Tomorrow's practice -

the impact of basis period reform and MTD for income tax

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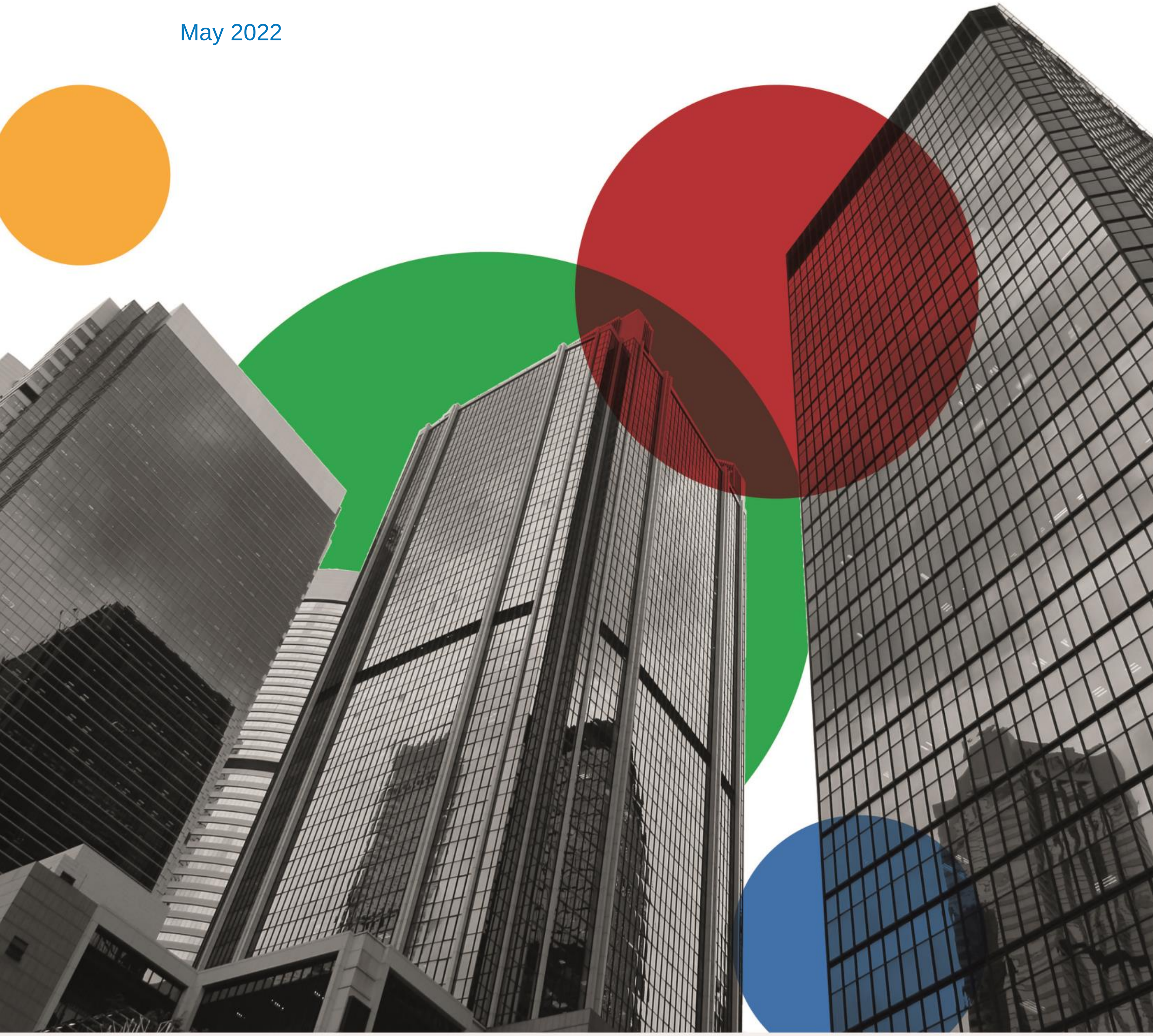


Tomorrow's practice – the impact of basis period reform and MTD for income tax

Change is on the horizon for unincorporated businesses. Basis period reform and Making Tax Digital for income tax (MTD ITSA) are the biggest changes to income tax administration since the roll out of self assessment in 1996. What is the impact and how can firms prepare?

What's changing?

There are two distinct changes being made:

- Basis period reform – moving from the current year to the tax year basis of assessment – which applies to all unincorporated business; and
- MTD ITSA, which will be phased in from April 2024 where trading/property gross income is over £10,000. On the current announced timetable, MTD ITSA will apply to sole traders from April 2024, and be extended to general partnerships from April 2025.

The detailed legislation for basis period reform is already in place and can be found in the Finance Act 2022, section 7 and schedule 1 (abolition of basis periods) and section 8 (profits of property businesses late accounting date rules).

There are also changes to Income Tax (Trading and Other Income) Act 2005. There are new rules on basis periods and equivalence in sections 7A – 7D, and section 31A cash basis rules are modified too. Section 275 covers apportionment of profits to tax year and new sections 275A to 275C. Income Tax Act 2007 is also affected, especially as regards to the order of set off for losses etc in the transition year.

These rules provide for a new relief, spreading relief, which reduces the impact of potentially higher tax bills by enabling profits of the transition period to be spread over five years. The rules also provide for 31 March year ends to be treated as 5 April for tax assessments. The rules cover both trading and property income.

MTD ITSA will introduce quarterly reporting and the requirement for digital accounting records. The basic legislation for Making Tax Digital for Income Tax has been in place since 2017. Detailed rules on the format of quarterly submissions and records for MTD ITSA are expected this summer.

Expected impact of basis period reform

Basis period reform is an opportunity for firms to engage with their small business clients. It undoubtedly will result in some additional advisory and tax planning opportunities. It will be important for practices to explain the value of the additional work rather than a necessary compliance service.

Basis period reform impacts all unincorporated business which don't have a 31 March/5 April accounting year end. The impact will be particularly significant for businesses with a year end early in the tax year. The impact is both administrative, affecting timescale for preparation of accounts and submission of return, and financial, as tax will be payable nearer to real-time.

Businesses with year ends early in the tax year, such as 30 April or 30 June, have been taxed significantly in arrears.

For example, trading income earned in say, May 2021, with a 30 April year end, would not be reported until the 2022-23 tax year (based on accounts to 30 April 2022), with the final tax payment by 31 January 2024. Payments on account would be due in the interim, but there would still be significant earnings on which no tax liability had been calculated or paid.

By moving to a tax year basis, where the tax bill for the tax year is based on the profits earned in the tax year, this slack is taken out of the system. The transition from current year to tax year basis of assessment happens in 2023-24. Many businesses will face higher tax bills in the year of transition.

The policy paper published alongside the Autumn Budget 2021 forecast additional tax revenues of £1,715 million over the four years 2023-2027.

Basis reform also means preparation of accounts nearer to real-time. To calculate the taxable profit for 2023-34 (the transition year), unless a business is already using a 31 March or 5 April year end, two sets of accounts will be needed in order to submit the self assessment return.

This is likely to result in increased concentration of workloads within firms and will place resourcing demands on firms. It may also as a consequence result in increased costs for clients.

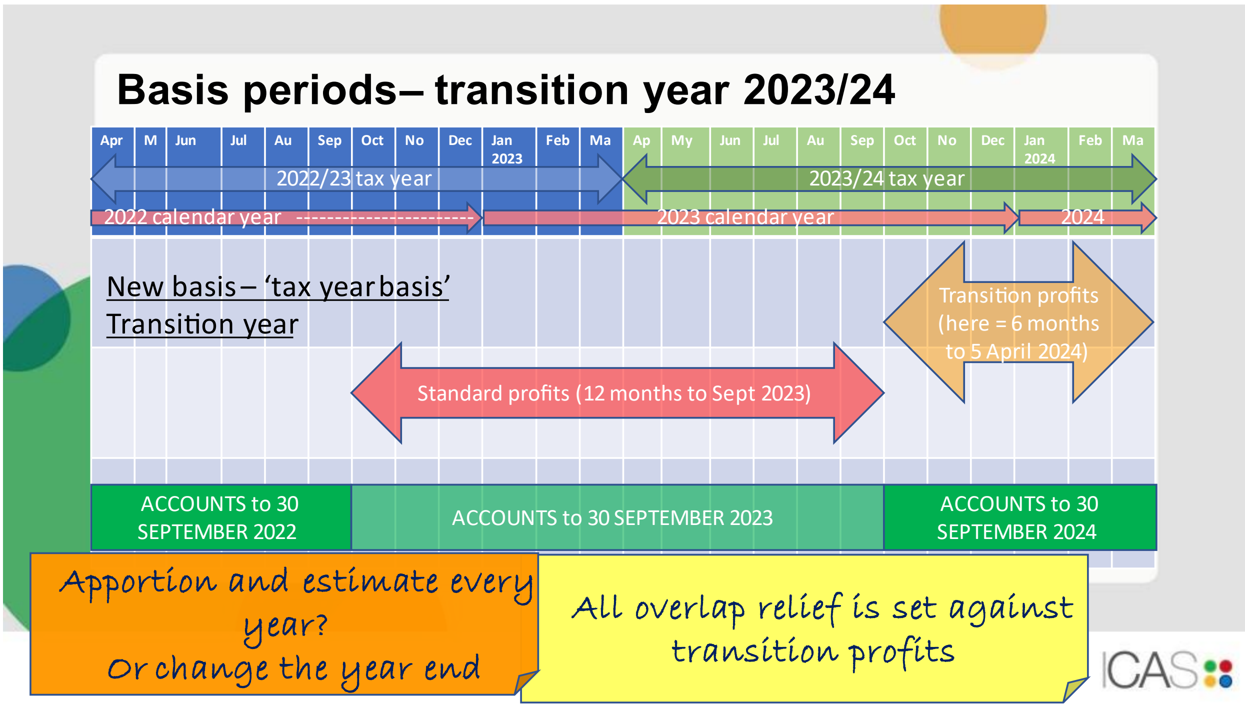
Example – Accounts requirements for year ends other than 31 March or 5 April

Business Z has a 30 September year end. For 2023-24, due to basis period reform, the assessable profit is the profit for the year to 30 September 2023, plus the profit for the period 1 October 2023 to 5 April 2024.

Unless the business changes its year end, this second period profit will be apportioned from the accounts to 30 September 2024. Hence, accounts to 30 September 2023 and 30 September 2024 will be needed to finalise the tax position for 2023-24, the final return being due by 31 January 2025.

The transition year 2023-24

No review of basis period reform would be complete without a detailed look at the transition year 2023-24. This is the tax year in which businesses move from the current year to the tax year basis of assessment. The diagram below shows the situation for a business with a 30 September year end.



For the tax year 2022-23, accounts to 30 September 2022 will provide the taxable profit figure. But moving into 2023-24, the position changes. To get the calculations right, it is necessary to split the profit into two parts:

1. The 'standard profit', which is the 12 months from the last set of accounts (those for the 2022-23 tax year), and
2. The 'transition profit' which is the profit for the period from the end of the standard part up to 5 April 2024. In this case 1 October 2023 to 5 April 2024. This figure can be calculated by apportioning, on a daily basis, the profit for the year to 30 September 2024.

As an alternative, the 'transition profit' could be calculated by changing the accounting date permanently to 31 March, starting with 31 March 2024. (Note that due to the equivalence rules, this period is actually 5 days shorter than that the one using 30 September 2024 accounts).

The red arrow on the diagram represents the standard part of the profit, and the orange arrow the transition profit. The distinction is important as overlap relief is deducted from the transition profit.

From 2024-25 onwards, the taxable profits to be assessed are those earned in the tax year. With a September year end, this would mean apportioning from accounts to 30 September 2024 and 30 September 2025, etc.

As 2024 is a leap year, the accounts to 30 September 2024 will cover 366 days. The apportionment would therefore be 178/366 days x profits for the year ending 30 September 2024 plus 187/365 x profits for year ending 30 September 2025.

Preparing for basis period reform

What are the challenges and options for a business with an accounting date which doesn't match the tax year? One challenge is tax bills. The other is accounting date.

As regards tax bills, there are two options to help: overlap relief and spreading relief.

As regards accounting date, as outlined above, from 2023-24 onwards apportionment of accounts will be needed unless the business has a 31 March or 5 April accounting date. A possible solution here is to change the accounting date.

Taking a business with a 30 June year end as an example, the impact on tax bills will be considered first, and then the options for year ends.

Payment of tax – catch up – example 30 June year

Spreading relief (over five years) is, available on transition profits (but not standard profits) in 2023-24, and overlap relief can be set off against transition profits. These are the main ways in which the 'catch up' tax bills can be reduced.

The exact outcome, and best options, will depend on the taxpayer's exact details such as the amount of basic rate band available, the level of overlap relief, amounts of other income and the pattern of profits/losses.

Example

(Note: this example is based on retaining the 30 June accounting date. The impact of changing accounting date is considered later.)

Basis periods in the run up to basis period reform, for a trader with a 30 June year end, would be:

2022-23	**2023-24** (the transition year)	**2024-25** (first full year on new tax year basis)
Based on year to 30 June 2023: 12 month's profits	Year to 30 June 2023 ('standard profit'), plus 1 July 2023 to 5 April 2024 ('transition profit', apportioned from accounts to 30 June 2024): 21 month's profits, less overlap relief. Spreading relief available for transition profit (over five years going forwards).	6 April 2024 to 30 June 2024 (apportioned from accounts to 30 June 2024); plus 1 July 2024 to 5 April 2025 (apportioned from accounts to 30 June 2025): 12 month's profits.

The outcome in terms of tax bill will depend on the specific figures and the overlap relief available. But generally, overlap relief, if available, is likely to be lower than current profits. Taxable profit in 2023-24 could therefore be substantially higher.

Example – spreading relief, overlap relief and transition profit:

Profits to 30 June 2023 = £30,000

Profits to 30 June 2024 = £32,000

Overlap relief (9 months) = £15,000

2023-24 assessment:

	£	£
12 months to 30 June 2023		30,000
1 July 2023 to 5 April 2024	24,480	
(280/366 days x £32,000)		
Overlap relief	(15,000)	
		9,480
Total assessable 2023-24 before spreading relief		39,480
Spreading relief (4/5 of transition profit carried forward to future years)		(7,584)
9,480 x 4/5		
Total assessable 2023-24 after overlap and spreading relief		31,896

The transition profit of £9,480 will be spread over 5 years. The taxpayer may opt to bring some of the profit forward, e.g. to use basic rate band in earlier years.

Changing year end

Changing year end, where there is an accounting date early on the tax year, potentially brings additional challenges. Changing before 2023-24 potentially increases taxable profit, without the benefit of spreading relief.

Calculation of profits for 2023-24

With a 30 June year end, the transition year 2023-24 will need the following figures: Profits for the year to 30 June 2023, plus profits for the period 1 July 2023 to 5 April 2024 (9 Months).

The figures could be obtained in a number of different ways. For example, the business could change its accounting date to 31 March, starting with 31 March 2024. Or it could retain the 30 June accounting date indefinitely. Or it could change the year end to 31 March either before or after 2023-24. These options are considered below.

Change of accounting date to 31 March, starting with 31 March 2024

In this case, the usual 12 months accounting period to 30 June 2023 would be followed by a nine month accounting period to 31 March 2024. 31 March 2024, in this case would be treated as equivalent to 5 April 2024, so the additional five days 1-5 April 2024, would fall into the next tax year. (This differs from the treatment of apportioning years to 30 June, as 'equivalence', treating 31 March as if it is 5 April, only applies for accounting dates 31 March, and 1-4 April).

Retaining the 30 June year end for the transition year/ change in a later tax year

Alternatively, the business could retain the 30 June year end for the transition year, so the accounts needed for 2023-24 would be those to 30 June 2023 and 30 June 2024. All overlap relief would be claimed against the transition part of the profits (1 July 2023 to 5 April 2024). This would be apportioned from the accounts to 30 June 2024 using a daily basis – note that 2024 is a leap year.

The accounting date could be changed to 31 March in a later year, if preferred, subject to the normal rules. Changes of accounting date in a later year would not change the basis of taxation (profits of the tax year), neither would there be any overlap relief, as all overlap relief is extinguished from 6 April 2024. The change would essentially be administrative.

Change of accounting date before 31 March 2024

It would be possible for the business to change its accounting date before 31 March 2024. This would mean that overlap relief could be claimed in the year of change, but any additional profits arising on the change would not be eligible for the five year spreading relief. Spreading relief only applies to transition profits arising in 2023-24: once a business has a 31 March/5 April year end, there are no transition profits.

Summary

The best outcome may be relatively straight forward to identify, once overlap relief, and profitability figures are available and can be accurately forecast. Different routes may be optimal for different individuals. Much will depend on overall profitability and levels of other income.

A major risk is that transition profits push the taxpayer into higher rates of tax. If there have been lower profits or losses in previous years, perhaps due to the impact of the pandemic, then the possible advantages of an earlier change in year end would need to be weighed against the loss of spreading relief. It would even be possible to make the change in two stages, using an intermediate date part-way to 31 March in one tax year. This is all subject to the normal restrictions on change in accounting date.

An overview of the rules on change of accounting date can be found in the HMRC Business Income Manual:

Change of accounting date BIM81090

Overlap relief and basis periods BIM81000

Computational liability: basis periods – change of accounting date in year four onwards BIM81045

MTD ITSA quarterly reporting

For sole trader businesses with trading turnover above £10,000, quarterly reporting is due to start on 6 April 2024. Individuals with gross property income over £10,000, or a mix of trading turnover and gross property income over £10,000 are also due to join from 6 April 2024.

On top of basis period reform, this brings logistical challenges. 31 January 2024 is the filing date for income tax self assessment returns for 2022-23. The tax year 2023-24 just ending potentially requires two set of accounts. And 6 April 2024 is a 'big bang' start for quarterly reporting, with submissions for the first quarter due by 5 August 2024.

How does this look in numbers?

Example with 30 June year end

- 30 June 2022 accounts needed for filing ITSA return for 2022-23 by 31 January 2024
- 30 June 2023 and 30 June 2024 accounts needed to finalise the transition year of 2023-24 by 31 January 2025
- Quarter to 30 June 2024 under MTD quarterly reporting, needs to be submitted by 5 August 2024

If clients do want to change year ends, this too will need to be factored in.

MTD ITSA quarterly reporting month ends and the pilot

Conditions for entering the pilot change are changing frequently. The current list includes, for 2022-23, the requirement for accounting date to align exactly with the tax year: this means 5 April, not 31 March. This is essentially a software issue, not the tax rules. The criteria can be checked on Gov.uk at who can sign up.

It is hoped that the pilot will be extended to include other year ends soon, but note that entering MTD ITSA part way through the tax year will necessitate making submissions for earlier quarters digitally via MTD ITSA API.

Where the accounting date is 5 April, then quarterly returns will all be to 5 of the month, on the standard quarters: 5 July, 5 October, 5 January, 5 April.

MTD ITSA quarterly reporting – calendar month election

Once the pilot opens up to non 5 April year ends, then it will be possible to make a calendar month election under MTD ITSA. In this case returns would be to 30 June, 30 September, 31 December and 31 March, whatever the business' year end accounting date.

Once this happens, a 31 March year end will align to the tax year, both for MTD ITSA quarterly returns and for self assessment under basis period reform. Traders using other accounting dates, such as 30 June, or 30 November, for example, would still need to report to these standard quarters, which may cause practical issues with bookkeeping/year end cut-off dates.

Getting there – challenges and opportunities

Putting all these aspects together will mean significant change for many firms. The demand from clients, particularly for bookkeeping services, is likely to increase. Meeting these challenges may mean different staffing patterns, new arrangements with bookkeepers and different workloads.

There are opportunities too. Once the transitional phase is over, there will be a realistic possibility of providing businesses owners with an accurate tax position very soon after the end of the tax year. This would be dependent on most tax adjustments being made in real-time each quarter. Such a premium service could attract a premium fee.

What is clear is that planning needs to start now to avoid significant bottlenecks in the coming years. While software providers and HMRC may talk generic solutions, it is bespoke advice to match specific circumstances that brings value to clients.

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