**House of Lords Economic Affairs Committee Finance Bill Sub-Committee**
**Call for evidence: basis period reform**
**Response from the Low Incomes Tax Reform Group (LITRG)**

## 1. Summary

1.1. Our evidence reflects our experience of assisting self-employed individuals and micro businesses with at most modest incomes. For these businesses, reform of basis periods offers some potential simplification. For example, the reform encourages the newly self-employed to choose an accounting date of 31 March or 5 April which we think will lead to a better understanding of their tax affairs from the outset and make compliance with Making Tax Digital much easier.

1.2. However there is a risk that complexity, and therefore costs of tax compliance and possibility of errors, are increased for those who choose an alternative accounting date, which may be for commercial reasons. To mitigate these risks, we urge the government and HMRC to use the extra time from the one-year delay in implementation to consider how problem areas could be eased. Failure to do so could risk damaging trust in the tax system (rather than engendering it, as is HMRC's ambition).

1.3. April 2024 is still a very tight timescale in which to have implemented basis period reform and bring in MTD for income tax Self Assessment (ITSA). We would rather see basis period reform – if it goes ahead – introduced and settled first, which would necessitate a further delay in the MTD timetable.

1.3.1. HMRC should proactively identify and contact unincorporated businesses with accounting period ends other than 31 March or 5 April to encourage them to consider the impact of basis period change as soon as possible and let them know what overlap profit information (if any) is held on HMRC's records.

1.3.2. Taxing extra profits in the transition year (or subsequent years if a spreading election is made) will have implications elsewhere due to interactions with other areas of financial support such as tax credits or student maintenance support. These interactions need to be fully explored to avoid unintended consequences arising. If some consequences cannot be avoided guidance must be produced for those potentially affected so that people can make informed decisions about the transition. While the flexibility of spreading is welcome in many ways, there is significant potential for confusion – and indeed for taxpayers to make detrimental decisions if all of the ramifications are not considered.

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## 2. Q1. How far does the reform represent a useful simplification?

2.1. We support the general principle of these proposals as they mean the complexity of basis periods is removed and tax for the self-employed (including partners) will be based on profits in the tax year. This will be easier for unrepresented taxpayers (who are often on a low income) to understand.

2.2. We think one of the main benefits of this change will be to encourage new businesses to choose either 31 March or 5 April as their accounting date. We believe this will help those who are newly self-employed to better understand their tax affairs from the outset. However, these changes may increase complexity for some larger (likely represented) businesses, or those who need an alternative accounting date for commercial reasons, compared to the current system.

## 3. Q2. To what extent would the reform deliver a fairer result than the current rules?

3.1. Taxing the self-employed based on their profits earned during the tax year could be viewed as a fairer way of taxing this cohort as the tax due for the year will be seen to have a direct correlation to the profits earned in that year. The 'current year basis' of assessment used now is a misnomer as the majority of the taxable profits for a tax year could have been earned in the previous tax year if an accounting period ends early in the tax year. For example, the profits for the accounting period ended 30 April 2021 are taxed in the 2021/22 tax year, even though the tax year starts on 6 April 2021. This can give a cash flow advantage to a business with steadily rising profits.

3.2. However, there is a risk that increased taxable profits in the transitional year (or subsequent years if a spreading election is made) could inadvertently create unfairness for some taxpayers due to interactions with another source of financial support such as tax credits or student maintenance support. HMRC must take advantage of the 12 month delay to the implementation of the policy to fully work through all the potential interactions.

## 4. Q3. Would either of the alternative options mentioned in the consultation document be a better solution? If so, why?

4.1. In our paper 'A better deal for the low income taxpayer'[1] we proposed a default year end of 31 March (or 5 April) for new businesses as a simplification measure. We envisaged an option to elect for an alternative year end to still be available to accommodate, for example, some seasonal and international businesses who may prefer a different year end for commercial reasons.

4.2. We acknowledge this would not simplify matters for existing businesses, but as a consequence it would not require transitional measures. It would mean most sole traders starting a small business on a self-employed basis would have accounting periods to 31 March (or 5 April), which is our aim with this proposal. There would still be some traders with a non-31 March (or 5 April) year end, and so overlap issues would still arise for them, but we would expect that these traders are more likely to have professional advisers and so would be able to cope with this or they may take the view that

[1] Paper published in December 2020 - see https://www.litrg.org.uk/latest-news/reports/201204-better-deal-low-income-taxpayer

the benefits of having a non-31 March (or 5 April) year end outweigh the complexities of calculating overlap profits.

4.3. As the proposed new basis period rules are also likely to have the effect of encouraging new start-ups to have a 31 March or 5 April year end, and they suggest transitional measures to deal with existing businesses, we do not feel it is a case of one option being better than another but more a case of which alternative best fits the specific objectives that the change to the rules is intended to achieve. If eliminating overlap profits and overlap relief is a priority then the new proposals may well be the best fit. We have noted above that the impact of the proposed changes, in terms of whether they are a simplification or complexity, varies depending on the circumstances of the taxpayer/business involved.

4.4. But now that the Making Tax Digital for Income Tax Regulations have been laid[1], it is clear that having an accounting period ending on 31 March or 5 April will make compliance with Making Tax Digital for Income Tax much more straightforward. Therefore, a policy aiming at simplification which encourages as many businesses as possible to use these accounting periods is now likely to be a greater priority.

4.5. The other alternative proposed is for a move to a way of taxing unincorporated profits like company profits, with the tax period being determined by the accounting period of the business. This would involve fundamental changes to the way that unincorporated business profits are taxed which would take several years to consult on and develop. Therefore, in our view this is not a realistic option to deal with the basis period conundrum as it would be preferable to make changes sooner rather than later (provided they are properly thought through) so that MTD for ITSA is easier to understand and to comply with.

**5. Q4. Are the transitional provisions sufficiently robust? If not, how do they need to change?**

5.1. We have several concerns with the transitional provisions, set out below.

5.1.1. We are concerned about the level of understanding 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.[2] HMRC may be able to supply this information but some taxpayers might never have correctly included it on a tax return so there might not be a record of it with HMRC.

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[1] https://www.legislation.gov.uk/uksi/2021/1076/contents/made

[2] Overlap profits arise where the tax rules mean that some profits are taxed more than once. Most commonly this is when a business starts. Overlap relief is the method of compensating for the double taxation of profits. In certain circumstances, taxable profits can be reduced by the overlap profits (called overlap relief), usually on cessation of the business. A business that started trading prior to the introduction of Self Assessment and has traded continuously since then may have transitional overlap profits, which arose on the transition to Self Assessment in 1996/97.

5.1.2. The option to spread additional profits over a maximum period of five years gives welcome flexibility to taxpayers, but also it inevitably introduces complexity. We are concerned the choice available to taxpayers 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. This could be further exacerbated when interactions with other entitlements based on taxable income[1] are factored in.

5.1.3. The transitional rules are likely to mean there are additional taxable profits in the transitional tax year[2] for most taxpayers, and so additional tax to pay, but no actual additional income. The interactions between this and Universal Credit (UC) and tax credits awards needs to be fully explored. Our initial impression is that tax credit awards are likely to be reduced as the taxpayer will have higher taxable profits (although no additional actual income) in that period and so they will potentially be out of pocket. However, the taxpayer's net income for UC purposes could be reduced due to the additional tax payment and so a higher UC award could result in some instances[3]. More detailed consideration of these – and other[4] – interactions is required to avoid unintended consequences arising such as was the case when the changes to the tax relief for finance costs for residential landlords were introduced[5]. The delay to the introduction of basis period reform will allow HMRC time to carry out more detailed work in this area. Even if some consequences cannot be avoided they must be sufficiently explained to people.

5.1.4. As explained above, we expect additional tax to be due for most taxpayers in the transitional year. Although this is a one-off cost, we think most taxpayers will struggle to understand why they have the extra tax to pay and will regard it as unfair. However, proposed options to deal with the payment of any additional tax are welcome, such as agreeing a 'time to pay' instalment plan.

**6. Q5. How onerous is apportionment of profits between tax years likely to be for businesses which do not have an accounting period aligned with the financial/tax year?**

6.1. We anticipate that this will be an onerous process. Each tax return cycle is likely to involve:

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[1] For example, entitlement to student maintenance grants, liability to the High Income Child Benefit Charge, eligibility for passported benefits such as free school meals.

[2] This will arise where the additional income in the transitional year is more than any available overlap relief

[3] Whether a UC award will increase when additional tax is paid by a self-employed claimant will depend on whether the minimum income floor is applied to the award or whether the extra tax will trigger the minimum income floor to apply. Where the minimum income floor applies, there may not be an increase in the UC award even though the taxpayers net income falls due to the extra tax due.

[4] See paragraph 3.33 of basis period consultation: https://www.gov.uk/government/consultations/basis-period-reform/basis-period-reform-consultation#proposal-the-tax-year-basis

[5] See page 47-48 of our paper 'A better deal for the low income taxpayer' https://www.litrg.org.uk/sites/default/files/files/LITRG-A-better-deal-for-the-low-income-taxpayer-2020.pdf

- initially submitting a tax return with estimated profits (as the exact profit figure for the second accounting period is unlikely to be known by the time the tax return is filed) and so
- paying a tax bill which is necessarily estimated, and then
- submitting an amended tax return when the profits for the second accounting period are finalised, and then
- paying any additional tax or claiming a repayment of overpaid tax once the tax calculation is adjusted for the amended return.

6.2. We expect that some self-employed taxpayers will change their accounting date to 31 March (or 5 April) once they realise how complicated and time consuming this is unless there are commercial reasons for them not to do so. Therefore we would urge HMRC to make it as easy as possible to change accounting dates to 31 March or 5 April and also to ensure there is good detailed practical guidance available to enable taxpayers to do this easily themselves.

6.3. Those who have agents are likely to have to pay higher fees if they have to follow this process.

6.4. The consultation suggests some alternative options to apportioning profits that could be explored.[1] We strongly recommend these are considered in more detail before the process is finalised. The delay in introducing the basis period reform should allow time to do this.

## 7. Q6. How manageable is the timetable, especially vis-à-vis the introduction of Making Tax Digital for income tax?

7.1. Although the implementation of Making Tax Digital for income tax has now been delayed until 6 April 2024, which we have welcomed[2], we remain concerned that the new time frame envisaged for implementing this basis period change (for 2023/24 to be the transitional year and then the new basis of assessment to apply from 2024/25) is still 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.

7.2. The potential introduction of two major changes to the tax system may be too much for some unrepresented 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 the coronavirus pandemic.

7.3. Therefore, while we welcomed the one-year delay to the introduction of MTD for ITSA, we still think the timescale to implement both this and basis period reform together is too tight. We would therefore like to see a further delay to MTD for ITSA so that basis period reform – if it goes ahead – can be implemented and 'bed in' to the system first. If this is not done, the strain on both HMRC's

[1] See paragraph 3.13 of basis period consultation: https://www.gov.uk/government/consultations/basis-period-reform/basis-period-reform-consultation#proposal-the-tax-year-basis

[2] The delay was necessary in order to allow more time for a full cycle of testing, to allow more time for more software to be developed and to allow HMRC sufficient time to prepare guidance.

resources and unrepresented taxpayers running small businesses will likely be significant, and the broader ramifications (e.g. economic and societal, as well as trust in HMRC) could be far-reaching. Whatever the eventual timescale, HMRC will need to work extremely hard to educate and support taxpayers. They should also consider other mitigating measures, such as a soft landing in terms of penalties for those who initially struggle to get up to speed with MTD.

**8. Q7. What is Her Majesty's Revenue and Customs doing to support businesses in making the change?**

8.1. We would like confirmation that HMRC will be planning targeted communications to make businesses who will be affected by the changes aware of the new rules. It would be helpful for unrepresented taxpayers if HMRC contact all unincorporated businesses which do not have a 31 March or 5 April year end to explain the changes and how they can change their accounting period if they choose to do so.

8.2. They will also need to ensure that detailed and practical guidance is available in good time for the implementation of the transitional period, and helpline staff are well trained in the technical points relevant to this change. We would like to see HMRC's extra support service better publicised so that vulnerable taxpayers can get the specialist support they may well need.

8.3. We also hope HMRC will make every effort to let people know what overlap relief information HMRC have on their records as we expect this to be one of the biggest gaps in information for businesses when they come to deal with this change which will drive contact to HMRC helplines. Where HMRC have no overlap profit information for a taxpayer, it would be helpful if they were to proactively tell them (and their adviser if they have one) to allow them additional time to try to confirm their overlap position. The information could be included in the targeted correspondence discussed at 8.1 above. Alternatively, such information could be made readily available in digital tax accounts.

**9. Q8. How important is reform of the basis period rules in the context of the Government's 10-year strategy for the tax administration framework?**

9.1. The recent consultation on 'The tax administration framework: Supporting a 21st century tax system'[1] highlighted basis period reform as a simplification opportunity to help achieve a trusted, modern system. To be clear, basis period reform is not an administrative measure but a technical change to the underlying tax rules. As we believe the reform will make the tax system simpler to understand and easier to comply with for some taxpayers, this should mean that those people have a better experience of the tax system. It should also help to provide certainty around their tax affairs if they can be confident they have made correct declarations. In the longer term, once the new

[1] See https://www.gov.uk/government/consultations/call-for-evidence-the-tax-administration-framework-supporting-a-21st-century-tax-system and LITRG's full response to this consultation: https://www.litrg.org.uk/sites/default/files/files/210712-LITRG-response-Tax-Administration-Framework-Review.pdf

system has settled in, this could lead to less confusion and misunderstandings, and so help build trust in the tax system.

9.2. It is also important that there are sufficient resources available to enable HMRC to support taxpayers if they need to change their accounting period or use overlap relief to continue to build trust in the tax system.

**10. Q9. How much of a problem are the existing basis period rules in practice?**

10.1. In our experience, many people find the existing basis period rules confusing. Those who can afford to engage an agent may rely on them to make sure the correct profits are declared on the correct tax returns, rather than having to understand the rules themselves. However unrepresented taxpayers, who are often on low incomes, struggle with the concept of a basis period and all that it entails.

10.2. Some unrepresented taxpayers have a non-31 March (or 5 April) year end by accident[1] rather than intention, and undoubtedly make inadvertent errors on their tax returns due to a lack of understanding of these rules.

**11. Q10. How does the proposal fit with the work the Office of Tax Simplification is doing on the date of the end of the tax year?**

11.1. The OTS report on changing the date of the end of the tax year[2] summarises the benefits of a change of date, but stresses that it will be very costly to change the tax year end and a very long lead time is needed to do so. It concludes that this would be the case to a greater or lesser extent whether it was a change to 31 March or to 31 December.

11.2. As we believe there will be a benefit to low income unrepresented taxpayers from basis period reform to dovetail with the introduction of MTD for income tax, we do not recommend deferring action on this while further work is done on the possibility of changing the tax year end.

11.3. The OTS report recommends treating accounts drawn up to 31 March and those drawn up to 5 April as equivalent for tax purposes, as do the proposals in the basis period consultation. We believe this would be a welcome simplification, codifying something that is already happening widely in practice. If the tax year end did then move to 31 March, this could be regarded as an interim step. If a change of year end to 31 December ultimately happens, basis periods would need to be aligned accordingly.

LITRG
13 October 2021

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[1] For example, if someone incorrectly assumes they need to do accounts for a 12 month period from when they start their business.

[2] https://www.gov.uk/government/publications/exploring-a-change-to-the-uk-tax-year-end-date

**About Us**

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.

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.

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.