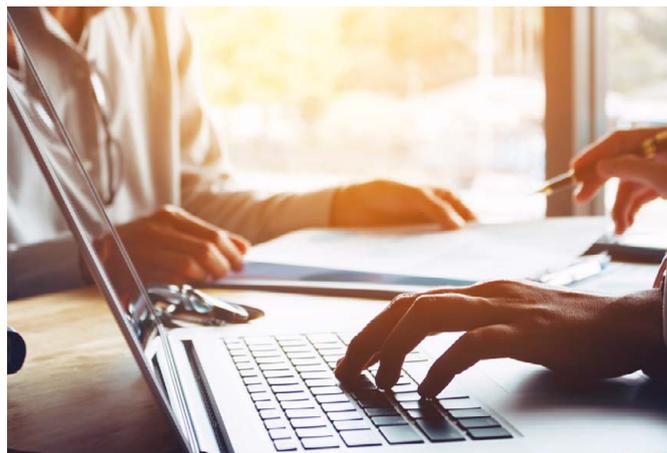


Accounts and adjustments

Tax computations involving long periods of account are regular features of tax examinations.

DEBBIE BRAY explains the various steps and adjustments that are needed to arrive at the correct result.



The difference between the taxation of sole traders and partnerships and companies can be challenging for students, particularly if the business concerned has prepared its profit and loss account for a period exceeding 12 months (otherwise known as a 'long period of account'). This topic often features in Part II of the ATT Paper 2 exam, so let's look in detail at the approach for dealing with this subject using a worked example.

Worked example

Let's say that a business, which has for many years been preparing trading accounts to 30 September, changed its accounting date and prepared the draft **Profit and Loss Account** for the 15 months to 31 December 2017.

We have been given the following further information in connection with these accounts.

- Legal fees include £2,300 for a new ten-year lease on the business premises and £800 for collecting trade debts.
- Entertaining includes £1,100 for the staff Christmas party, £600 for client entertaining and £700 for food hampers given to several important clients at Christmas.
- Repairs and maintenance includes the purchase of a new computerised till for £4,000 in November 2017.
- The capital allowances main pool balance was £20,000 at 1 October 2016.
- A new delivery van was purchased in December 2016 for £15,000.
- The old delivery van was sold in January 2017 for £6,000.

KEY POINTS FOR INDIVIDUALS

- Calculate the tax-adjusted trading profit after deducting disallowable expenditure and capital allowances for the *whole* accounting period.
- Plant and machinery that has been used privately must be shown in a separate 'private use asset column'.
- A capital allowances computation must be prepared for the extended accounting period and any writing down allowances and annual investment allowance will need to be adjusted for the length of the period.
- Either the rules relating to a change in accounting date must be followed or the long period might be dealt with under the opening year or closing year rules as appropriate

PROFIT AND LOSS ACCOUNT

	£	£
Sales income		430,000
<i>Less: Expenses</i>		
Depreciation	9,000	
Legal fees	3,100	
Staff costs	62,000	
Entertaining	2,400	
General office costs	8,500	
Rent, rates and insurance	42,000	
Repairs and maintenance	6,200	
		133,200
Net profit		296,800

The type of business

The first thing we need to identify is the type of business we are dealing with.

Let's say the business is called Marvellous Marmalade. This is an unincorporated business which is operated by a sole trader or a group of individuals together in a partnership. The information in the question would have to explain who runs the business. In either case, the business is owned and run by individuals and therefore the income tax rules apply.

If instead the business is called Marvellous Marmalade Ltd, or Marvellous Marmalade plc, the fact that there is a 'Ltd' or 'plc' at the end of the business name means that this is a company, owned by shareholders and run by directors. In such instances, the corporation tax rules would apply.

Sole trader

Let's start by assuming that Marvellous Marmalade is run by Paddington who is a sole trader. In this case, because the income tax rules apply, we must calculate the **Tax-Adjusted Trading Profit** after capital allowances for the *whole* accounting period.

The disallowable expenditure would also include any private expenditure of Paddington, the sole trader, that has been expensed in the profit and loss account, but here there is none.

The **Capital Allowances Computation** is prepared for the *whole* 15-month accounting period. Because the capital allowances period exceeds 12 months we must remember to time-apportion:

- the maximum annual investment allowance (AIA) limit of £200,000 by 15/12 to give £250,000 available in the AIA column for the addition of plant and machinery (excluding cars) in the period; and
- any writing-down allowances by 15/12.

TAX-ADJUSTED TRADING PROFIT

1 October 2016 – 31 December 2017 (15 months)

	£	£
Net profit per accounts		296,800
<i>Add back: Disallowable expenditure</i>		
Depreciation	9,000	
Legal fees re new short lease	2,300	
Client entertaining	600	
Food hampers (gifts of food not allowed)	700	
Computerised till (capital)	4,000	
Total adjustments		<u>16,600</u>
Tax-adjusted trading profit before capital allowances		<u>313,400</u>

CAPITAL ALLOWANCES COMPUTATION

Capital allowances	AIA @ 100%	Main Pool	Capital Allowances
15 months ended 31 December 2017	£	£	£
Tax written-down value brought forward		20,000	
<i>Additions:</i>			
Van (December 2016)	15,000		
Computerised till (November 2017)	4,000		
<i>Disposals:</i>			
Old van (January 2017)		(6,000)	
		<u>19,000</u>	<u>14,000</u>
AIA @ 100%	(19,000)		19,000
WDA @ 18% x 15/12		(3,150)	3,150
Tax written-down value carried forward	<u>0</u>	<u>10,850</u>	
Capital allowances			<u>22,150</u>

If, as here, the amount of the additions is small and will clearly be covered by the AIA there will be no need to show a working for the maximum AIA.

Remember that if any item of plant and machinery had been used privately by Paddington, it would have to be shown in a separate 'private use asset column' and only the business use proportion of the relevant writing-down allowance would be taken across into the capital allowances column.

We can now calculate the tax-adjusted profit for the 15-month period from 1 October 2016 to 31 December 2017 as follows:

	£
Tax-adjusted trading profit before capital allowances	313,400
Less: Capital allowances	(22,150)
Tax-adjusted trading profit for the 15 months ended 31 December 2017	<u>291,250</u>

Change in accounting date rules

The final stage is to allocate this tax-adjusted trading profit for the 15 months ended 31 December 2017 to the tax years using the change in accounting date rules. We can represent the accounting periods diagrammatically.

Year ended	15 months ended	Year ended
30 September	31 December	31 December
2016	2017	2018

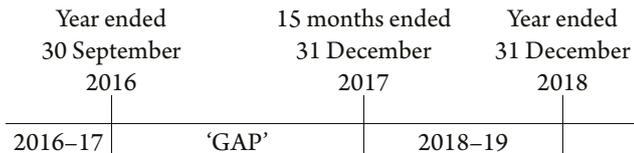
First, we must identify the tax year of change. This is the *earlier* of:

- the first time there is no 'old' accounting period ending on 30 September (in other words 30 September 2017) that would fall into a tax year (here 2017-18); and
- the first time there is a 'new' accounting period ending on 31 December (31 December 2017) that would also fall into a tax year (again, 2017-18).

Therefore, 2017-18 is the tax year of change.

Second, the tax years before and after 2017-18 would have been assessed on a current year basis, so we would assess 12 months up to the end of the accounting period ending in that tax year. Therefore:

- 2016-17: assess the year ended 30 September 2016
- 2018-19: assess the year ended 31 December 2018



Third, in 2017-18 we assess the 'gap' which means we assess the period that has not yet been taxed. In this case we will be assessing the 15 months ended 31 December 2017.

However, because Paddington traded for only 12 months in 2017-18 we reduce this gap down to 12 months by giving relief for three months of overlap profits from the start of the trade if we can.

“Two separate corporation tax computations must be prepared.”

Let's assume that Paddington had £30,000 of unrelieved overlap profits from the commencement of trade which related to six months that had been taxed twice. The trading profit taxable in 2017-18 would therefore be calculated as:

	£
15 months ended 31 December 2017	291,250
Less: Overlap profits 3/6 x £30,000	(15,000)
2017-18 Trading profit	<u>276,250</u>

CORPORATE COMPUTATION I

	AIA @ 100%	Main Pool	Capital Allowances
12 months ended 30 September 2017	£	£	£
Tax written-down value brought forward		20,000	
Additions:			
Van (December 2016)	15,000		
Disposals:			
Old van (January 2017)		(6,000)	
	<u>15,000</u>	<u>14,000</u>	
AIA @ 100%	(15,000)		15,000
WDA @ 18%		(2,520)	2,520
Tax written-down value c/f	<u>0</u>	<u>11,480</u>	
Capital allowances			<u>17,520</u>

KEY POINTS FOR COMPANIES

- The profit and loss account period is split into two corporation tax accounting periods.
- The first corporation tax accounting period is for the first 12 months, the second is for the remainder of the profit and loss account period.
- Calculate the tax-adjusted trading profit before capital allowances for the whole profit and loss account period then time apportion between the two corporation tax accounting periods.
- There is no adjustment for any private expenditure incurred by the directors of the company.
- There are two capital allowances computations - one for each corporation tax accounting period.
- There is no add back of private use asset column for companies.

Company calculations

We are now going to rework the same example, but on the basis that the business was Marvellous Marmalade Ltd, a company.

For a company we must first split the 15-month accounting period into two separate corporation tax accounting periods as follows:

- A first corporation tax accounting period for the 12 months ended 30 September 2017.
- A second corporation tax accounting period for the remaining three months ended 31 December 2017.

Two separate corporation tax computations must be prepared for the periods as shown above. However, in calculating the trading profit figure to take into each of the corporation tax computations we have only one profit and loss account which covers the whole 15-month period.

Consequently, there is one working which we have to do for the whole 15-month period, namely the calculation of the tax adjusted trading profit *before* capital allowances.

Because there was no private expenditure disallowed for the sole trader in our scenario, here we can use the same adjustment of profit working as we did above so the tax-adjusted trading profit before capital allowances for the 15 months is £313,400. We now split this figure between the two corporation tax accounting periods as follows:

12 months ended 30 September 2017	£
Tax-adjusted trading profit before capital allowances	
£313,400 x 12/15	250,720
<i>Three months ended 31 December 2017</i>	<i>£</i>
Tax-adjusted trading profit before capital allowances	
£313,400 x 3/15	62,680

Private expenditure

Note that we would ignore any private expenditure of the directors in the company in adding back our disallowable expenditure because the directors would be taxed on their private use as an employment benefit, so there would be no need to restrict the tax relief available to the company. For the same reason, we would not have a private use asset column in the capital allowances computation for a company.

Two separate capital allowance computations are then prepared, one for each corporation tax accounting period. See **Corporate Computation 1** and **Corporate Computation 2**.

Because the first capital allowances computation is prepared for a 12-month period, the AIA maximum limit is £200,000 and there is no need to time-apportion the writing-down allowances.

The second capital allowances period will always be less than 12 months. In this case it is for a three-month period, so we must remember to time-apportion:

- the maximum annual investment allowance (AIA) limit of £200,000 by 3/12 to give £50,000 available in the AIA column for the addition of plant and machinery (excluding cars) in the period; and
- any writing-down allowances by 3/12.

As before, if the amount of the additions is small and will clearly be covered by the AIA there is no need to show a working for the maximum AIA.

We can now deduct these capital allowances figures from the adjusted trading profits before capital allowances for each corporation tax accounting period to give us the final trading profit figures.

Year ended 30 September 2017	£
Tax-adjusted trading profit before capital allowances	
£313,400 x 12/15	250,720
Less: Capital allowances	(17,520)
Trading profit	233,200

CORPORATE COMPUTATION 2

Three months ended 31 December 2017	AIA @ 100% £	Main Pool £	Capital Allowances £
Tax written-down value brought forward		11,480	
Additions:			
Computerised till (November 2017)	4,000		
	4,000	11,480	
AIA @ 100%	(4,000)		4,000
WDA @ 18% x 3/12		(517)	517
Tax written-down value c/f	0	10,963	
Capital allowances			4,517

Three months ended 31 December 2017	£
Tax-adjusted trading profit before capital allowances	
£313,400 x 3/15	62,680
Less: Capital allowances	(4,517)
Trading profit	58,163

Now all that would be left for us to do is to finish the corporation tax computations for the 12 months ended 30 September 2017 and the three months ended 31 December 2017.

The main points are summarised in **Key Points for Companies**.

Summary

As can be seen, the taxation of individuals and companies is very different when dealing with long periods of account. It is therefore vital to understand the different approaches and ensure that the type of business has been identified before starting to answer the question. ■

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