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 trading profit must now be included in the Income Tax Computation for the relevant Tax Year of assessment.

Traders are assessed on their trading profit using a current year basis (CYB), this is the accounting year ending in the year of assessment (i.e. the tax year).

If a trader makes accounts to 31 October each year, his 2014/15 assessment will be based on the trading profit for the accounting year ending 31 October 2014.

Example 1

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

Which tax year will the trading profits for the year ended 31 March 2014 be assessed in?

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

Which tax year will the trading profits for the year ended 31 August 2014 be assessed in?

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

Which tax year will the trading profits for the year ended 30 April 2014 be assessed in?

1.1 Opening year rules

(a) There are special rules for the opening tax years of trading until a CYB assessment is available:

(b) For a new business:

Tax year	Basis of assessment
Year 1	Actual profits from commencement of trade to the following 5 April
Year 2	Is there an accounting period which ends in tax year 2?

yes → How long is this accounting period?

- < 12 months long → Assess profits for the first 12 months of trading
- ≥ 12 months long → Assess profits for the 12 months to the accounting period end date ending in year 2

no → Assess the actual profits in tax year 2 i.e 6 April to 5 April

Year 3	Assess profits for the 12 months to the accounting period end date ending in year 3

(c) 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 in the final tax year of assessment - see section 1.2.

Example 2

Andrew started to trade on 1 January 2012 and makes up his first accounts to 30 June 2012 and then 30 June annually thereafter. His trading profits are as follows:

6 months	to 30 June 2012	£30,000
Year	to 30 June 2013	£70,000
Year	to 30 June 2014	£82,000

What are the assessments for 2011/12 to 2014/15?

How much overlap relief is available?

Example 3

Chris started to trade on 1 May 2013 and makes up his first accounts to 31 October 2014 and then 31 October annually thereafter.

He made £36,000 trading profits in the 18 months to 31 October 2014 and £30,000 in the year ended 31 October 2015.

Compute the assessments for the relevant tax years so far as the above information will allow.

How much overlap profit arises?

1.2 Closing year rules

The basis of assessment for the final tax year of a business is as follows:

(a) Closing year: the actual trading profits from the end of the basis period for the previous year of assessment until the date of cessation (anything not yet taxed). The previous tax year should be assessed on a CYB

(b) Any overlap profits / relief is then deducted in deriving the assessment for the final tax year.

Example 4

Boris, who has been trading for many years making up his accounts to 31 January, ceases to trade on 31 May 2014 with trading profits as follows:

	Trading Profit
	£
Year to 31 January 2014	47,000
4 months to 31 May 2014	8,000

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

What are the assessments for 2013/14 and 2014/15?

2 Basis periods for capital allowances

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

2.1 Opening years

Capital allowances are deducted from profits before the opening year rules are applied. For an accounting period longer or shorter than 12 months the AIA and WDAs are scaled up or down as appropriate. The FYA at 100% on cars with emissions of ≤ 95g/km, is never time apportioned.

Example 5

Until 30 June 2014 Wendy was employed as a management consultant at an annual salary of £40,000.

On 1 July 2014 Wendy commenced in self-employment running a music-recording studio. The following information relates to the period of self-employment from 1 July 2014 to 5 April 2015:

1 The Adjusted profit for the period 1 July 2014 to 5 April 2015 is £89,000. This figure is before taking account of capital allowances.
2 Wendy purchased the following assets:

		£
1 July 2014	Recording equipment	30,000
15 August 2014	Motor car (CO_2 emissions are 170 g/km) used by Wendy - 60% business use	14,800
20 October 2014	Motor car (CO_2 emissions are 125 g/km) used privately by employee - 20% private use)	10,400
4 March 2015	Computer	2,600

Compute Wendy's income tax liability for 2014/15

2.2 Cessation of trade

(a) No allowances (WDA, AIA or FYA) are available in the final period of trading.

(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

From 6 April 2014 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 the VAT registration limit of £81,000.

A trader must leave the scheme if receipts assessable in the previous tax year exceed twice the VAT registration limit (£162,000).

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 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.

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)	xx

Example 6

Adam commenced trading as a sole trader selling fresh fruit on June 1, 2014 and prepared his first set of accounts to May 31, 2015, 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, 2015 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, 2014 Adam purchased equipment for use within the trade costing £8,000 and on 1 October, 2014 a motor car costing £12,000 with CO2 emissions of 122 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 May 31, 2015 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. 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 7

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, 2015 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 puroses 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