HMRC Basis Period Reform

You may have heard recently that HMRC have announced plans to reform Income Tax Basis Periods as part of the tax simplification process, alongside introducing Making Tax Digital for Income Tax Self-Assessment. The basis period reform is now in the process of being mandated by the 2021-22 Finance Bill and the change to a tax year basis for sole traders & landlords from April 2024 and for partnerships from April 2025 is also planned.

What is Basis Period Reform?

Currently an individual or unincorporated business can draw up accounts to their annual accounting year end date, e.g. 30 June, 31 October, etc and they will be taxed on the profit made in this 12 month 'basis period' on their tax return. If accounts are made up to an accounting date which is not in line with the tax year this will usually result in profits being taxed twice at the start of the trade resulting in overlap relief arising. Overlap relief is then utilised when the business ceases trading.

Under the basis period reform HMRC plan to have every individual/unincorporated business taxed on the 12 month period to 31 March/5 April and therefore taxed in line with the tax year.

HMRC aim to have the tax year basis implemented fully by the 2024/25 tax year, with individuals making the transition to this basis in the 2023/24 tax year. Partnerships will make the transition in the following year.

For those who currently draw up their accounts to 31 March/5 April no change will be required. However, for those that do not currently draw up their accounts in line with the tax year currently there is potential for some high tax bills to be incurred when making the transition. This may require some tax planning to ensure potential liabilities can be quantified and mitigated where possible. HMRC are proposing to allow the profit from the transitional part of the accounting period to be spread over 5 years.

The following example from HMRC highlights how the transition would work.

HMRC Example:

A sole trader draws up their accounts to 30 April. Their profits for the year ended 30 April 2023 are £55,000, and for the year ended 30 April 2024 £66,000. They have overlap profits brought forward of £20,000.

The profits for the tax year 2023/24 are as follows:

- Current year basis element – year ended 30 April 2023 – £55,000
- Plus transitional element – 1 May 2022 to 5 April 2024 – £66,000 x 11/12 = £60,500
- Less overlap profits (£20,000)
- Total profits for tax year 2023/24 = £95,500

These profits exceed the profits under the current year basis by £40,500 (i.e. the transitional element less overlap profits). The sole trader can therefore elect to spread the excess over up to 5 years.

The minimum amount per year to be added is £40,500 / 5 = £8,100. Under this election, assuming the sole trader chooses to add the minimum amount, the profits for the tax year 2023/24 are reduced to £55,000 + £8,100 = £63,100.

A minimum adjustment of £8,100 per year will be required to the profits of each of the tax years from 2024/25 onwards (until 2027/28 at the latest) until the £40,500 is extinguished.

The example above demonstrates that there is potential for higher liabilities to arise as a result of the transition period. It should be noted that NIC will also potentially be due on the higher profits. **Depending on profit levels the transition may also push some taxpayers into a higher rate tax band resulting in even more tax due and at higher rates.**

As highlighted above there could be a significant impact on tax liabilities for some individuals and planning will be required to help mitigate the potential impact of the basis period reform. If you think this may affect you and wish to discuss this further, please contact Thomson Cooper at info@thomsoncooper.com or call 01383 628800.