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Basis period reform – HMRC consultation

Response by the Chartered Institute of Taxation

1 Executive Summary

1.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the UK for advisers dealing with all aspects of taxation. We are a charity, and our primary purpose is to promote education in taxation with a key aim of achieving a more efficient and less complex tax system for all. We draw on the experience of our 19,000 members, and extensive volunteer network, in providing our response.

1.2 We recognise that, according to HMRC's figures, the majority of businesses will be largely unaffected by these proposals as they already draw up accounts to a date that is aligned (or will be treated as aligned) with the tax year. Therefore, most of our comments are directed towards the impact on businesses that do not draw up accounts to 31 March / 5 April (referred to as 'affected businesses'), and those who advise them.

1.3 **We recommend that any changes to the basis period rules are deferred by at least a year to allow for more thorough consultation, greater understanding of the wider impacts of the change (including the interaction with Making Tax Digital for Self-Assessment (MTD for ITSA)), and a longer lead in time to allow businesses, agents and HMRC sufficient time to prepare. Such preparation is not solely related to the tax position, but - for those businesses that move their year end to 31 March or 5 April - to deal with the significant practical issues which will arise from such a change.**

1.4 **We further recommend that mandation of MTD for ITSA, which is currently due to start in April 2023, is also deferred to allow the basis period rules to 'bed in', provide adequate time for software development and testing, and again ensure businesses, agents and HMRC are duly prepared.**

1.5 Our main concern with the basis periods proposal is the timing of the change:

Firstly, the additional financial and administrative burdens for affected businesses, at a time when we are emerging from a pandemic that has imposed huge pressures on businesses, their agents and HMRC. Many businesses which have survived the pandemic are looking for a period of stability and rebuilding. Adding financial and administrative burdens on already overworked business owners (and their agents) at this time could be counter-productive.

1.6 Secondly, the extremely short timescales for consultation and implementation are likely to result in mistakes and unforeseen outcomes. The consultation recognises that it is dealing with the 'fundamental building blocks of the tax system', yet stage one of the tax consultation process is absent, and stages two and three have been combined into one brief consultation for six weeks during the holiday season amidst a pandemic. This is simply not sufficient for businesses, tax professionals and others to assess the detail of this significant change, how it will affect them and their clients, consider all the likely knock-on effects, and provide constructive feedback to government. Equally, we do not consider that the government will have sufficient time to digest and provide for the various impacts, update its systems to accommodate the change, and provide the necessary guidance and support to businesses throughout. The start of the proposed transitional year of 2022/23 is only just over 6 months away and indeed many affected businesses may already be several months into their accounting period which ends in the transitional year. This means that the implementing legislation, and supporting guidance, is unlikely to be finalised prior to the changes impacting some affected businesses.

1.7 Thirdly, the wider tax administration environment is already bringing, or proposing, significant further changes. MTD is being further extended in April 2022 and 2023, bringing with it an entirely new penalty regime. The Office of Tax Simplification (OTS) is currently undertaking a review of the UK's tax year end date and considering options of moving the tax year end to either 31 March or 31 December, and a fundamental 10-year review of the tax administration framework by HMRC is also underway. While many of these are long-term projects, it would certainly seem sensible to allow the OTS review to conclude first before the basis period reforms are implemented.

1.8 A key driver for reforming basis period rules is MTD for ITSA. But we remain extremely concerned over readiness (software, businesses, agents and HMRC) for mandation of MTD for ITSA in April 2023. This is especially the case if the equivalence rule means that businesses with a year end of 31 March will be mandated from 1 April 2023 (rather than 1 April 2024 as previously envisaged), leading to a 'big bang' where all mandated businesses have to comply with the new regime from April 2023. We think this will put unmanageable pressures on all parties and the government should not only defer the start date of MTD for ITSA, but also consider a staged application of the rules to give the best possible chance of a successful roll-out.

1.9 Whilst we consider that any reform of the basis period rules should come before MTD for ITSA is introduced, in the absence of MTD we would question whether reform is necessary at all. As stated in the consultation, 93% of sole traders and 67% of partnerships will be unaffected by these proposals. While some affected businesses will change their year ends so as to coincide with the tax year because of this reform, many of the remaining affected businesses (ie those that will continue to draw up accounts to a date other than 31 March / 5 April) will be larger or more sophisticated businesses (such as LLPs) which will not be mandated into MTD for ITSA in April 2023. If the government considers that basis period reform is necessary now, we think that some businesses, such as those larger businesses that will not be mandated into MTD for ITSA in April 2023, should be excepted from the change or the change should be deferred until they are mandated into MTD for ITSA. They are likely to be among those most affected by the basis period change and indeed many will already be in the accounting period which forms their basis period for the transitional year of 2022/23. Hence, we think that further consultation on this might be beneficial.

1.10 Whilst potentially achieving the simplification HMRC desire in relation to MTD reporting, the basis periods proposals bring with them several downsides, including:

i. For those businesses unable, or for which it would be inconvenient or undesirable, to adopt a tax year accounting period end, the complexities of the existing regime will be replaced with different (and potentially greater) complexities of apportioning profits, and (for some) making estimates in – and amendments to – ITSA returns. These will be issues which arise not just typically in opening or closing years (like the current complexities), but on an ongoing basis. This is the opposite of simplification and is a backward step, rather than progress. Administrative burdens and costs for these affected businesses will be increased as a result. These should be factored into the impact assessment for the proposal.

ii. The need to make amendments to submitted returns will have the knock-on effect of extending the enquiry window for those returns, arguably 'by the back door', which will increase the length of time before an affected taxpayer can have certainty over their tax affairs for the year. This could lead to an erosion of trust in the tax system.

iii. Where an affected business does not change its accounting period end to align with the tax year, its ITSA return will include time-apportioned figures from two accounting periods. It is unclear what impact this might have on HMRC's ability to enquire into the tax return, because, unlike currently, the return will not include figures from accounts for just one period. This should not mean that HMRC can enquire twice into the same figures, simply because figures from one accounting period have been time-apportioned to different tax returns. This requires further thought and possibly a separate consultation.

iv. The likely bunching of work for businesses, agents and HMRC, as even more businesses will adopt a tax year (or equivalent) accounting period end, and MTD for ITSA quarterly reports will all be made based on calendar quarters. Also, if businesses move to a 31 March year end the VAT quarters may well also move to calendar quarters. We suggest that to help ease the pressure, the deadline for submitting the MTD quarterly reports should be extended from one month to two months after the end of the relevant quarter. The government might also wish to consider a later ITSA filing deadline (eg 31 March rather than 31 January), and a later deadline for the MTD end of period update, either for affected businesses or across the board, in order to spread the workload and in part address the need for estimates in – and amendments to – returns.

v. The impact of excess profits in the year of transition and spreading over 5 years on an individual's total income will have cash-flow implications for some affected businesses, and there will also be knock-on effects on the rate of income tax paid, loss of personal allowance, the High Income Child Benefit Charge (HICBC), superannuation, pension contributions, repayment of student loans and so on. The impact will be felt differently by each taxpayer so it is difficult to know what the total impact could be. How individual taxpayers will be impacted will be based on their own personal circumstances, which will need to be carefully worked out, meaning clear and prompt guidance from HMRC is essential. This will be particularly needed if the taxpayer is not represented by an agent, as they will be relying on HMRC to provide guidance and support. If the taxpayer has an agent, this will no doubt increase costs for the taxpayer.

vi. There is also the potential for excess profits to be taxed at much higher income tax rates than would be normal, even if the excess profit is spread over 5 years. Consideration should be given to ring-fencing the excess profit and treating it as a one-off receipt (including when the profit is spread) and taxing it at the individual's marginal tax rate (ignoring the excess profit) rather than treating it as additional income (with the result that it could then be taxed at a higher rate than would be normal for that taxpayer). This approach could also address the issues highlighted in v. above.

vii. HMRC's proposal is to allow overlap relief brought forward to be deducted in full in the transitional year. This raises the following issues:

a. In some cases, the business may not know the amount of its overlap profits as they may have been 'lost' due to the passage of time since they arose. The business will need to rely on HMRC to provide it with the figure. HMRC should make this information available through the business's Digital Tax Account, and ideally it should also be done by automatically populating the figure into tax returns including via APIs into third party software. We would urge HMRC to put the resources into making this possible as a matter of urgency. Existing Self-Assessment agent authorisations should allow access to this information.
b. Whilst HMRC have told us that they have these overlap figures on their system (or can 'recalculate' the figures from their records), we would like further assurances that this is in fact the case and that they will supply the information promptly when it is requested by a taxpayer or their agent. Experience to date from our members is that HMRC are very reluctant to help with queries about overlap.
c. Since overlap is not index-linked and in many cases will have arisen many years ago, the value of it is likely to be very low compared to the (more than 12 months) profits arising in the transitional year, meaning that for some affected businesses the excess profits in the year of transition will be significant (leading to the problems outlined in v. and vi. above).

viii. As already noted, it is essential that HMRC communicate this change promptly and clearly and provide guidance as soon as possible so affected businesses and their agents (if they have one) are aware of the change, can assess its impact, and plan and make any changes as they consider appropriate to their own circumstances (such as to their accounting period-end). We also think that, in view of the speed at which the change is being introduced, HMRC should establish a dedicated helpline to assist taxpayers and their agents with understanding the changes and providing support, including supplying overlap figures.

Whilst individually these issues might affect a modest number of taxpayers, when taken together a significant amount of work is needed to inform taxpayers of these changes, prepare for them, and deal with the consequences.

1.11 The government is keen to build trust in the tax system. We believe that rushing in changes to the fundamental building blocks of the tax system, in order to facilitate introduction of a policy which remains controversial, will not help that aim.

2 About us

2.1 The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. Our comments and recommendations on tax issues are made solely in order to achieve this aim; we are a non-party-political organisation.

2.2 The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

2.3 The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most

effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries.

2.4 Our members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

3 Introduction

3.1 The CIOT sets out below its detailed comments on the proposal to change the rules under which profits of an unincorporated trading business are taxed, from a 'current year' basis (introduced when Self-Assessment was introduced in 1997), to a 'tax year' basis.

3.2 Affected businesses, ie those which do not align their accounting periods end with the tax year end, will need to apportion their profits to the relevant tax year, making estimates where actual figures are not available.

3.3 As part of the reforms, 31 March and the following four days will be deemed as equivalent to 5 April, ie the end of the tax year, and views are sought on whether this should similarly extend to property businesses.

3.4 Our stated objectives for the tax system, relevant to the proposals in this consultation, include:

- A legislative process that translates policy intentions into statute accurately and effectively, without unintended consequences.
- Greater simplicity and clarity, so people can understand how much tax they should be paying and why.
- Greater certainty, so businesses and individuals can plan ahead with confidence.
- A fair balance between the powers of tax collectors and the rights of taxpayers (both represented and unrepresented).
- Responsive and competent tax administration, with a minimum of bureaucracy.

4 The proposal: The tax year basis

4.1 ***Question 1: Do you think that the proposed 'tax year basis' for trading income is the best option for simplifying the basis period rules, and the best way to achieve simplicity and fairness between businesses? If not, do you think there is a better option?***

4.2 We do not think that the current basis period rules are overly complicated and believe that they have worked well since they were introduced in the mid-1990's. Whilst there is some complexity in opening and closing years, and the change of accounting period end rules, they arise only at those specific points in a business's life and will mainly affect the minority of businesses that do not use the tax year as their accounting period end. Overall they are well understood by tax professionals. Further, tax software and HMRC's systems can adequately deal with these rules and calculate and store overlap profits. However, we accept that unrepresented taxpayers (those without a tax agent) may find the rules difficult to understand, although we

would have expected most unrepresented taxpayers to be using the tax year end (or 31 March) as their accounting period end.

4.3 The proposed tax year basis will require businesses with a period of account that does not match the tax year to prepare, report and apportion two sets of accounts or computations in order to complete one year's Self-Assessment tax return (with all the associated additional administrative burdens and costs).

4.4 These complexities will, for affected businesses, repeat year on year. When contrasted with the existing regime where the complexity mainly lies only in the opening or closing years, we question whether overall simplicity will be increased as a result of these proposals.

4.5 It is also hard to understand the unfairness that these proposals are seeking to (and will) address. In terms of fairness a comparison seems to be being made between smaller businesses which, much more commonly, use 5 April or 31 March for their accounts and therefore (if they have a rising profit) do not get the cash-flow advantages which eg larger professional partnerships can get from adopting a different date (typically 30 April). However, we believe this comparison is misplaced (see our further comments at para 4.40 below). In short, we do not see any particular unfairness or inequality within the existing regime.

4.6 ***Question 2: Will the proposed tax year basis have an effect on how businesses choose their accounting date, and whether they choose 31 March or 5 April?***

4.7 Yes. In order to prevent having to apportion accounting profits to establish their taxable profits for a tax year (and the associated costs and burdens), we think that it is likely that more businesses will choose a tax year end or 31 March accounting date, even though that date may not be the most suitable for their business's needs.

4.8 Businesses choose an accounting date other than the tax year for several non-tax reasons. For international businesses, a calendar year end accounting period is often chosen, as that coincides with many other countries' tax years (eg USA, Ireland, France, Germany and many others), or a specific other date where that aligns with their wider networks (for example 30 June is often used where the business trades in Australia). This is the case even though it can cause issues with reporting in the year (especially when foreign tax credits arise).

4.9 Other businesses will choose an accounting period that ends either in their slow / down period, or after the majority of their income is received (so as to match income to outgoings, which can be very important when seeking financial investment). This is the 'classic' scenario for many businesses. For example, farmers will often choose 30 September as that coincides with the end of the harvest (much easier to account for income than if 31 March is chosen when you need to estimate potential crop yields and prices). Those in the leisure sector may choose a year end in the autumn, to ensure that they capture a full tourism period, and preventing fluctuations caused (for example) by the timing of Easter (a tax year end accounting period could result in very distorting profits year on year with Easter falling either once, twice or not at all in any given tax year). Businesses whose clientele are children, or which operate in the academic sector, often choose 31 July or 31 August (to coincide with the sector's financial year – and the summer holidays being a good 'downtime' to rest, recuperate and deal with paperwork). And, of course, quite a few, especially unrepresented taxpayers, just choose a date 12-months from commencement because they think they must – the latter probably are the businesses for which aligning with the tax year would be most advisable (in order to avoid them having to deal with the complexity of the new 'tax year' basis). It is essential that HMRC provide appropriate support and guidance to these taxpayers, otherwise they will be in a much worse position than they are now.

4.10 The proposals may cause businesses to feel obliged to choose a tax year end accounting date, even when that date falls at their busiest time (for example, Easter often falls around the tax year end which for many hospitality and leisure businesses can be one of their busiest periods – imagine requiring a business to undertake a stock take at this time!). In this respect the proposal might be considered to be 'business-unfriendly'.

4.11 ***Question 3: For businesses with a non-tax year accounting date, what would be the cost of the additional administrative burden of apportioning profits into tax years? Are there any simpler alternative approaches to apportionment?***

4.12 For businesses with a non-tax year accounting period end date, the main additional administrative burden and cost would be the requirement to apportion profits or losses from two accounting periods in order to determine the tax year profits. Compared with the current year basis, which simply takes the accounting period accounts profit or loss and makes the necessary adjustments for tax purposes (eg removes depreciation and deducts capital allowances, etc), a tax year basis will take these same adjusted profits and then add an extra step – apportioning two years profits – thus adding another step where potentially a mistake can arise.

4.13 It is not possible for us to put a precise figure on the additional costs. It might be expected that tax software will undertake the calculation automatically, but we would be happy to work with HMRC on their estimates of business compliance costs. The key problem here relates to the work involved in preparing estimates (as explained below), rather than the apportionment itself.

4.14 It is also not clear how other aspects will interact with the tax year basis of assessment. For example, will capital allowances be an adjustment to the accounting period accounts and then apportioned or be claimed as a separate adjustment based on expenditure in the tax year? Adjustments to accounts for depreciation and capital allowances are an area that often results in inadvertent errors. Another example is double taxation relief and how relief is claimed for taxes paid in other countries. This is already a difficult issue as the UK's tax year does not correspond with the tax years of other countries so allocating foreign tax paid on, say, a calendar year basis to a UK tax year is difficult (under the current year basis there is more likely to be a match between the profits assessed in each tax jurisdiction). If the UK adopts a tax year basis will foreign tax paid on accounting profits also need to be apportioned? If so, this will undoubtedly add to compliance costs and the potential for errors to be made.

4.15 ***Question 4a: Businesses with accounting dates later in the tax year will have to estimate profits for a proportion of the tax year, before accounts are prepared. For which accounting dates do you think this would be necessary? Do you expect that businesses that have accounting dates earlier in the tax year than 30 September will have to estimate profits? If so, which types of business would be affected?***

4.16 We would anticipate any business with an accounting period end between, say, 30 September and 30 March to have to estimate their profit for the accounting period ending after the relevant tax year, in order to complete their Self-Assessment tax return by the 31 January deadline. It is very unlikely that any business with an accounting period end from December onwards will be able to prepare any form of accounts by 31 January and those between September and November will, at best, only have draft accounts (and realistically not even that) by 31 January.

4.17 It is possible that some businesses with an accounting period end falling before 30 September may have to estimate their profit or loss. There can be many reasons why it can take time to finalise accounts, including

business / agent capacity. As noted elsewhere, the reforms could result in a bottleneck of work which might otherwise have been spread across the year.

4.18 While businesses with accounting dates in the first half of the tax year are more likely to be able to provide reasonably accurate estimates, or indeed final figures, of profits by the time the Self-Assessment tax return for the previous year has to be filed, there can be many reasons why either the accounts are not ready by 31 January, or the estimate provided proves to be inaccurate. Consequently, many businesses will find themselves needing to amend submitted tax returns as a result of these changes.

4.19 Considering the likely need for estimates in – and amendments to – tax returns, by virtue of the 31 January Self-Assessment deadline, it might be appropriate to consider a later filing deadline (eg 31 March as a minimum with an alternative for even longer filing deadlines linked to the accounting date of the second period from which profits would be included, at least for those businesses which do not have a tax year accounting period end). This might ease the bottlenecks of work, whilst reducing the number of interactions with HMRC, ie to amend estimated returns.

4.20 The increase in amendments being necessary to submitted tax returns (because estimates have had to be used) will have the knock-on effect of extending the enquiry window for those returns which will increase the length of time before an affected taxpayer can have certainty over their tax affairs for the year. This is an unfortunate consequence of these proposals and could lead to an erosion of trust in the tax system. Perhaps a rule could be introduced that an amendment that simply corrects a previous estimate does not extend the enquiry window for all other matters?

4.21 ***Question 4b: Will estimation be a significant burden for those businesses affected, and what will the cost be? Are there any simpler alternative methods of estimating profit or finalising estimates, which could mitigate any extra administrative burden?***

4.22 Yes, we think that estimation, and the need to correct those estimates, will be a significant burden for affected businesses.

4.23 To some extent, the overall impact will depend upon how accurate the estimate needs to be. If it can be based on the previous year (eg by default) that might be relatively straight forward. However, if it is expected to be a more ‘real time’ approximation, with penalties for estimates outside specified parameters, then this could in effect require the business to prepare an interim, as well as final, set of accounts. This will significantly increase the costs for affected businesses.

4.24 We also query what ‘actual’ profit the estimate will be measured against. If it is the pro-rated profits when the final accounts are prepared, the pro-rating itself is a broad-brush allocation (being simply time-apportioned) and may not be a reliable figure for actual profits generated in relation to the period covered by the estimation.

4.25 In any event, under the existing proposals businesses (or their advisers) will have to submit returns twice (one by 31 January which contains estimates, and a second amending return with the actual figures). This work takes time (either internally, paid for, or both), and the cost of advice and / or internal business costs will increase as a result of these changes. Advisers will also have to plan in order to accommodate the additional work. Even where taxpayers choose to align their accounting year end date with 31 March or 5 April, this will have workflow implications for the transitional year (and for future years it will mean many more accounts and tax returns having to be prepared within the same small time frame). By way of example, a sole trader with a 30 June 2021 year end, could expect to be able to file his or her 2021/22 personal tax return fairly soon after 6 April 2022. However, if the sole trader decides to move to a 31 March year end, a set of accounts for

the 21-month period to 31 March 2023 would be required and such accounts are unlikely to be prepared until several months into the tax year commencing 6 April 2023. This will in turn delay when the 2023 personal return can be prepared and filed with HMRC. In effect, the transitional year could create a bottleneck of 2023 tax return work towards the end of the 2023 right up to the filing date of 31 January 2024.

4.26 In terms of alternative options that might be considered, the following may be worth exploring further:

- Extending the Self-Assessment filing deadline from 31 January to (say) 31 March. This would not only provide a further two months in which actual accounts might be prepared, it would also help with the likely bottlenecks of work.
- Due to the inherent inaccuracy of pro-rating in order to determine 'actual' figures, simply enable the estimated figures to 'stand' and do not require them to be amended to 'actual' figures. To prevent manipulation between tax years, a tolerance could be introduced so that only estimates outside that level of tolerance would need to be revisited. However, some businesses will want or need to file final figures so this option would not work for everyone.
- Allow businesses to file their Self-Assessment tax return, and pay their taxes, based on the taxable profit for the 12 month accounting period ending in the relevant tax year (ie the current year basis). Those businesses could then be allowed / required to amend their return within, say, 6-months of the normal filing date (or, say, 9 months of the accounting period end), to reflect the actual apportioned profit. In this scenario, the taxpayer would still have their normal 12-month amendment window for other amendments etc which would be subject to the normal rules for late payment of tax etc. The aim of allowing tax to be initially paid based on the current year basis then allowing an amendment to the tax year basis, would be to allow taxpayers to retain their existing accounting period ends, and provide certainty to taxpayers (requiring estimates to be included in tax returns because the accounting period end does not coincide with the tax year introduces a significant level of anxiety for taxpayers that they may be penalised if they get their estimates wrong).
- Simply allow the return to be filed on a 'current year basis' and if 'actual' profits to be assessed proved to be within a certain tolerance, no amended return is required. Only cases outside that level of tolerance would need to be corrected.
- Permit all affected businesses (ie those with an accounting date other than the tax year end) to initially use the same figures for the profits/losses that were assessed in the previous tax year, and then when the actual figures are known the legislation would permit the person to submit an amended return to correct to actual.

4.27 One concern we have is the basis on which estimations can or should be made. An under-estimation has the potential to lead to an underpayment of taxes, and thus interest (and, potentially, penalties). An over-estimation could lead to excess tax being paid (including an overpayment of tax on account for the following tax year), when it can be very difficult to obtain timely repayments of overpaid tax from HMRC (and will also affect cash-flow in that business).

4.28 We think that there should be an agreed approach on including estimations so that all businesses that follow it will be deemed to have taken reasonable care, such that no penalties are charged unless the estimates are deliberately understated. HMRC will need to publish detailed guidance as to what to include in the return, what is a reasonable estimate, and when penalties will or will not be applied, etc.

4.29 ***Question 5: Would the proposed equivalence of 31 March to 5 April help businesses that would have to make apportionments to work out their profit or loss under the tax year basis? Would extending this equivalence***

to property income help property businesses, which would otherwise have to apportion profit or loss each year? Are there any problems with this equivalence proposal?

4.30 We note that the Office of Tax Simplification (OTS) is currently undertaking a review of the tax year end and considering whether the tax year end should move to 31 March or 31 December. We think that a change of tax year end to a more intuitive date would benefit the UK and await with interest the OTS's report and the government's response.

4.31 Assuming the tax year end remains 5 April for the foreseeable future, then we agree allowing businesses with an accounting period ending between 31 March and 4 April to treat those accounts as if they coincided with the tax year end on 5 April would help businesses enormously, as they would not then have to undertake apportionments to work out their profit under the tax year basis. We assume that where a business draws up accounts to slightly varying dates HMRC will continue to treat each account as an account for a period of 12 months to that mean date? Hence, that if that mean date is between 31 March and 4 April the accounts will be treated as coterminous with the end of the tax year?

4.32 Similarly, extending the equivalence to property businesses would help those businesses too.

4.33 In our experience many businesses (whether trading or property) draw accounts up to 31 March and treat those accounts as coinciding with the tax year end anyway. Thus, formalising this and legislating for an HMRC practice (in relation to trading profits) that already treats any apportionment of profit for a period of five days or less as nil (so has the effect that profits of the account to 31 March each year are taxed as though they were for the year to the following 5 April and for businesses which commence in the period 1 to 5 April assesses the profits for 'year 1' as nil) is a welcome easement.

4.34 We are not aware of any problems with this informal practice in the past so would not expect any problems with this equivalence proposal.

4.35 If the tax year end does change in the future this will affect these proposals. The requirement for equivalence of 31 March to 5 April would longer be relevant if the tax year end is changed to 31 March. However, if the tax year is changed to coincide with the calendar year, businesses would need a much longer lead in time in order to avoid significant changes to the tax system in short succession.

4.36 One major concern with treating accounts drawn up to 31 March (to 4 April) as if they were drawn up to the tax year end is the implications for MTD for ITSA. We understand that deeming 31 March as equivalent to 5 April is likely to mean that unincorporated businesses will need to follow the rules for MTD for ITSA from April 2023, rather than from April 2024, although this has not yet been confirmed by HMRC. For this and numerous other reasons we believe that the start date for MTD for ITSA should be deferred in order to accommodate a more thorough basis periods consultation process and give businesses more time to absorb the impact of the change in the basis period rules before they transition into the MTD regime (the timescales for which are already problematic).

4.37 ***Question 6: Are there any specific issues, costs, or benefits to the tax year basis for partners in trading partnerships?***

4.38 A potential burden for partners will be the need (especially for those partnerships with an accounting period end falling into the latter half of the tax year) to wait until the partnership return is filed with profit allocations between partners before the partner can finalise their personal tax return. We are not entirely certain but we think that the proposed changes will have no impact on what the partnership itself needs to file, ie they will continue to file tax returns for their accounting periods ending in the tax year. For those partnerships that will

retain an accounting date that is not 31 March or 5 April, they will however need to provide their partners with estimated profit allocations for the period following the end of the relevant accounting date to 31 March or 5 April where final figures are not known. This is the same as is currently required for new joiners and also for partners who leave within this period. The difference is that, under the proposed new basis period rules, it will be required for all partners every year.

4.39 As noted above, one option could be extending the Self-Assessment filing deadline from 31 January to (say) 31 March, providing a further two months in which actual accounts and partnership allocations might be determined.

4.40 It should be noted that, for many large partnerships with a 30 April (common for UK partnerships) or 31 December (common for international partnerships) year end, the choice of accounting date does not, per se, mean that they are deferring the time when tax is paid. Whereas a small business with a tax year end accounting date is likely to be preparing accounts on a cash basis, many partnerships have to apply the full rigour of GAAP/IFRS. So, while the small business is taxed on profits for a year that is closer to the receipt of the cash with which to pay the tax, in comparison the large partnership has to recognise profit when work is done, notwithstanding that even in the best managed partnerships, it would not be unusual to take 6 months to realise payment (ie time between doing the work and issuing the invoice and getting paid). This time lag reduces the 'benefit' of an accounting period end date earlier in the tax year.

4.41 ***Question 7: Are there any other issues and interactions to consider for the tax year basis, or the transition, in the areas of tax outlined in paragraph 3.33?***

4.42 *Capital allowances*

On the assumption that capital allowances will continue to be treated as a deduction (business expense), will the basis period for qualifying expenditure and disposals be whatever a business' accounting period is, rather than capital allowances having to be claimed on a tax year basis? Will capital allowances then be time-apportioned between tax years where the business has a non-tax year accounting year end?

4.43 Whilst the Annual Investment Allowance is due to return to £200,000 on 1 January 2022, any extension of the current £1m allowance into 2022/23 needs careful consideration and communication so it is clear how investment in the transitional year will be relieved.

4.44 *Losses*

One issue that will arise as a result of the change to a tax year basis is that loss claims may be delayed. For example, under current basis period rules a business with an accounting period ended on 30 September that incurs a loss for the year to 30 September 2021 can file its 2021/22 tax return shortly after 5 April 2022 and claim relief for that loss. But will the new basis period rules change this? For example, if a business is estimating a loss for, say, the accounting period ended on 30 September 2025, can you file the ITSA return for the 2024/25 tax year with an estimate of the loss for that accounting period, and utilise that loss in the normal way, or do you need to wait until the accounts for the year ended 30 September 2025 are finalised in order to use the apportioned loss?

4.45 There is also a risk that an 'artificial' loss could be created in the transitional year, if the individual is winding the business down, or not working due to maternity / illness etc. The brought forward overlap relief could create a loss (when a loss would not otherwise arise). This could have numerous impacts, such as the personal allowance being unused, or the inability to secure a mortgage etc.

4.46 If a loss arises in the transitional year, HMRC should consider whether any easements can be introduced into how that loss can be utilised. For example, there may be timing issues in that you may need to pay tax for 2021/22 even though it is clear a loss will arise in 2022/23 and can be carried back. Can provisional carry-back claims be made prior to filing the 2022/23 return? Also the temporary extension to carry-back losses recently introduced should be kept available for income tax purposes until the transitional year.

4.47 *Payment of tax and payments on account*

For the transitional year itself we think that the calculation of payments on account should be straightforward.

4.48 For the following year 2023/24, the payments on account should be based upon the profit earned for a 12 month period, not that for the 2022/23 transitional year which could be up to 23 months' worth of profit for those with a 30 April year end. This should be automatic rather than relying on an application to reduce payments on account.

4.49 The default position will be to include 20% of the transitional period profit in the transitional year (and 20% in each of the next 4 years). In many cases, this is likely to mean that claims to reduce payments on account will not be valid as expected profits (including the 20%) will be no lower than in the previous year. This means the value of the spreading will be diminished by the higher payments on account. We would suggest that the excess transitional period profit is ignored when calculating payments on account to further alleviate the cash flow issues.

4.50 *Double Taxation Relief*

The elimination of overlap will remove the need to track and calculate foreign tax credits on overlap profits, which provides a welcome simplification.

4.51 Our main concern is for which tax year double taxation relief / foreign tax credits will be given. For a business trading with the USA that has a 31 December accounting period end it was relatively simple to match the current year basis of assessment to the tax paid in the USA and thus claim double taxation relief.

4.52 Accounts to 31 December will be apportioned such that 3/4 of the profit of one period of account and 1/4 of the profit of another period of account is allocated to a tax year under the tax year basis. How will double taxation relief be given in such circumstances? How will foreign tax paid be credited against the UK tax due? Will the foreign tax be similarly apportioned?

4.53 *Averaging of fluctuating profits*

We are concerned that the interaction of estimates, filing of amended returns once actual profits are known, and the averaging / spreading rules (for farmers and artists and authors) may mean that the current one-year time limit for amending Self-Assessment tax returns is too short.

4.54 We refer to the submission by our 'sister' charity the Association of Taxation Technicians who address this issue more comprehensively.

4.55 *National Insurance Contributions (NICs)*

One aspect that will need to be decided is whether the excess profits will be considered for the purposes of calculating liability to Class 2 and Class 4 NICs. For example, if excess profits are spread over 5 years and in one of those years the taxpayer would otherwise have qualified for exemption from Class 2 NICs due to profits for the year being below the Small Earnings Exemption threshold (eg due to the taxpayer winding down their

trade or involvement in a partnership), but the inclusion of the spread profit takes them above the threshold, can the taxpayer still claim the exemption if they so wish?

4.56 At the other end of the scale with the excess profit be added on to the actual profit for the year to determine whether the upper threshold has been exceeded and, if so, at what rate (9% or 2%) will Class 4 NICs be paid?

4.57 *Student loan repayments*

Assuming the excess profit is earnings for NIC purposes, the taxation of excess profits in the transitional year (or the spreading of the excess profit over 5 years) could cause a taxpayer's earnings to exceed the threshold for student loan repayments (either in the transitional year or subsequent years). This could result in student loan repayments being due that otherwise would not have been payable (or higher than anticipated liabilities). One option would be to exclude the excess profits from the calculation of student loan repayments.

4.58 *Tax Credits (and Universal Credit)*

We refer to the submission by our Low Incomes Tax Reform Group (LITRG) who address this issue more comprehensively.

4.59 *High Income Child Benefit Charge (HICBC)*

Excess profits, either in the transitional year or, if spread, over the 5-year spreading period, could cause a taxpayer to become liable to the HICBC when, without this change of basis period rules, the taxpayer would not otherwise have been liable for this charge.

4.60 We suggest that any excess profit arising in the transitional year (or as a result of spreading) is excluded from income for the purposes of calculating liability to this charge - see also below).

4.61 *Other – Gift Aid relief and tax relief on Pension Contributions*

One aspect that will need to be clarified is how gift aid relief and pension contribution limits and relief interact both in the transitional year and where excess profits are spread. Will spread excess profits count as 'earned income' for pension contribution purposes? If there is excessive overlap relief in the transitional year will pension contribution limits be reduced (see also below)? Equally, if there are excess profits in the transitional year (or in subsequent years if the excess profit is spread) that cause earnings to exceed £240,000 will the pensions annual allowance taper rules apply?

4.62 Furthermore, since businesses will not know what their profits are until after the end of the tax year, they will have to estimate profits when determining what their maximum pension contributions are. Given the potential for pension annual allowance charges to arise if an individual's contributions exceed their annual limit, we think some flexibility in the pensions tax regime will be required. This could be to allow excess pension contributions to be either carried back or forward one year.

4.63 *Other – Businesses changing accounting date in or prior to the transitional year*

We understand that HMRC are aware of this issue and the intention is that the legislation will be amended accordingly, but we mention it for completeness.

4.64 In the light of these proposals, some businesses will change their accounting periods to 31 March (or 5 April). Under the draft legislation if a business does this before 2023/24, they will not be able to spread their excess profits over five years. For example, a business with a 30 April accounting date changes it to 31 March in 2022/23, so the basis period runs from 1 May 2021 to 31 March 2023 (ie nearly two years) and any overlap (if

it exists) will be relieved in 2022/23. If, say, the overlap relief is negligible, there is essentially an extra 11 months' worth of profits in the transitional year. The 'transition period' is the five days from 1 April to 5 April 2023 and the 'transition period profits' are nil in accordance with paragraph 36(2) of Part 3 of the draft Schedule. There is therefore nothing to spread, so the full 23 months of profit are taxable in 2022/23. Had the trader deferred the change of accounting date until 2023/24, the transitional year profits would be essentially the same, but the business would be able to spread the excess profits (ie the additional 11 months) over five years.

4.65 Although this is just the current rules working as they have always worked, at is stands it is a bizarre disincentive to align the accounting period sooner rather than later and, potentially, a trap for the unrepresented or poorly advised taxpayer who thinks they are doing what HMRC wants them to do. As noted above, we understand that HMRC are aware of this and that it was not intended. We suggest that the legislation be amended to permit any business that changes its account date to align with the tax year end (including 31 March) either this tax year (2021/22) or the transitional year (2022/23) to be able to spread any excess profits arising as a result. We suggest including a change of accounting date that takes places this year as we think that many unrepresented taxpayers could think that it would be easier for them to do that now rather than next tax year and do not think they should have the 'shock' of an extra tax charge for doing what they think is 'right' (and what they think HMRC want them to do).

4.66 *Other – Personal allowance*

The addition of excess profits in either the transitional year or, if spread, in subsequent years could cause a taxpayer's income to exceed £100,000 with the result that their personal allowance will be tapered away when, without the inclusion of the excess profits, this would not have been the case. We suggest that any excess profits should be omitted from the calculation of income for the purposes of determining entitlement to the personal allowance.

4.67 *Other – Income Tax Rates etc*

The addition of excess profits in either the transitional year or, if spread, in subsequent years could also move individuals between different rates of taxation, not just only in relation to their business profits, but on capital gains and dividends. Similarly, it could also impact the ability to transfer the Married Couple's Allowance.

5 Implementation and transition

5.1 Before we address the specific questions, we would like to make some observations regarding the timescale for these changes.

5.2 If this proposal is implemented, we would recommend deferring the transitional year until at least 2023/24, so that the new tax year basis applies from no earlier than 2024/25. The legislation will need to be passed before the proposed transitional year of 2022/23 begins, which is a very tight timescale. The detailed guidance businesses will need to manage the impacts of this change must be made available by HMRC before the transitional year starts. Delaying the transitional year by at least one year will provide more time for affected businesses, their tax advisers and HMRC to prepare for the transition. It will also allow sufficient time to explore alternative options and identify and address the various knock-on effects – something which the existing timescale prevents. It might also allow more businesses to give proper consideration to changing their accounting year to 31 March (or 5 April) which, we understand, is an outcome which HMRC would welcome.

5.3 By way of comparison, in March 1994 the then government confirmed that the basis period for the taxation of trading businesses would change from the previous year basis to the current year basis and that 1996-97 would be the 'transitional year'. The legislation effecting this change was included in the Finance Act 1994 and the (then) Inland Revenue published a detailed guide (SAT1) 'for Inland Revenue Officers and Tax Practitioners' on 'The new current year basis of assessment' in July 1994. This provided businesses (and their agents) with sufficient time – almost two years - to absorb the implications of that change in basis period assessment and prepare for the change. A similar timescale should be provided now.

5.4 The current year rules were subject to discussion and have since been reviewed because it was felt that overlap relief is too complicated and should be abolished. As noted above, the current year basis was introduced to facilitate Self-Assessment, which still exists, and is straightforward for all years apart from opening and closing. These past reviews have concluded that the current rules, and the overlap provisions, are the 'least bad' option. This illustrates why any change now needs to be fully consulted on and not rushed in so we can ensure we do not simply end up with even more complicated basis period rules – which is regrettably very likely considering the proposed rules will require affected businesses to undertake apportionments every year, rather than just opening and closing years under the current rules.

5.5 ***Question 8a: Does the proposed method of transitioning to the tax year basis using a long basis period combined with allowing all unused overlap relief achieve the best balance between simplicity and fairness? If not, is there a better option for transition?***

5.6 The move to the tax year basis will accelerate increased tax liabilities for many businesses. Commonly, opening years are the hardest for any small business to survive. That means, usually, those businesses have very little overlap relief to bring forward, plus overlap is not index-linked so its value diminishes over time. Normally, at the end of the lifetime of the business either the business is being sold, in which case the capital from the sale can offset any excess income tax liabilities arising from profits being proportionately higher than the available overlap relief, or the business is likely to have reduced as the owner slows down ahead of retirement, in which the available overlap relief is more likely to be in proportion to the profits. In both these scenarios the business is in a better position to 'afford' the catch-up tax arising from a final long period of account. This will not be the case with the change to the tax year basis.

5.7 Many businesses will still be recovering from the impact on their finances arising from the pandemic. Imposing a long period of account on, what we all hope will be 'normal', profits arising in the transitional year when there is likely to be, proportionately, very little overlap relief available, will cause cash-flow problems for many businesses. The proposal to mitigate this cashflow impact on transition (which we comment on further below) will go some way to help businesses but it is still likely that some businesses will struggle during this period. In this regard, we think that spreading excess profits is one answer (although we suggest some alternatives below) but it is vital that HMRC continue their supportive approach to the payment of tax, including facilitating time to pay (TTP) arrangements, particularly where there is an increased liability.

5.8 In a very few cases the crystallisation of overlap relief under the transitional rules could result in some anomalies whereby tax liabilities are reduced, and potentially even losses could arise. For example, a partner could have quite high overlap relief (because their first-year profits were high), but they are now on a much lower profit share. This could be due to winding down to retirement or it might be a temporary reduction because the partner has reduced their hours for caring responsibilities, ill health, parental leave etc. The high overlap is not normally a problem provided their income goes back up by the time they retire but will be a potential problem under these transitional rules. The result could be that much of the overlap relief could be 'wasted' on lower rate tax bands (when the overlap profit was taxed at higher rates and the expectation was

that the relief would be given at similar rates in the final years of trading). It could also mean that the taxpayer has zero relevant UK earnings for pension purposes, so relievable contributions would be limited to the £3,600 de minimis in the transitional year, rather than the expected £40,000.

5.9 For partnerships that operate reserves this 'loss' of overlap relief because of the lower tax rates is a further problem, as the partnership would have prepared their computations on the assumption that relief at higher rates would ultimately arise on the overlap (matching the tax suffered at the higher rates at the outset). While this can already be an issue for partners who reduce their hours prior to retirement and never increase them again, a) the partnership has time to adjust the reserves to spread the impact; and b) retirees often start receiving other income after they retire. If we are looking at a 40-something partner on temporarily reduced hours, their circumstances and the timescales will make it impractical to mitigate the problem.

5.10 One alternative to overlap relief and the spreading of 'excess' profits would be to simply apportion the profits arising in the transitional year, ignoring overlap relief, and taxing the equivalent of 12 months profit for the transitional long period of account. For example, for accounts drawn up to 30 September, the transitional period of account would be the 18 months from 1 October 2021 to 31 March (5 April) 2023. Thus, the transitional profits would be the 12 months to 30 September 2022 and 6/12 of the profits to 30 September 2023. Instead of deducting overlap relief (ie the 6 months of overlap profits from the opening years of trading) and spreading any 'excess' profit, simply tax in 2022/23 12/18 of the transitional profits. While there may be winners and losers, it could be a simpler approach.

5.11 Another approach would be to provide an option for the spreading of the 2022/23 tax liability, rather than the spreading of profits. This will avoid many of the issues discussed above (eg impacts on rates, personal allowance etc for the next five years), whilst still providing a period over which the tax liability can be paid.

5.12 Another option might be to make the tax year basis of assessment apply to all new businesses starting on or after 6 April 2022, but for existing businesses while the tax year basis could be the default, there could be an option of an election to continue to use the current year basis.

5.13 Alternatively, the reform could be restricted to traders who will have MTD for income tax obligations from April 2023 (ie excluding LLPs and complex partnerships) or at least deferred for a longer period until it is known how and when LLPs etc will be mandated to join MTD. The justification would be that these businesses are those which are most likely to have non-tax year accounting period and will likely find it most difficult to align to the tax year even if they want to but also more likely that they are not able to (eg because of international issues) so they will suffer a disproportionate burden as a result of the reforms.

5.14 ***Question 8b: Are there any other specific circumstances on transition to the tax year basis that would require additional rules?***

5.15 Another issue that arises is for firms which may wish to change their accounting date as a result of these changes. This takes time to plan for and has wide-ranging impacts on systems and processes among other things, including changing VAT return staggers, staff holiday entitlement periods, client communications, resourcing requirements etc. These predominantly non-tax aspects take significant preparation and deferring the transitional year by one year might help these businesses make the change. We also note that there can be limitations on the frequency of changing accounting period end dates (eg for LLPs), and it may be necessary to provide for a specific relaxation of these rules in this respect.

5.16 One of our biggest concerns with the transitional arrangements is whether there is a record of overlap profits. Businesses that have stayed with the same agent throughout their lifetime would be expected to have a record

of overlap profits. But other businesses, especially the unrepresented, are unlikely to have the historic record of their overlap profit. Those businesses will be reliant on HMRC advising what their overlap relief figure is. We understand that HMRC have, or can generate, this information.

5.17 We believe that HMRC should make this information to businesses through their digital tax account, and to agents via an API (at a minimum). We would urge HMRC to put the resources into making this possible as a matter of urgency. Existing Self-Assessment authorisations should allow access to this information.

5.18 ***Question 9a: Would the proposals for spreading excess profit mitigate the impact of transition without affecting the simplification of moving to the tax year basis? If not, are there any other ways of mitigating the transition impact that you would suggest?***

5.19 Yes, we believe they would go some way to mitigate the impact of transition. We think some mitigation of the extra tax that is likely to arise as a result of the transitional rules is necessary. We note, for example, recent press articles that between 300,000 and 500,000 sole traders and partners may face higher tax bills than expected next year if this proposal is implemented.

5.20 As noted above, the alternative is to tax the equivalent of 12-months profit for the transitional period, which would avoid the need to calculate excess profits and then spread the liability. If such a simple solution is not accepted by government, then the proposal to spread the excess profits over a number of years would seem to be the 'best' alternative.

5.21 Consideration should be given to ring-fencing the excess profit and taxing it at the business owner's marginal tax rate (ie the rate of tax excluding the excess profit), rather than added to their income and taxed as 'extra' income. In other words, the excess profit should be excluded from the calculation of total income and the taxpayer's income tax liability would then be calculated ignoring the excess profit and the excess profit would be taxed at whatever the taxpayer's highest marginal income tax rate is absent the excess profit. This would prevent the excess profit pushing a taxpayer into a higher than usual tax bracket because of the addition of the excess profit to their taxable income for the year and prevent some of the unwelcome outcomes (noted above) such as becoming subject to the HICBC, trigger student loan repayments etc.

5.22 If added to other income for the tax year, the excess profit could push a taxpayer into a higher-than-normal tax rate. This, we think, would be unfair, especially when, often, the triggering of overlap relief is the cessation of trade and the winding down of a business, so profits are lower and thus the owner would expect to pay less tax rather than more tax when their overlap relief arises. Hence, we believe that the excess profit should, initially, be excluded from the calculation of the taxpayer's tax liability and then taxed at whatever is the taxpayer's marginal tax rate (excluding these excess profits). We would also suggest that at the end of the spreading period (or the transitional year if the excess profit is not spread) the excess profit is excluded when calculating the payments on account required for the following tax year.

5.23 For partnerships (including LLPs) it would be helpful to have confirmed that the spreading is at the option of each partner rather than the partnership as a whole and, thus, each partner can individually elect to accelerate the charge without affecting any other partners ability to spread the charge.

5.24 ***Question 9b: Would the proposal to spread excess transitional profits over five years be enough to resolve the cash flow impacts of the proposed reform? Are there any situations which would need additional rules or anti-avoidance provisions?***

5.25 We think that for some businesses the proposal to allow excess profits to be spread over five years will be enough to help mitigate the cash-flow implications arising from the transitional year rules. However, for some

businesses, particularly those that have been growing rapidly and with very little overlap relief, the amount of excess profit could be significant in comparison to available cash, and for those businesses a longer period of time may be required.

5.26 We understand that a 5 year period was selected, at least in part, to prevent taxpayers 'forgetting' to include the spread profits in later years. We do not consider this a risk, seeing as HMRC have the ability to record this in their systems, and auto-correct returns which are filed with the spread profits missing (in a similar way to how it has approached Self-Assessment returns filed without SEISS grants being reported).

5.27 We also note that 5 years compares unfavourably with the changes from the cash basis to GAAP, which provided for a 10 year spreading. Considering that up to 11 months' profits are being accelerated (as compared to two or three months of 'cash collection'), we believe there is a strong case for a longer spreading period. We also understand that in some cases Inheritance Tax can be spread over 10 years.

5.28 We consider therefore that the spreading period should be up to ten years.

5.29 A further aspect to consider is the proposal that ceasing to trade triggers the remaining spread excess profits to become taxable in that final year. Obviously, this already happens under the existing rules but currently the cessation date can be controlled to some extent after considering the tax impact. This forced 'cessation' removes that flexibility. Hence, we think alternative options should be considered, including (as suggested above) taxing the excess profit at the taxpayer's marginal rate rather than treating as additional income, or allowing payment of the tax arising on the spread profits to be deferred and paid over the remainder of the spreading period.

5.30 Additionally, it would be helpful to clarify what happens to the spread excess profit if the taxpayer moves overseas and becomes non-UK resident. We assume that the 'normal' special rule applies to deem that the trade has ceased (and, if continued, that a new trade has commenced) at the time of the change of residence. We assume this then also triggers the balance of the transition period excess profits to become taxable in the UK in the year of leaving the UK but would welcome clarification in this respect. Perhaps spreading could continue in this case?

5.31 ***Question 10: Are there any other impacts, benefits, or costs in the core policy, transition, or mitigation proposals that we have not considered above?***

5.32 No mention is made in the consultation of the impact on enquiry time limits. The requirement to submit an amended return, for those affected businesses that have submitted estimated returns, extends the enquiry window even though the original return did not contain an error.

5.33 Indeed, many taxpayers might consider this to be an extension of enquiry time limits 'by the back door', undermining trust in the tax system. HMRC should consult further on how the proposed regime will impact their enquiry powers and use thereof.

6 Acknowledgement of submission

6.1 We would be grateful if you could acknowledge safe receipt of this submission and ensure that the Chartered Institute of Taxation is included in the List of Respondents when any outcome of the consultation is published.

The Chartered Institute of Taxation
31 August 2021