All change!

Income tax rules when a business changes its accounting date can be complex. Sophie Hill clarifies.


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If a sole trader draws up a set of accounts that are not 12 months long it will be necessary to use special rules to work out what profits to allocate to the tax years involved. This is a topic that is regularly tested in both the ATT and CTA examinations. Although the government has announced a review of basis period, the existing rules will continue to be relevant for some time and therefore this article does not cover any of the proposed changes.

If the accounts are either the first or last set of accounts, the opening or closing year rules should be used. However, if the change is made at any other point then the change of accounting date rules are used.

HMRC always aims to tax 12 months' worth of profits in each tax year. The current year basis (CYB) rules achieve exactly that by allocating the profits from the 12-month set of accounts which end in a tax year to that tax year so the profits for the year ended 31 December 2021 are allocated to the tax year 2021-22.

If the sole trader changes their accounting date, they will draw up either a set of short (less than 12 months) accounts or a set of long (greater than 12 months) accounts.

The first step is to work out which tax year each set of accounts ends in and to identify the first tax year where it is not possible to use the straightforward CYB rule, ie when there is not the usual situation of one 12-month set of accounts ending in that tax year – this could perhaps be because:

- the set of accounts that ends in that tax year is not 12 months long; or
- two sets of accounts end in that tax year; or
- there is even no set of accounts ending in that tax year.

This tax year is called the year of change.

It is then necessary to consider the overlap profits position. Overlap profits are the profits that were taxed twice under the opening year rules and are usually carried forward and offset in the final tax year of trade under the closing year rules.

Another key thing to bear in mind is that the number of months' worth of overlap profits that a trader has will always equal the number of months *counting forwards* from their chosen accounting date to 31 March. So, with a December year end the trader will have three months' worth of overlap (from 31 December to 31 March), with a June year end the trader will have nine months' worth of overlap (from 30 June to 31 March).

If the accounting date is changed, the overlap profits carried forward will also change – they could increase or decrease. The change in months of overlap will be the adjustment required to ensure that exactly 12 months of profits are taxed in the tax year of change.

Let's have a look at how this works with some examples.

Example 1

A sole trader draws up accounts for year ended 30 June 2021 and then six months ended 31 December 2021 – both these periods end in 2021-22 so 18 months' worth of profits fall into 2021-22. This 18-month figure needs to be reduced by six months to tax only 12 months' worth of profits in 2021-22. This is done by offsetting six months' worth of the overlap profits brought forward. The old accounting date to June means nine months of overlap brought forward – the new accounting date to December means only three months of overlap are required to carry forward so we need to use up six months of overlap. We therefore reduce the profits allocated to 2021-22 by six-ninths of the overlap brought forward leaving the other three-ninths of overlap profits to be carried forward.

Summary of example 1

Before	June year end = 9 months' worth of overlap brought forward
Change	Relieve 6 months' worth of overlap (6/9ths of brought forward figure)
After	December year end = 3 months' worth of overlap carried forward
2021-22	'Year of change' Year to 30 June 2021 ends in 2021-22 Six months to 31 December 2021 ends in 2021-22 1.7.20 – 31.12.21 = 18 months of profits Deduct: 6 months' worth of overlap profits

Key points

- Income tax is charged on the results of an unincorporated business.
- The current year basis rules allocate the profits from a 12-month set of accounts to the tax year in which they end.
- Special rules apply when the period is not a 12-month period.

Example 2

A sole trader changes from a September year end by drawing up accounts for 15 months ended 31 December 2021 – 15 months' worth of profits fall into 2021-22. This 15-month figure needs to be reduced by three months to tax only 12 months' worth of profits in 2021-22. This is done by offsetting three months' worth of the overlap profits brought forward. A September year end means six months of overlap brought forward – December year end means three months of overlap to carry forward and so we reduce the profits allocated to 2021-22 by three-sixths of the overlap brought forward leaving the other three-sixths of overlap to be carried forward.

Summary of example 2

Before	September year end = 6 months' worth of overlap brought forward
Change	Relieve 3 months' worth of overlap (3/6ths of brought forward figure)
After	December year end = 3 months' worth of overlap carried forward
2021-22	'Year of change' 15 months to 30 December 2021 ends in 2021-22 1.10.20 – 31.12.21 = 15 months of profits Deduct: 3 months' worth of overlap profits

Example 3

A sole trader changes from a September year end by drawing up accounts for eight months ended 30 May 2021 – eight months' worth of profits fall into 2021-22. This eight months figure needs to be increased by four months to tax 12 months' worth of profits. This is done by taxing 4/12ths of the profits of year ended September 2020 again. A September year end means six months of overlap brought forward – May year end means ten months of overlap to carry forward and so we increase the overlap by creating four months of new overlap, that is, taxing four months of profits for a second time, leading to ten months of overlap being carried forward now.

Summary of example 3

Before	September year end = 6 months' worth of overlap brought forward
Change	Create 4 months' worth of overlap (assess 4 months from previous accounting period again)
After	May year end = 10 months' worth of overlap carried forward
2021-22	'Year of change' 8 months to 31 May 2021 ends in 2021-22 1.10.20 – 31.5.21 = 8 months of profits Add: 4 months' worth of profits from previous accounting period 4/12 x year ended 30 September 2020 creating 4 months' worth of overlap

Example 4

A sole trader changes from a December year end by drawing up accounts for 16 months in year end – April 2022 – here CYB does not work for *two* tax years – no accounts end in 2021-22 and the 16- month set of accounts end in 2022-23. Here we have 16 months' worth of profits to allocate to *two* tax years. This 16-month figure needs to be increased to 24 months by creating eight months more overlap. A December year end means three months of overlap brought forward – April year end means 11 months of overlap to carry forward and so we increase the overlap by creating eight months of new overlap, that is, taxing eight months of profits for a second time) leading to 11 months of overlap being carried forward now. The profits taxed in 2021-22 will be 8/12ths of the profits in y/e 31 December 2020 (these were already taxed in 2020-21 so this creates eight months of overlap) and 4/16ths of the long period profits. The profits taxed in 2022-23 will be the other 12/16ths of the long period profits.

Summary of example 4

Before	December year end = 3 months' worth of overlap brought forward
Change	Create 8 months' worth of overlap (assess 4 months from previous accounting period again)
After	April year end = 11 months' worth of overlap carried forward
2021-22	'Year of change' 16 months to 30 April 2022 ends in 2022/23 No accounting period ending in 2021/22 16 months of profits here Need 24 months for two tax years Create 8 months' worth of overlap Assess 4/16 x 16 months ended 30 April 2022 in 2021-22 Add: 8 months' worth of profits from previous accounting period 8/12 x year ended 31 December 2020 creating 8 months' worth of overlap Assess 12/16 x 16 months ended 30 April 2022 in 2022-23

By identifying which years are not simply assessed using CYB and then working out what change is required to the overlap profits, it is possible to work out how to obtain 12 months' worth of profits taxable in all the tax years affected when a sole trader changes their accounting date. ●

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