TAX SEMINAR

The New Cash Basis Explained

2 December 2013
THE OLD CASH BASIS

The old cash basis is a special basis of accounting available to self-employed barristers during their first seven years of practice.

The professional income is taxed when received and expenditure is relieved when paid.

It avoids the barrister having to pay tax on the realisable value of work done, until it is billed and collected.

From 6 April 2013, the old cash basis is withdrawn.

Under transitional provisions, barristers who used this basis of accounting for tax year 2012/13 can continue to use it until the 7 years have lapsed. The barrister then has to move to the earnings basis or the new cash basis.

Example

Alison started in practice on 1 April 2012, with her 1st accounts prepared to 31 March 2013. She can continue to prepare her accounts on the old basis until the year to 31 March 2019.
On moving to the earnings basis, transitional relief allows the opening aged debt and work-in-progress (‘adjustment income’) to be deducted from the 1st earnings accounts.

The “adjustment income” is then taxed separately, spread evenly over 10 years.

It is commonly known as the ‘catch up’ charge.

Example (of moving to earnings basis)

For the year ended 31 March 2020, Alison’s net receipts are £80,000. Her opening aged debt and WIP is £20,000 and her closing aged debt and WIP is £33,000.

Her assessable income for tax year 2019/20 will be

Profit per accounts £93,000 (including increase in WIP)

Catch up charge £ 2,000

Total assessable income £95,000
For many barristers, the old cash basis will continue to remain the accounting basis of choice for the remaining part of the 1st seven years.

Possible reasons:

- Ineligibility to join the new cash basis, as income already over the entry threshold. The old cash basis has no entry threshold.

- Income is likely to exceed the exit threshold under the new cash basis within 7 years. The old cash basis has no exit threshold.

- To take advantage of the 10 years spreading of the ‘adjustment income’ when moving to the earnings basis.
Election and Related Matters

- What the election is “out of”
- “Out of” earnings basis or GAAP accounts
- Use by bank managers and third parties
- True view of financial position
- General use for income tax
- Particular aspects in application to self-employed barristers
  - Position as regards debtors
  - Position of work-in-progress
Election Procedures

- Made by ticking the relevant box in the Tax Return
- Applicable for subsequent tax years
- No revocation at will
- Commercial aspects of early revocation

Key Threshold Requirements

- VAT registration threshold – Approximately: £79,000
- Pro-rated, as necessary
- Total cash receipts
- Other businesses
- Preservation of accounting period
- Position of VAT-registered persons in respect of threshold
- Effect of VAT-registration limit changes in – are the limits unknown?
- Mandatory exit threshold - Approximately: £158,000
Taxable Receipts on New Cash Basis

- Professional receipts
- Capital receipts
- Market value adjustments
- Just and reasonable adjustment
- VAT receipts

Summary

- Standard accounting may produce earnings well before cash realisations
- Cash basis availability subject to election and VAT threshold conditions
- Market value adjustments
- Under cash basis debtors and work-in-progress are not brought into accounts
- Other rules prescribe what income must be brought in: these rules prescribe actual professional receipts, certain capital amounts, potentially VAT repayments, and occasionally market value adjustments
THE NEW CASH BASIS - EXPENSES

Expenses
In general the new cash basis does not change the type of expenses you can claim, just when you claim them, with exceptions.

Key point: expenses are deducted when paid.

For credit or debit cards it is when the supplier makes out the sales voucher (not the date when payment is made to the card company)

VAT
If you are not registered for VAT the expense is the VAT inclusive amount.

If you are registered for VAT you can record income and expenses either excluding or including VAT. However you must treat income and expenses in the same way.

If you choose to include VAT in your income and expenses, you have to record VAT payments you make to HMRC as expenses (and VAT repayments you receive from HMRC as income).
THE NEW CASH BASIS - EXPENSES

VAT (continued)

Example

Alison is VAT registered with income and expenses net of VAT of £100,000 and £25,000 respectively. Her income is £10,000 for each of the first three quarters but in the fourth quarter she receives £70,000. In each of months 4, 7 and 10 she pays VAT of £750. In month 1 she pays VAT of £3,750 in respect of the last quarter of the previous year. The VAT of £12,750 due for the fourth quarter is paid in month 1 of the next year.

If Alison includes VAT:

Income £120,000 (£100,000 + VAT of £20,000)
Expenses £36,000 (£25,000 + VAT of £5,000 plus payments to HMRC of £3,750, £750, £750 and £750)

Taxable income £84,000

If Alison excludes VAT:

Income £100,000
Expenses £25,000
Taxable income £75,000

Normally, we recommend that VAT be excluded from the calculations to avoid any distortion of the figures.
Deductible expenditure

For expenditure to be deductible from income it must be of an allowable nature. Normally capital expenditure cannot be treated as an expense, but under cash accounting there is an exception which is referred to below.

Generally, the following will be regarded as deductible expenses:

- Chambers’ rent
- Clerks’ fees
- Stationery
- Repairs
- Professional fees
- Telephone charges (line rental and call charges)
- Hotels while working away from home
- Business travel
- Library and periodical subscriptions
- Devilling fees
Deductible expenditure (continued)

- Robing room fees
- Professional indemnity insurance premiums
- Bank charges
- Bar Council subscriptions
- Circuit subscriptions
- Specialist Bar Association subscriptions
- Law report subscriptions
- Other professional association subscriptions
- Staff costs
- Equipment rental (e.g. computer leasing)
- Software licence where the useful economic life of the software is less than two years
- Website expenditure
- Computer running costs

Under the new cash basis, with the exception of cars, capital expenditure (which would otherwise be eligible for capital allowances) is deductible against income when paid.
Deductible expenditure (continued)

If paid by instalments, expenditure is deducted as those instalments are paid.

Examples of Eligible Capital Expenditure

- Furniture and office equipment
- Sets of law reports
- Computers, peripheral equipment and initial purchase of software
- Wig and gown

Wholly and Exclusively

If an expense is primarily for business purposes but includes a non-business proportion, the relief is restricted to the business part only.
Finance Charges

Interest charges on business borrowings are restricted to £500 only. The cap does not apply to routine bank account charges.

Motor expenses

As always, there is no deduction for travel between home and chambers.

Motor expense claims can be based as either the business portion of the actual outlay or using HMRC’s prescribed mileage rates. The annual rates are 45p per mile for up to 10,000 business miles and 25p per mile thereafter. A business log should be retained.

The use of these rates precludes a claim for capital allowances on the cost of the vehicle. The rates cannot be used where the vehicle has been subject to a claim for capital allowances previously.
Use of home as office / study

From tax year 2013/14, barristers have the choice of claiming a statutorily fixed rate deduction or actual (apportioned) expenditure. The fixed rate deduction is calculated by reference to the number of hours worked at home in a month as follows:

<table>
<thead>
<tr>
<th>Number of hours worked</th>
<th>Applicable amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>25 or more</td>
<td>£10</td>
</tr>
<tr>
<td>51 or more</td>
<td>£18</td>
</tr>
<tr>
<td>101 or more</td>
<td>£26</td>
</tr>
</tbody>
</table>

The total fixed deduction for a year is the sum of the monthly amounts. A note of hours worked will need to be kept.
Capital allowances on cars

Capital expenditure on cars is calculated using the capital allowances rules which will require knowledge of the car’s CO₂ emissions. Alternatively the mileage rates, mentioned earlier, can be used to cover both capital and running costs in which case there will be no claim for capital allowances.

Losses

If a loss is incurred it can only be carried forward for relief against future profits as a barrister. The loss cannot be offset against other non-barrister income, or carried back.

This compares with the earnings or the old cash basis where there are fewer restrictions.

Records

Don’t forget to maintain records. HMRC may well request them.
MOVING TO THE NEW CASH BASIS

Two scenarios

- Old cash basis to new cash basis
- Earnings basis to new cash basis

Old Cash Basis to New Cash Basis

There are no accounting adjustments to be made, as its cash for cash. But remember to make the election when adopting the new cash basis.

Excluding cars, any residual pool of capital expenditure eligible for capital allowances can be deducted as an expense in the 1st year under the new cash basis, provided it has been paid for.

Example

Alison has net receipts of £79,000 for the year ended 31 March 2014. Her capital allowances pool brought forward from the old cash basis is £1,500, which is all paid for.

Her assessable “Bar” income for 2013/14 will be £77,500.
Earnings Basis to New Cash Basis

To avoid double counting, the closing aged debt and work-in-progress (as computed under the earnings basis) are treated as deductions in 1st accounts under the new cash basis. This ensures receipts are taxed once only; and likewise, payments are deducted once only.

Any residue of eligible capital expenditure brought forward can be deducted – see above

Example

Alison’s last earnings accounts for the year ended 31 March 2013 included £5,000 of closing aged debt/WIP. Her unrelieved capital allowances pool was £1,500, which is all paid for.

Her net receipts for the next year ended 31 March 2014 are £79,000.

Her assessable “Bar” income on the new cash basis for 2013/14 will be:

<table>
<thead>
<tr>
<th>Net receipts</th>
<th>£79,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Aged debt/WIP B/fwd</td>
<td>£(5,000)</td>
</tr>
<tr>
<td>Capital allowances pool B/fwd</td>
<td>£(1,500)</td>
</tr>
<tr>
<td>Assessable “Bar” income</td>
<td>£72,500</td>
</tr>
</tbody>
</table>
LEAVING THE NEW CASH BASIS

On leaving the new cash basis, as future accounts will be prepared under Generally Accepted Accounting Practice (‘the earnings basis’), adjustment will be required for income, less expenses, that have not been brought into the cash accounts and do not relate to the first period under GAAP.

The income element of this Adjustment will broadly be your book debts and unbilled work at the end of the accounting period you leave the new cash basis.

This Adjustment serves two purposes. Firstly, it is brought into charge to tax equally over the six years commencing with the first year for which accounts are prepared under GAAP, although it can be accelerated.

The Adjustment is to allow the tax effect of the step up on the change in basis to be spread over the six years.
The Adjustment will count as income for all purposes. Acceleration might be considered where for example you are looking to maximise pension contributions for a particular tax year.

The second purpose of the Adjustment is to establish your earnings under GAAP so that work carried out is brought into charge to tax when earned whether or not it has been paid or billed. This is effected by the Adjustment being deducted from your receipts for the first year under GAAP. Your debt and unbilled fees at the end of your accounting period are added.

For example, if a barrister has debt and unbilled work at the end of his last period on the new cash basis of, say, £40,000 and there are related costs, for example clerks fees and Chambers’ contribution that will be payable on receipts of, say, 10%, that is £4,000, the Adjustment will be the net of these two figures, £36,000, (‘the Opening Adjustment’).

This will be brought into the barrister’s accounts as additional income for each of the next six years at £6,000 per year, although acceleration is possible.
In addition, the £36,000 is deducted from the net receipts for the first year under GAAP with the equivalent closing figure added to determine the net income for the year.

Taking the example forward, if the barrister’s net receipts for the year were £116,000, the opening adjustment of £36,000 would be deducted and the closing adjustment of, say, £50,000 added, to arrive at net income for the year of £130,000.

Thus, the profit chargeable on the earnings basis would be £130,000. To this would be added one-sixth of the opening adjustment, established above as £6,000, so that the total profits chargeable to income tax for the year would be £136,000.

This procedure would continue for all subsequent years on the earnings basis, with the £6,000 adjustment no longer being brought in after the sixth year.

The profits calculated above would be reduced by allowances on capital expenditure which is outside the scope of these notes. This includes any unpaid instalments – discussed earlier.
One final point concerns National Insurance contributions. Class 4 National Insurance contributions are payable on your profits but this does not apply to an amount arising from a change in accounting basis, so that the Adjustment brought into the six years of accounts on the earnings basis is not chargeable to Class 4 NIC and you need to so indicate in the self-employment pages of your tax returns.
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