These notes refer to the Income Tax (Trading and Other Income) Act 2005 (c.5) which received Royal Assent on 24 March 2005

INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 2: Trading income

Chapter 15: Basis periods

Overview

812. Profits for a tax year are taxed by reference to the amount of profit earned in the basis period for that tax year.

813. This Chapter gives the rules that identify the basis period for a particular tax year.

814. For established, on-going trades with a constant accounting date – the majority of cases –the rules operate very simply: the basis period for a tax year is the 12 month period ending on the accounting date in that year.

815. But special rules are needed when a trade begins or ends. And further rules have to deal with less common events such as a change of accounting date or if accounts are regularly prepared to a particular day (rather than a particular date) in the year.

816. The rules in this Chapter are ordered so that the rules dealing with the more unusual cases are located at the end of the Chapter: the simplest cases are fully dealt with by the first six sections.

Section 196: Professions and vocations

817. This section makes it clear to whom the basis period rules apply. It is new.

Section 197: Meaning of "accounting date"

818. The basis period rules operate by reference to the accounting date falling in the tax year. This section defines the key term "accounting date". It is based on sections 60(5) and 62(2) of ICTA.

819. *Subsection (1)* gives the main rule. Sub-paragraph (b) deals with the case where two periods of account end in the same tax year and so there are two accounting dates.

820. *Subsection (2)* deals with two particular cases outside the main rule.

821. *Subsection (2)(a)* refers to section 211. That provision applies if the accounts are made up to a particular day in the year rather than a particular date. See the commentary on section 211 and *Change 56* in Annex 1.

822. *Subsection (2)(b)* refers to section 214. That provision extends the definition of "accounting date" to include the date in the tax year to which accounts are treated as

being prepared under the change of accounting date rules. That can arise when the period of account ending with the new date starts in, say, year six and ends in year eight: then an accounting date - the new date - is treated as falling in year seven.

Section 198: General rule

823. This section gives the general rule which will apply year on year to most taxpayers unless it is displaced by a special rule. It is based on section 60(3) of ICTA.

824. *Subsection (2)* lists the provisions that displace the general rule.

Section 199: First tax year

825. This section gives the rule that applies to the first year of trading. It is based on section 61(1) of ICTA.

826. *Subsection (2)* addresses the case where the trade both starts and ends in the same tax year and signposts the reader to the "final tax year" rule in section 202.

Section 200: Second tax year

827. This section gives the rules that apply to the second year of trading. It is based on sections 60(3)(a) and (b), 61(2) and 63 of ICTA.

828. It makes explicit what is merely implicit in the source legislation. It covers several possible cases and a separate subsection addresses each.

829. *Subsection (4)* applies only when there is no accounting date in the second year and the accounting dates in the first and third years are the same. When there is no accounting date in the second year and the accounting dates in the first and third years are not the same there is a change of accounting date and section 214(3) applies to give a notional accounting date for the second year. Under section 197 that is treated as an accounting date for the purpose of the Chapter 15 rules and section 200(2) or (3) then determines the basis period for the second year depending on when the notional accounting date falls.

Section 201: Tax year in which there is no accounting date

830. This section deals with the case where there is no accounting date in a tax year. It is based on section 60(3)(b) of ICTA.

831. This section does not apply if there is no accounting date in a tax year because there is a change of accounting date effected by a period of account which entirely spans the year in question. In that case section 214 applies and treats an accounting date as falling in the spanned year.

Section 202: Final tax year

832. This section gives the basis period for the final year of trading. It is based on sections 61(1) and 63 of ICTA.

833. *Subsection (1)* deals with the more usual case and *subsection (2)* the less usual case.

Section 203: Apportionment etc. of profits to basis periods

834. If the period of account does not coincide with the basis period, profits must be apportioned. This section gives the rules for the apportionment. It is based on section 72(1) and (2) of ICTA and the non-statutory practice described in paragraph 71025 of the Business Income Manual.

835. *Subsection (4)* legislates that non-statutory practice. It allows apportionment in ways other than the apportionment by reference to days permitted by section 72(2) of ICTA. See *Change 52* in Annex 1. The wording of subsection (4) makes it clear that the option

to choose an alternative basis of apportionment is exercisable only by the taxpayer, not the Inland Revenue.

Section 204: Meaning of "overlap period" and "overlap profit"

836. The basis period rules are designed to ensure that, over the lifetime of a trade, the total profits assessed exactly equal the total profits earned. This section defines the key concepts of "overlap period" and "overlap profit" that are central to achieving that. It is based on section 63A(5) of ICTA.

Section 205: Deduction for overlap profit in final tax year

837. This section provides the authority for deducting overlap profit in what is probably the more common of the two cases where it may be deducted: in calculating the profits of the final year of trading. (The other, on certain changes of accounting date, is dealt with in section 220.) It is based on section 63A(3) of ICTA.

838. This adjustment is a key part of the rules which ensure that, over the lifetime of a trade, the total profits assessed exactly equal the total profits earned.

Section 206: Restriction on bringing losses into account twice

839. This section states a short but important rule which prevents an "overlap loss" from being used more than once in aggregation. It is based on section 63A(4) of ICTA.

Section 207: Treatment of business start-up payments received in an overlap period

840. This section provides a special rule for business start-up payments. It is based on section 127 of ICTA.

841. The charge in ICTA is under Schedule D Case VI. But logically the income is trade profits.

842. The policy is that business start-up payments should be taxed only once. This section achieves that result directly, instead of by taking the income out of the calculation of trade profits. See *Change 53* in Annex 1. There is a transitional rule in paragraph 49 of Schedule 2 to this Act to ensure that the new treatment applies only to payments received after 5 April 2005.

843. Paragraph 108 of Schedule 1 to this Act repeals section 127 of ICTA. Subsection (3) of that section treats business start-up payments as earned income and as relevant earnings. This Act preserves that treatment because the payments are brought into account as receipts of the trade.

844. *Subsection (3)* sets out in full what the "corresponding payments" are in Northern Ireland and reflects the effect of the devolution settlements. See *Change 19* in Annex 1.

Section 208: When the late accounting date rules apply

845. This is the first of three sections whose purpose is to simplify the normal operation of the basis period rules in particular circumstances. They avoid the creation of very short overlaps (less than six days) between basis periods - and therefore small amounts of overlap profit. They are based on the non-statutory practice described in paragraph 71170 of the Business Income Manual.

846. That practice benefits taxpayers who, at the start of trading, prepare accounts to 31 March - a popular accounting date. They allow the accounts for the opening years to be treated as though they were prepared to 5 April.

847. And because it would be illogical to exclude cases where the chosen accounting date would result in overlaps even shorter than those arising from an accounting date of 31 March, accounts prepared to 1 to 4 April are also included. See *Change 55* in Annex 1.

848. Despite the simple purpose of this provision it gives rise to some complex issues. As well as covering those cases involving accounts prepared to dates between 30 March and 5 April, it needs also to deal with cases where:

- trading begins late in the tax year (that is, after 31 March); or
- the first account is for a period longer than 12 months.

849. And it has to ensure that:

- the application of the rule remains optional (some taxpayers may, depending on their own particular circumstances, wish their opening profits to be dealt with under the normal rules); and
- no profits are assessed twice or slip out of account.

850. For these reasons the rules are set out in three sections. The first section (section 208) sets the scene and the two following sections (sections 209 and 210) state the rules depending on whether or not there is an actual accounting date in the tax year.

851. Section 208 sets the scene by stating the purpose of the rules and when they can apply.

852. *Subsection (2)* applies the relevant rules. Most taxpayers with a late accounting date will probably wish to take advantage of these rules. So the rules apply automatically unless the taxpayer "elects out". See *Change 54* in Annex 1.

853. *Subsection (3)(b)* refers to the intention of the taxpayer. This addresses practical difficulties that arise when the accounting date is only an intended accounting date at the time the return is made.

854. *Subsection (4)* states the time limit for an opt out election. It has been made as straightforward as possible by adopting the procedures and time limits of the Self Assessment cycle.

Section 209: Rule if there is an accounting date

855. This is the second of the three sections whose purpose is to simplify the normal operation of the basis period rules in particular circumstances. It deals with the case where there is an actual accounting date in the tax year.

Section 210: Rules if there is no accounting date

856. This is the third of the three sections whose purpose is to simplify the normal operation of the basis period rules in particular circumstances. It deals with the more complex case where there is no accounting date in the tax year.

857. That case is more complex because in those circumstances it is necessary:

- to bring a notional accounting date into the tax year, corresponding to the intended accounting date; and
- if the trade begins very near the end of the tax year, to charge the profits of the first tax year as part of the profits of the following tax year.

Section 211: Treating middle date as accounting date

858. This is the first of three sections that, together, prevent the complex change of accounting date rules (in sections 214 to 220) from applying in particular circumstances. They are based on the non-statutory practice described in paragraph 71175 of the Business Income Manual.

859. Some taxpayers prefer to prepare their accounts regularly to a particular day in the tax year (for example, the last Friday in September) rather than to a particular date. The

chosen day can then fall on a range of (normally) seven dates. Because the chosen day will not, from year to year, fall on the same date this would trigger the change of accounting date rules every year.

860. These sections legislate the practice that enables those taxpayers to choose the middle date of the actual dates to which accounts may be prepared as the accounting date. They prevent the change of accounting date rules applying. See *Change 56* in Annex 1.

861. In these sections the date which is to be taken as the accounting date is referred to as the "middle date" rather than the "mean date" (the term used in paragraph 71175 of the Business Income Manual). "Middle date" better reflects common usage and the fact that the actual accounting date does not normally vary by more than four days from that middle date. The only exception is when the day to which accounts are prepared is at or near the end of February and the day can fall on 29 February. Then the spread of dates on which the chosen day can fall is extended from seven to eight. But the "middle date" is still the fourth of those dates.

862. These sections express a rule based on a simple idea. But there are surprisingly complex implications. It is, for example, necessary:

- to express concisely, yet clearly, the "four day" condition while allowing for the fact that accounts may be prepared to a particular day (such as the last Sunday in the year) or to a day in a particular week (such as the last day of a school term);
- to preserve the optional nature of the practice;
- to ensure that taxpayers can, if they wish, move in or out of the practice authorised by the sections without the same profits being assessed twice or dropping out of charge; and
- to ensure that no profits are assessed twice or drop out of charge when the trade ends.

863. Because of this complexity the rule is set out in three sections.

864. Section 211 is the first of the three sections and sets the scene by stating the purpose of the rule and the election requirements.

865. The bracketed words in *subsection (1)(b)* address the case of a chosen day that can fall on 29 February.

866. *Subsection (4)* make elections as straightforward as possible by adopting the procedures and time limits of the Self Assessment cycle. Unlike the opt out election for the late accounting date rules (see the commentary on section 208) the election for the middle date rules is "opt in". This is because it is less clear that taxpayers will want automatically to choose the middle date treatment than it is that they will want to choose the late accounting date treatment.

Section 212: Consequence of treating middle date as accounting date

867. This is the second of the three sections that, together, prevent the complex change of accounting date rules from applying in particular circumstances. It states the effect of electing for the middle date treatment.

868. The section can apply whether or not the previous year was treated in the same way: if it was not, *subsection (2)* applies, and if it was, *subsection (3)* applies. See *Change 56* in Annex 1.

Section 213: Circumstances in which middle date not treated as accounting date

869. This is the third of the three sections that, together, prevent the complex change of accounting date rules from applying in particular circumstances. It ensures that when

the middle date treatment ceases to apply no profits are assessed twice and no profits drop out of charge.

870. The section does this by imposing continuity in profit counting between the two relevant basis periods. This is necessary because when a middle date is used to mark the end of the basis period for the earlier year, the actual date to which its profits are calculated may otherwise result in a gap preceding, or an overlap with, the actual date on which the basis period for the following year begins. This section ensures continuity between the two when the basis period for the second year is given by any of the provisions listed in *subsection (2)*.

Section 214: When a change of accounting date occurs

871. This is the first in a group of seven sections dealing with changes of accounting date. This is the most complex aspect of the basis period rules. By separating these “change” sections from the main sections the taxpayer who does not change accounting date is sheltered from most of that complexity.

872. Section 214 determines the basis period for the year in which a change of accounting date takes place. It is based on section 62(1)(a), (2) and (5) of ICTA.

873. *Subsection (1)* covers two cases. Normally the year in which the change takes place is the first year in which accounts are prepared to the new date. But sometimes the period of account ending on the new accounting date will straddle an entire tax year (because that period of account is longer than 12 months). In these circumstances the straddled year is the year in which the change is treated as having taken place.

874. *Subsection (2)* is necessary to “switch off” the middle date treatment and to allow the provisions of section 213 to operate if appropriate (see the commentary on section 213).

875. *Subsection (3)* attributes an accounting date to a year which is straddled by the period of account ending with the new accounting date. That is necessary to determine the correct basis period for the straddled year. For example, if the period of account effecting the change of accounting date runs for 15 months from 1 April 2006 to 30 June 2007 an accounting date is treated as falling on 30 June 2006 in the tax year 2006-07 although, in fact, there is no accounting date in that year.

Section 215: Change of accounting date in third tax year

876. This section is the first of two sections that deal with a change of accounting date in particular years and for which special rules are required. It is based on sections 62(1) and (2)(b) and 63 of ICTA.

877. The approach in the change of accounting date sections follows that adopted in the earlier sections: that the general rule in section 198 applies unless a specific rule applies. A specific rule will apply when the basis period must be different from that which would be given by the general rule or when additional conditions apply.

878. In a continuing trade, specific rules will always apply to years in which a change of accounting date occurs after the third year (see section 216). This is because conditions have to be met for changes of accounting date in those years to be effective for tax purposes (see the commentary on section 216 and section 217). But for changes in the second and third years there are no conditions and the general rule will often apply. Section 215 deals with the case where the general rule does not apply in the third year.

Section 216: Change of accounting date in later tax year

879. This section applies to changes of accounting date occurring at any time after the third year, other than in the final year. It is based on sections 62(1), (2) and (3) and 63 of ICTA.

880. Changes of accounting date are normally effective for tax purposes and the basis period then aligns with accounts prepared to the new accounting date. But exceptionally, changes of accounting date will not be effective for tax purposes and then the basis period becomes out of step with the period of account.

881. *Subsections (2)* and *(3)* give the main change of accounting date rule. When a change is effective for tax purposes the basis period simply aligns with the new accounting date in the year of change.

882. Both subsections refer to section 217 that sets out the conditions that a change must meet to be effective for tax purposes.

883. When subsection (3) applies, the basis period for the year of change will be longer than 12 months.

884. *Subsection (4)* preserves the old basis period, notwithstanding the change of accounting date, when, exceptionally the conditions in section 217 are not met. This means that apportionment of the profits of the periods of account to the basis period is required.

Section 217: Conditions for basis period to end with new accounting date

885. This section sets out the conditions which must be satisfied for a change of accounting date to be effective for tax purposes. It is based on section 62A(1), (2), (3), (4), and (5) of ICTA.

886. *Subsection (1)(c)* imposes a test which may be satisfied by meeting either of two conditions. The first, condition A in *subsection (4)*, is a "no recent change" condition and is of the same "mechanical" type as those in *subsections (1)(a)* and *(1)(b)*.

887. The second, in *subsection (6)*, is, in part, a condition of purpose. Unlike the others, it introduces a test which is qualitative in nature. But it becomes relevant only if condition A in *subsection (4)* is not met. It is therefore likely to apply in relatively few cases. For those reasons and to achieve a simpler rule for the more common cases, the associated Inland Revenue notice and taxpayer appeal rules are stated in a separate section (section 218).

Section 218: Commercial reasons for change of accounting date

888. This section deals with three aspects of the "commercial reason" condition in section 217(6)(a):

- the automatic assumption of commerciality;
- timely notice by the Inland Revenue to the contrary; and
- appeals to the Commissioners if the Inland Revenue's view is disputed.

It is based on section 62A(5), (6), (7), (8), and (9) of ICTA.

889. *Subsection (1)* makes the effect of section 62A(5)(b) of ICTA clear: that a change is treated as having been made for a commercial reason in the absence of a timely challenge by the Inland Revenue.

890. *Subsection (6)* prevents a wish to obtain a tax advantage from being a commercial reason for the change of accounting date rules.

Section 219: The year after an ineffective change of accounting date

891. This section sets out the rules that apply in the tax year following a year in which a change of accounting date takes place that does not result in a change of basis period. It is based on section 62(3) and (4) of ICTA.

892. When a change of accounting date takes place that does not result in a change of basis period, section 216(4) applies and the basis period for the year of change remains the 12 month period ending with the old accounting date. As a result, basis period and period of account fall out of alignment. Such cases may be relatively uncommon. But, where they do arise, specific rules are needed to ensure the proper working of the basis period rules in subsequent years. In those years, the taxpayer can revert to the old accounting date, maintain the new one, or change to a different date altogether.

893. *Subsection (2)* deals with the case where, in the year after the ineffective change, the new date is maintained. It allows the rules to operate as though the change takes place for the first time in that later year (rather than in the actual year of change). This allows the taxpayer to make a fresh attempt to change the basis period without, for example, falling foul of the "any recent change" rule in section 217(4).

894. *Subsection (3)* deals with the case where, in the later year, the taxpayer reverts to the old accounting date. This second change is not counted as a change for the purpose of the relevant rules.

Section 220: Deduction for overlap profit on change of accounting date

895. This section allows the deduction of overlap profit in a year in which there is a change of accounting date leading to a change of basis period and that basis period is longer than 12 months. It is based on section 63A(1) and (2) of ICTA and paragraphs 71140, 71155, and 71170 of the Inland Revenue Business Income Manual.

896. This adjustment for overlap profit is one of the two rules which help to ensure that, over the lifetime of a trade, the total profits assessed exactly equal the total profits earned. (The other, which authorises a deduction of overlap profit in the tax year in which the trade ceases, is in section 205). And it ensures that, in the year of change, no more than 12 months' profits are assessed.

897. Calculating the deduction can be quite complex, particularly, for example, if there have been other changes of accounting date and deductions for overlap profit in previous years. *Subsection (3)* uses a step-by-step method statement to aid calculation.

898. This section includes three aspects which have previously been dealt with on a non-statutory basis.

899. *Subsection (4)* deals with the first (described in paragraph 71140 of the Business Income Manual). Where profits must be apportioned, it allows the use of any reasonable basis of calculation instead of the measure by days referred to elsewhere in the section, provided its use is reasonable and consistent. See *Change 52* in Annex 1. The wording of subsection (4) makes it clear that the option to choose an alternative basis of apportionment is exercisable only by the taxpayer, not the Inland Revenue.

900. *Subsection (5)* deals with the second. It permits a change of accounting date to 31 March (or to 1, 2, 3, or 4 April) to be treated as though it were a change to 5 April (described in paragraph 71170 of the Business Income Manual). This avoids the need to make small restrictions to the deduction for overlap profit and will always work to the taxpayer's advantage. See *Change 55* in Annex 1.

901. Finally, *subsection (6)* provides the option (described in paragraph 71155 of the Business Income Manual) to disregard 29 February in calculating a deduction for overlap profit if the change of accounting date is to a date falling on 31 March to 5 April inclusive. This always works to the taxpayer's advantage. See *Change 57* in Annex 1.