

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.

Changes to the cash basis rule

HMRC has been looking at expanding the scheme and a number of changes came into effect on 6 April 2024.

The main changes are as follows:

- The removal of the turnover thresholds for businesses to use the cash basis. Prior to the 2024-25 tax year, businesses were only able to join the cash basis if their cash basis turnover was less than £150,000. These businesses were also forced to stop using the cash basis in certain circumstances where their turnover exceeded £300,000. These turnover restrictions have now been removed entirely. Businesses that are not entitled to use the cash basis for other reasons will continue to be excluded.
- The cash basis is now the default method of calculating taxable profits, with an opt-out for businesses to make an election to use the accruals basis.
- The removal of the £500 limit on interest deductions in the cash basis. This aligns the cash basis and accruals basis rules on interest deductions.
- The removal of the restrictions on using relief for losses made in the cash basis, aligning the rules with accruals. This means that cash basis losses can now 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.

Who can’t use the cash basis?

Limited companies and limited liability partnerships cannot use the cash basis.

Other businesses that are unable to use this scheme, are as follows:

- 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 of your business. The previous restrictions on interest deductions have now been removed.

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 and is now the default position for qualifying businesses. You should still check if this is the best option for your business.
- Make sure you are not disqualified from using the scheme. See section "Who can't use the Cash Basis?" above.

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