

## CHAPTER 5

### CURRENT YEAR BASIS AND OPENING YEAR RULES

In this chapter you will cover the rules for charging the profits of the self-employed to tax including:

- the relevant terminology;
- current year basis;
- commencement of trade;
- the rules for the opening years.

#### 5.1 Terminology

When a self employed individual starts to trade, he will be required to prepare a set of accounts which show profits or losses made during a particular period. This period is usually referred to as the **period of account** but may also be referred to as the **accounting period**. Once a trader has chosen his accounting date, he will normally make up accounts annually to a date known as his **year end**. For example, if a trader has a year end of 31 December it means that he makes up accounts for the year ended 31 December each year.

The **tax year** runs from the 6 April until the next 5 April each year, but traders are allowed to make up accounts for whatever period they want to. They do not have to use the tax year as their accounting period.

We must ensure that for every tax year in which a trader is trading, tax is paid on his profits. **The period that we charge his profits for is known as the "basis period"**. The basis period is determined by the "current year basis" (CYB) rules.

#### 5.2 Current Year Basis

s. 60

A trader is allowed to make up accounts to whichever date he chooses. However, we must **allocate those profits to a tax year** as income tax is calculated using rates & allowances for a tax year (eg, 2004/05).

We therefore tax the profits of the 12 month accounting period which ends in the tax year. For example, assume a trader has a 31 December year-end and makes up a set of accounts for the year ended 31 December 2004. As the accounting period ends between 6 April 2004 and 5 April 2005, the profits shown in those accounts (after adjustment for tax purposes) will be taxed in the tax year 2004/05. Putting it another way, the basis period for 2004/05 is the year ended 31 December 2004.

**Example 1**

Which tax year will the following periods of account will be the basis period for?

- a) Y/e 30.4.04
- b) Y/e 31.5.05
- c) Y/e 31.3.07

**5.3 Commencement of Trade**

s. 61

Special rules apply when someone starts to trade. A trade actually commences when the **main activity** starts.

Consider someone who is thinking of starting up a trade. He hires some staff, acquires some premises, sets up supplier and customer contracts. Once this has all been done, the actual manufacturing activity commences.

The commencement date for tax purposes of this trade is the date that the actual activity began, i.e. the date that the manufacturing started. This rule was given in the case of the *Birmingham District Cattle By-Product Company*.

In determining when somebody starts trading, we must look for the **main activity**. For example, a shop keeper will start to trade on the day he first opens his doors to the public, or an accountant may start to trade when he is first available to accept work. The actual commencement date will depend on the facts in each individual case.

**5.4 The First Year**

For the first tax year in which somebody is trading, the period which we recognise for tax purposes (the "basis period"), is very straightforward. We simply tax profits **from the date the trade started to the following 5 April**.

If the trade started on 1 January 2005 (ie, in 2004/05), we take the period from 1 January 2005 to 5 April 2005. Profits accruing in this period will be subject to tax in tax year 2004/05.

**Example 2**

Some commencement dates for trades are listed below. Determine the basis period and first tax year for each case.

- a) 1.8.04
- b) 1.3.06
- c) 1.9.06

## 5.5 The Second Year

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This is more complicated and we must look at the rules very carefully.

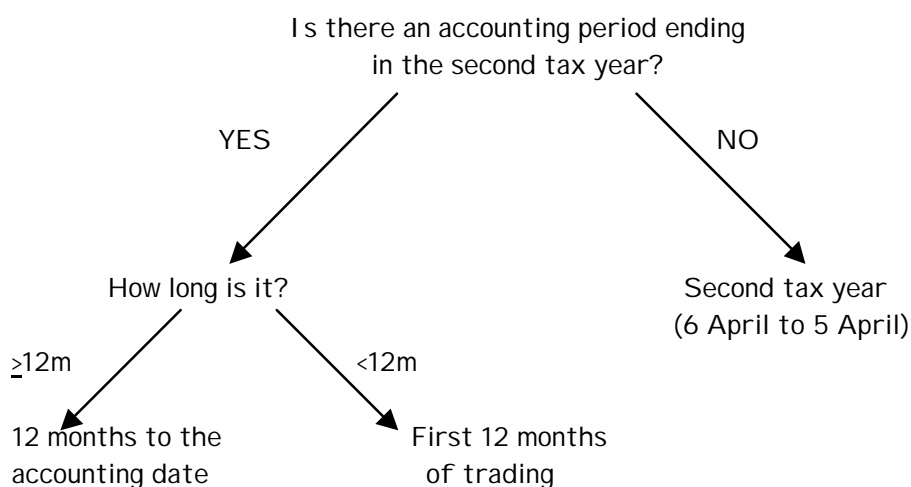
The first question we must ask is **whether there is an accounting period ending in the second tax year**, i.e. has the trader drawn up a set of accounts which **end** between 6 April and 5 April in the second tax year of trading. The answer to this question can be "yes" or "no".

If the answer is "yes", we then need to ask ourselves, **how long is that accounting period?**

If the accounting period is **equal to or greater than 12 months**, we tax the profits for the **12 months leading up to that accounting date**.

If the accounting period is **less than 12 months long** we tax profits of the **first 12 months of trading**.

If there is **not an accounting period ending** in the second tax year of trading, then the basis period for the second tax year is **that actual tax year**, i.e. the basis period will be from 6 April to 5 April of the second tax year of trading.



Under current year basis rules, if a trader is trading throughout the whole of a tax year, we must **tax exactly 12 months worth of profit**, no more and no less.

Consequently, if the first set of accounts is more than 12 months long, by taxing the profits of the whole of the accounting period, we would be taxing profits of more than 12 months (i.e. too much). Therefore, we take the last 12 months leading up to the end of that accounting period.

Conversely, if the first set of accounts is less than 12 months long, by taxing the profits of that accounting period we are taxing less than 12 months (ie, too little). By taking the **first 12 months** of trading, we add sufficient profit from the next accounting period to top up the assessment to exactly 12 months.

If there is no accounting date ending in the second tax year, we take the **tax year itself** to be the basis period. As that period is exactly 12 months long, all we have to do is time apportion the profits shown in the trader's accounts into that tax year.

### Illustration 1

Jimmy starts trading as an accountant on 1 October 2004. He chooses 31 December to be his year end and makes up accounts as follows,.

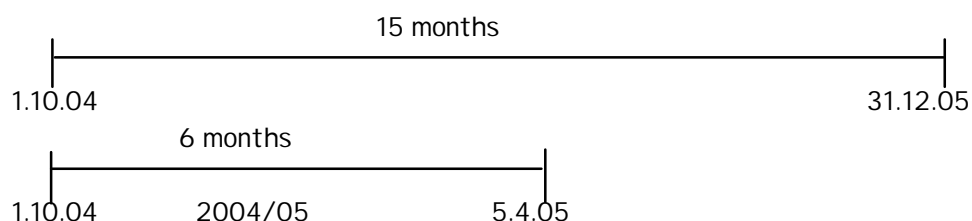
	£
15 m/e 31 December 2005	30,000
y/e 31 December 2006	40,000

Looking at the first accounting period (15 months long), we need to determine how the profit of £30,000 will be subject to tax in the first two tax years of trading.

*Year 1 (2004/05):*

Jimmy started trading on 1 October 2004. Therefore we tax profits accruing between the date of commencement (1 October 2004) and the following 5 April which is 5 April 2005. This is 6 months.

The first tax year of trading is 2004/05 so we taking the first 6 months out of the 15 months ended 31 December 2005.



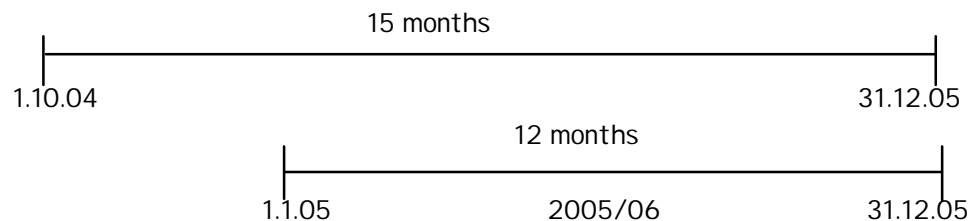
*2004/05*

$$1.10.04 - 5.4.05 = \frac{6}{15} \times £30,000 = \underline{£12,000}$$

When apportioning we assume profits are earned evenly over the accounting period. We apportion to the nearest month (ie, ignoring the 5 days at the start of April).

Year 2 (2005/06):

Using the flow chart, we ask, "is there an accounting period ending between 6 April 2005 and 5 April 2006"? The answer to that question is **yes**. The 15 month period ended 31 December 2005 ends in 2005/06 which is the second tax year of trading. This period is 15 months long. Consequently the basis period is the **last 12 months** leading up to the accounting date. This period is 1 January 2005 to 31 December 2005. We are therefore taxing the last 12 months of the 15 months worth of profit.



2005/06

$$1.1.05 - 31.12.05 = \frac{12}{15} \times \text{£}30,000 = \underline{\text{£}24,000}$$

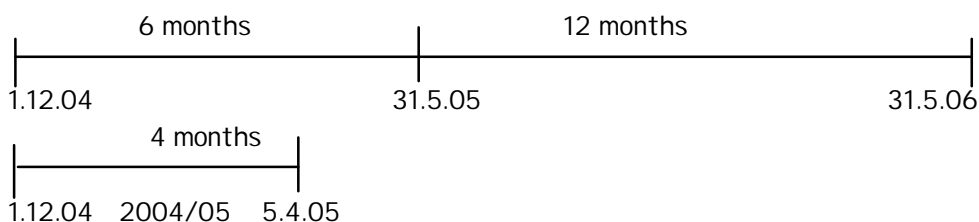
### Illustration 2

Mandy starts trading as a florist on 1 December 2004 and makes up accounts as follows:

	£
6 m/e 31 May 2005	12,000
y/e 31 May 2006	18,000

Year 1 (2004/05):

Mandy started trading on 1 December 2004 so in 2004/05 (first year) we tax profits between the date of commencement and 5 April 2005.



2004/05

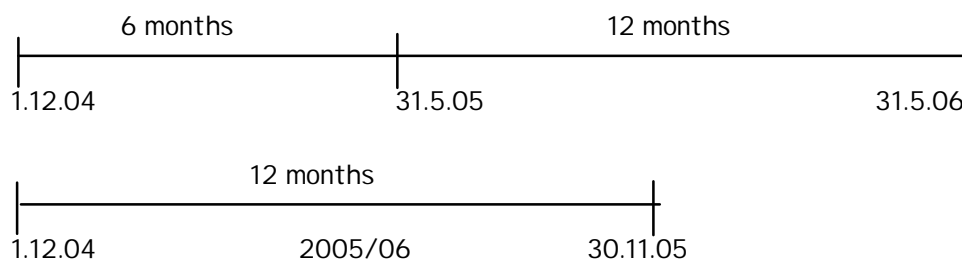
$$1.12.04 - 5.4.05 = \frac{4}{6} \times \text{£}12,000 = \underline{\text{£}8,000}$$

Year 2 (2005/06):

"Is there an accounting period which ends between 6 April 2005 and 5 April 2006"? The answer to the question is **yes**. The first set of accounts end on 31 May 2005 which is in the tax year 2005/06.

How long is that accounting period? The first accounting period starts on 1 December 2004 and runs through to 31 May 2005. It is therefore 6 months long. This is **too short**. If we were to tax those profits we would only tax 6 months of profits. We must make sure we tax 12 months worth of profit as Mandy is trading throughout the whole of the second tax year.

Therefore using our flow chart, her basis period is the **first 12 months** of trading. This is from 1 December 2004 to 30 November 2005.



2005/06

$$1.12.04 - 30.11.05 = £12,000 + \left(\frac{6}{12} \times £18,000\right) = \underline{£21,000}$$

### Illustration 3

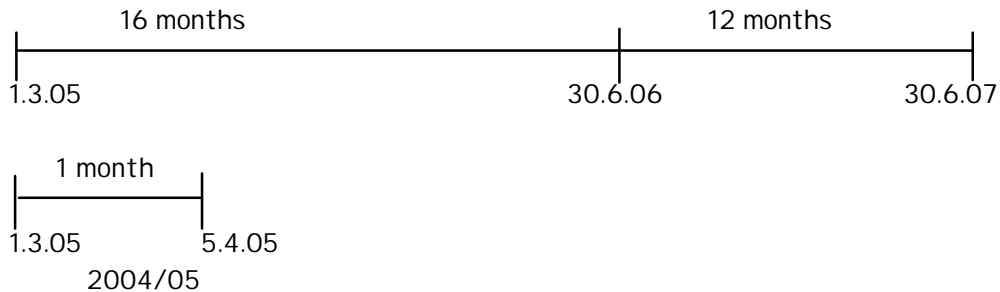
Rachel commences trading as a PR Consultant on 1 March 2005 and makes up accounts as follows:

	£
16 m/e 30 June 2006	32,000
y/e 30 June 2007	38,000

Let us now build up the tax assessments for the first two years.

*Year 1 (2004/05):*

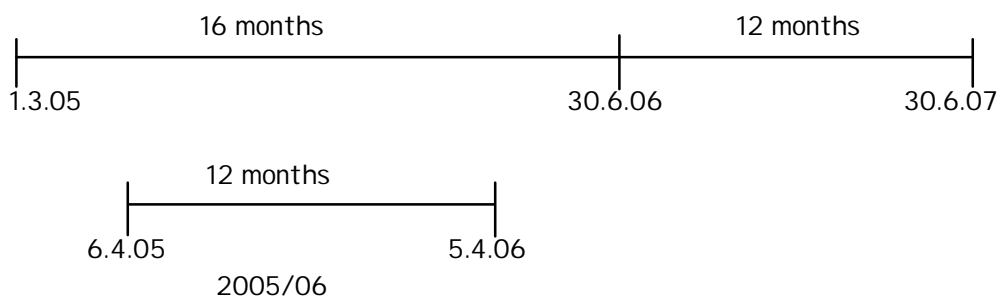
Rachel commences trading on 1 March 2005, so the basis period will run through to 5 April 2005, ie 1 month.

*2004/05*

$$1.3.05 - 5.4.05 = \frac{1}{16} \times \text{£}32,000 = \underline{\text{£}2,000}$$

*Year 2 (2005/06):*

Is an accounting period ending between 6 April 2005 and 5 April 2006? Here the answer is “no” as there is **not an accounting period ending in the second tax year**. The first accounting period does not end until 30 June 2006, which is after the end of the second tax year. In this scenario the basis period in year 2 is **the actual tax year**, i.e. the basis period is 6 April 2005 to 5 April 2006.

*2005/06*

$$6.4.05 - 5.4.06 = \frac{12}{16} \times \text{£}32,000 = \underline{\text{£}24,000}$$

## 5.6 The Third Year

By the third year of trading, the amounts on which the trader will be taxed will usually be determined by using the normal CYB rules. i.e. we tax the **profits of the 12 month accounting period ending in the tax year**. This rule does not apply if the second year's basis period is actually the second tax year (as was the case in Illustration 3). If this is the case, in the third tax year we tax the profits of the 12 months to the accounting date.

### Illustration 4

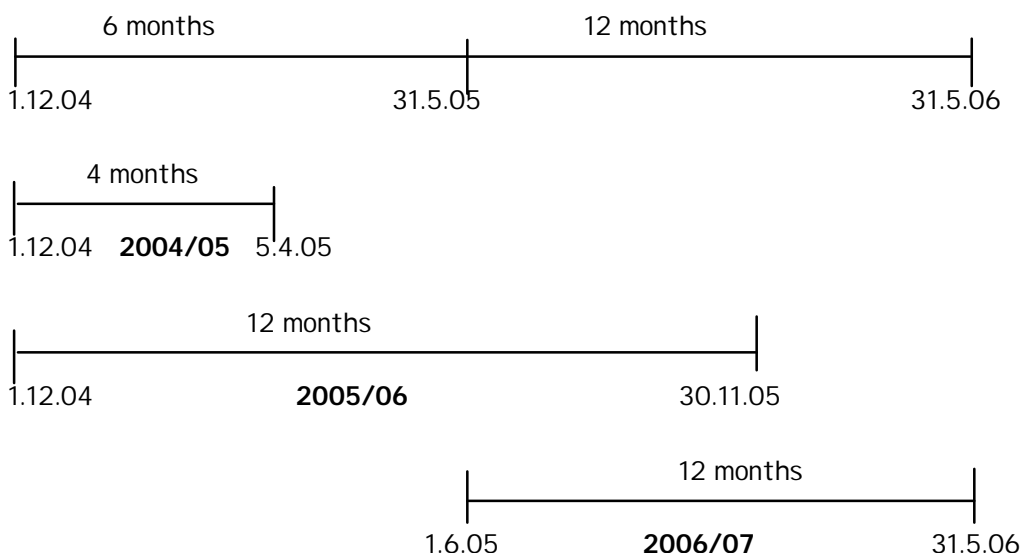
In Illustration 2, Mandy started trading on 1 December 2004 making up accounts to the end of May each year. We built up her assessments as follows:

The first tax year was 2004/05, and the basis period was from the start of trading to 5 April 2005.

The second tax year of trading was 2005/06. As the set of accounts ending in that year was less than 12 months, long we took the first 12 months of trading to be the basis period for the second tax year.

*Year 3 (2006/07):*

The first accounting period ends in the second tax year of trading. Therefore in the third tax year we use **normal CYB rules**.



*2006/07*

CYB y/e 31.5.06 = £18,000

**Illustration 5**

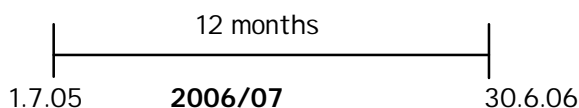
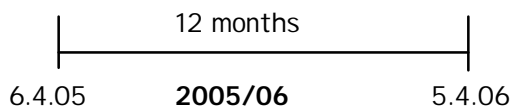
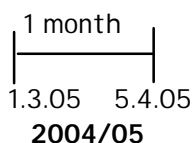
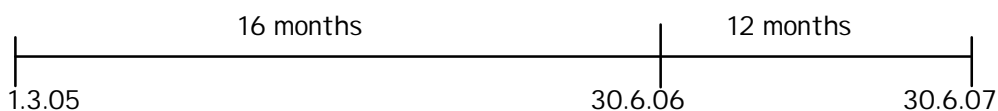
In Illustration 3, Rachel made up accounts to the end of June each year.

The first tax year was 2004/05 and we taxed the first 1 month of profit from 1 March 2005 to 5 April 2005.

Rachel's first accounting period did not end in the second tax year 2005/06, as her first set of accounts were not made up until 30 June 2006. Consequently her basis period for the second tax year of trading was the **actual tax year**, from 6 April 2005 to 5 April 2006.

*Year 3 (2006/07):*

As her first accounting period does not end until the third tax year of trading, (ie, 2006/07), her assessment for the third tax year will be based on the **12 months worth of profit ending on 30 June 2006**.



*2006/07*

$$1.7.05 - 30.6.06 = \frac{12}{16} \times \text{£}32,000 = \underline{\text{£}24,000}$$

*Year 4 (2007/08):*

By the 4<sup>th</sup> tax year, profits will be taxed using the normal current year basis.

*2007/08*

$$\text{CYB y/e } 30.6.07 = \underline{\text{£}38,000}$$

**Answer 1**

- |                |         |
|----------------|---------|
| a) y/e 30.4.04 | 2004/05 |
| b) y/e 31.5.05 | 2005/06 |
| c) y/e 31.3.07 | 2006/07 |

**Answer 2**

<i>Commencement Date</i>	<i>Basis Period</i>	<i>First Tax Year</i>
a) 1.8.04	1.8.04 – 5.4.05	2004/05
b) 1.3.06	1.3.06 – 5.4.06	2005/06
c) 1.9.06	1.9.06 – 5.4.07	2006/07

**Q**

Now test your understanding by attempting the questions from this chapter in your Question Bank.

## SUMMARY - CURRENT YEAR BASIS AND OPENING YEAR RULES

The period for which a trader makes up his accounts is known as the accounting period.

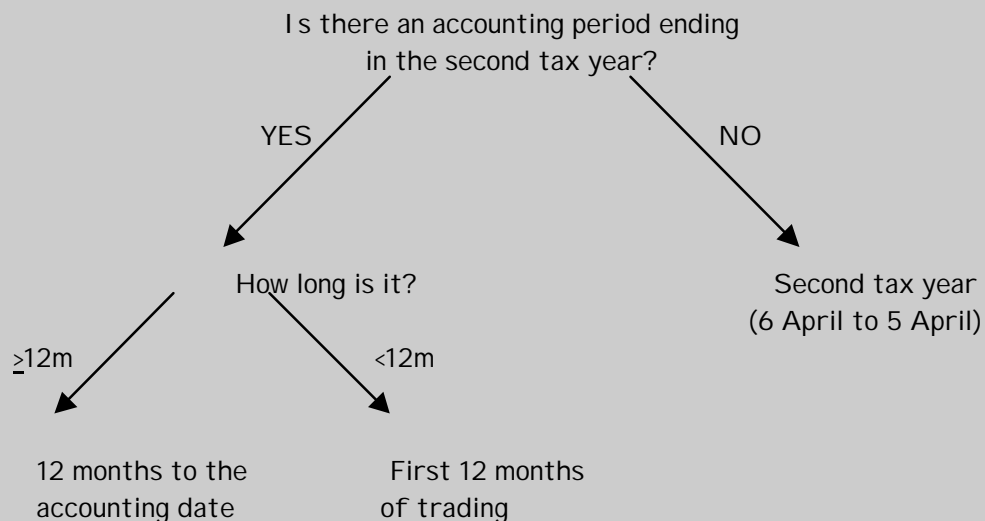
The period for which we charge his profits for a particular tax year is known as the basis period for that tax year.

The normal current year basis (CYB) rule is that we tax the profits of the 12 month accounting period ending in the tax year.

We use different rules in the opening years. A trade commences for tax purposes when the main activity starts.

In the first year we tax the profits from the date the trade started to the following 5 April.

In the second tax year we must tax twelve months worth of profits and we use various rules according to the following flowchart:



In the third year you can usually use the normal CYB rule. If however long first accounts were drawn up that did not end until the third tax year, the basis period is the 12 months to the accounting date.

All traders will be on normal CYB rules from the fourth tax year onwards.

