BASIS PERIOD REFORM – CHANGES IN THE 2023/24 TAX YEAR

Although we have already discussed with most of our impacted clients, we thought it would be good to send a summary of the changes to the way self employment profits are to be taxed.

Key points

There are significant changes in the way that the self-employed (including partners) are taxed. These changes have taken effect for the 2023/24 tax year.

Referred to as basis period reform, the changes mean that more tax may be due on income from self-employment, or a partnership, in the five tax years starting in 2023/24.

The impact will be felt by those using a business accounting year end other than 31 March or 5 April.

While it is clear that business income is affected, what may come as a surprise is that more tax may be payable on some other types of income as well, due to the changes.

We are sending you this summary, as we believe it may impact you.

What to look out for

If you do not have a 31 March or 5 April accounting date for your business, an additional slice of trading profit is taxable in 2023/24. The amount of profit is called 'transition profit' and will run from the end of your usual accounting date up to 5 April 2024.

For example, with a 31 December 2023 accounting year end, profits for the period 1 January 2024 to 5 April 2024 are transition profits. These are taxed in addition to your normal annual profits.

Transition profit will be automatically spread over the five years to 2027/28, with 20% of transition profits taxed in each of the tax years.

It is possible to choose to be taxed sooner on these profits, with more than 20% being brought into charge in an earlier tax year, and the balance spread over the remaining years. Indeed, all of the transitional profit can be taxed in the 2023/24 tax year if beneficial, meaning no further transitional profits taxed in later years.

This may be advantageous in certain circumstances, for example if you know that your income is likely to increase and you would be liable to higher rates of tax in later years. Or, if you purchase some large plant & machinery, the additional profits could be offset versus the allowances available.

Overlap Relief

Taxpayers with non 5 April (or 31 March) year ends may have overlap relief profits brought forward, which can be used to reduce the transitional profit. However, as overlap profits are often established in the first year of trade, these overlaps profits are usually lower than the transitional profit (due to lower profits in the opening year) or indeed nil (if there was no profit in the opening year).

Which key areas are affected?

Two key areas of impact are restriction of the personal allowance and tax on savings income.

The personal allowance (the amount of tax-free income you are allowed each tax year) is reduced where taxable income is over £100,000.

Transition profits increase income for this test, so where inclusion of transition profits pushes total income over £100,000, personal allowance will be reduced. All the personal allowance is lost when income is over £125,140.

As regards savings income, the savings allowance (strictly a nil rate band), means that there is no tax to pay on the first £1,000 of savings for a basic rate taxpayer, or the first £500 of savings income for a higher rate taxpayer. Additional rate taxpayers do not get the savings allowance.

Where inclusion of transition profits brings total income into a higher tax band, savings allowance is reduced or lost.

A potentially unexpected area of impact is student and postgraduate loan deductions for the self employed. These are based on total income.

What is unaffected?

Special rules about how transition profits are taxed mean that some other items based on the level of income are not affected.

These include the high income child benefit charge, which applies where someone is in receipt of child benefit and they or their partner have income of over £50,000.

The £60,000 cap for income tax relief on pension contributions is also unaffected.

Planning opportunities

The timing of income peaks in relation to transition profits will be significant. There are a number of strategies available for managing taxable income. These include pension planning, use of gift aid to donate to charity, transferring income producing assets between spouses / civil partners and employing family members in a business.

Where there is discretion over the timing of income, for example with some trust income and family company dividends, the best decisions will be made by keeping transition profits and spreading relief in view.

It may also be a good time to review property income portfolios to maximise the opportunities afforded.

So, what does this ultimately mean?

For example, if we use a year end of 31 December, whose profits are £50,000. The profit of the business will remain at £50,000.

Let us also assume there is no overlap profits brought forward, due to loss in the opening year.

In the 2023/24 tax year, the tax payer will be assessed on profits for the year ended 31 December 2023 **AND** the three months period to 31 March (so: 3/12 x £50,000 = £12,500).

The £12,500 is the transitional profit.

This transitional profit can be spread over 5 year. However, this means at least £2,500 will be taxable in the 2023/24 tax year, being subject to higher rate tax.

So, due to the transitional profit, this taxpayer will pay more tax in the 2023/24 and subsequent (up to another) 4 years.

The results for a business with say a 30 April year end, will be potentially significantly worse!

Further information

Although you do not have to change your accounting year end to 5 April (or 31 March), given the basis period reform we would suggest most sole traders and partnerships change their year end. We will of course discuss and advise accordingly.

Should you have any further questions, please do not hesitate to contact a member of the tax team.