



Cash basis accounting for tax

Ordinarily, businesses prepare their accounts on what is called the accruals basis. This means that profit is based on the difference between sales and costs "incurred" in a specific accounting period, not on income received and expenses paid. For example, you may sell goods on credit that are unpaid at the end of your accounts year, and these sales would be included in your profits calculation.

Certain businesses can elect to prepare accounts in a different way: based on their taxable receipts and payments in an accounting period. This is known as the "cash basis". In this way businesses that decide to use this method won't have to pay tax on money they didn't receive.

When the cash basis may not suit your business

Cash basis probably won't suit you if you:

- want to claim interest or bank charges of more than £500 as an expense,
- run a business that's more complex, for example, if you have high levels of stock,
- need to get finance for your business - a bank could ask to see accounts drawn up using traditional accounting to see what you owe and are due before agreeing a loan,
- have losses that you want to offset against other taxable income ('sideways loss relief').



Additionally, farmers or market gardeners, who may benefit from the use of a special scheme that allows them to average profits over a number of years to smooth the impact of Income Tax, would need to continue to use the accruals method when preparing accounts for tax purposes.

Who can use the cash basis?

The cash basis is only available to sole traders and partners, i.e. the self-employed. Since April 2017, the cash basis was also made available to landlords. In both cases, you cannot use the cash basis if your turnover is more than £150,000.

If you have more than one business, you will have to use the cash basis for all these businesses, you can't pick and choose. And the combined turnover from all the businesses must not be over £150,000.

You can stay in the scheme until your total business turnover exceeds £300,000.

Who can't use the cash basis?

Limited companies and limited liability partnerships cannot use the cash basis. Also, the following different types of business cannot use the scheme:

- Lloyd's underwriters
- farming businesses with a current herd basis election
- farming and creative businesses with a section 221 ITTOIA profit averaging election
- businesses that have claimed business premises renovation allowance
- businesses that carry on a mineral extraction trade
- businesses that have claimed research and development allowance
- dealers in securities
- relief for mineral royalties
- lease premiums
- ministers of religion
- pool betting duty
- intermediaries treated as making employment payments
- managed service companies
- waste disposal
- cemeteries and crematoria

How do I record income and expenses if I use the cash basis?

Income

Only record money from sales that you have actually received in the accounts year.

Expenditure

Only count expenses you have paid. You can claim for most running costs but beware: interest and charges (on your bank overdraft for example) are capped at a maximum of £500.

Since April 2013, you can also elect to claim expenses for running a vehicle, working from home and planning for living on your business premises, using pre-set, simplified expenses calculated by HMRC.

Assets that you would normally buy and claim a capital allowance tax deduction can be written off as expenses, with the exception of cars which you would need to continue to claim a capital allowance (a further complication, if you use the simplified method of claiming expenses for the use of a car you cannot also claim a capital allowance).

Cash basis for VAT registered businesses

There are also options to consider if you are VAT registered.

You can start to use cash basis if you're VAT registered if your income is £150,000 or less during the tax year. You can record your business income and expenses either excluding or including VAT. However, you must treat income and expenses the same way.

If you choose to include VAT, you must record VAT payments you make to HMRC as expenses and VAT repayments you receive from HMRC as income.



Micro-sized businesses

If your business venture is small scale, with gross income under £1,000, instead of considering the cash basis for accounting you could claim the annual tax-free allowance for trading or property income. This is how this allowance works:

You can claim up to £1,000 each tax year against property or trading income. If you have both types of income, you will qualify for a £1,000 allowance for each source of income.

According to HMRC, if your annual gross property income is £1,000 or less, from one or more property businesses you won't have to tell HMRC or declare this income on a tax return.

If your annual gross trading income is £1,000 or less, from one or more trades you may not have to tell HMRC, however there are circumstances when you will need to register for self-assessment.

If your annual gross trading or property income, from one or more trades or businesses is more than £1,000 you can use the tax-free allowances, instead of deducting any expenses or other allowances.

If you use the allowances you can deduct up to £1,000, but not more than the amount of your income. This is known as 'partial relief'. In other words, you cannot use the allowance to create a loss.

If your expenses are more than your income it may be beneficial to claim expenses instead of the allowances, in this way you may be able to utilise any trading losses and set them off against other income.

Gross income means the total amount you would put on your tax return before any allowances or expenses are taken off. This applies whether you use the cash basis or traditional accounting.

Conclusion

The cash basis may simplify the accounting entries, but it will not always produce an overall cash saving; in some cases, you may be worse off.

If you would like to consider the cash basis, please call so we can help you consider your options.

Summary action list

- The cash accounting basis may simplify your accounting and tax affairs but be sure to quantify any downside risks before taking the plunge.
- If you incur significant finance costs and interest charges then cash accounting may not be for you. Under cash accounting claims under this heading are limited to £500.
- Make sure you are not disqualified from using the scheme. See section "Who can't use the Cash Basis?" above.

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