Timing is everything

Rachael Brown outlines some of the implications of HMRC's decision to align all basis periods with the tax year

Big changes are on the horizon for self-employed clients with year ends that do not correlate with the tax year. The overarching intention is to simplify the process by aligning all basis periods with the tax year, which ends on 5 April each year.

As with most changes to the tax system, the transition period is far from simple and there is work to be done to help clients prepare for it.

Current year basis

Currently, a sole trader's and a partnership's basis periods are the 12 months to the accounting date ending in the tax year. For example, a sole trader with an accounting date of 30 April 2022 will be assessed on profits for the 12 months to 30 April 2022 in 2022/23. The self-assessment tax return is due by 31 January 2024 along with any balancing tax payment, giving the taxpayer a staggering 21 months to report the earnings to HMRC.

There are of course different rules for the opening and closing years of the business, and in some cases overlap profits, whereby profits from the same accounting period are taxed twice, may arise.

Tax year basis – from 2024/25

From 6 April 2024, all businesses will need to report profits on a tax year basis. This means that regardless of the date on the accounts, time apportioned profits for the tax year will be assessed in that tax year. Note that for these purposes, a 31 March year end is accepted as fulfilling the tax year requirement regardless of the missing five days.

Continuing with the same example, to find the profits assessable in 2024/25, profits would need to be apportioned by taking one month from the accounts for the year to 30 April 2024 and 11 months from the year to 30 April 2025. At face value, it appears to be straightforward; however, this does mean taxpayers will need to wait for the 2025 accounts to be finalised before they have the full picture for the 2024/25 tax year.

In practice, this could mean that a business with a 28 February 2025 year end, for example, may be required to estimate figures. Such an example would require one month of the following year's accounting period, ending in February 2026, to be added, even though this will not close until after the filing date of 31 January 2026.

Making Tax Digital (MTD)

It is expected that the basis period reforms will help with the new quarterly reporting required under MTD. Here, sole traders and landlords with turnover exceeding £10,000 will be within MTD from April 2024 and will be required to report their trading and rental income profits on a simplified basis to HMRC. For these clients, figures will be available for each quarter, so the apportionment will hopefully be less of an issue.

However, general partnerships will not be within MTD until April 2025 and are more likely to resist changes to the accounting date so the timeline for these clients will need to be carefully managed.

LLPs and partnerships with a corporate member do not yet have an MTD start date, so it is particularly important to bring these changes to their attention as soon as possible. Where there is a corporate member, the LLP may have been set up with the same accounting date as the corporate and changing the date may not be commercially viable.

Transition 2023/24

The 2023/24 tax year is the transition year, and special rules apply to bring all basis periods in line with the tax year.

The basis period for the year will be the 12 months from the end of the basis period from 2022/ 2023, plus a transition component to 5 April 2024. Any overlap profits will be relieved in full in 2023/24. If there is excess overlap relief arising in the transition year, the time period for these losses to be carried-back is extended from one to three years.

Clients with a 30 April year end will therefore have just shy of two years profits taxed in 2023/24. There could be a significant cashflow issue if profits for the transition component exceeds any overlap relief.

Spreading

Taxing up to two years of profits in a single tax year creates other unwelcome consequences, for example, a client's income could be so high that they lose their personal allowance, breach the threshold for the high-income child benefit charge or even see their pension annual allowances tapered.

To counteract this, profits for the transition period will automatically be spread over five years and will not count as the client's income for the purposes of means tested benefits and reliefs. Unfortunately, the impact on the personal allowance remains if one fifth of the transition component pushes their income over £100,000.

Clients can however elect out of spreading and accelerate the tax charge to the 2023/24 tax year. This could be beneficial to clients with losses, or lower profits because of the pandemic.

Advice will need to be given on an individual basis, which will be particularly time consuming for large partnerships, with each partner having different amounts of overlap relief.

Solutions

One potential solution is to assess projected profits and cash requirements now and consider changing the accounting date to 31 March or 5 April ahead of the changes. Some clients may welcome the early use of overlap relief whilst others will be counting on the spreading provisions to manage their cash.

For those clients that don't want to change their accounting date, additional fees and new deadlines for the work may need to be agreed.

Finally, this is a great opportunity to consider incorporation. Companies are not affected by basis period reform and do not have an MTD start date yet. Add to that the ability to decide how and when income is extracted, and this route puts the client back in control of their tax affairs.

At Claritas, we are often advising clients on incorporation and helping them decide on the best long term tax strategy. Now is the perfect time to consider whether the structure of the business is still fit for purpose, keeping in mind the upcoming changes and any plans for retirement and succession.

Summing up

HMRC's policy paper states that the changes will make the income tax system more responsive, giving effect to changes in rates and rules sooner for self-employed people. It will certainly simplify the taxation of new businesses and ease the cashflow position now that overlap profits won't be created.

However, with the cost-of-living crisis, it is arguably not the right time to change the fundamental way in which established businesses and partnerships are taxed. At a minimum, clients will see their accountancy fees increase and advisers need to find sufficient resource for the double whammy of the transition year and the introduction of MTD.

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