Basis period reform- a step by step guide

RICHARD JONES

TAX FACULTY, ICAEW

Presenters

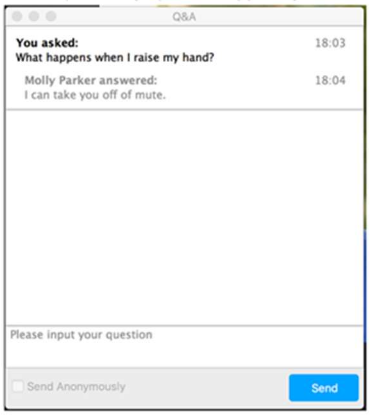
Richard Jones
Technical Manager
Business Tax
ICAEW

Today's speaker
Anita Monteith
Technical Lead
ICAEW Tax Faculty

Today's speak
Caroline Miski
Practitioner Ta
ICAEW Tax Fa

Good morning and welcome to today's webinar.

Ask a question



To ask a question

Click on the **Q&A** button in the bottom toolbar to open the submit question prompt.

Type in your question and click **send**.

Note. If you wish to ask your question anonymously check the **send anonymously** box shown on the illustration to the left.

RICHARD

I want to talk briefly about how you can participate in today's webinar. You can submit your questions at any time during the presentation. The way to do that is to click on the Q&A button on the bottom toolbar. Type in your question and press send. If you would prefer to remain anonymous simply select the send anonymously box before submitting your question.

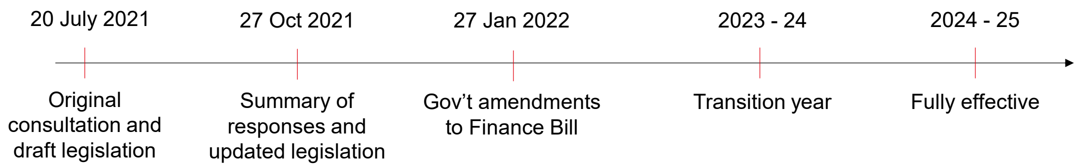
A recording of the webinar, with the slides as well as the audio, will be available to you after the event. The slides can be downloaded from the event page, a link to which was provided in the e-mail you should have received earlier today.

Basis period reform

- Timeline
- Current basis period method of taxation
- New tax year basis from 2024 - 25
- Calculation of profits in transition year 2023 – 24
- Taxation of transition profits
- Q&A

This is what we will cover.

Basis period reform timeline



This timeline shows how we have got to where we are now and when the new regime comes into force.

The original consultation into the proposals started on 20 July 2021. The consultation window was shorter than the usual 12 week period and took place over summer which gave relatively little opportunity for input.

We raised concerns during the consultation about the impact in the transitional year on personal allowances and other items based on the concept of 'adjusted net income'. These were addressed through updated legislation published in 27 October.

More problems remained with the legislation, including the inability to claim double tax relief against transition profits. This was dealt with by government amendments to the Finance Bill issued on 27 January 2022.

The Finance Bill implementing the new regime is currently passing through the House of Lords and is expected to receive Royal Assent soon.

The regime will come into force in 2024 – 25. However, to get from the current regime to the new one, we need a transition year which will be 2023 – 24.

HMRC is continuing to consult on the practical implementation of these rules as we come onto talk about later in this webinar.

Who does this change impact?

- All unincorporated businesses without a 31 March – 5 April year end
- HMRC estimates that is 7% of sole traders and 33% of partnerships
- Most likely affected includes:
  - Large and international partnerships
  - Seasonal businesses (eg tourism)
  - Farming businesses
- Basically, any business that chooses to adopt a non-tax year end basis of accounting for commercial or practical reasons

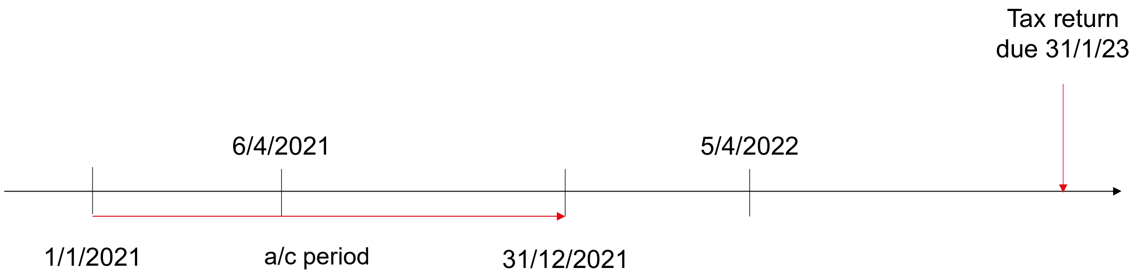
Approx 3.5m sole traders and 400,000 ordinary partnerships in the UK

So that equates to approx. 245,000 sole traders and 132,000 partnerships affected. So, at least 400,000 businesses once LLPs are included.

Some of those businesses will have an accounting year that differs from the tax year in order to defer tax liabilities. Those businesses may choose to shift to a tax year end to remove the additional complexity that this change will produce.

Others will wish to retain their existing accounting year for commercial or practice reasons, especially those listed on the slide.

The basis period method (31 December y/e)

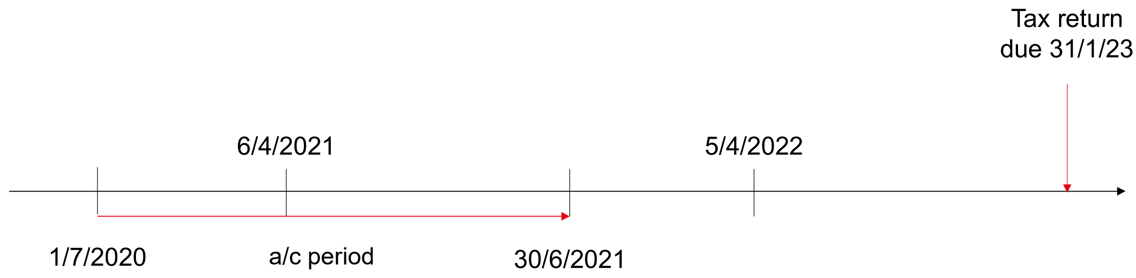


Profits of the accounting period ended 31 December 2021 are taxed in the tax year 2021/22
Final tax payment made just over a year after end of accounting period

This slide illustrates the current position for an unincorporated business with a 31 December year end.

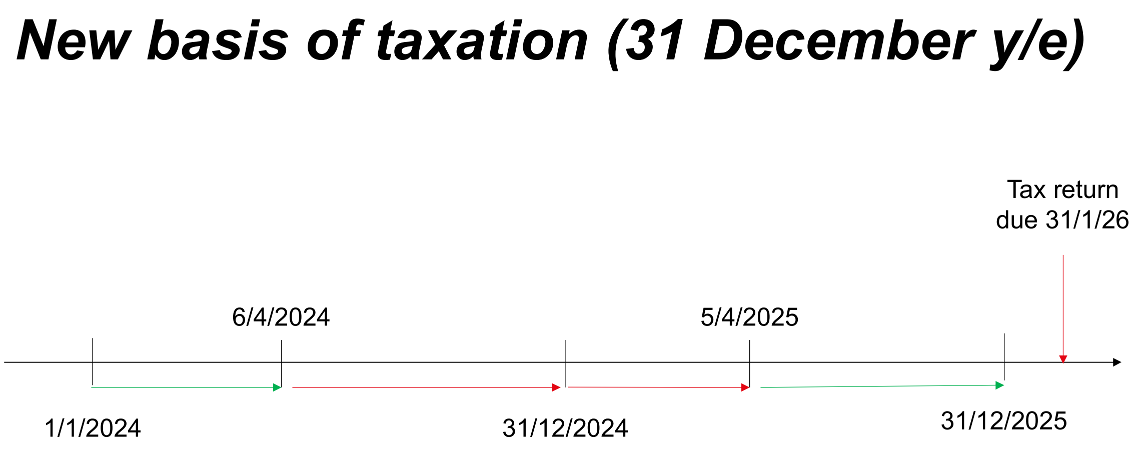
As you can see, the business owner has more than a year after the end of the accounting period to pay their final tax bill, though payments on account may be required.

The basis period method (30 June y/e)



Profits of the accounting period ended 31 December 2021 are taxed in the tax year 2021/22
Final tax payment due 19 months after end of accounting period

For a business with a 30 June year end, the gap between year end and final tax payment is even larger, at 19 months.



In 2024 – 25, profits taxed are:

- Profits from 2024 accounting period between 6 April 2024 and 31 December 2024; plus
- Profits from 2025 accounting period between 1 January 2025 and 5 April 2025

So, how will it work under the new tax year basis for businesses that have an accounting period different to the tax year?

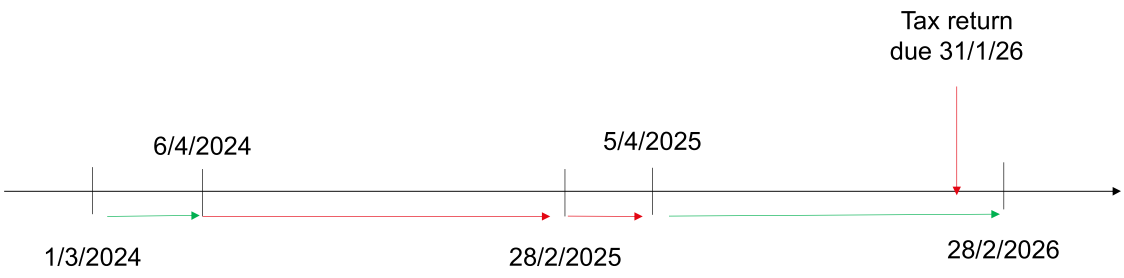
In calculating the taxable profits for a tax year, the profits (or losses) of two accounting periods will need to be taken into account.

In this example, for the tax year 2024 – 25 you need to calculate the profits for the 2024 and 2025 calendar years first, under income tax rules.

You then take a pro-rata amount of each period’s profits that fall within the tax year concerned. This is calculated on a day count basis, but a different method can be used if it produces a just and reasonable result.

You then add these up and deduct capital allowances to arrive at the taxable profit for the tax year.

New basis of taxation (28 February y/e)



In 2024 – 25, profits taxed are:

- Profits from first accounting period between 6 April 2024 and 28 February 2025; plus
- Profits from second accounting period between 1 March 2025 and 5 April 2025

This is the position for a 28 February year end.

As you can see, there is a problem here because we don't know what the profits will be for the accounting period ended 28 February 2026 before the tax return for 2024 – 25 is due to be filed.

The nearer the filing date is to 5 April, the more burdensome this problem becomes.

Challenges with new basis of tax

- Estimates required for profits of second accounting period in tax year
- That period may not have ended by time tax return needs to be filed
- Particular estimation challenges for seasonal businesses

In order to comply with the new tax year basis, it will therefore be necessary in some cases to estimate the profits of the second accounting period falling within the tax year in order to calculate the profits for the tax year.

This will be a particular challenge for businesses that do not accrue profits or revenue on a uniform basis over the accounting period. Seasonal businesses like those reliant on tourism or agriculture will be particularly affected. Hence, their estimates may not be especially accurate.

HMRC's suggested solutions

- Allowing taxpayers to amend a provisional figure at the same time as they file their returns for the following tax year
- Allowing an extension of the filing deadline for some groups of taxpayers, such as more complex partnerships or seasonal trades
- Allowing taxpayers to include in the next year's tax return any differences between provisional and actual figures in the previous year

HMRC has acknowledged that it will be difficult for some businesses to make estimates and has proposed a number of potential solutions to address this. It is not clear at this stage whether businesses could mix and match these or have to stick to just one.

Provisional figures- Benefits:
- Understanding that initial figures are approximate
- Formal facility to correct

Limitations:
- Lack of certainty over final tax position
- Will late payment interest be retained?

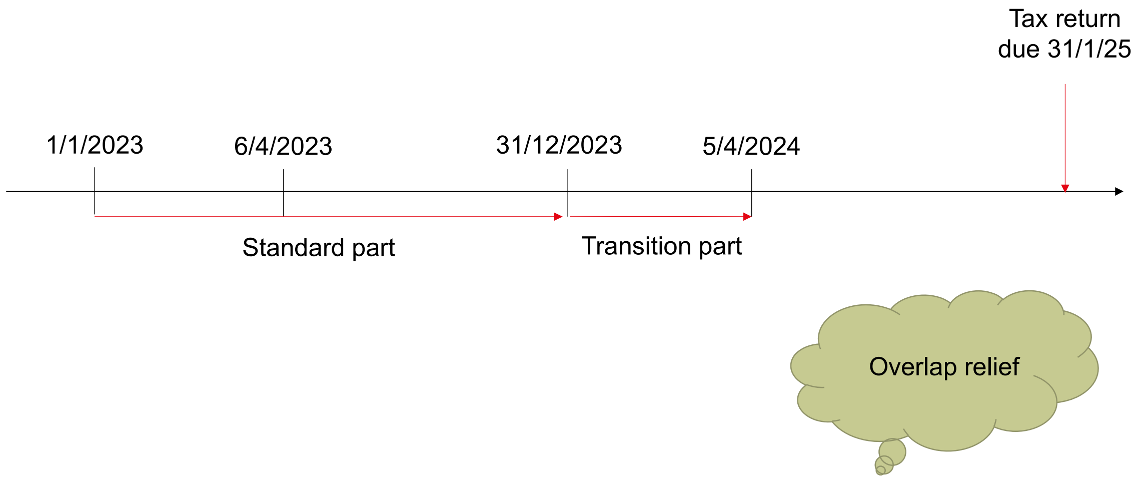
Deadline extension- Benefits:
- Recognises different needs of different businesses

Limitations:
- Some may need a significant extension. Will this be acceptable to HMRC?
- Will HMRC be able to cope with diff businesses working to diff deadlines?
- Definitions of businesses required to determine who can use them

Include in next year's tax return- Benefits:
- As with provisional figures

Limitations:
- Could prove very complicated and businesses/agents may get confused

Transition year 2023 - 24 – example with a 31 December year end



We need some form of transition process to get from the old to the new basis

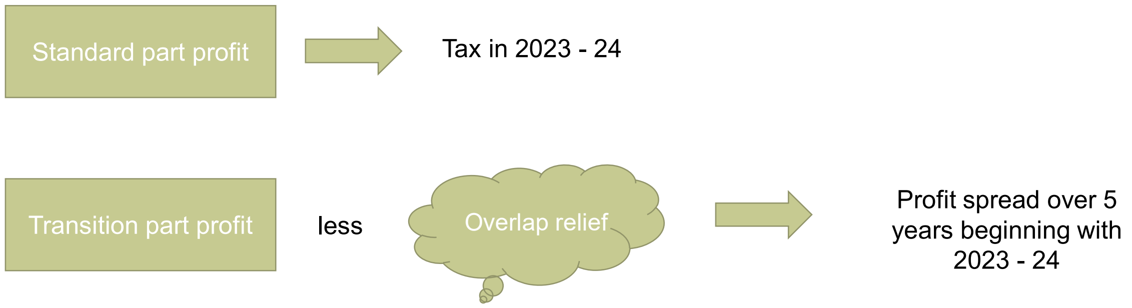
Special rules for transition year 2023 – 24, modelled on the rules for first tax year after a business changes its accounting year end

Taxed profits for that year comprise of two parts:
- Standard part- 12 months from end of previously taxed AP
- Transition part- from end of that 12 months to 5 April 2024

Overlap relief can also be taken at this point too. Note that overlap relief is being removed on transition to the new basis of taxation and so you either use it or lose it. And, as we will see, if you create or enhance a loss as a result, you can pretend that this is a terminal loss and carry it back up to three years.

Most businesses with overlap relief will have a year end different to 5 April but that is not always the case. For example, a business may have started with a different year end then switched to 5 April and forgot or decided not to take overlap relief at that point. Any remaining overlap relief will be used in the transitional year in any case.

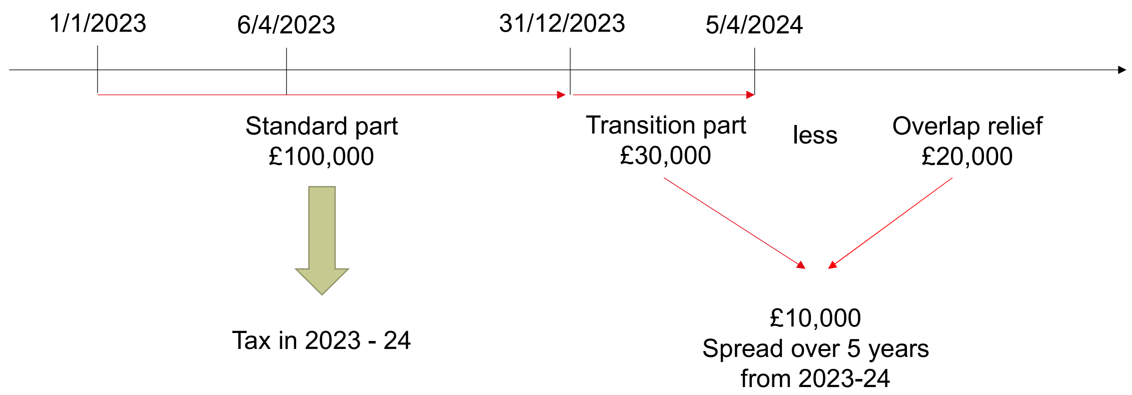
Transition year end profit computation process (where there are no losses)



Where both standard and transition parts are profits:

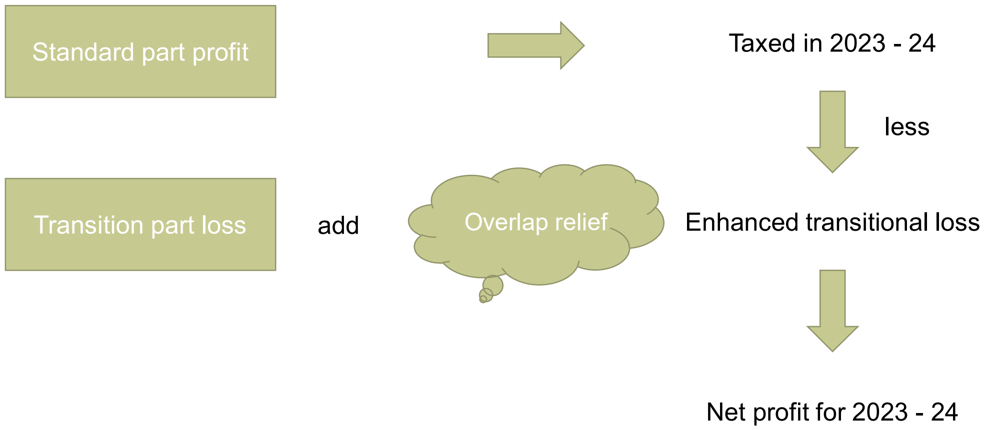
- Standard part is taxed in 2023 – 24
- Overlap relief set against transition part and then spread over 5 years

Transition example 1 - (31 December y/e)



This example illustrates that outcome for a 31 December year end

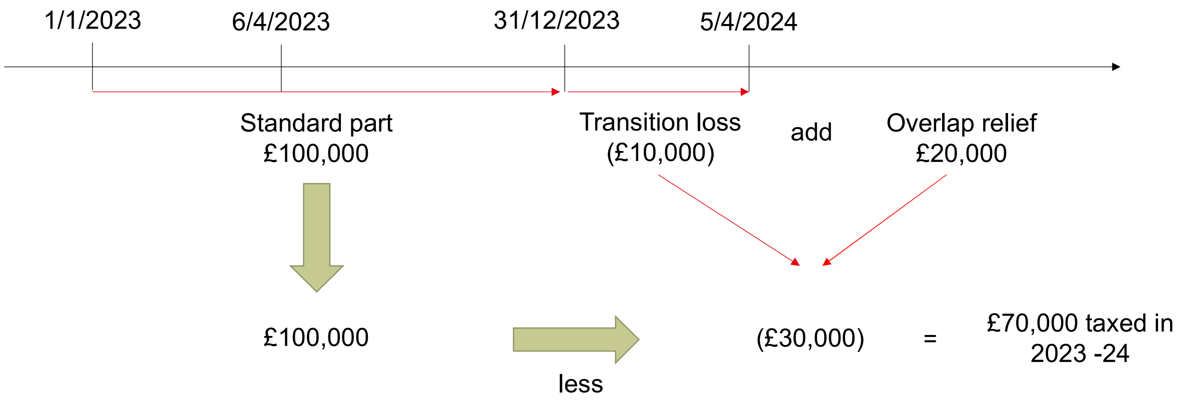
Process where there is part loss but overall profit (after overlap relief)



What if there is a profit for 2023 – 24 overall but one of the standard or transition part is a loss?

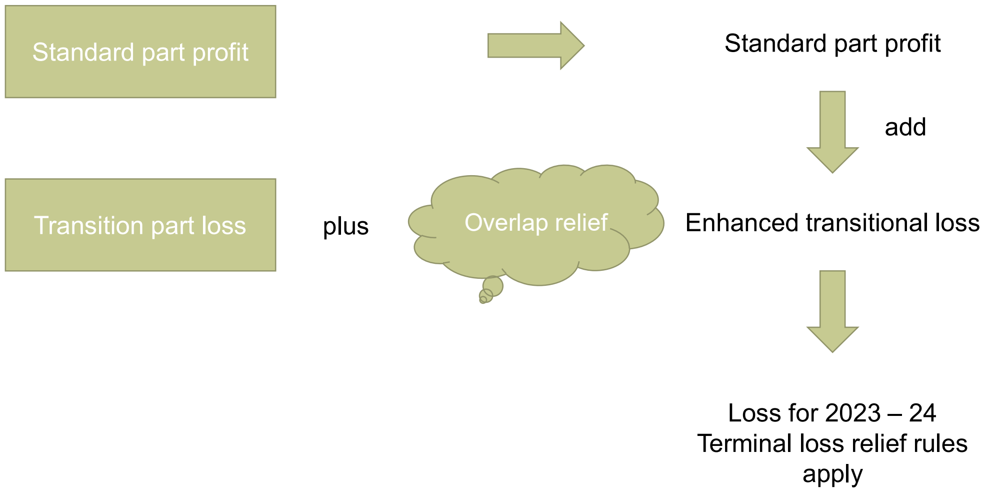
In that case, you just deduct the loss and the overlap relief against the profit and tax the net amount in 2023 – 24.

Transition example 2 - (31 December y/e)



This example shows how the net amount of profit (including £20,000 overlap relief) is taxed in 2023 – 24

Process where there is part profit but overall loss



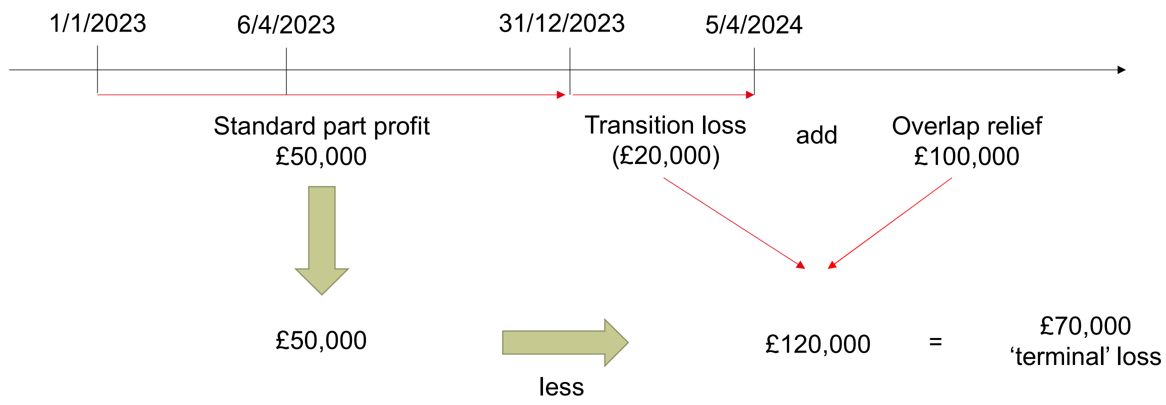
As with an overall profit position, you off-set the loss against the profit and deduct overlap relief to arrive at a net position (this time a loss).

The difference is what you can do with that loss.

All or a proportion can be treated as if it were a terminal loss and be available to carry back up to three years before 2023 – 24 which is the lower of:

- The overall loss and
- The overlap relief

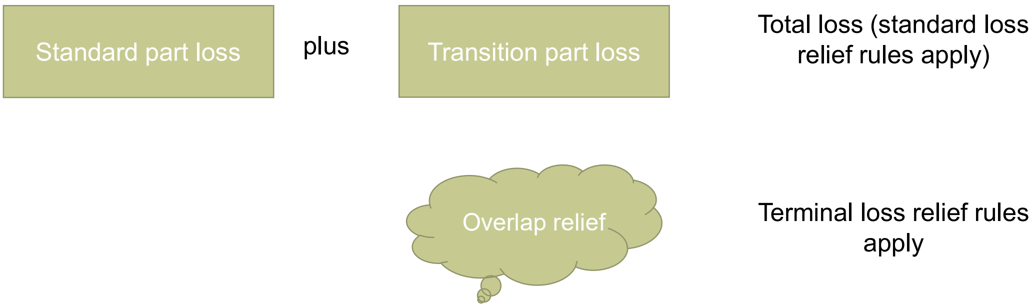
Transition example 3 - (31 December y/e)



In this example, you can see that the net position is an overall loss of £70,000.

This is smaller than the overlap relief of £100,000 so the whole £70,000 is treated as a terminal loss.

Process where there is an overall loss (without overlap relief)

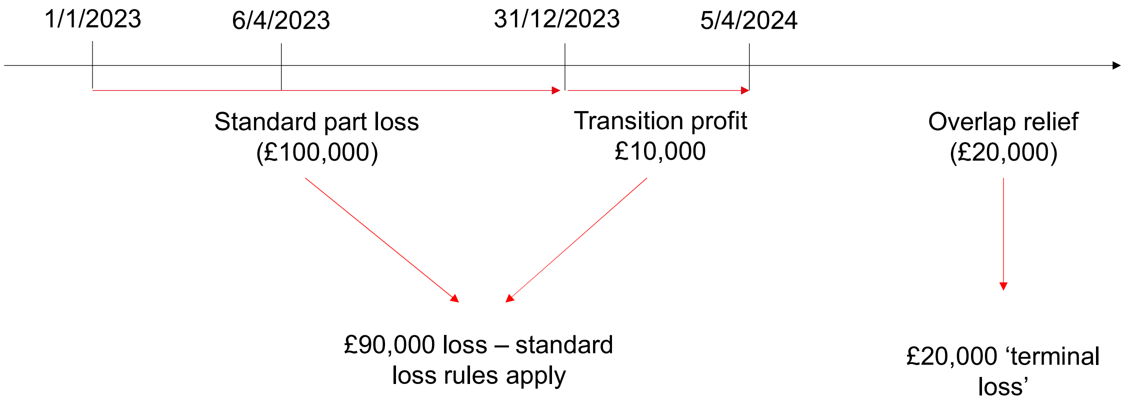


If there is an overall loss without needing to deduct overlap relief then that amount is treated as a standard loss. Ie

- Off-set against current year or prior year general income
- Carry forward against profits of the trade

The overlap relief is treated separately as a terminal loss.

Transition example 4 - (31 December y/e)



In this example, the £90,000 is a standard loss

The overlap relief of £20,000 can be treated as a terminal loss

Spreading of transition profits

Example 1 – Transition profit of £10,000

	2023/24	2024/25	2025/26	2026/27	2027/28
Standard	£2,000	£2,000	£2,000	£2,000	£2,000
Trade ceases in 2025/26	£2,000	£2,000	£6,000		
Elect to allocate more to 2024/25	£2,000	£5,000	£1,000	£1,000	£1,000

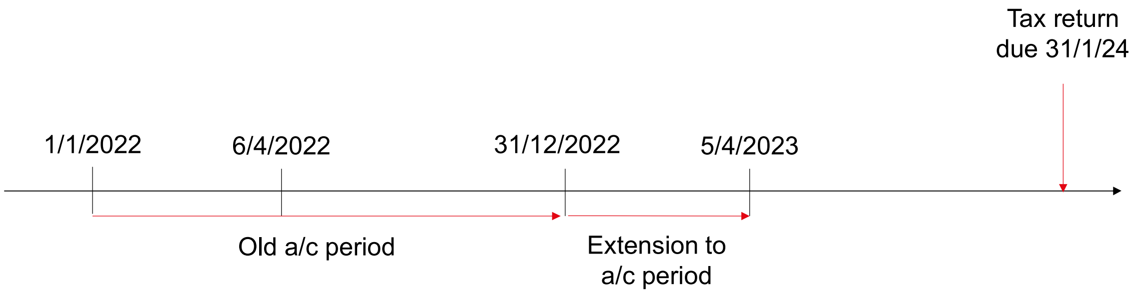
Notes:
- No spreading if business changes its year end prior to 2023 – 24
- But spreading is available if year end change is in 2023 – 24
- Transition profits ignored for farmers' and creative artists' averaging calculations

Where there is a net transition part profit, this is spread over 5 years beginning with the transition tax year

However, if the trade ceases before the end of the 5 years, the remaining profit is allocated to the tax year in which the trade ceases

You can elect to have more profit allocated to a tax year. If you do, the extra amount is deducted from the remaining years' profits equally.

Change a/c date from 31 December to 5 April in 2022 - 23



Tax year	Profits charged
2021 - 22	12 months to 31/12/21
2022 - 23	15 months to 5/4/2023
2023 - 24	12 months to 5/4/2024

- 3 months' worth of overlap relief given
- No spreading of additional profits

We will do a longer on demand webinar if there is appetite on change of accounting dates, but this is in overview what happens if you change before 6 April 2023:

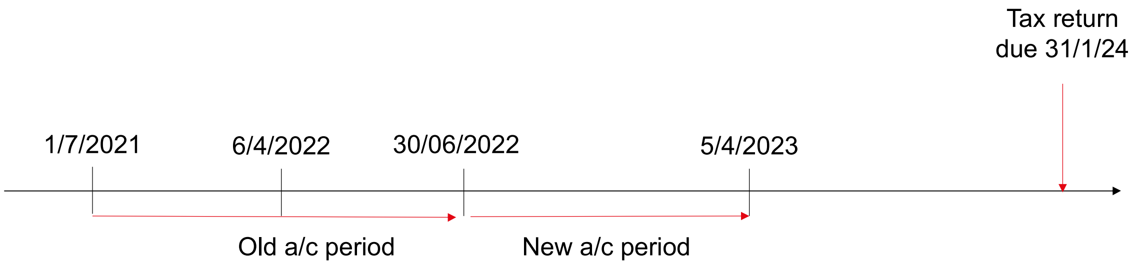
- To an accounting date no more than 6 months after the existing AP end
- The business is at least in its 4th tax year; and
- The conditions for the change applying for tax purposes are met.

Here, the extra 3 months' worth of profits in 2022 – 23 are taxed in that year.

Overlap relief is given to off-set against those additional profits

But any net additional profit cannot be spread

Change a/c date from 30 June to 5 April in 2022 - 23



Tax year	Profits charged
2021 - 22	12 months to 1/7/2021
2022 - 23	21 months to 5/4/2023
2023 - 24	12 months to 5/4/2024

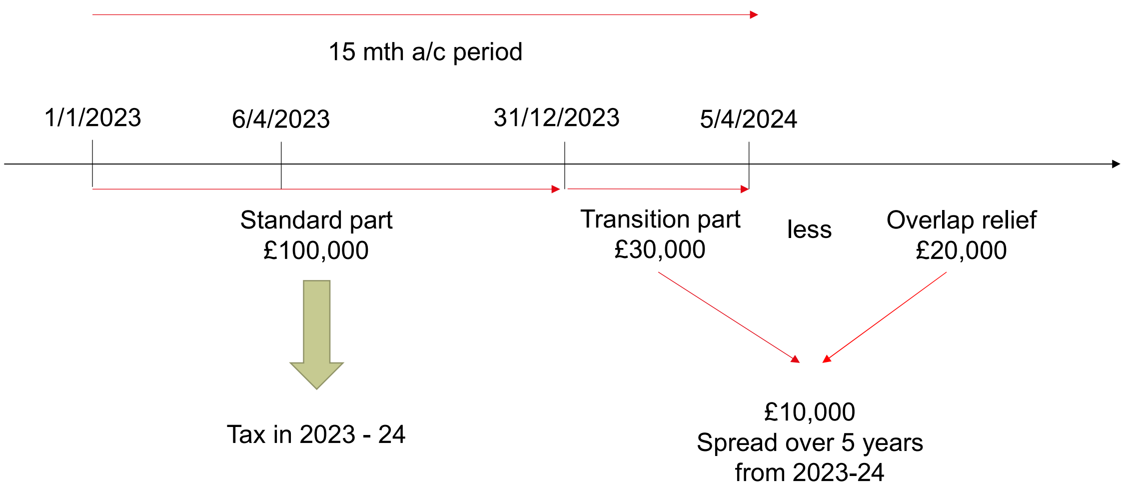
- 9 months' worth of overlap relief given
- No spreading of additional profits

Similar situation where the year end date moves by more than 6 months.

In the previous example, there would be a 15 month accounting period. In this one, there will be a short 9 month period.

Both the 12 months to 30 June 2022 and the 9 months to 5 April 2023 are taxed in 2022 – 23.

Transition example 1 revisited – move from 31 December to 5 April y/e in 2023 - 24



This example illustrates what happens if you move to a 5 April year end in the transitional year by, for example, having a long accounting period.

In this case, you treat the first 12 months' of the AP as the standard part and the remainder as the transitional part.

You then offset any overlap relief against the transitional part and spread this over 5 years as in example 1.

New equivalence rule

- Accounting periods ending between 31 March and 4 April effectively treated as ending on 5 April
- Impact on businesses with year end between these dates:
  - No pro-rating of a few days' worth of profits each year
  - No transition part of profits in 2023 – 24
- Can elect out of this treatment but must be for five tax years

HMRC has realised that a lot of businesses prepare accounts to 31 March, rather than 5 April.

Without special rules this would mean that a 31 March year end business:

- would need to estimate profits for the first 5 days of every accounting period
- would have a transitional 5 day period in 2023 – 24

Equivalence rule automatically treats 31 March – 4 April year ends as actually arising on 5 April.

However, if some bizarre reason you are OK with that, you can elect out of this for five years.

Taxation of transition profits

- Excluded from 'adjusted net income' for purposes of personal allowances, high income child benefit charge etc
- Brought back into tax calculation at step 4 of s23 ITA 2007
- Tax can be reduced by 'tax reducers' at step 6 of s23 ITA 2007 eg
  - Double tax relief
  - EIS, SEIS and VCT reliefs

Once you have calculated transitional profits and spread over five years, you need to know how to treat these for tax purposes.

These amounts do form part of taxable income for the tax years concerned

But they are ignored for the purposes of personal allowances, high income child benefit charge and anything reliant on 'adjusted net income' definition

DTR and other tax reducers can be off-set against tax arising on them

Example – Tax Calculation (2023 – 24)

	£	£
Standard profits	100,000	
Personal allowance	(12,570)	
	87,430	
Add: transition profit	2,000	
	89,430	
Tax £37,700 at 20%		7,540
Tax £51,730 at 40%		20,692
		28,232
Less: DTR		(5,000)
UK income tax liability		23,232

Full PA entitlement as transition profit not included in net adjusted income

In this example, although transitional profit causes total income to exceed £100,000, there is no restricting of the personal allowance

The £2,000 transitional profit is added to taxable income and then taxed at marginal tax rates

Any foreign tax arising on the standard or transitional profits can be off-set against UK tax icaew.com