

Chapter 6

TRADING PROFIT – BASIS PERIODS

1 Basis periods

Having adjusted the trading profit of the accounting period and computed and deducted the capital allowances for this period the tax adjusted trading profit must now be included in the Income Tax Computation for the relevant Tax Year of assessment.

The problem is that not all traders will prepare their accounts to 5th April so a basis of assessment is required that will allow HMRC to relate any accounting period of profit to the tax year in which it will be charged to tax. Traders are assessed on their trading profit using a current year basis (CYB), this is the tax adjusted trading profit of the accounting year **ending** in the tax year of assessment.

If a trader prepares accounts to 31 December each year, his 2018/19 assessment will be based on the trading profit for the accounting year ending 31 December 2018.

EXAMPLE 1

- (a) Andrew has been trading for many years preparing accounts to 31 March

In which tax year will the trading profits for the accounting year ended 31 March 2017 be assessed?

- (b) Eric has been trading for many years preparing accounts to 31 August.

In which tax year will the trading profits for the accounting year ended 31 August 2017 be assessed?

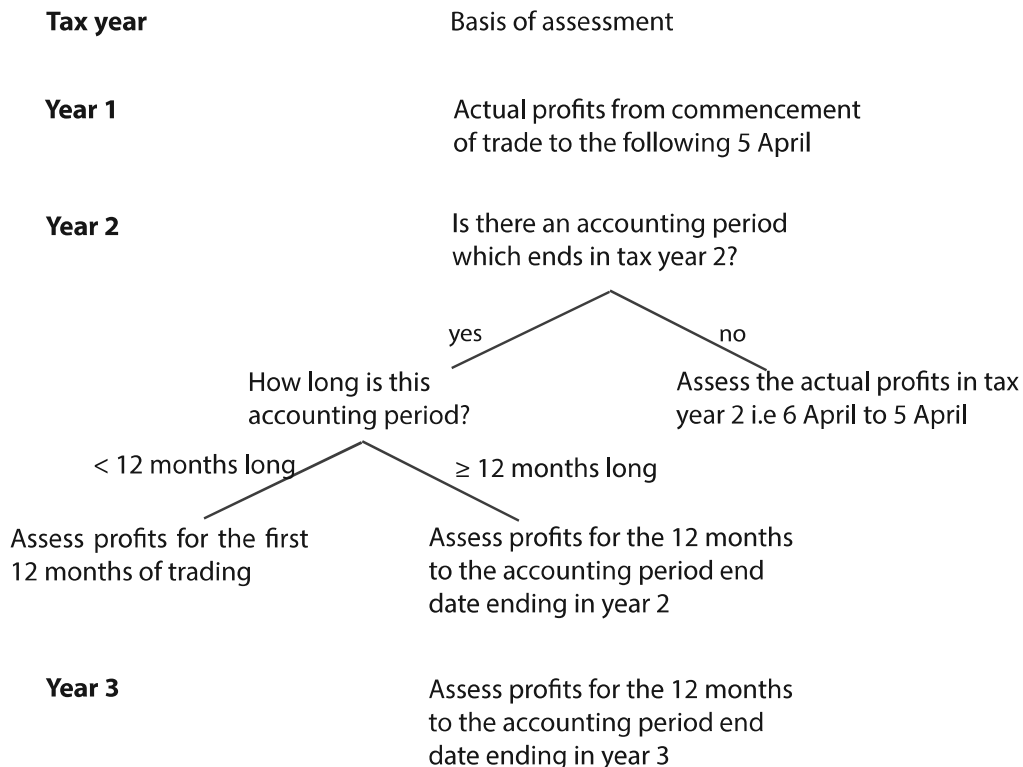
- (c) Cathy has been trading for many years preparing accounts to 30 April.

In which tax year will the trading profits for the accounting year ended 30 April 2017 be assessed?

1.1 Opening years rules

- (a) There are special rules that apply for the opening tax years of a new trade until a CYB assessment is available:
- (b) A new business is unlikely to start trading on 6th April and prepare accounts to following 5th April and therefore permit the CYB assessment to apply in its first tax year of trading. Indeed as we will discover it may not be until the third or even fourth tax year of trading before there will be an accounting YEAR ended in a tax year and thus allow CYB to apply.
- (c) HMRC will however assess a taxpayer from the first tax year in which they trade.
- (d) As you will see in the detailed rules that follow, the first tax year is quite easy to deal with as we will always use an **ACTUAL** basis of assessment and assess the profit actually made from the date the trade commenced through to the following 5th April. The only issue here is that some time apportionment of a profit period will be required if the taxpayer has prepared accounts to a date other than 5th April (or 31st March as apportionments will be made to the nearest month) - be sure however to correctly determine which tax year is the first tax year by looking carefully at the date the taxpayer started to trade.

- (e) It is the second tax year where there are alternative bases of assessment that may apply depending on the choice of accounting date and the detailed rules for this and the third tax year of assessment follow overleaf.



- (f) Some profits may fall into more than one basis period in the opening years and are known as overlap profits. Where there has been an overlap, overlap relief will be available on cessation of trading allowing the overlap profit to be deducted in the final tax year of assessment - see section 1.2.

EXAMPLE 2

Andrew started to trade on 1 January 2015 and makes up his first accounts to 30 June 2015 and then 30 June annually thereafter. His trading profits are as follows:

6 months	to 30 June 2015	£30,000
Year	to 30 June 2016	£70,000
Year	to 30 June 2017	£82,000

- (a) *What are the assessments for the relevant tax years?*
(b) *How much overlap relief is available?*

EXAMPLE 3

Chris started to trade on 1 May 2016 and makes up his first accounts to 31 October 2017 and then 31 October annually thereafter.

He made £36,000 trading profits in the 18 months to 31 October 2017 and £30,000 in the year ended 31 October 2018.

Compute the assessments for the relevant tax years so far as the above information will allow and compute the amount of overlap profit that arises.

EXAMPLE 4

John commenced trading on 1 December 2016 and prepared accounts to 31 May 2018 in which period he made an adjusted trading profit of £54,000. The projected adjusted trading profit for the accounting year ended 31 May 2019 is £48,000.

Compute the assessments for the relevant tax years of assessment for the information provided and calculate the amount of overlap profit arising and state what will happen to the overlap profit

1.2 Closing years rules

The rules for dealing with the closing years of a taxpayer ceasing to trade are much more straightforward than opening years with CYB being used up to and including the penultimate tax year (one before last). The basis of assessment for the final tax year is then as follows:

- (a) The actual trading profits from the end of the basis period for the previous (penultimate) year of assessment until the date of cessation (all profits not yet taxed).
- (b) Any overlap profit / relief from the opening years of the trade is then deducted in deriving the assessment for the final tax year.

EXAMPLE 5

Boris, who has been trading for many years making up his accounts to 31 January, ceases to trade on 31 May 2018 with trading profits as follows:

	<i>Trading Profit</i> £
Year to 31 January 2018	47,000
4 months to 31 May 2018	8,000

The overlap profits from the opening years of his trade were £6,000.

Compute the assessments for the final tax years of trading as far as the available information will allow.

2 Basis periods for capital allowances

Capital allowances are calculated for a period of account. They are then treated as an expense, and deducted from the profits of that period. This tax adjusted trading profit figure is then what is used to determine the assessment for a relevant Tax Year.

2.1 Opening years

Capital allowances are deducted from profits before the opening year rules are applied. For an accounting period longer or shorter than 12 months the AIA and WDAs are scaled up or down as appropriate. The FYA at 100% on cars with emissions of $\leq 50\text{g/km}$, is never time apportioned.

EXAMPLE 6

Until 30 June 2018 Wendy was employed as a management consultant at an annual salary of £40,000.

On 1 July 2018 Wendy commenced in self-employment running a music-recording studio. The following information relates to the period of self-employment from 1 July 2018 to 5 April 2019:

- 1 The adjusted profit for the period 1 July 2018 to 5 April 2019 is £89,000. This figure is before taking account of capital allowances.
- 2 Wendy purchased the following assets:

		£
1 July 2018	Recording equipment	30,000
15 August 2018	Motor car (CO ₂ emissions are 170 g/km) used by Wendy - 60% business use	14,800
20 October 2018	Motor car (CO ₂ emissions are 105 g/km) used privately by employee - 20% private use)	10,400
4 March 2019	Computer	2,600

Compute Wendy's income tax liability for 2018/19

2.2 Cessation of trade

- (a) No WDA, AIA or FYA are available in the final period of trading and balancing adjustments will arise on cessation.
- (b) If there are additions in the final period, these are added to the relevant pool, then disposal proceeds (limited to cost) are deducted to find a balance.
- (c) If the net balance is still positive then a balancing allowance will arise, whereas if the net balance is a negative figure then a balancing charge arises.

3 Cash Basis for Small Businesses

Certain small unincorporated businesses (sole traders and partnerships) may elect to use a cash basis to determine their tax adjusted trading profits instead of the normal accruals basis.

The election is available to those businesses with receipts for a 12 month accounting period assessable in the tax year that do not exceed £150,000.

A trader must leave the scheme if receipts assessable in the previous tax year exceed £300,000.

The cash basis will assess a business on its cash receipts less cash payments of allowable business expenses. Payables, receivables and inventory are ignored.

The accounting profit must be adjusted for taxation purposes mostly as for accruals accounting but with the main difference being in relation to capital expenditure.

Expenditure on plant and machinery which would normally attract capital allowances will now attract tax relief with capital payments for plant and machinery (except cars) being deductible and capital receipts from sale of plant and machinery (except cars) being included in the calculation of the adjusted trading profit.

In respect of cars instead of claiming capital allowances the trader may instead use a fixed (or flat) rate deduction for tax purposes. The actual capital cost of acquiring a car for use in the business, the running costs and the sale proceeds are excluded from the profit calculation. The trader can instead claim as a deduction against the trading profit a mileage allowance for the business mileage. The allowance is at a rate of 45p per mile for the first 10,000 business miles and 25p thereafter - you will see these figures again when dealing with employees who use their own cars to do business mileage in relation to their employment

Taxable trading profits for an accounting period under the cash basis are computed as:

	£
Receipts (inc. sale of plant & machinery)	xxx
Expense payments (inc. purchase of plant & machinery)	(xxx)
Tax adjusted trading profit / (loss)	<u>xx</u>

EXAMPLE 7

Adam commenced trading as a sole trader selling fresh fruit on June 1, 2018 and prepared his first set of accounts to May 31, 2019, for which the following information is available:

Sales for the period were £61,000 of which £4,000 was still owed by business customers at the end of the period.

Inventory at May 31, 2019 amounted to £1,800.

Purchases and expenses of the period (all allowable) amounted to £29,000 of which £2,000 was still owed to suppliers at the end of the period.

On June 1, 2018 Adam purchased equipment for use within the trade costing £8,000 and on 1 October, 2018 a motor car costing £12,000 with CO₂ emissions of 102 grams per kilometre. Adam uses the car 40% for private use and incurred motor expenses during the period of £3,600 in driving a total of 10,000 miles.

Calculate Adam's adjusted trading profit for the accounting period ended 31 May 2019 using the normal basis and using the cash basis.

If a trading loss arises under the cash basis then the only relief available to the trader is to carry forward the loss to set off against future trading profits of the same trade.

This compares unfavourably with the normal loss reliefs available to a trader which are detailed in Chapter 7 and may be a critical issue especially for new businesses in making the decision as to whether to elect for the cash basis to apply and may also be a reason for a business in the future to withdraw the election.

Premises used as both home and business premises such as a small hotel, guest house, bed and breakfast or public house can elect for a flat rate private use adjustment to apply under the cash basis in respect of

private use of the property for such expenses as food and heat and light rather than attempting to compute a business / private split of the expenditure. Note this is an add back not a deduction.

The relevant flat rates will be provided in an examination question and are based on the number of occupants. For example if the property had one occupant the add back would be £350 per month or part thereof (£4,200 per annum) and for two occupants it would be £500 per month (£6,000 per annum).

The flat rate add back does not include other property expenses such as rent or loan interest payments.

EXAMPLE 8

Eve, a single lady, runs a small guest house in which she lives and prepares accounts to April 5 each year. For the year ended April 5, 2019 she has a trading profit before any private use adjustment of £23,000. The total cost for food, heating and lighting charged for this period amounted to £14,000.

State how the total cost of food and heat and light may be dealt with for tax purposes and calculate Eve's adjusted trading profit assuming the election for the flat rate private use adjustment has been made.

Students may now attempt Practice Questions 12 to 15