

Simplified cash basis for unincorporated property businesses Response by the Chartered Institute of Taxation

1 Introduction

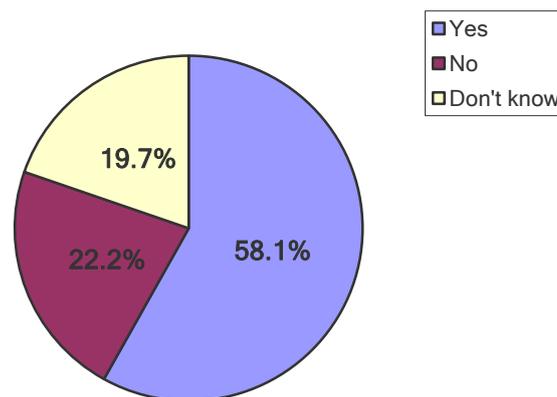
- 1.1 This consultation document is proposing to introduce an optional cash basis for unincorporated property businesses ('landlords'), the intention being to simplify the tax system for these businesses and at the same time fit with the Making Tax Digital (MTD) reforms.
- 1.2 As an educational charity, our primary purpose is to promote education in taxation. One of the key aims of the CIOT is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.
- 1.3 Our response to this consultation document should be read in conjunction with our responses to the other consultation documents on MTD in particular '*Making Tax Digital: Bringing business tax into the digital age*' and '*Simplifying tax for unincorporated businesses*'.
- 1.4 We conducted a member survey on MTD during September 2016. We received some 1,082 responses, and we refer to the results of the survey in this response document. Over 90% (965) of respondents work in accountancy practices, and 61% (647) of respondents were members in small practices, including sole traders, with 22% (234) of responses from members in medium sized practices. Amongst the others, there were 36 responses from members in commerce and industry, and 5 responses from members in HM Revenue and Customs (HMRC).
- 1.5 Note that we have only answered those questions where we have substantive comments to make.

2 Key messages from the CIOT about Making Tax Digital

- 2.1 Whilst MTD will bring benefits to HMRC, the likely impact on most businesses and taxpayers will be an increased workload and / or increased costs. It is not at all clear that there will be commercial benefits to offset such costs, particularly for smaller businesses.
- 2.2 The timetable for mandation of MTD is far too optimistic and must be pushed back. The proposed deferral of MTD for certain small businesses over the proposed exemption threshold is insufficient. Effective software is not yet available and fully tested, so the substantial number of businesses that currently do not use software will inevitably have difficulties both selecting the appropriate software and getting to grips with its functionality. Businesses that currently do use software will be prejudiced if their provider cannot keep up with the demanding timescales.
- 2.3 Deferral of MTD will allow a smoother and more effective transition. The continued widespread use of spreadsheets, and an upload facility onto an HMRC portal, will assist businesses get used to updating HMRC more regularly, in a more digitised fashion, whilst ensuring that transition time and costs can be better managed.
- 2.4 The thresholds for mandation need to be increased. The £10,000 threshold for exemption is far too low. It could place the obligation on non-taxpayers and landlords with a single buy-to-let residential property.
- 2.5 That said, the case for mandating larger businesses into MTD has not been made out. These businesses are already likely to have comprehensive record-keeping systems, already in a digital format, and many corporates will be subject to independent external audit. Mandation of a particular method of digital record keeping, and quarterly reporting, will create significant administrative costs and burdens. The figures being submitted quarterly would still need to be adjusted at the end of the year for tax purposes, and the submission of unadjusted figures will be of little or no benefit to HMRC or to the business.
- 2.6 Real simplification of the tax system, particularly for small businesses, will help MTD work. For example, a simple income-minus-business expenses model would be easier for taxpayers to understand and report. The simplification proposed is inadequate and potentially detrimental to taxpayers. In any event, simplification should take place BEFORE introducing mandatory digital record keeping and reporting.
- 2.7 Agents will be an integral part of MTD, yet the consultations are worrying devoid of much mention of agents, and seemingly imply that businesses will wish to 'do it themselves'. Agent access and functionality needs to keep progress with taxpayer access, and consideration needs to be given to the different types of agent and the various functions that they carry out.
- 2.8 In any event, communication of MTD, direct to businesses and individuals, is vital. There is much work to be done to educate and inform the public about these very significant proposals, and how they change the interaction they will have with HMRC. In our view, HMRC will need to step-up its promotion of MTD. Digital communications such as YouTube and Twitter will not reach businesses that currently do not use digital tools. Traditional mechanisms such as television, radio and newsprint should be considered.

3 Executive summary

- 3.1 We agree that an optional cash basis should be extended to landlords. Many landlords are probably preparing accounts on a cash basis anyway, so permitting them to use the cash basis in legislation will regularise this.
- 3.2 The introduction of MTD will be a significant change for landlords who will have to start keeping their records digitally and sending quarterly updates of their income and expenses to HMRC. Simplified reporting using an easily understandable property cash basis would seem to be essential in helping landlords adapt to the additional burdens of MTD.
- 3.3 We believe that consideration should be given to aligning the cash basis rules for property with the cash basis rules for trading income. If simplification is really being sought, one set of rules is far simpler than two.
- 3.4 We conducted a member survey on MTD during September 2016. In the survey we included a question on extending the cash basis to landlords.
- 3.5 'HMRC are consulting on extending the cash basis to property businesses, but are not proposing a turnover threshold. Do you agree that the cash basis should be extended in this way?'



Answer Options	Response Percent	Response Count
Yes	58.1%	618
No	22.2%	236
Don't know	19.7%	210
<i>answered question</i>		1064

- 3.6 While the majority of our members consider that having no turnover threshold would be preferable, we recognise that such an approach might lead to increased complexity within the cash basis (such as the treatment of lease premiums, deposits etc), and could create scope for issues such as accelerated tax payments or possibly avoidance / manipulation, particularly between connected parties. However, any impact of these issues is likely to be predominantly a one-off issue in year one. It will therefore be necessary to balance these elements carefully in order to ensure that a simplification measure is not peppered with restrictions and exceptions –

especially in a sector that already has complexities around (for example) interest deduction.

- 3.7 It is proposed that landlords whose annual rental income is below £10,000 will not be required to keep digital records or provide quarterly updates to HMRC. In our opinion, this threshold is far too low. In some parts of the country, one buy to let property will generate gross income above £10,000 on its own. It seems disproportionate that a landlord with only one rental property should have to comply with the MTD obligations.
- 3.8 It would be helpful if taxpayers had the option to align quarterly reporting periods under MTD for different sources of reportable income. A taxpayer may have income from a sole trade and a let property, both of which need to be reported quarterly under MTD. Since rental income is taxed on a tax year (6 April to 5 April) basis it is likely that the quarters will not be aligned. This means that 8 quarterly reports would have to be sent to HMRC on 8 separate occasions throughout the year, together with (quite possibly) 2 end of year declarations. Allowing the taxpayer to align the reporting of their rental income with the income from their sole trade would be extremely useful. However we note in paragraph 2.11 of the consultation document that it is proposed that the cash basis for unincorporated property businesses would operate by reference to the tax year. We think this should be reconsidered.
- 3.9 As we explain in more detail in the consultation response 'Simplifying tax for unincorporated businesses', the cash basis provides both simplification, and a choice of bases of taxation. These elements are not always complementary, because the tax rules underlying each basis are different. For example, under the cash basis for trading income, there is a £500 limit for deductibility of interest, meaning it is not generally suitable for businesses with interest bearing borrowings.
- 3.10 With this in mind, the timing of making a property cash basis election (either to enter or to leave) needs to be carefully considered. We assume that this will be done on the property pages of the SATR when it is first introduced in April 2017, but once quarterly updates and End of Year declarations are introduced, at what point will the taxpayer have to commit to using the property cash basis?
- 3.11 Whilst a once and for all decision at the start of the accounting period will provide simplicity, it could result in taxpayers making inappropriate choices, and being significantly out of pocket as a result.
- 3.12 In our view, the final decision must therefore be left to the End of Year declaration because it may not be until then when the contrasting rules can be compared and (perhaps with the benefit of professional advice) an informed decision made.
- 3.13 Either way, HMRC must provide clear and comprehensive guidance for landlords so they are able to make informed decisions about whether to use the cash basis or not for their unincorporated property businesses.
- 3.14 What is not known at present is how software and apps being developed for MTD will support the different bases of accounts preparation. With the proposals both to extend the cash basis to property businesses and retain normal GAAP accounting, our concern is that software and apps will need to have sufficient functionality to enable taxpayers to choose and even move between different bases if they choose to do so. If not, this will reduce flexibility and increase costs for taxpayers and risk errors in any period of transition.

- 3.15 Software and apps that support MTD will need to contain appropriate nudges and prompts to assist taxpayers in understanding the implications of using different bases of accounting.
- 3.16 We would be very interested in seeing the responses to HMRC's property questionnaire (paragraph 5.1 of the consultation document), and would ask that they are included within HMRC's Summary of Responses.
- 3.17 The proposal includes submission of a summary within a month of the quarter end. Where there are property loans, then taxpayers may need to obtain from the lender a split of payments between mortgage interest and capital repayment (or payment to a linked savings account for offset loans). Where the taxpayer has access to an online mortgage account, this might be possible within the month time limit. However, in other cases this may prove impossible. Consideration should be given to the report being merely an estimate in-year, with the actual figures provided in the End of Year submission.
- 3.18 Similarly, where a rental agent collects the rent and organises certain expenses including repairs, it may not be possible to obtain the breakdown of information from the agent in time for the submission, especially if the reporting periods are not co-terminous. Again, the ability to provide estimates should be considered.

4 Question 1: Do you feel there should be a relevant maximum limit imposed for eligibility for the cash basis for unincorporated property businesses? If so, what should this limit be and why?

- 4.1 If the property cash basis is optional then, arguably, there may not need to be a maximum limit. Larger or valuable property portfolios may lend themselves to the accruals basis, and so there may become a natural threshold at which the cash basis becomes inappropriate.
- 4.2 However, a limit may be an option in order to minimise the risk of avoidance or manipulation, which might become possible between connected parties (see question 9 below). We would rather see a limit imposed, at a sensible level (perhaps in line with the cash basis for trading businesses), if that is the alternative to complex anti-avoidance legislation, which would otherwise make the property cash basis much more difficult to understand.
- 4.3 Further, we note that it is proposed to limit the deductibility of interest expenses and other borrowing costs to £500, replicating the rules for the trading income cash basis.¹ We believe that this limit may seriously limit the attractiveness of this proposal for all but the smallest property rental businesses, as this would act as a significant additional restriction on the deduction of one of the most common expenses.

5 Question 2: Do you feel there is any reason why the cash basis should not be optional for all eligible unincorporated property businesses?

- 5.1 No, we agree that it should be optional for all such businesses.

¹ Paragraph 2.14 of the condoc.

6 Question 3: Would you want to opt in for each of their property businesses separately (for example, UK property business and overseas property business) or would they prefer to choose whether to opt in for all their property business income or none of it?

- 6.1 To maintain maximum flexibility, we think a landlord should be able to opt in for each of their property businesses separately.
- 6.2 However, we do recognise that increased flexibility also brings further complexity, and again highlights the importance of clear and comprehensive guidance.

7 Question 4: Does the above advice give you enough information to decide whether or not to use the cash basis with/without (please indicate) professional advice? If not, what else would you need to know about the new rules?

- 7.1 This question implies that, by extending the cash basis to unincorporated property businesses, HMRC's intention is to reduce the need for landlords to use an agent. This may well be the result, although we also think that the introduction of digital record keeping and quarterly reporting obligations for landlords may have the opposite effect.
- 7.2 Our concern is that an unrepresented taxpayer will not have sufficient knowledge or information to make an informed choice as to which basis is more appropriate for their own circumstances, and as a result could make a decision which results in them paying more tax than they otherwise would have done. It is not unusual for unrepresented taxpayers to have no comprehension of the difference between the accruals and the cash basis and not know which basis they are using.
- 7.3 HMRC say that they will provide guidance to help eligible landlords make the decision around whether the cash basis is right for them. This is essential. Examples detailing the treatment of common types of income and expenses would be useful. No further details are given, but since we understand that the intention is to introduce the property cash basis with effect from April 2017 HMRC need to act quickly to publicise the changes.
- 7.4 It is unclear from the consultation document how often a landlord will be able to enter and leave the property cash basis. This is dealt with under the cash basis for trading income by having an entry and exit threshold, and a 'change in circumstances' rule (ITTOIA 2005 section 31D). In our view, it would not be helpful if a landlord could go in and out of the property cash basis frequently. It can be a difficult and time-consuming task to accurately reflect the changes from a cash basis, to an accruals basis (or vice-versa), and could lead to confusion and errors (possibly double counting) and omissions. Therefore, there should be some criteria to determine when a landlord is eligible to exit the property cash basis, and similarly before a landlord can re-enter the property cash basis.
- 7.5 It makes sense to adapt the 'change in circumstances' rule used in the cash basis for trading income legislation. This is not defined in the legislation but HMRC's *Simpler*

*Income Tax for the Simplest Small Businesses: Technical Note*² states that examples of such changes include a business that is expanding and wishes to claim more than £500 in interest deductions, a business that wishes to claim 'sideways' loss relief and a business that decides to register for VAT. Clearly, these are not all relevant for an unincorporated property business using the cash basis. We would therefore suggest that a more suitable 'change in circumstances' rule would be that the landlord considers that it is more appropriate for their property business to prepare accounts using Generally Accepted Accounting Practice (GAAP). This should be wide enough to cover most scenarios and ensure that the landlord has to have considered the alternative accounting bases when making their decision.

- 7.6 If true alignment can be achieved between the cash basis rules for property and the cash basis rules for trading income (see paragraph 2.3 above), then one set of rules covering 'change of circumstances' would be possible as well.
- 7.7 We refer to paragraphs 3.25 and 3.30 of the consultation document, which consider the treatment of lease premiums received and lease premiums paid. Although we think that in general a property business that encounters lease premiums might be too complex to choose the property cash basis, the proposals for taxing (in full on receipt) and deducting (no deduction as they will be treated as capital payments) could result in an uninformed landlord making a very costly decision to use the property cash basis. An unrepresented taxpayer would be at particular risk of doing this.
- 7.8 If there was an entry threshold limit (as for the trading cash basis), then it might be possible to allow full taxation of premiums received, and full deduction of premiums paid, as the scope for manipulation would be potentially quite small. However, having no upper threshold means that complexities like this are introduced.
- 7.9 It should be a key part of the rules that a landlord is not able to finalise a decision to use the property cash basis under MTD until the End of Year declaration is submitted, even if this means having to make amendments to previously submitted information.
- 7.10 Software should make it clear to the user through nudges and prompts what the tax treatment is of different types of income and expenditure.

8 Question 5: Does a regime that allows for individuals letting jointly, not in partnership, to separately opt to report using the cash basis present particular difficulties or issues?

- 8.1 First of all, there appears to be an inconsistency between the proposal at 3.13 ('each individual will be able to separately opt to report the profits from their personal rental business'), and what is envisaged at paragraph 4.45 of the consultation 'Bringing business tax into the digital age' ('HMRC's proposal is that one of the landlords would be the 'nominated individual'...and would fulfil the obligations of MTD'). This apparent inconsistency needs to be resolved, with clarity over how the digital records

² Simpler Income Tax for the Simplest Small Businesses: Technical Note 28 March 2013
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207418/021_simpler_income_tax_for_simplest_small_business_mar20013.pdf

should be maintained, and who and on what basis the quarterly updates should be submitted.

- 8.2 Whilst most joint letting businesses are simple husband and wife situations, there are many circumstances where there are different joint owners; for example as a result of inheritances or commercial arrangements. If the decision were not independent, there could end up being a number of diverse individuals who would all need to be on the same basis.
- 8.3 Further, owners don't necessarily have identical expenses. For example, some may have borrowings but others not.
- 8.4 Therefore, we agree that individuals should be allowed to separately opt to report using the cash basis.
- 8.5 However, we recognise that this is more complex than if all joint owners reported in the same way. Similarly, HMRC would need to recognise that if joint owners opted for different bases differences in reconciling accounts figures does not mean that errors have occurred.

9 Question 6: Should eligibility for the trading cash basis affect eligibility for the cash basis for unincorporated property businesses? If so, do you have any suggestions on what this interdependence should be?

- 9.1 We do not think eligibility to use the trading cash basis should affect eligibility to use the property cash basis. The two should be independent.
- 9.2 A taxpayer with both trading and property income may find it more straightforward to adopt the cash basis for both (assuming they are eligible), or the accruals basis for both, but we think this should be left as a choice, particularly if the underlying tax rules are not aligned.
- 9.3 We refer also to our comments above on aligning quarterly reporting periods under MTD for different sources of reportable income.

10 Question 7: Would only recognising deposits that landlords are entitled to keep at the end of a tenancy create unnecessary complexity?

- 10.1 In our view, deposits should not be taxed on receipt as they are not the landlord's money (particularly if paid into a tenancy deposit protection scheme – although that payment should represent a deduction anyway).
- 10.2 We believe that landlords will sufficiently monitor deposits to be able to account for the income only when they become entitled to retain it.

11 Question 9: Are you aware of any risks that the cash basis for unincorporated property business could present which could lead to the avoidance or reduction of liability to income tax? If so, please provide details.

- 11.1 We do not think there needs to be a restriction for sideways loss relief under the property cash basis. As the consultation document notes in paragraph 3.35, the current rules for the majority of unincorporated property businesses do not permit sideways loss relief anyway. We think the avoidance risks of permitting sideways loss relief are exaggerated.
- 11.2 There is a potential risk of manipulation between connected businesses. For example, it is not uncommon for business premises to be held outside of the business – so the sole shareholder of a trading company may own the business premises personally and charge a rental to the trading company. The shareholder (landlord) could operate on the cash basis, with the company having to operate on the accruals basis. If the company did not pay the rent that was due to the landlord, the company would still obtain a deduction for the rent, which was due, but the landlord would not be taxed on any income.
- 11.3 This type of cash-flow planning was prevalent for VAT purposes for transactions between connected companies until anti-avoidance measures were introduced. The government will need to balance the simplification offered by the property cash basis, against the risks of avoidance and manipulation.

12 Acknowledgement of submission

- 12.1 We would be grateful if you could acknowledge safe receipt of this submission, and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

13 The Chartered Institute of Taxation

- 13.1 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.

The Chartered Institute of Taxation
7 November 2016