

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 30 June each year, his 2021/22 assessment will be based on the tax adjusted trading profit for the accounting year ending 30 June 2021, as the 30 June which falls into the 2021/22 tax year (6 April 2021 - 5 April 2022) and his 2022/23 assessment on the accounting year ended 30 June 2022.

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 2021 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 2020 be assessed?

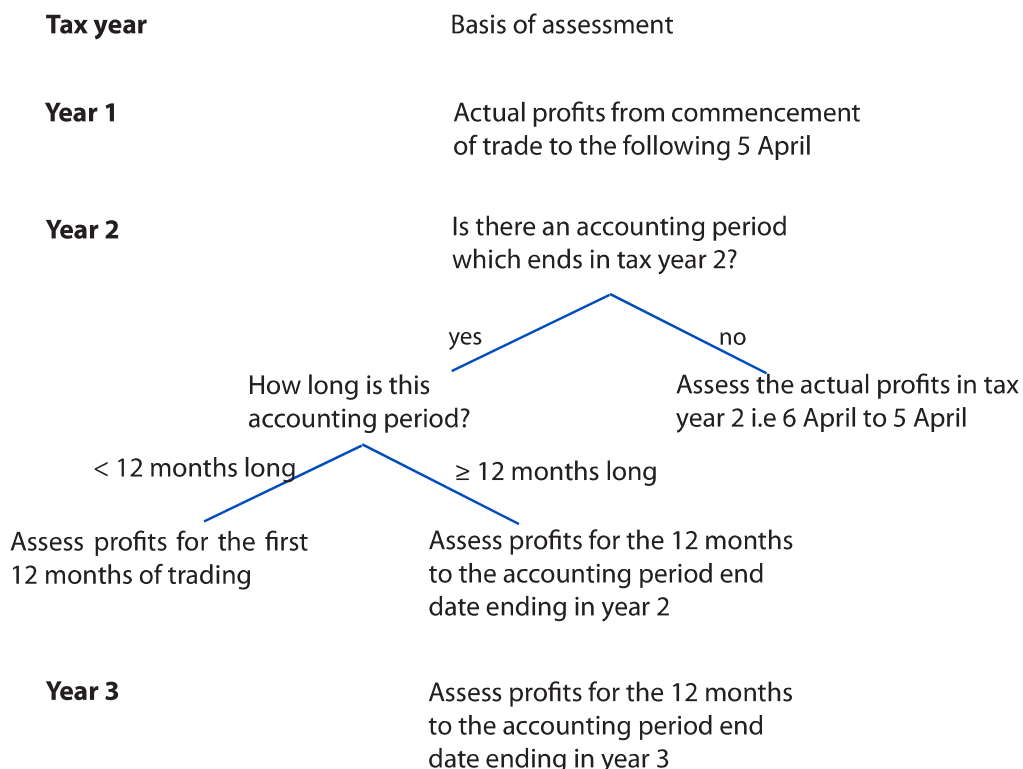
- (c) Cathy has been trading for many years preparing accounts to 30 April.

In which tax year will the trading profits for the accounting year ended 30 April 2021 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 and hence a basis of assessment is required for each tax year.
- (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 2021 and makes up his first accounts to 30 June 2021 and then 30 June annually thereafter. His trading profits are as follows:

6 months	to 30 June 2021	£30,000
Year	to 30 June 2022	£70,000
Year	to 30 June 2023	£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 2020 and makes up his first accounts to 31 October 2021 and then 31 October annually thereafter.

He made £36,000 trading profits in the 18 months to 31 October 2021 and £30,000 in the year ended 31 October 2022.

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 2020 and prepared accounts to 31 May 2022 in which period he made an adjusted trading profit of £54,000. The adjusted trading profit for the accounting year ended 31 May 2023 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 2022 with trading profits as follows:

	<i>Trading Profit</i> £
Year to 31 January 2022	47,000
4 months to 31 May 2022	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 an accounting period. 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 zero emissions is never time apportioned.

EXAMPLE 6

Until 30 June 2021 Wendy was employed as a management consultant at an annual salary of £40,000.

On 1 July 2021 Wendy commenced in self-employment running a music-recording studio. The following information relates to the period of self-employment from 1 July 2021 to 5 April 2022:

- 1 The adjusted profit for the period 1 July 2021 to 5 April 2022 is £89,000. This figure is before taking account of capital allowances.
- 2 Wendy purchased the following assets:

		£
1 July 2021	Recording equipment	30,000
15 August 2021	Motor car (CO ₂ emissions are 70 g/km) used by Wendy - 60% business use	14,800
20 October 2021	Motor car (CO ₂ emissions are 35 g/km) used privately by employee - 20% private use)	10,400
4 March 2022	Computer	2,600

Compute Wendy's income tax liability for 2021/22

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 in Chapter 9 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, 2021 and prepared his first set of accounts to May 31, 2022, 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, 2022 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, 2021 Adam purchased equipment for use within the trade costing £8,000 and on 1 October, 2021 a motor car costing £12,000 with CO2 emissions of 42 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 2022 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, 2022 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

Chapter 7

TAX ADJUSTED TRADING LOSSES – INDIVIDUALS

1 Trading losses

1.1 Trading Profit assessment

- (a) If the basis period for a tax year has a trading loss, the trading profit assessment to include in the income tax computation is **nil**.
- (b) The trading profit figure in an income tax computation can never be negative

1.2 Relieving the loss

The loss may be relieved according to the following rules. A repayment of income tax may result in some circumstances.

2 The reliefs available

The main reliefs available for a trading loss, are as follows:

- (a) Carry forward against future trading profits of the same trade
- (b) Relief against total income of current and/or preceding tax year.
- (c) Following a claim in (b) above if any trading loss still remains, the taxpayer may choose to extend the loss claim against chargeable gains of that tax year
- (d) Opening years loss relief against total income of preceding 3 tax years
- (e) Terminal loss relief (on cessation of trading) against previous 3 years trading profits

3 Carry forward of trading losses

- (a) A trading loss may be carried forward and set against the first trading profits arising from the same trade.
- (b) The trading loss must be set off in full against the next available trading profit if this option is chosen.
- (c) Any loss remaining is carried forward until further profits arise.
- (d) The loss may be carried forward indefinitely

EXAMPLE 1

Albert has had the following recent trading results as adjusted for tax:

		£
Year to 31 December 2019	Loss	(5,000)
Year to 31 December 2020	Profit	3,000
Year to 31 December 2021	Profit	10,000

Assume that Albert chose to carry forward the loss.

Calculate his assessable amounts for all relevant tax years.

4 Loss relief against total income

- (a) A trading loss may be relieved against total income (after any qualifying loan interest payments) of the tax year of the loss and/or the preceding tax year.
- » the loss is calculated on an accounting period basis. The accounting period is then assessed using the normal bases of assessment
 - » a loss for the year ended 30 June 2021 (assessable in 2021/22 using CYB) may be relieved against total income of 2021/22 (the tax year of loss using CYB) and/or 2020/21 (the preceding tax year)
- (b) If relief against total income is taken,
- » the loss must be set off to the maximum possible extent subject to a cap on income tax reliefs - see section (c) below
 - » personal allowances may therefore be lost as total income is before the deduction of the personal allowance and partial claims are not allowed.
 - » a claim against total income may be made for either the tax year of the loss or the previous year or both. The two years are treated separately and thus a claim is required for each year.

EXAMPLE 2

Charles has the following trading profit/ (loss) results:

	£
Year ended 31 December 2020	32,000
Year ended 31 December 2021	25,000
Year ended 31 December 2022	(84,000)

Charles also has property income in each year of £6,000.

Calculate Charles' taxable income for each relevant tax year, assuming that the trading loss is used in the most beneficial way and trading losses will continue for the next few years. Assume the personal allowance for 2021/22 applies in all tax years.

- (c) A cap applies that limits the amount of loss relief available against a person's total income. The cap is the higher of:
- » £50,000, or
 - » 25% of person's adjusted total income
- Adjusted total income is after deducting from the total income, the gross amount of any personal pension contributions.
- Importantly the cap does NOT apply to any trading profits within the total income figure (this would be relevant to a claim made in respect of the preceding tax year).
- The cap will only be tested at TX-UK within this section of relief against the total income of current and / or the preceding tax year.

ILLUSTRATION

Louise Serr has always prepared accounts to 31 March in each year in respect of her trade while also receiving employment income of £60,000 each tax year. For the accounting year ended 31 March 2022 she made a trading loss of £125,000 having made a trading profit of £20,000 in the year ended 31 March 2021.

The personal allowance for 2021/22 also applied in 2020/21.

Compute the taxable income for each of these tax years assuming that loss relief claims against total income are made in both tax years.

	2020/21	2021/22
	£	£
Trading Profit	20,000	Nil
Employment Income	60,000	60,000
	80,000	60,000
Loss Relief	(70,000)	(50,000)
	10,000	10,000
Personal Allowance	(12,570)	(12,570)
Taxable Income	-	-

Loss relief claim in 2021/22 is capped at £50,000 as this is higher than £15,000 (25% x 60,000).

In 2020/21 the loss relief claim is made in full against the trading profit of £20,000, but the cap of £50,000 then applies against the remaining total income (employment income of £60,000).

The cap can here be seen in fact to be of advantage to Louise as it leaves sufficient total income in both years to absorb the majority of the available personal allowance.

The remaining trading loss of the year of £5,000 (125,000 – 50,000 – 70,000) will be carried forward to set off against the next available trading profit of the business.

(d) Relief of trading losses against capital gains

- (i) This relief is an extension to a current year and/or carryback relief claim against total income and may only be claimed after such a claim has been made against the total income of the tax year of claim.
- (ii) A trading loss may be relieved against capital gains, but only after the total income of the tax year in question has been reduced by the maximum available trading loss relief under a normal claim, and an unrelieved loss still remains.
- (iii) The remaining unrelieved trading loss (restricted to a maximum loss as shown below) is then deducted from the net gains (gains less losses) of the tax year. This deduction is made BEFORE then deducting any Annual Exempt Amount (a level of tax free gains) and before deducting any capital losses brought forward.
- (iv) The maximum loss available for use in this relief is computed as the net gains of the tax year LESS any capital losses brought forward.

EXAMPLE 3

For 2021/22 Kathy has net gains of £44,000 and a capital loss brought forward of £4,000. She has trading loss remaining of £24,000 after a claim against the total income of the tax year has been made.

Calculate Kathy's taxable gains for 2021/22, assuming that Kathy makes the loss relief claim.

5 Losses in opening years

In the first tax year of the trade the assessable profit (or loss) is measured from the day trade commences to the following 5 April - the actual basis of assessment as seen in Chapter 6.

Unless the trader prepares accounts to 5 April, this requires the profit (or loss) to be apportioned.

- A loss may only be used once. If therefore in the opening years of assessment that as a result of overlap periods arising, a loss has been taken into account in computing the assessment of one tax year, that amount is then treated as nil when calculating an assessment / loss in a later tax year.

EXAMPLE 4

Matthew starts trading on 1 August 2020. His trading results, as adjusted for tax purposes are:

	£
10 months to 31 May 2021	Loss (20,000)
Year ended 31 May 2022	Profit 48,000

Calculate Matthew's trading profit assessments and the losses available for relief in respect of all relevant tax years.

5.1 Opening years loss relief

- The relief is available for losses incurred in the first four tax years of trading.
- Relief is available against total income of the three tax years preceding the tax year of loss.
There is no need for the trade to have been carried on in these preceding tax years
- The relief operates against all three preceding tax years on a FIFO basis. As with current and preceding year relief partial claims are not available and hence personal allowances may again be lost
- The loss available for this relief is computed in the same way as profits.
- In the early years of the trade it is possible to claim the following reliefs:
 - » Opening years loss relief
 - » Relief against total income of the current and/or previous tax year, including possible extended claim against gains
 - » Carry forward against future trading profit

EXAMPLE 5

Fiona started trading on 1 July 2020. Her results, as adjusted for tax purposes, for the first two years are as follows:

	£
Year ended 30 June 2021	Loss (12,000)
Year ended 30 June 2022	Profit 2,500

Fiona had previously been employed.

Her remuneration from this employment, which ceased on 30 September 2019 for recent years was:

	£
2019/20	5,868
2018/19	11,050
2017/18	15,800

Fiona has property income of £4,500 p.a.

Calculate the taxable income for all years after claiming opening years loss relief.

Assume the personal allowance for 2021/22 applies throughout.

6 Terminal loss relief

- (a) The terminal loss (as computed) is set against the trading profit for the tax year of cessation (if any - note this is usually a nil assessment given the loss arising) and then against the trading profits of the previous three tax years on a LIFO basis.
- (b) The terminal loss is the loss of the final 12 months of trading computed in 2 parts dividing the last 12 months of trading between the final and penultimate tax years, calculated as follows:
- (i) The actual trade loss for the tax year of cessation (from 6 April to the date of cessation) plus any overlap relief arising from opening years.
 - (ii) The actual trade loss for the period 12 months before cessation until the end of the penultimate tax year

If the result in i) or ii) is a profit, it is treated as zero for purposes of the terminal loss computation.

EXAMPLE 6

David had the following trading results before ceasing to trade on 31 May 2022

	£
Year ended 31 July 2020	28,000
Year ended 31 July 2021	6,000
10 months to 31 May 2022	(20,000)

Show the loss available for relief under terminal loss relief, assuming overlap profits on commencement were £5000 and state how this loss would then be relieved

Students may now attempt Practice Questions 16 & 17