

Basis period reform - tax repercussions (Lecture B1442 – 24.39 minutes)

The new tax year basis

The previous rules for taxing self-employed individuals date back to the mid-1990s and were themselves derived from a *modus operandi* which came into being in the early 1920s. They were straightforward enough for the vast majority of sole traders and most business partnerships drawing up their annual accounts for a period which tied in with the tax year (or to 31 March which, in practice, HMRC normally treated as being equivalent to 5 April). However, choosing an accounting date which was not coterminous with the tax year end was likely to create, HMRC said, 'complexities that lead to businesses making many thousands of tax return errors every year'.

What the Government therefore decided to do in FA 2022 was to reform the concept of basis periods by moving from a current year basis to a tax year basis. In other words, the profits and losses of a tax year are to be those arising in the tax year (often referred to as 'actual'). A sole trader with a 30 April year end date will find that his taxable profits for 2024/25 are based on:

- 1/12th of his profits for the year ended 30 April 2024; and
- 11/12ths of his profits for the year ended 30 April 2025,

whereas, under the previous code, his taxable profits would have comprised his profits for the year ended 30 April 2024.

Strictly speaking, any apportionment for non-tax year trading businesses should be done on a daily basis, but a different time-apportionment mechanism (e.g. by months) can be used as long as it is reasonable and is applied consistently. In all cases, the figures to be apportioned are the tax-adjusted profits or losses, i.e. after dealing with disallowable expenses and capital allowances.

These revised rules take effect for 2024/25 onwards, with 2023/24 being treated as a special transitional year.

Impact of the transitional year

The procedure for calculating taxable profits for a continuing trade for 2023/24 is:

Start with the profit for the current year basis period. Let us assume that this involves the year ended 30 June 2023.

To this must be added the profit of the 'transition part' defined as:

- beginning immediately after the end of the 'standard' basis period for 2023/24; and
- ending with 5 April 2024.

In other words, we are looking at the results of a nine-month period which runs from 1 July 2023 and ends on 5 April 2024. Where necessary, the usual apportionment rules are applied.

A deduction is then given for the overlap profit which would have been allowed if the trade had actually ceased on 5 April 2024. In practice, this has sometimes proved to be unexpectedly hard to establish.

The resulting figure represents the potentially assessable profits for 2023/24.

It should be remembered that FA 2022 contains a special election for the spreading forward of the transition profits (net of any overlap relief) over a five-year period, starting with 2023/24.

The transition profits are defined as the difference between:

- the potentially assessable profits for 2023/24 (see above); and
- the current year basis figure for 2023/24.

Where the former figure is greater than the latter, an election can be made to spread the excess evenly over the five years from 2023/24 onwards. However, there is no requirement that the spreading element has to be an exact one-fifth. It can always be accelerated to any amount of the transition profits not previously charged to tax. Where the former figure is smaller than the latter, there is no spreading.

Example 1

Anthony is an established sole trader whose accounting date is 30 April. His profits for the year ended 30 April 2023 were £55,000. For the year ended 30 April 2024, they are £66,000. Anthony has overlap profits brought forward amounting to £20,000.

Anthony's potentially assessable profits for 2023/24 are calculated as follows:

	£
Current year basis (year ended 30 April 2023)	55,000
Add: Transition part (1 May 2023 – 5 April 2024)	
11/12 x 66,000	<u>60,500</u>
	115,500
Less: Overlap relief	<u>20,000</u>
	<u>95,500</u>

These profits exceed the profits determined under the current year basis by £40,500 (£95,500 – £55,000) and so Anthony can spread the excess over five years. The amount to be added to his 2023/24 assessment is:

$$\text{£}40,500 \div 5 \qquad \text{£}8,100$$

Anthony's profits for 2023/24 are therefore £55,000 + £8,100 = £63,100. This adjustment of £8,100 must also be made for each of the next four tax years, unless he opts for a larger adjustment.

Example 2

Boris is an established sole trader whose accounting date is 30 June. His profits for the year ended 30 June 2023 were £35,000. For the year ended 30 June 2024, they are £20,000. Boris has overlap profits brought forward amounting to £30,000.

Boris' potentially assessable profits for 2023/24 are calculated as follows:

	£
Current year basis (year ended 30 June 2023)	35,000
Add: Transition part (1 July 2023 – 5 April 2024)	
$9/12 \times 20,000$	<u>15,000</u>
	50,000
Less: Overlap relief	<u>30,000</u>
	<u>20,000</u>

These profits do not exceed the profits of £35,000 determined under the current year basis. There is no spreading and Boris' assessable profits for 2023/24 are £20,000.

Calculation of income tax liability on the transition profits

Special rules found in Para 75 Sch 2 FA 2022 apply to calculate the trader's liability to income tax on the transition profits. These modify the normal calculation routine in S23 ITA 2007 such that the transition profits are treated as a separate component of total income. As a result:

- (i) any relief which is deductible under S24 ITA 2007 at Step 2 of S23 ITA 2007 (e.g. trading loss relief against general income under S64 ITA 2007) is set, if necessary, against the transition profits at this stage;
- (ii) any remaining profits are removed from the calculation of 'net income' (Step 2);
- (iii) a standalone amount of income tax is calculated on the left-out profits; and
- (iv) this tax is added back at Step 4.

The standalone tax added back at Step 4 is the difference between:

- (i) the tax which would have been payable had the transition profits remained in net income; and
- (ii) the tax which would have been payable had the transition profits been removed from net income.

Calculating the tax in this way allows the trader's personal allowance to be deducted from the transition profits in Step 3. It also allows the tax reducers in S26 ITA 2007 (e.g. the EIS, SEIS and VCT reliefs) to be set against the tax arising on the transition profits.

Effect of this regime on various tax provisions

The following technical details should be noted:

1. The HICBC threshold is based on 'adjusted net income' (as defined by S58 ITA 2007). Because transition profits are excluded from net income, the existence of transition profits should not, on their own, cause this threshold to be breached.
2. The pension annual allowance taper for high-income individuals in S228ZA FA 2004 uses one half of the excess of the taxpayer's 'adjusted income' over £260,000 (subject to a £10,000 minimum). The starting point for this calculation is the individual's net income and so the level of transition profits should not adversely affect annual allowance tapering.
3. Transition profits will, however, count towards 'relevant UK earnings' for the purposes of tax relief on pension contributions. This phrase is defined in S189(2) FA 2004 and, although doubts have been expressed about the correctness of this understanding, HMRC have recently confirmed the veracity of the statement.
4. Tapering of the personal allowance occurs where the taxpayer's adjusted net income exceeds £100,000. As mentioned in above, transition profits are excluded from net income and so it might be thought that such profits should be ignored in this context. Unfortunately, this is not the case. The calculation requires a comparison between the tax payable if the amount of the transition profits were left in net income versus the tax payable if they were excluded. Thus the personal allowance taper may still be felt if the amount of transition profits takes the adjusted net income figure over £100,000. For example, if, in 2023/24, a trader has current year basis profits of £100,000 and transition profits (after spreading) of £9,000, he will lose $\frac{1}{2} \times £9,000 = £4,500$ of his personal allowance when calculating the tax on the transition profits.
5. Another difficult area is whether transition profits can affect CGT rates. By virtue of S11 TCGA 1992, higher rates of CGT are in point where an individual's income 'is chargeable to income tax at a higher income tax rate'. The speaker's view is that CGT rates are not affected by the existence of transition profits. Such profits are not charged to any particular rate of income tax – they suffer a standalone tax charge. In addition, removing transition profits from net income means that they do not use up any part of the taxpayer's basic rate band. It is believed that HMRC agree with this analysis.

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