

Assessor
M Couch

Telephone: (01624) 685400
Fax: (01624) 685351
E-mail: incometax@treasury.gov.im
Website: www.gov.im/treasury/incometax

PRACTICE NOTE

PN 108/04

Date: 14th December 2004

Taxation of Income from Self-employment Following the Introduction of the Current Year Basis

Introduction:

In June 2004 the Income Tax (Amendment) Bill 2004 received Royal Assent. The resulting Act ('the 2004 Act') introduced new provisions that provide for the Current Year (CY) basis of assessment for non-corporate taxpayers.

This practice note follows on from PN 96/03 "The Introduction of a Current Year Basis" and provides further guidance on the proposed treatment of self-employment profits under the new rules.

The 2004 Act provides for regulations that support the assessment of self-employment profits. It is envisaged that, following a period of review and allowing for the identification and resolution of potential issues, these regulations will be drafted and laid before Tynwald.

Scope:

This practice note deals specifically with the taxation of self-employment profits that are received by a sole trader or by partners in a partnership.

Further practice notes and guidance notes will be available that cover other provisions that were included within the 2004 Act.

Contents:

This practice note will consider the following topics:

	Page Number
1) Existing Businesses:	3
a. Taxation of self-employment profits	3
b. Transition:	3
i. New Concession	3
ii. Capital Allowances	3
iii. Losses	4
iv. Exclusions	4
c. Cessations	4
d. Overlap Relief	4
2) The Accounts Basis of Assessment for New Businesses:	6
a. Conditions	6
b. Approval & Effect	6
c. Withdrawal of Approval	6
3) New Businesses where The Accounts Basis is approved:	7
a. Commencement of a business	7
b. Cessation of a new business	9
c. Change of accounting date	10
4) Capital Allowances	12
5) Losses	12

1) EXISTING BUSINESSES:

a. Taxation of Self-employment Profits

The Division has had a long-standing practice of allowing the profits shown in trading accounts ending in a year of assessment to be assessed as income for that year.

With the introduction of the CY basis of assessment it is proposed that this practice will not change. Trading profits of the period of account ending in the year of assessment rather than ending in the previous year will therefore be assessed.

b. Transition

i. New Concession

Although PN 96/03 detailed the strict position with regard to the cessation of all sources that are assessed on a previous year (PY) basis; in order to simplify the move to a current year basis for non-corporate self-employment profits the following concession is proposed.

2002/2003	assessment of trading income shown in the accounts ending in the previous year.
2003/2004	assessment of trading income shown in the accounts ending in the current year.
2004/2005	assessment of trading income shown in the accounts ending in the current year.

Income shown in the accounts ending in the 2002/2003 year of assessment will not be brought into charge for income tax purposes.

ii. Capital Allowances

For capital allowances purposes any additions or disposals during a year falling out of charge will be treated as though they occurred on the first day of the next accounting period; i.e. the accounts ending in the current year.

Example

A sole trader with an accounting year end of 30 April will be assessed as follows: -

2002/2003	trading income assessed for the year ended 30 April 2001
2003/2004	trading income assessed or the year ended 30 April 2003
2004/2005	trading income assessed for the year ended 30 April 2004

As the accounts for the year ended 30 April 2002 fall out of charge, any additions or disposals for capital allowances purposes will be treated as though they occurred on 1 May 2002.

iii. Losses

Any agreed loss for a period of account which falls out of charge can be utilised in the normal manner; i.e. offset against other income in the year of the loss or carried forward and offset against future profits from the same trade. Therefore a loss arising in an accounting period ending in the 2002/2003 year of assessment can be offset against other income in 2002/2003 or carried forward and offset against future profits for the following years.

iv. Exclusions

The concession applying in the transitional year will not apply where the profit for the year, which ultimately falls out of charge, is understated or is perceived to have been artificially increased.

c. Cessations

The cessation of an existing business will, with the exception of the availability of overlap relief, be assessed in the same manner as a new business. For instruction regarding the assessment on cessation please refer to paragraph 3)b. below; then, having established the profit assessable in the final year consider the overlap relief that is considered in the next paragraph.

d. Overlap Relief

Where a client commenced self-employment prior to the introduction of the CY basis of assessment, has continued to be assessed on a concessionary accounts basis throughout and ceases to trade under the new regime there may be an overcharge of profits. The potential overcharge will not arise until the year during which cessation occurs. At that point the overcharge may be calculated with reference to the number of months difference between the accounting date and the following 5th April.

Therefore a client who commenced trading prior to 6th April 2002 and ceases after 5th April 2004 may qualify for overlap relief, based on the accounting period end date used at the time of the transition to the current year basis i.e. 2003/2004.

For example

If the accounting period end date is 30 April the client will be charged to tax for 11 months more than they actually trade (i.e. the period between 30 April and the following 5 April). The final period's adjusted profit will therefore be reduced by 11 months.

The relief will apply as follows:-

30 April	11 months
31 May	10 months
30 June	9 months
31 July	8 months
31 August	7 months
30 September	6 months
31 October	5 months
30 November	4 months
31 December	3 months
31 January	2 months
29/28 February	1 month

Overlap Relief – Illustration

A client commenced trading on 1 May 1999 and has a year end of the 30 April. He finally ceases trading on the 31 October 2005.

The client will have traded for a period of 78 months but, before considering overlap relief, will be charged to tax for 89 months.

In the final year of assessment (2005/2006) the 18 months accounting period ended 31 October 2005 will be assessed in 2005/2006. However 11 months' overlap relief will be available and the client will only be assessed on 7/18ths of the adjusted profit for that period.

2) THE ACCOUNTS BASIS OF ASSESSMENT FOR NEW BUSINESSES:

a. Conditions

Strictly the profits assessed to income tax are those of the current year, but it is proposed that, subject to a successful application to the Assessor, the Accounts Basis of assessment may be adopted.

To apply for The Accounts Basis the following conditions must be met:-

- i. accounts must be made up to a date falling on or after 30th June in each tax year,
- ii. accounts must be prepared which run consecutively for the life of the business,
- iii. accounts must be accompanied by a tax computation,
- iv. a new business must prepare accounts to a date in the tax year ending on the 5th April following the commencement of the business or in the tax year ended on the 5th April next following,
- v. a business which has continued through transition and has opted for the statutory cessation cannot elect under the new regime.

b. Approval and Effect

As the Accounts Basis will only apply to certain cases an application must be made to the Assessor. The application should be made in writing at the time the accounts are filed.

Having made an application and following approval by the Assessor, the profit or loss computed as at an accounting period ending in the year will be charged to income tax as the profits for that tax year.

c. Withdrawal of Approval

Approval may be withdrawn or rescinded for future tax years by notification to the Assessor, or by the Assessor for all years in cases of serious omissions or false claims.

3) NEW BUSINESSES WHERE THE ACCOUNTS BASIS IS APPROVED:

a. Commencement of a Business

All non-corporate traders that have commenced business under the new regime and have successfully applied for the Accounts Basis will be charged in the opening years as follows:-

Year 1 - If accounts are prepared to a date in the tax year ending on the 5th April following the commencement of the business, the profits of those accounts will be included in any assessment for that tax year.

Year 2 - If accounts are prepared to a date ending in Year 1, then the profits of the period of 12 months from the end of those accounts to a date ending in Year 2 will be assessed in Year 2.

If the first set of accounts following commencement are not prepared to a date ending in Year 1, then the total profits from commencement to the accounting date ending in Year 2 will be assessed in Year 2.

If, following commencement, no accounts are prepared that end in Year 1 or Year 2, then the Accounts Basis will not apply.

Year 3 + The profits of the accounting period ending in the year of assessment will be assessed in that year.

Where, due to a change in accounting date there is no valid assessable period, a figure of profit for the 12 month period from the last accounting date will be used. Where two accounting periods end in a year of assessment, the profits from both will be charged within that one tax year.

Commencement of Business - Illustrations

Example 1 - 12 month opening set of accounts

A new business commences on 1.7.2003 and accounts are prepared for the 12 months ending on 30.6.2004 showing a net profit of £ 48,000. The second year's accounts ending on 30.6.2005 show a net profit of £ 60,000.

Year 1 -	No accounts prepared to a date in 2003/2004 (first period ends on 30.6.2004)	Nil
Year 2 -	First accounts prepared to a date in 2004/2005 (first period ends on 30.6.2004)	48,000

Year 3 -	Accounting period ending in 2005/2006 (period ends on 30.6.2005)	60,000
----------	---	--------

Example 2 - Short opening set of accounts ending in Year 1

A new business commences on 1.7.2003 and accounts are prepared for the 7 months ending on 31.1.2004, showing a net profit of £ 48,000. Accounts are then prepared for the 12 months ending on 31.1.2005, showing a net profit of £ 60,000 and to 31.1.2006, which show a net profit of £ 80,000.

Year 1 -	Accounts are prepared to a date in 2003/2004 (first period 1.7.2003 to 31.1.2004)	48,000
Year 2 -	Accounts are prepared for a 12 month period ending in 2004/2005 (12 months to 31.1.2005)	60,000
Year 3 -	Accounting period ending in 2005/2006 (period ends on 31.1.2006)	80,000

Example 3 - Short opening set of accounts ending in Year 2

A new business commences on 1.12.2003 and accounts are prepared for the 7 months ending on 30.6.2004, showing a net profit of £ 36,000. Accounts are then prepared for the 12 months ending on 30.6.2005, showing a net profit of £ 55,000 and to 30.6.2006, which show a net profit of £ 75,000.

Year 1 -	No accounts prepared to a date in 2003/2004 (first period ends on 30.6.2004)	Nil
Year 2 -	First accounts prepared to a date in 2004/2005 (first period 1.12.2003 to 30.6.2004)	36,000
Year 3 -	Accounts prepared for a 12 month period ending in 2005/2006 (12 months to 30.6.2005)	55,000

Example 4 - long opening set of accounts ending in Year 2

A new business commences on 1.7.2003 and accounts are prepared for the 14 months ending on 31.8.2004, showing a net profit of £ 68,000. Accounts are then prepared for the 12 months ending on 31.8.2005, which show a net profit of £ 60,000.

Year 1 -	No accounts prepared to a date in 2003/2004 (first period ends on 31.8.2004)	Nil
Year 2 -	First accounts prepared to a date in 2004/2005 (first period of 14 months ends on 31.8.2004)	68,000

Year 3 -	Accounts prepared for a 12 month period ending in 2005/2006 (12 months to 31.8.2005)	60,000
----------	---	--------

b. Cessation of a New Business

Where, having been assessed using the Accounts Basis, a non-corporate business ceases, the basis of assessment for the final tax year shall be the period:

- Beginning on the day after the end of the last period of account which was included in an assessment; and
- Ending on the last day that the business was operated.

If a non-corporate business, which has prepared accounts to a date early in the tax year (e.g. 30th June), ceases to operate on 31st March, then the final assessment will include accounts for both periods as both end in the same year of assessment.

The possibility that more than one period of account will be assessed during the final year should be considered carefully before applying for approval to use the Accounts Basis.

If the preparation of a long period of account at cessation means that no period of account ends in a particular year, then the profit of a 12 month period from the last accounting date will be used by apportioning profits of the long period. The balance will then be charged in the final year.

Cessation of a business – Illustrations

Example 5 Short period cessation accounts result in two sets of accounts ending in one tax year

A business prepares a 12 month set of accounts to 30.6.2004, showing a net profit of £68,000. Accounts are then prepared for the 7 month period to 31.1.2005 when the business ceases, and show a net profit of £45,000.

2003/04 -	12 months to 30.6.2003	
2004/05 -	12 months to 30.6.2004	68,000
	Plus 7 months to 31.1.2005	<u>45,000</u>
		113,000

Example 6 Long period cessation accounts prepared to a date in the tax year following the penultimate year of assessment

A business prepares a 12 month set of accounts to 31.8.2004, showing a net profit of £ 68,000. Accounts are then prepared for the 14 month period to cessation on 31.10.2005, and show a net profit of £ 80,000.

2004/05 -	12 months to 31.8.2004	68,000
2005/06 -	14 months to 31.10.2005	80,000

Example 7 Long period cessation accounts “missing” the penultimate year of assessment

A business prepares a 12 month set of accounts to 31.12.2004, showing a net profit of £48,000. Accounts are then prepared for the 18 month period to 30.6.2006 when the business ceases, which show a net profit of £ 90,000.

2004/05 -	12 months to 31.12.2004	48,000
2005/06 -	no valid date 12 months to 31.12.2005 $12/18 \times 90,000$	60,000
2006/07 -	6 months to 30.6.2006 $6/18 \times 90,000$	30,000

c. Change of Accounting Date

Where the Accounts Basis applies and accounts are then prepared for a period longer or shorter than 12 months, the profits of all periods of account ending in a particular tax year will be included in the assessment for that tax year. If the preparation of accounts for a period longer than 12 months means that no period of account ends in a particular year of assessment, then the profit of a 12 month period from the last accounting date will be used by apportioning profits of the long period. The balance will then be charged in the year in which the long period of account ends.

Change of Accounting date - Illustrations

Example 8 Long set of accounts prepared to a date in the tax year following the previous year of assessment

A business prepares a 12 month set of accounts to 31.8.2004, showing a net profit of £ 68,000. Accounts are then prepared for the 14 month period to 31.10.2005, and show a net profit of £ 80,000.

2004/05 -	12 months to 31.8.2004	68,000
2005/06 -	14 months to 31.10.2005	80,000

Example 9 Short period accounts result in two sets of accounts ending in one tax year

A business prepares a 12 month set of accounts to 30.6.2004, showing a net profit of £ 68,000. Accounts are then prepared for the 7 month period to 31.1.2005, showing a net profit of £ 45,000. A 12 month period of account then ends on 31.1.2006, which shows a net profit of £ 75,000.

2004/05 -	12 months to 30.6.2004	68,000
	Plus 7 months to 31.1.2005	<u>45,000</u>
		113,000

2005/06 -	12 Months to 31.1.2006	75,000
-----------	------------------------	--------

Example 10 Long period accounts "miss" the tax year of change

A business prepares a 12 month set of accounts to 31.12.2004, showing a net profit of £48,000. Accounts are then prepared for an 18 month period to 30.6.2006, which show a net profit of £ 90,000.

2004/05 -	12 months to 31.12.2004	48,000
2005/06 -	no valid date	
	12 months to 31.12.2005	
	12/18 x 90,000	60,000
2006/07 -	6 months to 30.6.2006	
	6/18 x 90,000	30,000

4) CAPITAL ALLOWANCES:

Capital Allowance Basis periods will, in cases where the new Accounts Basis applies, be the same as the period of account. Where a 100% initial allowance does not apply or is not claimed, any remaining writing down allowance will be adjusted where a long or short period of account is used to form the basis for an assessment year.

5) LOSSES:

Losses incurred in an accounting period which falls so as not to be included in any assessment under the change in basis of assessment (i.e. accounting periods ending on a date in the 2002/2003 tax year) will, where agreed, fall to be a loss incurred in 2002/2003 and relieved against other income of that year of assessment or carried forward against profits from the same trade.

A further Practice Note regarding loss relief will be issued in due course.

M Couch

Assessor of Income Tax

This practice note is intended only as a general guide and must be read in conjunction with the appropriate legislation. It does not have any binding force and does not affect a person's right of appeal on points concerning their own liability to income tax.

Comments and suggestions for improvements of issued Practice Notes and suggestions for future Practice Notes are always welcome.