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What a difference a year (end) can make...

The past 18 months have seen unprecedented changes around the world which have forced us to change how we go about our daily lives.

Although less dramatic, changes are also afoot from a taxation perspective for sole traders and partnerships. Last month, the Government published a consultation document seeking comments on its proposals.

Background

Historically, each sole trader or partnership has chosen the year end, or 'basis period', for their business based on their specific circumstances. Some may have chosen a basis period which does not coincide with the tax year end for business motives. This is often the case for farmers who may have a year end to correspond with the conclusion of harvest. Others may have sought to delay the timing of their first tax payment for cash flow purposes and, as such, have chosen a 30 April year end.

Subject to the complicated rules involving the early years of trade and changes to the basis period, for tax purposes the profits/losses arising in a particular basis period are taxed in the tax year in which the accounting year end falls.

For example, if the year end is 30 September 2020, currently the trade's results will be taxed in the tax year ending 5 April 2021.

Due to the rules involving earlier years, any year end which does not fall in line with the end of the tax year, 5 April or 31 March, may have had profits taxed twice. These are known as overlap profits and relief can only be obtained for the double taxation when the business ceases or a change of year end occurs.

Proposal

The Government has announced plans to make changes with regards to the basis period taxable in the tax year before MTD (Making Tax Digital) becomes mandatory. Rather than taxing the profits to the business' year end, it is proposed, with effect from tax year 2022/23 (the transitional year), that sole traders and partnerships will be taxed on a tax year basis (either to 5 April or 31 March) and any overlap profits brought forward will crystallise.

For a sole trader with a year end of 30 September 2022, under the current rules, the profits for that year will be taxed in the tax year ending 5 April 2023. Under the proposed changes and for the transitional year, the profits for the year ended 5 April 2023 will comprise the full year's results for the year ending 30 September 2022, plus a proportion of the next year's results for the six-month period 1 October 2022 to 31 March/5 April 2023, less any overlap relief brought forward.



It is recognised that the overall profit calculated for this transitional year will be higher than if the rules remained unchanged. Therefore, the Government intends to offer a facility to spread the transitional period profits over 5 tax years beginning with the transitional year.

Transitional profits are those taxable profits which exceed the profits which would have been assessed under the existing rules. An amount equal to 20% of the transitional profits is treated as arising in each of the tax years.

Example – Tax year 2022/23

Year end 30 September 2022 – taxable profit £50,000

Overlap relief brought forward £4,000

Before changes

£50,000 chargeable to tax in the year ended 5 April 2023

Overlap relief carried forward £4,000

After changes

Year end 30 September 2022 – taxable profit £50,000

Plus the transitional profits:

Year end 30 September 2023 – taxable profit £75,000

Adjusted profit for transitional period of six months from 1 October 2022 to 5 April 2023

$£75,000 \times 6/12 = £37,500$

Adjusted profit for the year ended 5 April 2023

$£50,000 + £37,500 = £87,500$

Less overlap brought forward £4,000

Actual taxable profit without the 5 year adjustment £83,500

Alternatively the transitional profits can be spread for 5 years from the transitional year (£37,500 reduced by overlap relief of £4,000) $£33,500 \times 20\% = £6,700$ each tax year.

Therefore, the revised adjusted profit for the year ended 5 April 2023 will be £56,700; with the subsequent 4 years' profits increased by £6,700.

Beyond 6 April 2023, the basic calculation of taxable profits each year will comprise:

6/12ths of the profits to 30 September within the tax year; plus

6/12ths of the following year's profits to 30 September; plus

Any adjustment for the transitional year.



Summary

The detailed rules will not be available until the Government has considered the responses to the consultation; and there is general concern that, once the legislation is in place, there will be insufficient time to implement these changes. However, it is clear the Government is determined to bring as many businesses as possible within the Making Tax Digital regime from 2023. Therefore, it is prudent to consider the possible implications of these changes and the impact they may have on your business as early as possible.

This document is intended as a general guide and although Chavereys have made every effort to ensure accuracy, they cannot accept liability for any errors of fact or opinion.

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