

**Basis period reform – consultation
Response from the Low Incomes Tax Reform Group (LITRG)**

1 Executive Summary

- 1.1 We are pleased to respond to the basis period reform consultation launched on 20 July 2021. Our perspective is that of tax professionals representing those on low incomes who are self-employed or in partnerships such as family member partnerships and who are unrepresented.
- 1.2 The consultation period for this basis period reform proposal, which potentially introduces a major change to the tax system, is very short. This is disappointing, given that it comes within the summer holiday period. We also note that stages 2 and 3 of the Tax Consultation Framework seem to have been merged which adds to the overall impression of rushing through the process to enable legislation to be passed as soon as possible. This risks not giving due consideration to all issues raised and implementing a policy which is less effective than it might otherwise be.
- 1.3 We support the general principle of these new proposals as they mean complicated rules around basis periods become obsolete and tax for the self-employed (including partners) will be based on self-employed profits in the tax year. This will be easier for low-income unrepresented taxpayers to understand. We think one of the main impacts of this change will be to encourage new businesses to choose either 31 March or 5 April as their accounting date, which we support as we believe it should help those who are self-employed gain a better overall understanding of their tax affairs. We acknowledge that these changes may increase complexity for some larger (likely represented) businesses compared to the current system.
- 1.4 However, we are extremely concerned that the time frame envisaged for implementing this change (for 2022/23 to be the transitional year and then the new basis of assessment to apply from 2023/24) is not realistic if a smooth transition is to be achieved for existing businesses which do not currently have a 31 March or 5 April accounting period.
- 1.5 The potential introduction of two major changes to the tax system, being basis period reform and the introduction of Making Tax Digital for Income Tax Self Assessment (MTD for ITSA) and the associated MTD quarterly updates, may be too much for some self-employed people to cope with at one time. They will need to be gearing up for the implementation of MTD at the same time as

transitioning to a tax year basis of assessment (if they do not currently have a 31 March or 5 April year-end), and many businesses are still addressing the financial impact of Coronavirus.

1.6 We strongly recommend that the basis period change should be given time to be fully and properly implemented before MTD for ITSA begins, and therefore we are of the view that serious consideration must be given to delaying the start date for MTD for ITSA. If this is not done, the strain on both HMRC's resources and unrepresented taxpayers running small businesses will likely be immense, and the broader ramifications (e.g. economic and societal, as well as trust in HMRC) could be far-reaching.

1.7 We have two main concerns with the transitional provisions:

- we are concerned about the level of understanding there will be among unrepresented taxpayers of what overlap relief is, and also how a business will find out what its overlap profits are if it doesn't have a record of them;
- the option to spread additional profits over a maximum period of 5 years inevitably introduces complexity, and we are concerned this will leave some unrepresented businesses at a disadvantage as they may be unable to do the necessary calculations to enable them to make an informed decision about whether to spread the profits, especially when factoring in interactions with other entitlements that are based on taxable income.

1.8 Detailed guidance will need to be provided by HMRC together with telephony support for these taxpayers.

1.9 We strongly urge government to ensure enough time is devoted to fully understanding the interactions between basis period reform and other areas of the tax system (including those listed at 3.33 in the consultation) and also other areas of financial support such as tax credits, universal credit and student maintenance so that unexpected and unintended consequences do not emerge at a later date. Steps should be taken to mitigate any unintended consequences as a result of interactions but where any impacts remain, comprehensive guidance must be made available to people and efforts made to raise awareness of these impacts.

2 About Us

2.1 The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998, LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low-income workers, pensioners, migrants, students, disabled people and carers.

2.2 LITRG works extensively with HM Revenue & Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and

practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 General comments

3.1 Due to the short timescale for responses, we have provided general comments and then addressed some specific areas of concern under the following headings, namely:

- The new tax year basis of assessment (Section 4 below)
- The transitional year (Section 5 below)
- Other issues and interactions (Section 6 below)
- Interactions with Making Tax Digital (Section 7 below)
- Assessment of impacts (Section 8 below)

3.2 We trust that any comments made by respondents to the Tax Administration Framework Review consultation relating to this area will also be considered as part of this overall process.¹

3.3 We support the general principle of these new proposals as they mean complicated rules around basis periods become obsolete and tax for the self-employed (including partners) will be based on self-employed profits in the tax year. This is a simpler concept to understand for unrepresented taxpayers and gives a more direct correlation between the tax liability for a tax year and the profits for that year.

3.4 Paragraph 3.4 of the consultation says that the new proposals mean “.... a business’s choice of accounting date would no longer have any impact on its taxation. Businesses would be free to choose any period of account without having to consider the basis period implications, and so would gain greater flexibility in drawing up their accounts for the period that suited them commercially.” This is true, but in reality we think one of the main impacts of this change is that it will encourage new businesses to choose either 31 March or 5 April as their accounting date; it will not be practical or efficient to choose a different date for most and it means individuals will be able to calculate the profit figures for their tax returns and meet the filing deadlines more easily. This is a welcome effect for low-income unrepresented taxpayers as it should enable new start-ups who go down this route to better understand their tax affairs due to the relative simplicity² of the new rules.

3.5 Our concern with the implementation timeline for this policy is mainly because HMRC’s Making Tax Digital for Income Tax (MTD for ITSA) programme is due to go live in April 2023 which, amongst

¹ LITRG submission to the Tax Administration Framework Review can be found here:

<https://www.litrg.org.uk/latest-news/submissions/210712-tax-administration-framework-review>

² The principle of simplicity was highlighted in our recent paper ‘A better deal for the low income taxpayer’, where we suggested that an optional default year end of 31 March might be a possible simplification for new unincorporated businesses in this area. See <https://www.litrg.org.uk/latest-news/reports/201204-better-deal-low-income-taxpayer>

other things, requires most people who are self-employed to submit quarterly updates to HMRC using MTD-compliant software.

- 3.6 These two major changes (ie basis period reform and MTD quarterly updates) will be too much for some self-employed people to cope with at one time as they will need to be gearing up for the implementation of MTD at the same time as transitioning to a tax year basis of assessment (if they do not currently have a 31 March or 5 April year-end), especially as many businesses are still addressing the financial impact of Coronavirus. Under the heading 'Scope of this consultation' the document says: "The aim is to simplify the system before Making Tax Digital is implemented." However, under the time frame proposed this is not quite the case, as the new basis of assessment will first apply at the same time as MTD is implemented.
- 3.7 Although the proportion of businesses that do not have a 31 March or 5 April year end is relatively small³, in absolute terms it is a significant minority of several hundred thousand individuals. The impact of these changes on these individuals should not be minimised just because it is a smaller proportion of the whole population. We believe that a substantial proportion of this population will be unrepresented taxpayers⁴ and some will find it extremely difficult to deal with the transition and so will contact HMRC for assistance. With the timeframe currently being suggested this will have resource implications for HMRC at a time when we expect that they will be facing increased contact relating to the introduction of MTD for ITSA. HMRC must be sufficiently resourced to provide the additional help and guidance these unrepresented taxpayers will need, such as providing information on available overlap profits, in a timely manner and with accuracy, bearing in mind HMRC's Charter commitment to 'Being responsive'.⁵
- 3.8 We strongly recommend that the basis period change should be given time to be fully and properly implemented before the MTD for ITSA begins. Combining this concern with our other concerns about the MTD for ITSA implementation, such as the low numbers in the pilot and the fact the timetable does not allow for a full cycle in the pilot, we are of the view that serious consideration must be given to delaying the start date for MTD for ITSA. If this is not done, the strain on both HMRC's resources and unrepresented taxpayers running small businesses will likely be immense, and the broader ramifications (e.g. economic and societal, as well as trust in HMRC) could be far-reaching.
- 3.9 We agree with the proposal to put on a legislative footing the convention of treating accounts for a year ending on 31 March or 1-4 April inclusive as if they ended on 5 April, for both trading and

³ Paragraph 1.2 of the consultation document says 7% of self-employed and 33% of trading partnerships have an accounting date other than 31 March or 5 April.

⁴ This is because many people who do not have an adviser when they start their business mistakenly believe they must always prepare accounts for 12 months and so do their first set of accounts for a period of 12 months from their start date.

⁵ <https://www.gov.uk/government/publications/hmrc-charter/the-hmrc-charter>

property income tax purposes, and observe that this has been generally accepted practice for a number of years. Therefore, it is sensible to take this opportunity to codify the practice.

- 3.10 We are aware that the Office for Tax Simplification is currently undertaking a review into changing the date of the tax year, including a potential change to 31 December. We consider it would be vastly unfair on businesses if after implementing these changes there was further reform to the way their profits are taxed following a change in the tax year dates. Basis period reform must be a one-off exercise and not re-visited again in the short to medium term. If this is to be a step towards bigger reform of the tax year, then this should be made clear.

4 The new tax year basis of assessment

- 4.1 The new basis of assessment means the elimination of opening and closing year rules, overlap profits and overlap relief, all of which are complicated concepts that some people find very difficult to understand, and so to this extent it is welcome.
- 4.2 However, the need to apportion profits into tax years where there is a non-31 March to 5 April accounting date introduces a different complexity, particularly for unrepresented taxpayers.
- 4.3 For businesses which do not change their accounting year end to match the tax year, this is likely to involve estimating profits for the second accounting period that contributes to profits taxable in a tax year to enable the tax return to be completed on a provisional basis, unless possibly the accounts year-end is near the beginning of the tax year, for example 30 June.⁶ Amendments to the tax return will then be required when the accounts for the second accounting period are finalised.
- 4.4 If a business is experienced and has regular income and expenditure, it may find making an estimate of profits for apportionment purposes fairly straightforward. This is likely to be more difficult and stressful for new businesses and any businesses with varying levels of income and expenses, whether because of seasonality or simply because of the nature of the business. Even for those that will come within Making Tax Digital in due course, the quarterly returns will not necessarily help as the actual taxable profits for an accounting period are not certain until the accounting period has ended and an End of Period Statement has been submitted.
- 4.5 This will be a confusing process for unrepresented taxpayers and will mean spending extra time (and possibly extra costs if they feel they need to turn to an agent and have the means to do so) managing their tax affairs. This process will also generate additional work and inevitably additional contacts for HMRC at a time when resources are significantly stretched.
- 4.6 This whole process is likely to mean that many self-employed taxpayers will choose to change their accounting date to 31 March for simplicity, which HMRC acknowledge at 3.11 in the consultation. HMRC need to devise an easy way to do this for businesses who decide it is best to make a

⁶ Our experience of small sole trader businesses is that as they only usually need their accounts to complete their tax returns, they will not usually be drawn up in advance of the annual tax return completion process, regardless of the accounting date to which they are made up.

permanent change and provide good step-by-step communication and guidance as well as understanding if genuine errors are made during this process.

- 4.7 For those that do not want to change their accounting date, for example for commercial reasons, the consultation suggests alternative ways in which profits could be calculated for the part of the second accounting period that falls into the tax year (para 3.13). We strongly recommend these are explored in more detail as soon as possible. If any of these options were to be taken forward, then legislative changes would of course be necessary.

5 The transitional year

- 5.1 The transitional rules mean that additional profits are potentially taxable in the transitional year 2022/23 but existing overlap relief can be offset against it. The additional profits are for the period from the end of accounting period which would usually form the basis period for the 2022/23 tax year to 5 April 2023.
- 5.2 We have two main concerns with these transitional provisions. Firstly, we are concerned about the level of understanding there will be among unrepresented taxpayers of what overlap relief is, and also how a business will find out what its overlap profits are if it doesn't have a record of them. We fear some businesses probably do not have a record of overlap profits, particularly if they have been trading for a number of years or only complete the short self-employment pages of the Self Assessment tax return, as there is no place to record them. Even though there is a space to record them in the full self-employment pages, not all businesses do so. Some overlap relief will date back to the transition to Self Assessment in 1996/97.
- 5.3 As HMRC note in the consultation, basis periods are very complex, and unrepresented taxpayers in particular may not have realised the importance of keeping a record of them to re-calculate overlap relief now. Taxpayers will assume HMRC have the necessary details on their records and so this will drive contact to HMRC helplines. Otherwise, people will just not claim anything when they are entitled to do so and so may well face an increased tax burden without the benefit of the tax relief that should be available to them. HMRC must therefore consider how overlap relief profits can be established for all relevant businesses where taxpayers do not have the requisite records.
- 5.4 Secondly, the option to spread additional profits over a maximum period of 5 years clearly opens the door to some basic tax planning to find the optimal spread of profits to minimise income tax. While this option could be advantageous to avoid a significant increase in the 2022/23 tax bill, it inevitably introduces complexity. We are concerned this will leave some unrepresented businesses at a disadvantage as significant number crunching may be required to work out whether spreading will be beneficial for them. This is especially so when other interactions, such as with High Income Child Benefit Charge or tax credits, need to be considered as well as the tax position. Detailed guidance will need to be provided by HMRC together with telephony support.

6 Other issues and interactions to consider

- 6.1 Given the very short consultation period, there is not sufficient time for us to fully consider the interactions in the areas listed in paragraph 3.33, which seems a fairly comprehensive list. We would strongly urge government to ensure enough time is devoted to fully understanding these interactions with the different areas so that difficulties don't emerge at a later date (as they did with the changes to allowable finance costs for residential landlords for example.⁷). Steps should be taken to mitigate any unintended consequences as a result of these interactions but where any impacts remain, comprehensive guidance must be made available to people and efforts made to raise awareness of these impacts.
- 6.2 For example, although universal credit is calculated using net income and does not directly follow tax rules, changes to the amount of tax paid in a universal credit assessment period can have an impact on the award. Increases to the amount of tax usually paid, as a result of changes to the basis period, may well result in lower self-employed earnings for universal credit which can lead to either an increased award or the minimum income floor policy being applied to an award. We recommend that interactions with universal credit is added to the list at paragraph 3.33, and would be happy to discuss this further.
- 6.3 We note that tax credits have been listed in paragraph 3.33 of the consultation document as an area deserving of particular consideration to explore the interactions with changes to the basis period. Gross income is used in establishing tax credit awards. Broadly speaking, trading income for tax credits follows the tax rules save for some specific exceptions, such as averaging and carry back of losses. It will be important to understand how changes to the basis period which lead to changes to the taxable profit figure for a tax year will impact tax credit awards especially in the transitional year and if the option of spreading is taken forward. In existing legislation, increases to the annual household income figure (above the disregard level) may well result in a claimant receiving a correspondingly lower tax credit award, indeed if that higher income figure becomes apparent only after the end of the tax year rather than during the year, the claimant may find they have been overpaid tax credits and the debt will need to be repaid.
- 6.4 There are specific provisions covering the rules about calculating tax credit awards where the claimant makes a claim for universal credit during the same tax year. The process is often referred to as 'in-year finalisation'. These rules apply whether the claimant moves to universal credit voluntarily or whether they are moved under the formal migration exercise (yet to commence). Where these rules apply, trading income for tax credits is calculated by reference to the basis period that ends during the tax year that the claimant moves to universal credit. It follows then that if the basis period changes, that may impact the outcome of the in-year finalisation decision. Furthermore, where the change to the basis period results in higher trading income for the year, again the claimant may find they have a tax credit overpayment to repay. It may be worth noting that the

⁷ See pages 47 and 48 of our recent paper 'A better deal for the low income taxpayer' at <https://www.litr.org.uk/sites/default/files/files/LITRG-A-better-deal-for-the-low-income-taxpayer-2020.pdf>

formal migration exercise to move the bulk of existing tax credit claimants to universal credit has yet to start but the most recent statements from Government indicate they expect it to be completed by September 2024, which implies the tax year 2022/23 may well fall within the crucial window for this cohort.

- 6.5 The effect of the transition will mean some taxpayers have higher taxable profits in 2022/23 and so a higher tax bill in that year (and possibly subsequent years if they spread their additional income) and we are pleased that the cashflow impact and the possibility of agreeing a 'Time to Pay' arrangement are both acknowledged.⁸ It should be borne in mind that having higher taxable profits may have greater impact in some parts of the UK due to the differing tax rates. For example, the higher rate threshold is lower in Scotland and the higher rate of tax is 1% more than in the rest of the UK.
- 6.6 Further, if it means that an individual becomes a higher rate taxpayer, then this may have a knock-on effect on other areas such as the amount of the Personal Savings Allowance they are entitled to, their entitlement to the Marriage Allowance if applicable, their rate of capital gains tax or a liability to High Income Child Benefit Charge.
- 6.7 An increase in self-employment profits may result in starting or making additional student loan repayments.
- 6.8 There may also be other less obvious cashflow impacts. For example, as far as student finance is concerned, higher taxable profits might also have implications with regard to the level of student support such as maintenance loans an individual is entitled to, as it is likely to increase overall parental household income on which assessments are based. When the residential landlord finance costs changes were introduced, we were contacted by many unrepresented taxpayers who, although not affected by the tax changes, were affected by a range of interactions that appeared not to have been considered. Although some of these are beyond our areas of expertise, they highlight the potential wide-ranging consequences of basis period changes for things such as child maintenance calculation and other government awards such as the dance and drama awards.

7 Interactions with MTD

- 7.1 The proposed changes mean that the quarterly updates required under Making Tax Digital will be due on calendar quarter dates for all of the self-employed population. As this will align with property income reporting quarter dates, it should make quarterly reporting simpler for businesses with both property and trading income (as they will need to do 2 reports every 3 months rather than 8 reports over 8 separate months).
- 7.2 However, for self-employed people with non-31 March to 5 April accounting dates it is possible that calendar quarters will not align with their own trading quarters. A VAT registered self-employed trader may well still need to do either a quarterly update or VAT return in 8 separate months every

⁸ See paragraphs 4.8-4.10 of consultation

year. This creates a fairly onerous administrative burden, as there is currently no flexibility to elect to change the quarters for the MTD updates. They would need to change their VAT quarters to reduce this burden, but that could be quite costly if things like accounting systems need to be changed to accommodate this.

- 7.3 Also, the taxable profits figure in 2022/23 is likely to be misleading if it is considered in isolation when it comes to determining whether an individual should come within the scope of MTD for ITSA. If this proposal goes ahead, it will be wrong to use 2022/23 as a base year for identifying who should have signed up and registered for MTD for ITSA by April 2023. This will be particularly relevant if HMRC decide to automatically sign up to MTD those who they think should be within MTD but who have not registered themselves.

8 Assessment of impacts

- 8.1 Those who are self-employed or partners in a partnership are individuals and are not operating through a separate entity, therefore any measure that affects their business, of necessity affects them as an individual. In relation to this measure, it will have an impact on them, their household and families to the extent their tax liabilities may be increased and they need to cope with increased admin burdens.
- 8.2 It is noted that IT changes are required at HMRC's end to accommodate this policy. In order to introduce it in April 2022, that leaves only seven months to introduce the necessary IT changes. It will also be necessary to produce comprehensive guidance as well as make changes to various documents (such as the tax return and tax return notes). We are concerned about HMRC's ability to do this in such a short period of time, especially at a time of ongoing uncertainty and impact on resources caused by the coronavirus pandemic.
- 8.3 The inevitable increase in contacts to HMRC is acknowledged in the consultation document. Current customer service standards are poor, so it is important that HMRC are given adequate resources to deal with this additional demand (as well as resource to improve existing services). One way of reducing telephone contact is to ensure that online guidance is accurate, detailed and timely. We continue to raise significant concerns about the poor standard of guidance on GOV.UK and the negative impact this has, particularly on unrepresented taxpayers, who have no choice but to contact HMRC instead.

LITRG
25 August 2021