Basis Periods

The basis period rules are complex, but in some circumstances can offer significant cash flow savings in the early years of a growing business.

Does my sole trader Year End have to be the same as the tax year?
No. You can choose any period for your accounts, and not necessarily 12 months long. This creates complications during the early years. The rules (known as the *basis year rules*) work as follows:

Year 1	Tax is paid on profits between start of business and end of tax year.
Year 2	
Period of less than 12 months, ends during year	Tax is paid on profits of first 12 months trading
Period of more than 12 months, ends during year	Tax is paid on profits to the accounting date
No period end during year	Tax is paid on profits of the tax year
Year 3	Tax is paid on profits of the period ending during year 3

Notes:

- The tax year ends on April 5th; for convenience, March 31st is often used.
- When an accounting period is too long for the tax period, profits are pro-rated. Technically this should be done to the day; however it will often be satisfactory to use a monthly calculation, eg, profits during a 15 month period are £30,000; 12 month profits are £24,000.
- In many cases, these rules will lead to periods of overlap. Such "overlap profits" are carried forward until the business ceases, or until there is a change of accounting year. It is important to bear this in mind when planning to close a business – which includes transferring from sole trader to company.

Example:

Flintoff commences trade on July 1st 2007 and draws up accounts to June 30th each year. Profits for the first year are £4,000 (due to start up expenses and time to build up sales) and for the second year £24,000 (evenly spread over the year).

Tax Year	Relevant accounts	Profit for tax
2007-8	July 1st 07- Mar 31st 08	£3,000
2008-9	July 1st 07-June 30th 08	£4,000
2009-10	July 1st 08-June 30th 09	£24,000

Notes:

- The first year taxable profit is 9/12 of the first year accounting profit
- The period July 07 to March 08 is taxed twice – this overlap profit of £3,000 will be carried forward
- If Flintoff does not have other income, part of his personal allowance of £5,225 is wasted in both the first two tax years.

Now suppose instead that Flintoff drew up accounts to September 2008:

Tax Year	Relevant accounts	Profit for tax
2007-8	July 1st 07- Mar 31st 08	£6,000
2008-9	July 1st 07- Sep 31st 08	£10,000
2009-10	Oct 1st 08- Sep 31st 09	£24,000

Notes:

- The first accounts to September show profit of £10,000 (£4,000 to June and £2,000 per month thereafter)
- First year profit is now 9/15 of the period to September
- Second year profit is based on the 12 months to September (see table above). This includes April – September, previously untaxed, and overlap profits between October – March.
- As a result, profits exceed the personal allowance, which is not wasted.

This may all appear rather artificial, and to an extent that is true. However:

- It is not unusual for the early months to be less profitable, and it may be valuable for cash flow purposes to minimise tax payments, and therefore to make use of low overlap profits.
- There is no rush to finalise accounts, and the self-assessment return for 2007-8 is not due until January 31st 2009.[1] With a good

[1] Provided it is completed online. From SA year 2007-8 paper returns must be filed by October 31st.

bookkeeping system, a monthly reckoning can be made, and the accounts drawn up to a suitable date.

- A choice can be made as to whether capital allowances are claimed, and possibly on the timing of capital expenditure.

IR 222 *How to Calculate your Taxable Profits* explains this further, with examples. http://www.hmrc.gov.uk/sa/forms/net-07-08.htm