

FB 2021-22 – Basis periods

Lecture B1291 – 15.15 minutes

Clause 7 introduces Schedule 1 which contains provisions for the abolition of basis periods.

For sole traders and individuals who are members of partnerships (including limited liability partnerships), currently the profits assessable in a tax year are those arising in the 'basis period' for that year, which is normally the accounting period ending in the tax year. Special rules apply on commencement and cessation of trade, as well as on a change of accounting date. These produce complications, such as some profits being assessed twice ('overlap profits'). The double charge then has to be relieved later, usually on cessation of trade, but also sometimes where the business changes its year-end.

The new provisions will amend s7 ITTOIA 2005 so that the trading income charged will be that which arises in the tax year. The provisions also apply to professions and vocations. Chapter 15 ITTOIA 2005 which contained the substantive provisions relating to basis periods is repealed.

New 7A ITTOIA 2005 contains provisions relating to apportionment of profits where the period of account does not coincide with the tax year. The apportionment must be done by reference to the number of days in the overlapping periods of accounts although the trader may use a different way of doing the apportionment if it is reasonable to do so and they use the alternative method consistently.

New s7B ITTOIA 2005 applies where a trade starts after 31 March in any tax year and does not permanently cease in the tax year. In this case, there is no need to apportion any profits or losses to the earlier year as it is all treated as falling in the subsequent year. New s7C ITTOIA 2005 confirms that an accounting date of 31 March or 1, 2, 3 or 4 April will be treated as 5 April and no apportionment will be required to determine the profits for the relevant tax year. An election can be made to disapply either s7B or s7C for a period of five years or, if sooner, until the tax year before the trade ceases.

The provisions relating to use of cash basis are amended so they now make reference to tax years rather than basis periods. There are, however, no substantive changes to the way in which the cash basis rules work within these amended provisions.

There are a large number of consequential amendments to various parts of the legislation to remove references to 'basis periods' and replace them with 'tax years' as well as removing references to overlap profits and overlap relief. No underlying technical principles are amended in making those amendments.

These provisions will apply for 2024/25 and subsequent years. However, they will apply from 2023/24 for any person starting to trade in that year who does not also cease to trade in that year.

2023/24 will be a transitional year for moving from the old to the new basis of assessment.

Anyone who starts to trade in 2023/24 will be taxed from commencement up to 5 April 2024.

For all other traders who did not commence in 2023/24, the basis period for that year will begin immediately after the end of the basis period for 2022/23 and end on 5 April 2024.

The basis period is divided into the 'standard' part of the basis period which is 12 months from the beginning of the period and the 'transition' part which is the remainder. If the accounting date is 31 March or 1, 2, 3 or 4 April, then this is taken to be 5 April for these purposes unless the trader elects to disapply this.

For this year, where the basis period is longer than 12 months, the relevant maximum for the purposes of the cash basis election will be proportionately increased.

A deduction is allowed in the transition year for any overlap profit which would have been allowed as a deduction from profits on the assumption that the trade had permanently ceased on 5 April 2024 or a deduction that was allowed, but not made, in an earlier accounting period where there had been a change of accounting date. Effectively all unused overlap profit will be deducted against the profits in the transition year.

If there is no transition part of the basis period for 2023/24 (because the standard part ends on or after 31 March 2024 and there is no election to use actual profits for the year) then the overlap profit is simply deducted from the profits for the year.

If there is a transition part of the basis period, then there are a series of steps to calculate the figures for the transition year as a whole:

1. calculate the profits for the standard part of the basis period;
2. calculate the profits attributable to the transition part of the basis period;
3. deduct the overlap profit from the profits attributable to the transition part of the basis period (step 2 profits);
4. add the figures at step 1 and step 3. If the amount of step 3 is a loss, then the profits for 2023/24 are this figure. If the amount of this step is a loss, then the profits are nil and the use of the loss is discussed below. If it is greater than nil, proceed to steps 5 and 6;
5. calculate the 'transition profits' which is the lesser of the step 3 figure and the step 4 figure;
6. the profit for 2023/24 is either the amount of the transition profits brought into account for the year (if the step 1 figure is nil or less than nil) or the sum of step 1 and the transition profit being brought into account. The amount brought into account is the amount according to the spreading rules below.

If there are transition profits at step 5 of the above calculation, these are spread over five years beginning with 2023/24. The first four years will bring into charge an amount equal to 20% of the transitional profits with the balance being taxed in the fifth tax year. If the trade permanently ceases before the whole of the amount has been brought into charge, any balance is taxed in the year of cessation.

The trader may make an election for an additional amount of profits to be treated as arising for any tax year where there is a charge relating to the 2023/24 transition profits. This election has to be made on or before the first anniversary of the self-assessment filing date for the tax year to which it relates. The election would specify the profits to be treated as arising in that year.

The amount of transition profits for any subsequent tax year is then reduced by the formula $A \times 5/T$ where:

- A is the additional amount of transitional profit treated as becoming chargeable, and
- T is the number of tax years remaining in the five-year spreading period.

If a loss is made in 2023/24 due to the deduction of overlap profit (or the loss is greater due to the deduction of overlap profits) then the amount of the loss/increased loss can be claimed as terminal loss relief as if the trader had permanently ceased to carry on the trade on 5 April 2024.

Example 1

John has an accounting period to 31 December each year. In the year ended 31 December 2023 he made profits of £58,613. His profits to 31 December 2024 are £47,236 and he is carrying forward 3 months' overlap profits of £9,214.

The profits from 1 January 2023 to 5 April 2024 are:

$$£58,613 \text{ plus } (96/366 \times £47,236 \text{ less } £9,214) = £58,613 + £3,175 = £61,788$$

The transitional profit is £3,175 and so only 20% of this is taxed in 2023/24 = £635 so the total taxable profit is £59,248. The balance of the transition profit is taxed over the next 4 years (subject to any election being made to recognise additional amounts in a future tax year).

Example 2

Georgina has an accounting period to 31 December each year. In the year ended 31 December 2023 she made profits of £58,613. Her profits to 31 December 2024 are £17,855 and she is carrying forward 3 months' overlap profits of £9,214.

The profits from 1 January 2023 to 5 April 2024 are:

$$£58,613 \text{ plus } (96/366 \times £17,855 \text{ less } £9,214) = £58,613 + (£4,531) = £54,082.$$

The transitional profit is nil so the total taxable profit is £54,082. No profits are taxed in subsequent years.

Example 3

Sadiq has an accounting period to 31 May each year. In the year ended 31 May 2023 he made a loss of £10,349. His profits to 31 May 2024 are £47,236 and he is carrying forward 10 months' overlap profits of £9,214.

The profits from 1 June 2022 to 5 April 2024 are:

$$(£10,349) \text{ plus } (310/366 \times £47,236 \text{ less } £9,214) = (£10,349) + £30,794 = £20,445.$$

The transitional profit is £20,445 and so only 20% of this is taxed in 2023/24 = £4,089. The balance is taxed over the next four tax years (subject to any election being made).

Example 4

Phyllis has an accounting period to 31 December each year. In the year ended 31 December 2023 she made a loss of £10,349. Her profits to 31 December 2024 are £47,236 and she is carrying forward 3 months' overlap profits of £9,214.

The profits from 1 January 2023 to 5 April 2024 are:

$$(\text{£}10,349) \text{ plus } (96/366 \times \text{£}47,236 \text{ less } \text{£}9,214) = (\text{£}10,349) + \text{£}3,175 = (\text{£}7,174)$$

There is no taxable profit for 2023/24 and no transition profit. The loss of £7,174 can be utilised in the same way as any trading loss for a tax year.

Example 5

Maurice has an accounting period to 31 December each year. In the year ended 31 December 2023 he made profits of £4,629. His profits to 31 December 2024 are £7,855 and he is carrying forward 3 months' overlap profits of £9,214.

The profits from 1 January 2023 to 5 April 2024 are:

$$\text{£}4,629 \text{ plus } (96/366 \times \text{£}7,855 \text{ less } \text{£}9,214) = \text{£}4,629 + (\text{£}7,154) = (\text{£}2,525)$$

There is no taxable profit for 2023/24 and no transition profit. The loss of £2,525 can be utilised either in the same way as any trading loss for a tax year or a terminal loss relief claim can be made.

Example 6

Jasmine has an accounting period to 31 May each year. In the year ended 31 May 2023 she made a loss of £10,349. Her profits to 31 May 2024 are £7,236 and she is carrying forward 10 months' overlap profits of £9,214.

The profits from 1 June 2022 to 5 April 2024 are:

$$(\text{£}10,349) \text{ plus } (310/366 \times \text{£}7,236 \text{ less } \text{£}9,214) = (\text{£}10,349) + (\text{£}3,086) = (\text{£}13,435)$$

There is no taxable profit for 2023/24 and no transition profit. The loss of £13,435 can be utilised in the same way as any trading loss for a tax year or £3,086 can be the subject of a terminal loss relief claim.

Example 7

Nigel has transitional profits arising of £42,743. £8,548 (i.e. 20%) of this is treated as arising in 2023/24 and the same amount is added to his profits in 2024/25.

His profits are reduced in 2025/26 so he decides that he wants to include £15,000 of transition profit in that year.

The transition profit is reduced by the formula $A \times 5/T$. $A = \text{£}6,452$ (being £15,000 less £8,548 so the excess being paid in this year) and $T = 2$ as there are two remaining years in the spreading period. The outcome of this calculation is £16,130. The transition profit is therefore treated as reduced to £42,743 less £16,130 = £26,613 so that the final two profit additions are 20% of this which is £5,323 per year.

In summary, the £42,743 transitional profit is spread as follows:

2023/24	£8,548
2024/25	£8,548
2025/26	£15,000
2026/27	£5,323
2027/28	<u>£5,324</u>
	<u>£42,743</u>

No amount of transition profit for the tax year 2023/24 and arising in any subsequent tax year is to be taken into account in determining the relevant profits for the purposes of averaging for farmers and creative artists.

There are specific provisions to determine the liability to income tax on the transition profits in subsequent years.

Looking at the steps in s23 ITA2007, the amount of transition profits is left out of the calculation at step 2. The difference between the tax liability calculated at step 5 and the tax liability that would have arisen if the amount left out of step 2 had not been left out is then added at step 7.

The limit on reliefs under s24A ITA2007 (which restrict loss and other reliefs to the greater of £50,000 or 25% of net income) does not apply to losses generated through overlap relief and that also applies to losses generated in the transitional year.

These rules also apply to partners in partnerships and the methodology for calculated trading profits is also applied to a notional business of a partner, which applies where there is untaxed non-trading income. The basis period for that notional business in the transitional year will be the same as for the trading partnership income with deductions for overlap profits as required. Any loss generated in the notional business will be deducted from the partner's income.