loans where the cash basis is used for loans to buy plant and machinery for partnership use or to buy an interest in a partnership.

56. Paragraph 57 provides for transitional rules in the case of barristers or advocates in the early years of practice who have calculated their profits on an alternative basis under section 160 ITTOIA in the tax year 2012-13. They are able to continue to calculate profits on that basis as if section 160, had not been repealed and to spread adjustment income on leaving the alternative basis under sections 238 and 239 ITTOIA as before.

Background

57. Existing income tax legislation requires the taxable profits of a business to be calculated in accordance with Generally Accepted Accounting Practice.

58. This means that profits are computed on the accruals basis so that income is the income earned in a tax year and not the amounts received in a year; expenses are those incurred in a tax year not the expenses paid out in a tax year.

59. The cash basis introduced by this schedule allows eligible small businesses to choose to use a simpler cash basis to work out their taxable income with effect from the tax year 2013-14.