BUSINESS & PERSONAL TAX SUPPORT

Self-Employed Changes to Basis Period Rules

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In preparation for the introduction of Making Tax Digital for Income Tax Self-Assessment (MTD for ITSA) the basis period rules for unincorporated businesses are being abolished. Instead, unincorporated businesses will be assessed on the profits for the tax year. The new rules take effect from 2024/25, with 2023/24 being a transitional year.

This will affect you if you run an unincorporated business and you currently prepare your accounts to a date other than one between 31 March and 5 April inclusive.

What is a basis period?

Literally, a basis period for a self-employed person or partnership is the period of accounts that is taxed in a particular tax year.

For example, the basis period taxed in the tax year 2021-22 is the annual accounts ending between 6 April 2021 and 5 April 2022. This could be any 12-month period ending between those two dates.

The current basis period rules

Under the current rules, once an unincorporated business is established, the profits are taxed on a current year basis. This means that the profits that are taxed for any given tax year are the profits for the accounting period that ends in that tax year.

For example, if you have been running your business for many years and prepare your accounts to 31 December each year, for 2022/23, you will be taxed on the profits of your business for the year to 31 December 2022 – 31 December 2022 falls in the 2022/23 tax year. This is the case regardless of the fact that the period from 1 January 2022 to 5 April 2022 falls in the 2021/22 tax year.

Different rules apply in the opening and closing years.

Overlap profits

In the opening years of the business, some profits may be taxed twice. For example, if you started your business on 1 January 2017 and prepare your accounts to 31 December, you would be taxed on the profits for the period from 1 January 2017 to 5 April 2017 in 2016/17 (actual basis) and on the profits for the period from 1 January to 31 December 2017 in 2017/18 (first 12 months). The profits for the period from 1 January 2017 to 5 April 2017 are taxed twice. These are overlap profits.

Overlap profits may also arise if you change your accounting date.

A deduction for overlap profits is normally given on cessation but it may also be given if you change your accounting date.

New rules – the tax year basis

Under the proposed reforms, from 2024/25 you will be taxed on the profits of the tax year (i.e., for 2024/25, on the profits for the period from 6 April 2024 to 5 April 2025).

If you already prepare your accounts to 5 April, the position is simple as the period for which the accounts are prepared matches the tax year. Under the equivalence rule, accounts prepared to a date falling between 31 March and 4 April inclusive are also treated as corresponding with the tax year.

If you prepare your accounts to another date, you will need to undertake an apportionment calculation to find the profits to be taxed for the tax year. For example, if you prepare your accounts to 30 September each year, for 2024/25, the profits for the tax year will comprise 6/12$^{\text{ths}}$ of the profits for the year to 30 September 2024 and 6/12$^{\text{ths}}$ of the profits for the year to 30 September 2025.

Transitional year 2023/24

The 2023/24 tax year is a transitional year in which unincorporated business that do not already prepare accounts for the tax year will need to move to a tax year basis. If you have any overlap profits, relief for these profits will be given in 2023/24, but only if you move to a new accounting date. If you already prepare your accounts for the tax year, you cannot relieve your overlap profits in 2023/24.

The profits that would be assessed in the transition year where accounts are prepared to a date other than 31 March -- 5 April are to be found by adding together two components and deducting any overlap profits from the early years to give effect to any available overlap relief. The two components are:

- the standard component – this is the profit assessable for the 2023/24 tax year under the current year basis, and
- the transition component – this is the profit attributable to the period running from the end of the current year basis period to 5 April 2024 (the end of the 2023/24 tax year).

For example, if you prepare your accounts to 30 September each year, for 2023/24, you will be assessed on your profits for the year to 30 September 2023 (the profits assessable for 2023/24 under the current year basis), plus profits for the period from 1 October 2023 to 5 April 2024, less any overlap profits not already relieved.

The implications

Depending on the date to which you prepare your accounts and the extent of your overlap profits, if any, your profits for 2023/23 may be considerably higher than normal. The problem will be exacerbated if you prepare your accounts to a date early in the tax year. For example, if you prepare your accounts to 30 April, there will be an additional 11 months of profits in 2023/24, whereas if you prepare your accounts to 28 February, there will only be an additional month's profits to consider.

However, relief is available as the transition profits are taxed over a five-year period rather than in full in 2023/24.

Depending on when you started your business, your overlap profits may have been eroded by inflation. You may also have lost track of your overlap profits.

Spreading of transitional profits

If you need to change your accounting date to correspond with the tax year, the excess profits that are brought into charge in 2023/24 (the transition profits) will be spread over five years, starting with the 2023/24 tax year. This happens automatically.

However, you can elect for the spreading of profits not to apply and for them to be taxed in full in 2023/24.

If your business ceases before the transition profits have been taxed in full, any balance not yet brought into charge is taxed in the final year.

The spreading of transition profits may mean that you have higher than normal tax bills for the next five years.

Change your accounting date now?

You may also wish to consider changing your accounting date prior to the introduction of the reforms and so accelerate the preparation of accounts to a tax year basis.

Much will depend on your present profitability and your expected levels of profitability in the coming years.

We can help.

If you do not currently prepare your accounts on a tax year basis, we can help you understand what the changes to the basis period rules mean for your business. We can also help you prepare for the change.