Further written evidence submitted by Chartered Institute of Taxation (FB15)

Calculation of profits of trades and property businesses (Clause 16 and Schedule 2)

Briefing Note from the Chartered Institute of Taxation for Finance Bill 2017

1 Calculation of profits of trades and property businesses

1.1 This legislation introduces new rules for the calculation of the taxable profits of unincorporated businesses:

1. A new cash basis for the calculation of profits for property businesses; and
2. A simplified treatment of capital expenditure under the existing trading cash basis.

It follows two consultation documents "Business income tax: simplified cash basis for unincorporated property businesses' and "Business income tax: simplifying tax for unincorporated businesses" issued on 15 August 2016 as part of the Making Tax Digital consultation. The CIOT responded to the consultation documents on 7 November 2016[1]. The Government published its responses to the two consultation documents on 31 January 2017[2].

1.2 Draft legislation was published for consultation on 31 January 2017 and the CIOT submitted comments to HMRC on 28 February 2017[3]. The key points we made were:

Cash basis: treatment of capital – Schedule 2 Part 1

- The legislative changes proposed replace the current rules with a more limited disallowance of capital expenditure incurred in relation to assets which are not used up in the business over a limited period. The policy objective is to simplify the rules for the deduction of capital expenditure within the cash basis.

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[1] Simplifying tax for unincorporated businesses – CIOT comments
https://www.tax.org.uk/system/files_force/file_uploads/161107%20MTD%20-%20Simplifying%20tax%20for%20unincorporated%20businesses%20-%20CIOT%20comments.pdf?download=1
Simplified cash basis for unincorporated property businesses – CIOT comments
https://www.tax.org.uk/system/files_force/file_uploads/161107%20MTD%20-%20Simplified%20cash%20basis%20for%20unincorporated%20property%20businesses%20-%20CIOT%20comments.pdf?download=1

[2] Simplifying tax for unincorporated businesses Summary of responses 31 January 2017
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/587427/Simplifying_tax_for_unincorporated_businesses_-_Summary_of_responses.pdf
Simplified cash basis for unincorporated property businesses Summary of responses 31 January 2017
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/587411/Making_Tax_Digital_-_Simplified_cash_basis_for_unincorporated_property_businesses_-_Summary_of_responses.pdf

[3] Calculation of profits of property businesses - CIOT comments
https://www.tax.org.uk/system/files_force/file_uploads/170228%20Simplified%20cash%20basis%20for%20unincorporated%20property%20business%20-%20CIOT%20comments.pdf?download=1
Cash basis: treatment of capital - CIOT comments
https://www.tax.org.uk/system/files_force/file_uploads/170228%20Cash%20basis%20-%20treatment%20of%20capital%20-%20CIOT%20comments.pdf?download=1

- At the same time as these changes, the threshold for the cash basis is being raised to £150,000 (from the previous entry level of the VAT registration threshold), ie with effect from 6 April 2017, and the exit threshold has been increased from double the VAT registration threshold to £300,000, so larger businesses that may have more complex affairs and be incurring a variety of different types of capital expenditure, will soon become eligible to use it. It is our view that the reforms to the rules regarding the capital v revenue divide would therefore have been better implemented alongside retaining the entry threshold at the level of the VAT registration threshold.
- We are not convinced that the policy objective of simplification will be met in all cases. It is likely that many businesses using the cash basis will not be represented by an agent, so HMRC must be very clear about how the new rules work so that taxpayers do not miss out on valuable tax relief or HMRC become unable to cope with the level of queries raised. The capital v revenue divide is a complex area of tax law.

<u>Property Cash Basis – Schedule 2 Part 2</u>

- It is not clear why HMRC have chosen to make the Property Cash Basis (PCB) the default basis of accounting for property businesses where the cash receipts of their business for the year do not exceed £150,000. If they wish to prepare accounts using Generally Accepted Accounting Practice (GAAP accounting) they will have to make an annual election to depart from the PCB in order to use GAAP. This is in direct contrast to the existing trading cash basis which is an 'opt in' model. In our view both should be an 'opt in' model, otherwise this risks confusing taxpayers.
- Another difference is the exit threshold which is £150,000 for the PCB but £300,000 for the trading cash basis.
- In order to achieve actual simplification, there should be consistency between both forms of cash basis (trading and property) as far as possible.
- We are not convinced that the policy objective of simplification will necessarily be fulfilled in all cases. It is inevitable that providing a choice of accounting bases will bring with it complexity, as will the contrast in the default position for the trading cash basis.
- A point we have raised with HMRC and on which we are seeking clarification concerns the deduction available for the costs of a loan in certain circumstances. Schedule 2 inserts new sections 307C and 307D into ITTOIA 2005, which contain special provisions for loan interest expenses for let properties on the cash basis. Where L (loan) exceeds V (value), loan interest is capped at V/L x interest.
  Condition C of section 307C, reads:

  > L > V where—
  > L is the total outstanding amount of relevant loans (see subsections (6) and (7)), and
  > V is the sum of the values of all relevant properties (see subsections (8) and (10)).

There would appear to be a problem with the loan exceeding value in the formula because V is the sum of the values of all relevant properties and a relevant property is one involved in the property business **on the last day of the tax year** (our emphasis) as defined in section 307C(8). Therefore where the property ceases to be part of the rental business before 5 April, V is deemed to be zero and section 307D then multiplies the interest by zero to arrive at the allowable amount. Consequently no loan interest relief is available at all under the cash basis. A taxpayer would have to elect into GAAP in the final year to obtain relief which does not seem compatible with simplification. We have asked HMRC if this position is intended and understand the matter is being looked into.

An example of the potential effect is on international assignees who typically let out their homes for the duration of the assignment in order to cover the mortgage costs and then move back in when the assignment ends. In the year of return, the effect of this restriction would mean that they would have no relief.

It would therefore be helpful, firstly, to understand the policy rationale for the loan to value restriction and, secondly, whether the Government intend that it has the effect of putting taxpayers using the cash basis at a disadvantage unless they know that they must opt back into GAAP in the final year (not necessarily obvious to anyone except the well-advised!) For a measure intended as a simplification this is a potentially rather nasty sting in the tail.

2 The Chartered Institute of Taxation

2.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 18,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

17 October 2017