



CHANGE OF BASIS PERIOD

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Major changes ahead for many unincorporated businesses and LLPs

Many sole traders and partnerships, including limited liability partnerships (LLPs), are going to be affected by tax changes that are in the process of taking place. **These changes will not impact such businesses if they have a 31 March or 5 April accounting year-end**, but other businesses may have significantly higher than normal tax bills for the current tax year (2023/24) and the following four tax years. This is not because of any increase in tax rates; it is due to changes (which have already been legislated) in the way that taxable business profits are calculated for a tax year.

These changes have supposedly been driven by the introduction of Making Tax Digital for Income Tax Self-Assessment (MTD ITSA). Although MTD ITSA, which affects how often you must report profits to HMRC, has now been delayed until at least 2026, the government has chosen not to delay the changes to how profits are assessed until the same date.

Note that if you operate your business through a limited company of which you are a director, these changes do not affect you at all.

In this document, we explain how the current rules work and what the new regime will be. There are many important related points, such as:

- Whether to change accounting date, so as to make compliance with the new regime easier;
- If the accounting date is changed, should you use one long period of account or a 12-month period followed by a separate short period (as such a choice can, bizarrely, have a big impact on your tax liabilities);
- The timing of any capital expenditure on plant and machinery; and
- Changes being made to the rules on the amendment of estimated figures in tax returns (because the use of estimates is going to be more common under the new regime).

Any references to 'partnership' or 'partner' in this document also apply to LLPs and members of LLPs respectively.

If you are going to be affected by these changes, there are many things that you might wish to discuss. We are here to help, so please contact us with your questions.

Current year basis

Under the existing system ("current year basis"), the taxable profits for a tax year are those of the basis period relating to that tax year. Usually, the basis period is the 12-month accounting period ending in that tax year. For example, for tax year 2022/23 (which runs from 6 April 2022 to 5 April 2023), the basis period of a business with a June year-end is the 12 months to 30 June 2022, whereas for a March year-end it is the 12 months to 31 March 2023. Thus, there can be a long

delay between earning profits and when they are assessed to tax.

There are special rules

- in the opening and closing years of a business; or
 - if a business changes its permanent accounting date.
- The opening year rules often involve some profits ("overlap profits") being taxed in more than one tax year, strange though this may seem. These are carried forward and relieved on cessation of trade, or (sometimes) a change of accounting date.

The new regime



Businesses will be taxed on the profits arising in a tax year from 2024/25 onwards, with 2023/24 being a transitional year. So, for 2024/25, the taxable profits will be those arising between 6 April 2024 and 5 April 2025, irrespective of the accounting date. Where a business does not have a 5 April accounting date, this will mean an apportionment (on a day-count basis) of two separate sets of accounts.

For example, if a business has a 31 December accounting date, the assessment for 2024/25 will consist of roughly nine months' worth of profits from the year to 31 December 2024 (i.e. 6 April 2024 to 31 December 2024) and three months' worth of profits for the year to 31 December 2025 (i.e. 1 January 2025 to 5 April 2025).

Note, however, that if your business has a 31 March year-end, you will not need to do this sort of apportioning, as the new legislation allows you to treat a 31 March accounting date as if it were 5 April.

With the final date for filing a tax return online remaining 31 January following the tax year (i.e. 31 January 2026 for 2024/25), the change in rules presents a practical problem. As the accounts for the year to 31 December 2025 are unlikely to be finalised by the tax return filing date, the return will need to include estimated figures, which will then need to be amended at a later date. Although HMRC is making changes to the procedures for correcting estimated figures (see later), businesses need to consider changing their accounting date to 5 April or 31 March, to avoid these annual apportionments and the use of estimates.

The transitional year (2023/24)

2023/24 is the transitional year from the current year basis of assessment to the tax year basis of assessment. The basis period for this year is:

- A. the current year basis period profits, plus
- B. the transitional period profits that arise in the period from the day after the current year basis period to 5 April 2024.

For example, for a business with an April year-end:

- A = the 12 months to 30 April 2023
 - B = the period from 1 May 2023 to 5 April 2024.
- Thus, a total of around 23 months' profits are assessable in 2023/24 where there is an April year-end!

Any overlap profit from commencement of trade is then deductible against B, but this may still mean a significant increase in taxable profits (and therefore tax liabilities) for the year, despite no extra profits having been earned.

To mitigate this, special rules apply to 'transition profits' (i.e. B, less the deduction for overlap profits), which:

- are automatically spread over five years, starting in 2023/24; and
- are ignored when determining a taxpayer's income for personal allowance (PA) abatement, where income goes above £100,000, and High Income Child Benefit Charge (HICBC), where income exceeds £50,000.

Example – Moeen

Moeen is a self-employed trader with the following profits:

- y/e 30 April 2023 £60,000
- y/e 30 April 2024 £80,000

Overlap profits brought forward are £20,000. The basis period for 2023/24 is:

- **Standard**
y/e 30.4.23 £60,000
- **Transitional**
1 May 2023 to 5 April 2024
i.e. (341 days/366 days) x £80k = £74,536
Less overlap profit (20,000)
Transition profits 54,536

The transition profits will be spread over 5 years, so an extra £10,907 will be taxable each year from 2023/24 to 2027/28. Moeen's total taxable profit for 2023/24 is therefore:

| | |
|---------------------------|---------------|
| Standard basis period | £60,000 |
| 1/5 of transition profits | <u>10,907</u> |
| Total | 70,907 |

So, in 2023/24 and each of the following four years, Moeen's taxable profits will be £10,907 higher than if the rules had not changed. He will need to budget for the extra income tax and National Insurance payable on these profits, which arise despite no additional profits having been earned.

Traders with low profits

These changes may in some circumstances cause traders with relatively low profits to pay, for a five-year period, a lot more tax and National Insurance than they are used to paying currently.

For example, if a trader with a June year-end normally makes annual profits of £16,000, most of that income is covered by their personal allowance (PA) and Class 4 National Insurance Contributions (NICs) threshold (both currently £12,570), leaving just £3,430 subject to income tax and Class 4 NICs.

Their transition basis period in 2023/24, running from 1 July 2023 to 5 April 2024, will add roughly another nine months of profits to this (i.e. about £12,000). With spreading, this will be another £2,400 per year for 5 years, commencing in 2023/24 (ignoring any overlap profit that may be available to set off).

Their taxable income will therefore increase (for five years) from £3,430 to £5,830, i.e. an increase of 70%!

Opting out of the spreading of transition profits

Although spreading is the default position, in the years 2023/24 to 2026/27, it will be possible (via an election on the tax return) to advance the assessment of transition profits from later years into the current year. This will be worthwhile, for example, if the profits of a year are lower than normal, such that advancing spread profits from a later year will use up basic rate band or personal allowance that would otherwise be unused.

Ceasing trading during the spreading years

If someone has transition profits being spread and ceases to trade during the spreading years, all remaining transition profits that are still to come into charge become taxable in the year of cessation. Note that, if you incorporate your business into a limited company, that counts as a cessation of the income tax trade and would therefore cause this advancing of the taxation of spread profits.

Changing accounting date

If a business changes its accounting date to either 31 March or 5 April, it will avoid the problems of (on an ongoing basis) having to apportion two different sets of accounts' figures when submitting its tax returns.

Under the existing current year basis rules, if an accounting date is to be changed from (say) 30 November to 31 March, this could be effected by preparing:

- a long period of account for the sixteen-month period; or
 - two separate sets of accounts, for year-ended 30 November and the four months to 31 March.
- As the former option would then (for tax purposes) involve time-apportioning the 16-month period's profits after capital allowances into 12-month and 4-month periods, these two methods produce rather different results. There would be no time-apportioning if separate accounting periods are chosen and capital expenditure would be allocated to the period in which it is incurred.

A practical example will hopefully help to clarify these complicated rules.



Example – Heidi

Heidi is a self-employed electrician and keen sailor. Her annual profits before capital allowances are £59,000, which accrue at a rate of £2,000 per month from April to August (when she spends a lot of time on the water) and £7,000 per month for the other seven months of the year. Her annual profits are therefore £59,000 [(5 x £2,000) + (7 x £7,000)]. She has negligible other income.

She has a December year-end and in the transition year to the new basis of assessment (2023/24) decides to change her accounting date to 31 March (which the new rules allow to be treated as a 5th April year-end).

She has £3,000 of overlap profits being carried forward from commencement of trade.

The options

1. Two separate accounting periods

If she makes up two separate sets of accounts, her results will be:

- y/e 31 December 2023: £59,000;
- 3m to 31 March 2024: [(3 x £7,000) - £3,000] = £18,000.

The latter are 'transition profits', which count as income for neither PA abatement nor HICBC purposes. They are subject to automatic spreading over 5 years, starting in 2023/24, so that only £3,600 will be taxable in 2023/24, in addition to the £59,000 from the standard basis period.

Suppose she spends £15,000 on a new van (to be used solely for business purposes) during the 15 months and claims annual investment allowance (AIA), which gives immediate 100% tax relief for the expenditure. If the van is bought in the 12-month period, the standard basis period profits will reduce to £44,000. She may therefore want to elect out of the full spreading, to bring more transition profits into charge and use up her basic rate band. (Higher rate tax kicks in at income above £50,270). The AIA will also save her being subject to the HICBC if she has any qualifying children.

If instead the van is purchased in the 3 months to 31 March 2024, the AIA will reduce the transition profits to £3,000 and the standard basis period profits will be unaffected (i.e. still £59,000). Thus, she will have reduced the profits that are being spread, so it is clearly beneficial to buy the van in the preceding 12-month period.

2. One long period of account

What would happen if, instead, she changed her accounting date by making up a 15-month set of accounts to 31 March 2024? In this situation, the profits after capital allowances are time-apportioned to get a split of the standard basis period profits and the transition profits. The profits after capital allowances (£59,000 + £21,000 - £15,000 = £65,000) are therefore split as follows:

- Standard basis period: £65,000 x 365/456 days = £52,028
- Transition basis period: £65,000 x 91/456 days = £12,972.

The overlap profits are deducted from the transition basis period to give transition profits of £9,972, which will be spread over 5 years. Thus, her assessable profits for 2023/24 will be £52,028 plus £1,994 = £54,022. She remains a higher rate taxpayer (despite her purchase of the van) and may be subject to the HICBC, based on her income of £52,028.

Further points on changing accounting date

1. A set of accounts exceeding eighteen months is ineffective for change of accounting date purposes. This means, for example, that someone wishing to change their accounting date from 30 June to 5 April will not have the same choice as Heidi in the above example, as a long period of account would be greater than 18 months in length. Such a trader would need to prepare two separate sets of accounts.
2. In most cases, it will be beneficial to change accounting date in tax year 2023/24, so that the extra profits brought into charge will be 'transition profits' and therefore subject to spreading. If the change is effected in 2022/23, any additional profits would be fully taxable in that year, as spreading is only available for the transitional year to the new regime (2023/24). In some circumstances though, it may be beneficial to make the change in 2022/23, for example if profits would otherwise be unusually low for that year under the current year basis rules.

Estimated figures

Currently, where estimated figures have been used in a tax return, businesses must make amendments to provide final figures 'without delay' once the appropriate information is available. If the figures originally used were the 'best estimate' that could be made at the time, no penalties will be due if the final tax payable turns out to be higher than originally estimated (although interest will be incurred on that extra tax).

This 'without delay' condition will be relaxed from the start of the basis period transition year in 2023/24. This follows a consultation last year that looked at ways of easing the administrative burden of having to use estimated figures each year and then subsequently make amendments.

Businesses will be allowed to amend provisional figures within the normal time limits for making amendments. This new rule will effectively allow businesses and agents to amend estimated figures at the same time as filing the following year's tax return of the business. Although this easement is welcome, it will be much simpler (and less of a compliance burden) if a business changes its accounting date to tie in with a tax year, as this should alleviate the whole problem of using estimates.

Partners in professional firms



If you are a partner in a large professional firm (for example of lawyers, accountants or architects), you will not yourself be able to change accounting date, as such decisions

will be for the firm to make at partnership level. Such firms may well decide to stick with their existing year-end (which is often 31 December, particularly if the firm trades internationally), so ongoing apportionments of your personal share of the profits will remain likely.

Overlap profits

Overlap profits may have arisen on commencements of trade or, for very old businesses, when they transitioned to the current year basis of assessment in the 1990s. These profits will be set off when calculating profits for the transition year (2023/24) or if changing accounting date for tax year 2022/23. Where a taxpayer or agent does not have a record of overlap profits, HMRC can provide details on request, if these figures are recorded in HMRC systems.

HMRC is launching an online tool on 29 August 2023 that will allow businesses and their agents to request details of overlap profits, where that data is held by HMRC. An online form will be available, with submissions processed by a dedicated team in HMRC, who will then respond by email.

Some final thoughts

We have not tried to cover every single aspect of these far-reaching changes in this document (for example, there are special rules if you make a loss in the transition year due to the deduction of overlap profit), but hopefully we have shown you how complex the changes are and that there may be many things to discuss with us. Although the transition year (2023/24) has started, there are plenty of areas where planning can still minimise tax bills (e.g. timing of capital expenditure), minimise compliance time (e.g. changing accounting date) or improve cash flow. The latter could be achieved by, where possible, having profits arise in the transition basis period of 2024/25 rather than the normal basis period for that year, so that they can be spread over five years.

Here is a short checklist of key points:

1. Make sure you understand what these changes might mean for you in practice and let us agree on any steps that need to be taken.
2. Budget for the extra tax that will arise in 2023-24 and the four subsequent years while transition profits are being spread.
3. Recognise that, especially where your accounting period ends early in the tax year, there will be an ongoing cashflow impact from having to pay tax closer in time to when profits are being earned.
4. Moving to a 31 March or 5 April accounting year-end should be considered where possible, as a way of reducing the ongoing administrative burden that will arise from having to
 - apportion and (potentially) estimate profits; and
 - file amended returns
5. If you are going to change your accounting date, we need to check whether it is best to do so for 2022/23 or 2023/24; as we have discussed, the latter will usually be more beneficial.

As we said earlier, we are here to help you navigate these major changes in how and when your business profits are assessed to tax.