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CHARTERED ACCOUNTANTS

Basis Period Reform

Plan now to calculate how the tax changes will affect your business

The way that profits are assessed for unincorporated businesses is changing from 6 April 2024 (i.e. the 2024/25 tax year), with transitional changes also taking place in the 2023/24 tax year.

Current position

Currently, for income tax purposes, trading profits assessed in a tax year are based on the profits for the 12-month accounting period ending in that tax year. A tax year runs from 6 April to 5 April. As an example, for a sole trader drawing up their accounts to 30 September each year, in the 2022/23 tax year (ending on 5 April 2023) the taxable profits will be based on the accounts for the year ended 30 September 2022. This is known as the "current year basis".

Under the current year basis special rules apply in the opening and closing years of trade. Using a 30 September year end again as an example, if an individual commences trade on 1 October 2021, they will draw up their first set of accounts to 30 September 2022. A Tax Return will have to be filed for the year 2021/22 and the basis period for the 2021/22 Tax Year will be 1 October 2021 until 5 April 2022. These profits may have to be estimated if the accounts to 30 September 2022 are not fully prepared by the 2021/22 Tax Return filing deadline of 31 January 2023. In the following 2022/23 tax year, the same profits (for the period 1 October 2021 to 5 April 2022) will be taxed again as part of the basis period 1 October 2021 to 30 September 2022. These profits are known as "overlap profits" and are carried forward until such a time that either the accounting period changes or the individual ceases self-employment. A deduction will then be given for the profits that have been taxed twice.

New tax year basis

From the 2024/25 Tax Year taxable profits will be based on the tax year irrespective of the accounting year end. A trader that does not prepare their annual accounts to 31 March / 5 April will be required to apportion their profits. For example, with an accounting year end of 30 September, 6 months of profits will be apportioned from the year ended 30 September 2024 and 6 months of profits will be apportioned from the year ended 30 September 2025.

By making this change HMRC hope to eliminate the burden of calculating overlap profits for new traders and simplify tax reporting. However, the change brings with it the added complication of estimating profits if the accounts figures are not available in time for the Tax Return filing deadline. In such cases an estimated Tax Return must be provisionally filed and later amended to reflect actual figures.

Transitional rules for 2023/24

In the 2023/24 tax year taxable profits will be based on profits for the accounting period that ends in 2023/24 plus an additional apportionment of profits to 5 April 2024. For example, for the accounting year ending 30 September 2023 the whole of that year will be assessed plus 6 months of the profits from the year ending 30 September 2024. To mitigate tax on the additional profits assessed, a profit deduction will be permitted for any overlap profits that arose on commencement of trade.

If the profits of the extended basis period exceed the 12 months profits from the original accounting year end, after the deduction of overlap profits, these excess "transitional profits" will be spread evenly across 5 tax years, commencing in the 2023/24 tax year. The 5-year spreading of transitional profits is automatic and intended to ease the additional tax burden for traders. However, a trader can elect to tax an additional amount of the transitional profits in a selected tax year during the 5-year period, if they wish to pay the tax charged on the transitional profits more quickly.

If the business ceases permanently during the 5-year period the balance of the transitional profits will be fully taxed in the tax year that the business ceases.

Where losses are created by the offset of overlap profits, terminal loss relief rules will apply. These rules permit the losses to be carried back over the previous 3 tax years against profits of the same trade.

Preparing for the changes

It may be difficult to estimate profits where the accounting period is not coterminous with the tax year, particularly if the accounting period ends shortly before the tax year. For example, with an accounting period ending in December, in the 2024/25 tax year taxable profits will consist of nine months from the accounting period to December 2024 year-end and three months from the accounting period to December 2025. The 2024/25 Self-Assessment Return must be filed by 31 January 2026, which only gives a one-month window in which to calculate the apportioned profits from the December 2025 year-end. For accounting periods ending in January or February, the profits of the latter period would have to be entirely estimated, and a provisional Tax Return filed until the final accounts and Tax Return can be prepared.

Changing the accounting period date to 31 March/5 April will simplify the reporting of annual profits going forward, however there may be commercial reasons why this is not possible.

Furthermore, many traders will see more profits taxed in the 2023/24 transitional year than would otherwise have been the case. The due date for payment of tax on these profits will be brought forward, and the impact on cash flow will have to be considered.

Making Tax Digital

From April 2026 Making Tax Digital (MTD) is scheduled to be mandatory for sole traders with turnover of more than £50,000, and from April 2027 will be extended to sole traders with turnover of more than £30,000. MTD will replace the current annual Self-Assessment reporting regime and require quarterly reporting of digitally maintained records, with quarters being based on the Tax Year. Therefore, changing to a 31 March/5 April accounting year end before MTD becomes mandatory will ease the administration involved in its introduction.

If you would like to discuss any of the issues raised in this article, please do not hesitate to get in touch with your usual DSG contact.

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