HMRC– Written evidence (DFF0020)

1. Effect of Transition on Reliefs and Benefits

Following the publication on 4 November of the Government's response to the consultation on basis period reform and of the Finance Bill, please can you confirm that the excess profits of the transitional year will not affect individual's entitlement to tax reliefs and benefits such as

- Relief for pension contributions
- Tax credits
- Universal credit

or

- Liability to the high-income child benefit charge

or

- Assessment of income for student finance purposes?

We can confirm that the excess profits of the transitional year (referred to in the Finance (No 2) Bill 2021-22 as the transition profits) will not affect any of the above items.

All of these, apart from Universal Credit, rely on the net income of the individual as defined at Step 2 of section 23 Income Tax Act 2007. The transitional profits will not be included in this net income figure.

For Universal Credit, the determining factors are the income and expenses of an assessment period, and these periods are unaffected by the abolition of basis periods.

2. Effect of Transition on Tax Rates

Please clarify whether excess profits will be taxed at the individual's marginal rate. So, for example, if normal income for a particular tax year was £40k (so the individual was a basis rate payer) but the transitional profit allocated to that year was £20k, then (part) of that £20k would be taxed at the higher rate and the individual's savings allowance reduced to £500? Similarly, at higher income brackets could excess profits lead to a withdrawal of the personal allowance?

Excess profits will be taxed at marginal rates. An individual's entitlement to the savings allowance and the personal allowance will be unchanged. However, the tax charged on the transition profit will reflect the normal rules for the reduction or removal of these allowances depending on income, as if the profit were taxed normally.

This is because the charge is based on a comparison of the tax liability calculated at Step 5 of the tax computation: the personal allowance is deducted at Step 3 of the computation, and the effect of the savings allowance is reflected in the rates of tax used at Step 4.

Example: standard profit £40,000, transition profit £20,000, savings income £1,500, using 2021/22 England rates and allowances.

Trading income		60,000
Less transition profit		(20,000)
		40,000
Savings income		1,500
Total income		41,500
Less personal allowance		(12,570)
Taxable income		28,930
Tax on trading income	27,430 @ 20%	5,486
Tax on savings income	1,000 @ 0%	0
	500 @ 20%	100
Tax charge on transition profit (W1)		6,246
Total income tax liability		11,832

(W1) Tax charge on transition profit is the difference between the tax liabilities at Step 5 of the section 23 ITA07 calculation with and without the transition profit

With transition profit:		
Trading income		60,000
Savings income		1,500
Total income		61,500
Less personal allowance		(12,570)
Taxable income		48,930
Tax on trading income	37,700 @ 20%	7,540
	9,730 @ 40%	3,892
Tax on savings income	500 @ 0%	0
	1,000 @ 40%	400
Total income tax liability at Step 5		11,832 (A)
Without transition profit: see main calculation	5,486 + 0 + 100 =	5,586 (B)
Difference between amounts A and B		6,246

3. Effect of Transition on Step 2 Reliefs

Please clarify the impact of the transitional year proposals on the ability to use any Step 2 reliefs against income given that such are subject to a limit.

Step 2 reliefs can be set against transition profits in the same way as the reliefs can be set against normal trading profits.

There is no change to the rules calculating the limit on Step 2 reliefs. Adjusted total income for the purpose of calculating the limit on Step 2 reliefs includes transition profit chargeable in 2023/24, meaning that for some businesses the limit could be increased.

Overlap relief is not subject to the limit on Step 2 reliefs, so can be used to its fullest extent on transition regardless of a taxpayer's use of, or limit to, Step 2 reliefs.

4. Changing Accounting Date before 2023/24.

At the meeting on 28 October Thomas Brown indicated that where an individual whose accounting period was not aligned with the tax year changed it in advance of basis period reform to make it aligned, the excess profits brought into charge would benefit from the spreading relief. Can you confirm that provision is made for this in the Finance Bill?

Under a niche provision of the existing basis period rules it is possible for some businesses to change the date to which they draw up their accounts without changing their basis period. This interaction will be removed on transition to the tax year basis, as the change of accounting date rules will be removed.

This process uses Box 11 of the full self-employment pages (SA103F), which a taxpayer marks if they have changed accounting date and they want this change to count for tax. If a taxpayer does not mark this box, a change of accounting date will have no tax effect, so their basis period will remain aligned with the old accounting date. In the transition year, the transitional provisions would apply as if the taxpayer had never changed their accounting date.

For example, a taxpayer with a 30 September 2022 accounting date changes to 31 March 2023, by preparing a short 6-month set of accounts to 31 March 2023. Normally, this would lead to a change of accounting date in 2022/23, but in this case the taxpayer does not mark box 11 on their SA103F so the change has no effect on tax basis periods. The taxpayer's basis period remains aligned to their old accounting date, the 12 months to 30 September 2022, and they will be taxed on profit arising in this period for the tax year 2022/23.

As the taxpayer's basis period for 2022/23 is not aligned with 31 March to 5 April, the transitional provisions will apply for 2023/24. This means that the taxpayer will be taxed on 18 months' worth of profits in 2023/24, from 1 October 2022 to 31 March 2024. This allows the taxpayer to benefit from spreading and other transitional provisions, even though they had already changed their accounting date to align with the tax year beforehand. The taxpayer can continue to account to 31 March without affecting their basis period reform transition.

As these rules already exist in the current basis period rules, and follow through into the transitional provisions included in the Finance Bill, no further provisions need to be made in the Finance Bill to allow taxpayers to change their accounting date in advance of transition.

A business using this approach would be able to change their accounting date in 2022/23 but still benefit from the transitional provisions, such as spreading, in 2023/24. However, this is a very technical process that would likely create additional complexities and misalignments for the business in 2022/23, although it could help accountants and agents to spread the work of changing accounting dates if businesses are content with taking this route.

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