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Preparing your accounts for income tax purposes – the cash basis

You may have heard that the Government has been considering whether to allow some small businesses to compute taxable profits for the purposes of income tax on a cash basis rather than the usual accruals basis. The Finance Act 2013 now allows this option.

The cash basis can first apply for the 2013/14 tax year which means that your tax return for 2012/13, which has to be submitted by 31 January 2014, will continue to be on the same basis as in previous years. There is therefore plenty of time for us to consider what is best for you and your business.

The key aspects of the cash basis are that:

- Small businesses would be taxed on their cash receipts less cash payments of allowable expenses.
- It is only available to unincorporated businesses.
- It is an optional scheme and requires an election by the owner(s) of a business.
- Businesses can enter the cash basis if their receipts for the year are less than the amount of the VAT registration threshold (currently £79,000) or twice that (currently £158,000) for recipients of Universal Credit. Universal Credit is being introduced by the Government from October 2013 and is the replacement to the Tax Credits system.
- Businesses will not have an option of leaving the cash basis in future tax years unless there is a ‘change of circumstances’.
- Businesses must leave the cash basis the year after their receipts exceed twice the amount of the VAT registration threshold unless their receipts fall back to below the VAT registration threshold.

This sounds simple so should you elect for it if you can?

The cash basis sounds simple but there may be significant complications depending on the nature of your business.

Points to consider from a tax perspective include:

- Cash receipts include all amounts received in connection with the business including those from the disposal of plant and machinery. The good news is that if a customer has not paid what is owed to you by the year end, the amount due to you is not taxable until next year.
- Allowable payments include paid expenses but will still need to meet the existing tax rule of being wholly and exclusively incurred for the purposes of the trade.
- Payments will include purchases of plant and machinery, when paid, rather than claiming capital allowances. The bad news is that if you have not paid a supplier by the year end, the amount is not relievable until next year.

In addition there are special rules in the draft legislation:

- Interest payments will only be allowed up to a limit of £500.
- Business losses may be carried forward to set against the profits of future years but not carried back or set off 'sideways' against other sources of income.

- Rules on entering or leaving the cash basis are intended to ensure that income is taxed 'once and once only' and expenses are relieved 'once and once only'. These rules will require special calculations to be performed.

Are there any non-tax considerations?

Yes, there may well be.

You may still need to have a set of accounts prepared which include a profit and loss account and balance sheet. The health of a business needs to be considered by you not just in relation to a positive bank balance but also the inherent profitability of the business. This is provided by a profit and loss account. Production of a balance sheet provides a snapshot of the assets and liabilities of the business.

If you need finance from the bank for your business, the bank is likely to require profit and loss accounts and balance sheets in addition to cash flow forecasts. The bank would want to see the profitability of the business and the assets tied up in your business.

As we have already stated the cash basis first applies for the submission of the 2013/14 tax return which we would normally send to HMRC mid to late 2014. There is therefore plenty of time for us to discuss the best option for you.

Please contact us if you require any further information or advice.