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BASIS PERIOD RULES IN LINE FOR REFORM?

Unincorporated businesses could be about to see significant changes to the way in which they are taxed, following the launch of a Government consultation. The Government plans to reform the basis period rules in a bid to simplify how unincorporated businesses, such as sole traders and partnerships, allocate trading profits to tax years for inclusion on their self-assessment returns. It aims to streamline the system before Making Tax Digital (MTD) for income tax becomes mandatory from April 2023 for these small businesses and align the way self-employed income is taxed with other forms of income, such as property income.

Unincorporated businesses are currently taxed on the profits of their accounting period ending in the tax year, whereas under the new proposals they would be taxed on the profits arising in the tax year. This change would have no impact on a business whose accounting period ends on 31 March or 5 April but could have considerable impact for those with an accounting year-end of, for example, 30 April. According to HM Revenue & Customs (HMRC), 7% of sole traders and 33% of trading business partnerships do not draw up accounts to the tax year or to 31 March, indicating business partnerships are more likely to be affected. Should the reform get the green light, the changes could kick in from April 2022, with 2022/23 being a transitional year and the reformed rules applying from 2023/24.

What are basis periods?

After the first year or two of running your own business, your basis period will be the 12-month period you use for your accounts (known as an accounting period). Most unincorporated businesses in the UK use either 31 March or 5 April as their accounting period end date and are therefore assessed for income tax based on the tax year. Where a different accounting period end date is used which does not align with the tax year-end, the basis period rules are applied to determine in which tax year the profits are taxed. In these circumstances, the profits are taxed in the tax year in which the accounting period ended. For example, if your business's most recent year-end was 31 December 2020, you will pay income tax on any profits made in the year ended 31 December 2020 on your 2020/21 self-assessment Tax Return, because your accounting period end date fell in the 2020/21 tax year.

How might the new rules work in future?

If the proposals get the go-ahead, tax will be assessed by reference to the trading profits of the tax year itself, from 6 April 2023 to 5 April 2024 onwards. Due to the proposed transition between the old and new rules, some businesses will find themselves being assessed for tax on a period greater than 12 months for the 2022/23 tax year. Businesses with a 30 April year-end could be particularly hit in 2022/23 as they may have to report profits for the period from 1 May 2021 to 5 April 2023 in that year – almost two years of trading profit. Where the business has overlap relief arising from earlier periods (often when it started to trade), that overlap relief can be offset against profits in 2022/23 to reduce the taxable profit in that tax year to help lessen the impact.

It is also planned that transitional relief would be available to spread the extra income falling in 2022/23 over the five tax years up to and including 2026/27, but that could potentially push people into higher tax bands for those years and carry a risk of tax and National Insurance rates increasing during this period as well.

Accounting periods

Under the proposed plans, unincorporated businesses will still be able to draw up accounts to any accounting date that suits them, although an apportionment of profit or loss from different periods of account might then be needed to fit to the tax year of assessment. For example, a partnership with an accounting period ending on 31 December would have to prepare accounts for the two years ended 31 December 2026 in order to file the partnership tax return for 2025/26. That tax return would need to be filed by 31 January 2027, giving the partnership just one month to either finalise the profit figures for 2026 or provide estimates for the tax return. In practice, businesses might find it easier to change their accounting periods to align with the tax year.

Making Tax Digital fuels change

With MTD for income tax set to commence from April 2023, HMRC wants to align the reporting of accounting data exactly with the tax year. HMRC deems accounting periods ending on dates between 31 March to 4 April as finishing on the standard tax year-end of 5 April. Businesses which already draw up accounts to 31 March or 5 April would therefore see no practical difference from 2022/23 onwards.

Without this change to reporting periods, taxpayers with several sources of income would need to file MTD reports for differing quarterly periods in the tax year, leading to up to 13 MTD filings a year. Under the tax-year basis, it is envisaged that self-employed taxpayers will file MTD reports for all their sources of income by the same dates each quarter, with filing deadlines on 5 May, 5 August, 5 November and 5 February for quarters ending the month before. They will still need to file an end-of-period statement on or before 31 January each year.

The estimated tax liabilities, based on those quarterly MTD reports, should make more sense to taxpayers, as the income reported in the quarter will be what drives the tax due for the year. HMRC has also recently consulted on accelerating tax payment dates for both companies and unincorporated businesses.

What happens next?

The consultation closed on 31 August 2021 and the Government has said it will update draft legislation if it receives any changes or additions as a result. Our professional bodies, the ICAEW and the Chartered Institute of Taxation, together with others, have voiced strong opposition to the proposals. They suggest that the planned changes should be dropped as they will put significant pressure on taxpayers, agents and HMRC itself. They also make the point that, as the UK attempts to recover from the pandemic, the one thing businesses need most of all is a period of certainty and stability, which is arguably at risk if the proposals go ahead.

It remains to be seen whether the Government's proposals will be given the green light so watch this space!

The above is for general guidance only and no action should be taken without obtaining specific advice.

Bath
37 Great Pulteney Street
Bath
BA2 4DA
+44 (0)1225 460491

Chippenham
67 & 68 St Mary Street
Chippenham, Wiltshire
SN15 3JF
+44 (0)1249 444666

Trowbridge
5 Wicker Hill
Trowbridge, Wiltshire
BA14 8JS
+44 (0)1225 764441