Basis period reform: transitional rules apply from 6 April 2023

Management of taxes | OMB



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Basis periods for income tax purposes are to be replaced the ‘tax year basis’, with transitional rules applying from 6 April 2023. We examine what this means in practice and how you can prepare.

Key Points

What is the issue?

Basis period reform involves the replacement of basis periods with the ‘tax year basis’ from 6 April 2024.

What does it mean for me?

Where accounts are not co-terminous with the tax year, time-apportionments from two accounting periods will be required every year. This shortens the window to

finalise profits by up to 12 months, which may result in provisional tax returns that require later amendments.

What can I take away?

Aligning accounting periods to the tax year may avoid much of the complexity, provided the taxpayer can finalise their tax compliance by the filing deadline. If this is not appropriate, preparations should be made for the additional administrative burdens.

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The government announced in the Autumn Budget 2021 that basis periods for income tax purposes (the ‘current year basis’) would be abolished from 6 April 2024 and replaced with the ‘tax year basis’. Broadly, the intention is to tax profits that are time-apportioned to the tax year instead of the profits for the 12 months to the accounting date in the tax year. The announcement was made after a brief consultation in the summer of 2021. Transitional rules will apply in 2023/24. The changes were enacted in Finance Act 2022 Schedule 1.

Traders with accounting periods that are already aligned to the tax year will generally not be affected by the changes. The legislation includes provisions to treat accounting periods ending between 31 March and 4 April as aligned to the tax year. According to HMRC’s statistics, 93% of sole traders and 67% of partnerships already have accounting periods aligned to the tax year, and it anticipates that many businesses will change their year ends to avoid the need to time-apportion profits.

In its consultation, HMRC stated that these reforms were intended to simplify the taxation of trading profits and the implementation of Making Tax Digital for Income Tax (MTD). It also wished to remove the tax deferral that can arise under the current year basis.

Is the abolition of the current year basis a simplification?

Although there is some complexity in the current year basis, this is limited to the opening and closing year rules and changes of accounting date. In most tax years of a business’s existence, the current year basis is extremely simple. It is encapsulated in a single sentence of legislation reading: ‘The general rule is that the basis period

for a tax year is the period of 12 months ending with the accounting date in that tax year' (Income Tax (Trading and Other Income) Act 2005 s 198). In most years, it is therefore only necessary to consider a single accounting period, which has already completed before the tax return is due.

The practical difficulties that arise on the current year basis usually relate to commencement rules where the accounting date is not aligned to the tax year. For example, if the individual started trading on 1 January 2023 and drew their first set of accounts to 31 December 2023, they need to include 95/365ths of the 2023 profit on the 2022/23 tax return, which is due only a month after the accounting period ends. In many of these cases, the 2022/23 tax return would need to be filed on a provisional basis and then amended when the 2023 profit has been finalised. Under the tax year basis, the commencement tax year issue is unchanged. Unlike the current year basis, however, the tax year basis will cause this problem to recur in every subsequent tax year.

Another important feature of the current year basis is that the potential complexity could be avoided by aligning accounting periods to the tax year. The reforms do not simplify the affairs of traders whose accounting periods already align with the tax year, but they do complicate the affairs of others.

The interaction with MTD also does not appear to have been considered fully. Under MTD, quarterly reports of receipts and expenses will need to be filed, with these figures supposedly driving the profit figure for the year. The reports for the 2026/27 tax year will cover the transactions in the year to 31 March 2027 or 5 April 2027, but this will not match the profits for 2026/27 unless the accounting period is aligned to the tax year. For example, if the trader has a 31 December year end, a one-off expense in October 2027 will affect the 2027 profit, 95/365ths of which is taxable in 2026/27. That expense will not feature in the MTD records for the 2026/27 tax year.

In addition to the intrinsic complications of the tax year basis, the transitional rules may be complex in some cases, particularly where there are creditable foreign taxes.

Transitional rules in 2023/24

Trading profits

In 2023/24, traders will normally have a basis period that runs from the day after the 2022/23 basis period ends until 5 April 2024. The first 12 months of the basis period is the ‘standard part’. If the standard part ends before 31 March 2024, the remainder of the basis period is the ‘transition part’. For example, if the trader draws up their accounts to 31 December every year, the standard part will normally be the year to 31 December 2023 and the transition part will run from 1 January to 5 April 2024.

‘Transition profits’ will be based on the profits of the transition part, on a time-apportionment basis, less any unused overlap profits. If there is excess overlap, it is set against the profits of the standard part. If transition profits are greater than zero, they are spread equally over the five tax years from 2023/24 to 2027/28 but the trader can make an election to accelerate all or part of them. On a partial acceleration, the remaining transition profits are spread evenly over the remaining tax years. In the tax year that the trade ceases, any untaxed transition profits will be taxed.

Transition profits are subject to special treatment in the income tax computation to prevent certain anomalies (Finance Act 2022 Sch 1 Para 75). The transition profits are deemed to be excluded from net income, but a standalone charge is added at Step 5 of the income tax computation based on the additional tax that would have arisen had the profits not been so excluded. This is effective for certain purposes, such as high income child benefit charge, pension taper and entitlement to tax-free childcare, which are all affected by the level of net income. It is not effective for the personal allowance taper, however, as any profits that would have suffered an effective 60% tax rate will have a notional effective 60% tax charge added at Step 5.

Non-trading income of a trading partnership (‘notional business’)

Similar transitional rules also apply to a partner’s ‘notional business’ (e.g. where untaxed interest is attributed to partners). Income up to 5 April 2024 is brought into charge and overlap for the notional business is deducted in full. The income is taxed in full in 2023/24 without spreading provisions or special computational rules.

Foreign tax credits

Where foreign tax is suffered on overlap profits, the same foreign tax may be relieved in both of the tax years when the profits were taxed (double tax relief overlap). Where overlap relief is given on profits, double tax relief overlap

crystallises in a similar way, reducing the foreign tax credit or creating a charge (Taxation (International and Other Provisions) Act 2010 ss 22-24). Double tax relief overlap will crystallise in full in 2023/24 under the transitional rules.

In addition to the overlap considerations, foreign taxes may also complicate the treatment of the transition profits. If we assume in the example of ***Michael's trading profits*** above that £54,900 of Michael's 2024 profits were foreign sourced and suffered foreign tax of £21,960 (40%), we need to consider when these profits are being taxed. Only 20% of 96/366ths of the profits are being recognised in 2023/24 (£2,880), so it appears that we should recognise the same proportion of the foreign tax (£1,152). The remaining foreign tax should be relieved when the transition profits are taxed in subsequent years. The calculation would be complicated further if he is crystallising double tax relief overlap.

Example: Michael's trading profits

Michael always draws his accounts to 31 December. His profits are as follows:

- Year to 31 December 2023: £98,500
- Year to 31 December 2024: £109,800
- Overlap profits brought forward: £7,600

Michael's transition part runs from 1 January to 5 April 2024. His transition profits are calculated as follows:

Profits from 1 January to 5 April 2024 (£109,800 x 96/366)	£28,800
Less overlap relief	(£7,600)
Transition profits	£21,200
Transition profits taxed in 2023/24 (20%)	£4,240

Unless Michael chooses to accelerate any transition profits, £4,240 will be added to the standard part profits of £98,500 to arrive at his total trading profits of £102,740 for 2023/24.

Partnerships

The issues facing smaller domestic trading partnerships are likely to be very similar to sole traders. However, basis period reform presents a number of additional challenges for larger and/or international partnerships in terms of tax compliance obligations, international aspects and, in some instances, cashflow.

Many of the large and/or international firms have a year end date early in the tax year (e.g. 30 April), as this affords them up to 21 months to complete their partnership tax return and calculate their double tax relief claims. Basis Period Reform shortens this period to just nine months (for a 30 April year end) during which the accounts may need to be audited, a process which itself can often take six to nine months.

As a result, it is unlikely that many of the larger firms will be able to finalise their tax computations by the filing deadline. Further, non-UK taxes may not be known by the filing deadline of the partners' returns. The use of provisional figures and estimated double tax relief claims, and the associated uncertainty and administrative burden, is inevitable for many large international firms.

For those firms with non-UK partners in receipt of UK sourced income, there is a question on how their local tax authorities will seek to tax the transition profits which are spread over five years, and a further question on how local tax authorities will give credit for UK taxes paid on transition profits.

Large, and particularly international, firms withhold estimates of UK and non-UK taxes ('tax reserves') from their distributions of profits to their partners and pay the taxes over to the relevant authorities. This is for administrative convenience, but it also forms a valuable source of working capital for the firm owing to the delay between profits being earned/distributed and being paid to tax authorities.

Basis period reform accelerates UK tax payments, in turn diminishing firms' tax reserve balances which may result in firms needing to find alternative sources of financing.

What is HMRC doing to help?

HMRC circulated a technical paper in April 2022 suggesting possible ways to alleviate the administrative burden of filing provisional returns and amending them later.

It confirmed in December 2022 that the only easement it would be taking forward was to allow the amendments to be made at the same time as the filing of the subsequent year's tax return rather than 'without delay'.

Based on experience of dealing with new partners on the current year basis, this is not expected to make an appreciable difference to international partnerships. This is because the partnership tax return and foreign tax figures tend to become available so late in the subsequent filing season that it is not possible for an unreasonable delay to arise.

HMRC has also indicated that it will help taxpayers and agents to reconstruct overlap profits if necessary, based on historical profits reported. As all taxpayers' overlap relief will crystallise in or before 2023/24, HMRC could potentially have to deal with a high volume of queries. It is currently unclear whether it will also be able to assist with double tax relief overlap, which is more difficult to identify if the only source material is self assessment returns.

Should traders be changing their year ends to 31 March?

The answer will depend on what a trader is aiming to achieve by changing their year end date and indeed whether they can change their year end date. The advantage of a 31 March year end date is that it gives the most amount of time (10 months) between the year end date and the filing deadline. It also makes for more straightforward filings (no pro-rating of accounting periods) and will very likely fit best with MTD.

However, there are some traders (such as large/international partnerships) that will not be able to finalise the tax computation and DTR claims even with the maximum 10 months preparation time. For these firms, it is questionable whether the effort which would be expended in changing the year end would be worth the limited benefits.

There will be some traders, for example seasonal traders, where a 31 March year end date could be disruptive over summer months, their busiest time of the year. There will be some traders who cannot change their year end as they are part of a

wider group which is required to report to a certain year end date (e.g. many US headed firms have to report to 31 December).

What does the future look like?

Although the tax year basis seems simple on the surface and is undoubtedly easier to explain to the uninitiated, it is likely to create complexity in the future for traders who cannot align their accounting periods to the tax year. Whereas the current year basis gave finality at an early stage, the tax year basis will force affected traders to file provisional returns year after year. As well as the extra administrative burden of estimating profits and amending them later, it may have a knock-on effect on other issues such as pension tax charges and loss reliefs. It may also expose traders to interest charges if there is a discrepancy.

It remains to be seen how MTD will be adapted to deal with traders whose accounting periods are not aligned to the tax year. The current year basis did present some challenges, due to different traders having different accounting quarters, but these seem to have been replaced with an even trickier problem. MTD will give a summary of receipts and expenses arising in a tax year, but this does not translate into taxable profit, which will be based on time-apportioned profits from two accounting periods. Reconciliation of the data will be particularly difficult if the accounting period does not end on a tax year quarter (e.g. 30 April).

One option for genuine simplification of the trading income rules could have been taken, but so far has not been. Had the current year basis been retained on an opt-in basis, with the tax year basis being the default method, this would have simplified compliance for those who struggle with overlap relief without creating complexity for those who don’t.