

# **Reforming the Personal Tax System**

**Report of a Committee set up by  
the Institute for Fiscal Studies**

**Chairman: Malcolm Gammie**

**Secretary: Edward Whitehouse**

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# REFORMING THE PERSONAL TAX SYSTEM

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REFORMING THE PERSONAL TAX SYSTEM

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<sup>1</sup> Paul Hill attended the Working Party meetings on the first Consultative Document as an observer for the Deregulation Unit. He became a full member of the Working Party on ceasing his period of secondment to the Unit in 1992. His place as observer was taken by Fiona Ridgeway with effect from December 1992.

## PREFACE

In August 1991, the Government published a consultative document entitled "*A Simpler System for Taxing the Self-Employed*". This document heralded a major reform of the way in which the self-employed are taxed. It was, however, a precursor to a more significant proposal to change the way in which taxpayers report and pay their tax. This wider change was hinted at in the 1991 Consultative Document but became apparent in a second Consultative Document published by the Government in November 1992, entitled "*A Simpler System for Assessing Personal Tax*". The reforms heralded by these two Consultative Documents could rank as among the most fundamental changes this century to the way in which individuals deal with their tax affairs. The need to get it right is clearly paramount.

Following the publication of the first Consultative Document, the Institute for Fiscal Studies established a Working Party to examine the proposals and to make recommendations. The conclusions arrived at by the Working Party were communicated to the Inland Revenue. Following the publication of the second Consultative Document, the Working Party reconvened to review its previous conclusions and to finalise for publication this Report of its deliberations.

The Working Party has been chaired by Malcolm Gammie and its members are listed at the beginning of this Report. Edward Whitehouse, a member of the IFS staff, acted as Secretary. The Report has been financed by contributions from a number of major professional firms, listed at the beginning of this Report. Each of the firms nominated an individual to serve on a Committee with whom the Working Party could liaise. To assist its deliberations, the Working Party also sought the views of a panel of 100 tax practitioners drawn from medium to small professional firms including sole practitioners, all of whom are members of The Institute of Taxation. In relation to the second Consultative Document, a questionnaire was also sent to some 600 small business proprietors for their views on certain aspects of the proposals. Finally, the Inland Revenue and the Deregulation Unit of the Department of Trade & Industry each provided observers who attended the meetings of the Working Party.

The Working Party has derived great benefit in its deliberations from these many individuals who have contributed in a variety of ways to its thinking. Nevertheless, the views expressed in this Report reflect the conclusions reached by the members of the Working Party in their individual capacity. Those views and the conclusions that we have reached are not necessarily those of the individuals we have consulted, of the bodies with which the members of the Working Party are associated or of their firms, of the firms which sponsored this Report, of those Departments that provided observers or, finally, of the IFS (which has no corporate views).

## SUMMARY

### The Problems Of The Present System

Winston Churchill introduced the present system for taxing the self-employed in 1926. In choosing the "preceding year" basis, he adopted the recommendations of the 1920 Royal Commission on The Income Tax. The "Schedular" system of income tax is older still. It dates back to 1803, to Addington's Income Tax Act of that year. Both the Schedular system and the preceding year basis are in need of reform. But it is important that we get it right, if our choices are to stand the test of time.

The self-employed increased in number from under 2 million in 1979 to nearly 3.5 million in 1990. Changes in work patterns, modern technology and the growth in "home-working" make a further increase likely. This expansion has put the system under strain and made reform all the more important. The majority of the self-employed derive only a small income from their activities. In 1988-89, around one-half of them earned less than £6,000 from this source. Many have other income - from an employment, a pension or their savings.

For people with several sources of income, the Schedular system of dealing with those sources is confusing and hard to understand. They may receive several demands for tax: at different times of the year; to be paid on different dates; covering different types of income and gain; sent out by more than one Inland Revenue office. None of these demands will tell them what their total taxable income is for the year, or the total tax they must pay for the year.

The confusion of the Schedular system is compounded by the "preceding year" basis for taxing the self-employed. The taxable income of today is the profit that was earned yesterday; profits earned today are taxed as the income of tomorrow. For example, profits earned between 1st July 1991 and 30th June 1992 are taxed as the income of the tax year starting on 6th April 1993. When a business starts up, some profits are taxed more than once; when the business closes down, some profits are not taxed at all. Over the lifetime of a business the profits that are taxed are likely to differ from the profits actually earned; they may be more or they may be less, but for a business carried on over a period of years, it will be pure coincidence if the profits earned are the same as the profits taxed. Two self-employed people can earn the same profits but pay different amounts in tax.

Despite last year's profits being taken as this year's income, details of those profits are frequently not given to the Inland Revenue on time. Tax paid is often estimated and wrong, and has to be corrected later. In short, the administration of the self-employed's tax affairs is likely to be chaotic and their compliance costs considerable.

## REFORMING THE PERSONAL TAX SYSTEM

How can we solve these problems? One thing is clear: sorting out how the self-employed are taxed needs to be tackled first. This is the key to reforming the Schedular system and how total income is taxed.

### Sorting Out How The Self-Employed Are Taxed

Taxing the self-employed in a satisfactory way requires a subtle blend of three things:

- First, we have to find a practical way to tax their profits. We need a statement of their net profits, prepared for the period that we want to tax. Unlike employees, they cannot just be taxed on what they receive when they receive it;
- Second, the preparation of that profits' statement, the submission of their tax return and the payment of tax has to fit into a practical timetable;
- Finally, we must be able to move from the present system to a new system, fairly. The change should not penalise the self-employed; nor should it offer them a tax holiday. Throughout, we need to maintain the flow of tax revenue on the self-employed's profits to the Exchequer.

Finding the right blend is critical: the self-employed and their advisers need to understand and be able to cope with the new system. They must see that it is fair, and that it is fairly administered. The success of any new system depends upon it. What has become an unsatisfactory system needs to be replaced by one that addresses and solves these problems. If we get it right now, we can hope that a new system might last as long as Churchill's, or even Addington's.

### Taxing Profits As They Are Earned

The best solution is to tax profits as they are earned: so that profits earned today are taxed as the income of today. This is easily understood and it is fair: the self-employed pay tax on what they earn - no more, no less. It fits in with the way in which most other income is taxed. It is the system that most other countries adopt.

At present, however, many businesses do not work out their profits for the tax year. They use a different accounting date. Under the preceding year basis, there is no need to adopt the tax year as the period for calculating profits. Indeed, for many there are tax advantages in *not* doing so. But most businesses could prepare a statement of their profits for the tax year if they had to, even though there will always be a minority who have good reason for using different accounting dates.

### The Current Year Basis

To tax profits as they are earned while still allowing businesses to use the accounting date of their choice, the Government has proposed a "current year" basis to replace the "preceding year" basis. Profits for the tax year will not be the profits earned in the tax year. Instead, they will be the profits of the accounts year *ending* in the tax year. For example, the profits for the accounts year beginning on 1st July



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1996 and ending on 30th June 1997 will be taxed as income of the tax year starting on 6th April 1997 and ending on 5th April 1998.

This ensures that in almost every case an individual pays tax on the actual profits earned. Further, if an individual chooses the tax year (or something close to it) as the period for which to state his or her profits, those profits will be taxed as they are earned. A business which states its profits from 1st April to 31st March should have few problems. This is the individual's easiest option and produces the result we want in designing a new system.

However, under the current year basis an individual has an incentive *not* to do this: by stating profits to a date *early* in the tax year - for example, for the period from 1st May to 30th April - tax payments can be deferred for longer. The current year basis gives those that want it the freedom to choose their accounting date, but in a way that encourages others to choose their accounting dates for tax reasons.

The current year proposals try to neutralise this effect by offering balancing incentives for businesses to state their profits for the tax year. For example, existing businesses will be encouraged to change their accounting date to coincide with the tax year, to avoid being penalised by the transitional rules. New businesses that defer paying tax by stating their profits for a period other than the tax year may find that in the year the business closes down, tax is due on more than one year's profits or income.

These are arbitrary ways in which to give people the freedom to choose any accounting date they wish, while at the same time encouraging them to state their profits for the tax year. Tax and not just commercial considerations will continue to feature in the choice of accounting dates.

The current year basis does, however, offer administrative advantages over a number of alternatives. For example, it should always be possible to submit a tax return showing the final profits that are to be taxed. However, this administrative advantage becomes rather less important once individuals are given responsibility for calculating and paying tax on their income, as is proposed. Furthermore, if we can, we should fashion the administration of the tax system to fit its design; we should not design the tax system to fit its administration, especially if that may produce arbitrary results. We have concluded, therefore, that the current year proposal is not a satisfactory way forward.

### The Fiscal Year Basis

What do we propose instead? We accept that a number of occupations and businesses are seasonal in nature. The self-employed should therefore have the option of choosing an accounting date that differs from the tax year. Where, however, profits are stated for a period other than the tax year, the profits should be apportioned to the tax year in which they were earned. Thus, three-quarters of the profits of a period from 1st July 1996 to 30th June 1997 would be taxed as income of the tax year 1996-97 and one-quarter in 1997-98.

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This approach -

- allows the self-employed to state their profits for any period they wish;
- ensures that the self-employed are always taxed on the profits that they earn in the tax year;
- requires no special rules to deal with the first or final years of trading or with changes in accounting dates;
- requires no special relief to deal with the transition from the old to the new system, and
- as no tax advantages attach to the choice of accounting date, ensures that most self-employed individuals will state their profits for the tax year as the simplest option, unless they have commercial reasons for doing otherwise or are existing businesses that wish to retain their present accounting date.

Our detailed recommendations are summarised below and we compare them in the Summary Table with the proposals for the current year basis.

### **Self-Assessment and Compliance**

Our proposals assume (and we support the idea) that taxpayers become responsible for calculating and paying their own tax, as the Government has proposed. We still envisage, therefore, that taxpayers will file a single tax return covering their total income and gains. We propose that the filing date should be 1st February, ten months after the end of the tax year.

The minority of self-employed who, for valid commercial reasons, state their profits for a period other than the tax year, would still have to meet this deadline. However, they would be allowed to pay tax based on their estimate of profits, if final figures were not available by 1st February. They would in that case have until the following 1st August to submit an amended return of profits and pay any outstanding tax, together with ordinary commercial interest on that tax from 1st February until payment.

Some bunching of compliance work is inevitable under any system that requires taxpayers to report income for the tax year. Taxpayers will have to deal more promptly with their tax affairs under either the Government's or our preferred proposals. The tax professions will need to adapt their work methods to provide the services that the new system demands. No change as major as this is likely to be comfortable or easy. It will take time for people to adapt and for a new system to bed down. Nevertheless, taxpayers and the tax professions in other countries have learned to work with more stringent time limits than are proposed and we believe that this will also prove to be the case in the UK.

## DETAILED RECOMMENDATIONS

- A self-employed person should state his profits by reference to the tax year, unless he or she elects to do otherwise or is an existing business (see below).
- Profits stated for any 12 month period ending between, say, 29th March and 12th April should be treated as the profits for the tax year.
- Consideration should be given to extending these dates so that profits stated for any 12 month period ending on or between 28th February and 30th April would be treated as the profits of the tax year. For example, profits of the year to any date between 28th February 1997 and 30th April 1997 would be taxed as income for 1996-97. This would allow a business to prepare its accounts to the same date as that on which it submits a VAT return, if it wishes.
- A self-employed person would be entitled to elect to prepare financial statements to any date that suits the commercial requirements of the business. Existing businesses would be entitled to retain their present accounting dates if they wished.
- If a date other than the tax year (or its equivalent) is chosen, the profits must be apportioned to the relevant tax years. For example, the profits earned in the year to 30th September 1997 will be apportioned one-half to 1996-97 and one-half to 1997-98. This would apply to both existing and new businesses.
- Tax returns, covering all income and gains for a tax year, would be required from the self-employed and from other taxpayers to whom returns are issued. Tax returns would have to be submitted by 1st February, ten months after the end of the tax year. For example, the return of income and gains for the tax year ending on 5th April 1997 would have to be submitted by 1st February 1998.
- As proposed by the Government, payments by the self-employed on account of the tax on their profits should continue to be made in two instalments, but on 1st February during the tax year and 1st August after the tax year instead of 1st January and 1st July as at present.
- The interim payments of tax on 1st February and 1st August should be based on the profits earned in the previous year. Consideration should be given to establishing a mechanism to enable those that wish to pay or to save for tax at more frequent intervals during the year to do so.
- As proposed by the Government, an individual should be responsible for calculating and paying tax. Tax for any year, after deducting any

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instalments paid on account, would be due on 1st February after the end of the tax year, based on the tax return made on that date.

- However, an individual should also have the option, as proposed by the Government, to submit details of his or her income and gains to the Inland Revenue by 1st October after the end of the tax year. The Inland Revenue would then calculate the tax to be paid by the taxpayer.
- An individual should have the option of submitting a tax return and paying tax earlier than 1st February. A discount on any tax liability should be given for tax paid early on submission of a tax return between 1st October and 1st February.
- Self-employed persons who state their profits for a period other than a tax year would be required to submit their tax return on 1st February after the end of the tax year. If their final profits for the tax year are not then known they would still have to pay tax on 1st February by reference to their estimate of those profits. They would have to file an amended tax return by the following 1st August and pay any balance of tax due on their profits, together with ordinary commercial interest from 1st February to payment.
- The opportunity should be taken on the introduction of the new system to ask all taxpayers to complete a statement setting out their sources of income.

SUMMARY TABLE COMPARISON OF THE PROPOSED CURRENT YEAR BASIS AND THE FISCAL YEAR BASIS WITH APPORTIONMENT OF PROFITS STATED FOR PERIODS OTHER THAN THE TAX YEAR				
DESIRABLE FEATURE OF CHOSEN BASIS	PROPOSED CY BASIS		FY BASIS WITH APPORTIONMENT	
	ACHIEVED?	COMMENT	ACHIEVED?	COMMENT
1. The basis should allow businesses to prepare their financial statements to any date that suits their commercial circumstances.	YES	But it will be more straight-forward to prepare financial statements to coincide with the tax year.	YES	But it will be more straight-forward to prepare financial statement to coincide with the tax year. <sup>1</sup>
2. The basis should not provide a tax advantage to a business from preparing its financial statements to a particular date.	NO	There will be a tax advantage for profitable businesses <sup>2</sup> to prepare their financial statements to a date early in the tax year.	YES	A business will always pay tax on the profits that it earns in the tax year, irrespective of the date to which it prepares its financial statements.
3. A business should be free to change the date to which it prepares its financial statements without obtaining any tax advantage or suffering any tax disadvantage from doing so.	NO	By extending the period covered by its financial statements within a tax year profits may be re-allocated to different tax years. Profits may be taxed twice if the period is shortened or extended beyond the end of the tax year, subject to tapered relief on cessation within six years.	YES	A change in the date of the financial statements alters the apportionment of the profits but profits are still apportioned to the tax year in which they are earned so that (subject to any averaging effect) the business continues to pay tax on the profits earned in the tax year.
4. The profits earned within a particular tax year should be taxed in that year.	NO	This is only achieved if the financial statements are prepared to coincide with the tax year.	YES	This is achieved irrespective of the date to which the financial statements are prepared.
5. Two businesses earning the same profits over their life should be taxed to the same extent.	NO	The effective tax rate on the profits earned may differ according to the tax years in which they are treated as arising and the date to which the financial statements are prepared.	YES	As noted in 3., apportionment between tax years may provide a degree of averaging but this is a natural consequence of taxing by reference to any specified period.

<sup>1</sup> Under our proposals the self-employed would be required to state their profits for the tax year unless they elected to adopt a different date for commercial reasons

<sup>2</sup> The opposite effect applies where a business incurs a loss

<b>SUMMARY TABLE</b> <b>COMPARISON OF THE PROPOSED CURRENT YEAR BASIS AND THE FISCAL YEAR BASIS</b> <b>WITH APPORTIONMENT OF PROFITS STATED FOR PERIODS OTHER THAN THE TAX YEAR</b>				
<b>DESIRABLE FEATURE OF CHOSEN BASIS</b>	<b>PROPOSED CY BASIS</b>		<b>FY BASIS WITH APPORTIONMENT</b>	
	<b>ACHIEVED?</b>	<b>COMMENT</b>	<b>ACHIEVED?</b>	<b>COMMENT</b>
6. Special rules should not be required to deal with opening and closing years of the business.	<b>NO</b>	The system may encourage adoption of an accounts date in the tax year after commencement. Bunching of income may occur for non-tax year accounting dates in the final year. Proposed election for final year may treat business profits more favourably than other income.	<b>YES</b>	Profits will always be taxed in the year in which they accrue and on commencement a return will be required to cover the initial trading period.
7. Existing businesses should not be taxed on more profits than they earn over their life as a result of the transition from the existing to the new system.	<b>NO</b>	The transition will cause some businesses to be taxed on more profits than they earn over the life of the business, although this may be mitigated by changing the accounting date to coincide with the fiscal year or by tapered transitional relief.	<b>YES</b>	Although the profits taxed may not equal exactly the profits earned, this is the effect of the present PY basis and not the FY basis. Overall, taxpayers should not be taxed on more profits than they earn.
8. The flow of tax revenues to the Exchequer should not be interrupted.	<b>YES</b>	Instalments of tax will continue to be paid on 1st January and 1st July in every year.	<b>YES</b>	Instalments of tax will continue to be paid in every year, although one month later on 1st February and 1st August.
9. The system should enable payments on account to be made by reference to some ascertained figure.	<b>YES</b>	Payments on account will be made by reference to the preceding year's reported profits, subject to the taxpayer's right to claim a reduction if profits fall.	<b>YES</b>	Payments on account will be made by reference to the preceding year's reported profits, subject to the taxpayer's right to claim a reduction if profits fall.

**SUMMARY TABLE  
COMPARISON OF THE PROPOSED CURRENT YEAR BASIS AND THE FISCAL YEAR BASIS  
WITH APPORTIONMENT OF PROFITS STATED FOR PERIODS OTHER THAN THE TAX YEAR**

DESIRABLE FEATURE OF CHOSEN BASIS	CY BASIS		FY BASIS WITH APPORTIONMENT	
	ACHIEVED?	COMMENT	ACHIEVED?	COMMENT
10. The system should enable taxpayers to make a single return of total income for the tax year.	YES	The extent to which there is bunching of compliance work will depend upon the spread of accounting dates under the CY basis. All returns will be required by 1st January at latest.	YES	All returns will be required by 1st February but some spreading of accounting dates will be achieved. Those businesses choosing an accounting date close to the tax year end may have estimate taxable profits initially, with interest due on any underpayment.
11. The system should enable taxpayers to pay the correct final balance of tax on filing their returns for the tax year.	YES (in nearly all cases)	But insufficient details of income, gains or valuations may not permit a final computation to be made at that time so that subsequent adjustment is required, and returns are always subject to subsequent adjustment on Revenue audit.	YES (in most cases)	Those businesses that choose an accounting date close to the year end may have to estimate profits and submit an amended return in due course. Otherwise subject to necessary details of income, gains and valuations being available and to Revenue audit.
12. System should not require unnecessary filing of amended tax returns or the issue of unnecessary assessments after the initial filing date.	YES (in nearly all cases)	But amended returns will be required if the taxpayer discovers undeclared income or gains or needs to correct errors in the initial return. Revenue powers of assessment in final resort will remain.	YES (in most cases)	Those businesses that choose an accounting date close to the year end will have to file an amended profit statement by 1st August following the tax return date and pay any underpayment with interest from 1st February until payment. Amended returns may also be required to correct errors and omissions. Revenue assessment powers in final resort will remain.

## CHAPTER 1.

### BACKGROUND AND OBJECTIVES

#### 1.1. SELF-ASSESSMENT & THE SCHEDULAR SYSTEM

The Scheduling system of income tax was one of Addington's three major reforms of Pitt's income tax when Addington was forced to reintroduce the tax in 1803 following the resumption of hostilities with France.<sup>1</sup> There are two aspects of the Scheduling system: first, to calculate taxable income it places different types of receipt into different Schedules and "sub-Schedules", known as "Cases". The Schedules and Cases lay down the rules under which expenses are deducted and losses are relieved, so as to convert income receipts into taxable income.

Over the years since 1803 there have been many changes to the rules for calculating taxable income. Receipts that fell outside Addington's original Schedules have been brought within their scope; receipts have been switched between Schedules. Of particular note in the context of this Report, Addington's original scheme taxed income from both employments and self-employments under Schedule D. Schedule E was limited to the income from a small number of public offices of profit. Only in 1922 were employments generally transferred from Schedule D Case II into Schedule E.

Under Addington's system, total taxable income could always be arrived at by aggregating the income taxed under each Schedule and Case. However, the need to calculate total income had been one aspect of Pitt's income tax of 1799 that had made it so unpopular. Addington avoided this by providing that income within each Schedule was separately assessed. It was the Scheduling assessment of income that was the second crucial aspect of Addington's income tax. With a single rate of tax at 5p in the £1, and tax being dealt with in many cases by deduction at source, nobody had to disclose to

the prying eyes of Inland Revenue officials their precise income for any year.

These two administrative traditions - separate assessment of different types of income and the deduction of tax at source, have had a profound influence on the shape of the UK's personal tax system. A taxpayer's obligation under the Taxes Acts is merely to notify the Inland Revenue that he has income or gains liable to be taxed, and to provide details of them when asked to fill in a tax return. While an individual may be liable to pay tax on the income or gains returned, there is in fact no obligation to pay anything unless and until the Inland Revenue issues an assessment in accordance with the relevant Schedule or Case or pursuant to some other statutory provision. When, however, the Inland Revenue does produce an assessment, the assessment will not inform the individual of the total income and gains on which he or she must pay tax for the year, or even the total amount of tax that is due for the year. The assessment merely deals with that part of the individual's income that comes within a particular Schedule or Case or with his or her capital gains.

Even in 1992, the Taxes Acts do not provide for taxpayers to receive a statement of their total income and gains for the tax year, or of the total tax that they must pay. Those who derive their income solely from employment and who have no capital gains may be able to glean this information from their end of year statement of salary and tax deductions. Others who have more than one type of income or capital gains are unlikely to be able to state the precise amount on which they have been taxed, or the total tax paid in any year, without either carrying out some detailed research or employing a professional adviser.

On the other hand, four factors -

- the cumulative deduction of tax on employees' earnings within the

<sup>1</sup> The other two innovations were deduction of tax at source and the establishment of the General Commissioners of Income Tax as an appellate body.



TABLE 1 PERSONAL INCOME TAX ASSESSMENT SYSTEMS			
Country	Majority of taxpayers complete an annual tax return <i>a</i>	If yes to <i>a</i> , taxpayer also calculates tax due <i>b</i>	If yes to <i>b</i> does taxpayer also send in tax payable with return? <i>c</i>
Australia	Yes	No	-
Austria	No	-	-
Belgium	Yes	-	-
Canada	Yes	Yes	Yes
Denmark	Yes	No	-
Finland	Yes	No	-
France	Yes	No	-
Germany	Yes	No	-
Greece	Yes	No	-
Ireland	No	-	-
Italy	Yes	Yes	Yes
Japan	Yes	Yes	Yes
Netherlands	Yes	No	-
New Zealand	Yes	No	-
Norway	Yes	No	-
Portugal	Yes	No	-
Spain	Yes	Yes	Yes
Sweden	Yes	No	-
Switzerland	Yes	No	-
Turkey	Yes	No	-
United Kingdom	No	-	-
United States	Yes	Yes	Yes

Source: OECD, *Taxpayers' Right & Obligations*, Paris 1990.

Pay As You Earn ("PAYE") system,

- the broad basic rate tax band and
- the deduction of tax at source on such income as bank and building society interest and, effectively, on dividends, and
- the high annual exemption for capital gains,

ensure that very few taxpayers in the UK are required to complete a tax return.

The issue and completion of relatively few taxpayer returns differs significantly from other OECD countries, as Table 1 illustrates. While the OECD's 1990 Report on *Taxpayers' Rights & Obligations* indicates that all OECD countries except Switzerland operate a withholding tax on employment income, only the UK and Ireland (which shares the UK's tax heritage) operate a

cumulative withholding tax designed to collect the right amount of tax from employees in the majority of cases over the course of the year. The OECD Report records that, in the UK, only some 17 per cent. of the population or 33 per cent. of all taxpayers received a tax return as compared with approximately 95 per cent. of the population in the United States who either filed a tax return or was shown as a dependent on a return.

Apart from those liable to tax at the higher rate, the main category of taxpayer in the UK affected by the Schedular assessment system is the self-employed who are taxed under Schedule D, Cases I and II. A key to the simplification of the administration of the personal tax system and for any move towards a greater degree of self-assessment is accordingly to sort out the basis upon which the self-employed's income is taxed.

## 1.2. TAXING THE SELF-EMPLOYED

### Self-employed or unincorporated business?

Self-employment in the UK comprises an enormous range of activities and circumstances. This is illustrated in Appendix D by the respondents to the questionnaire that we sent to small businesses. The form of business organisation ranges from part-time occupations to sole traders to large partnerships equal in magnitude to a substantial public company; from professions traditionally synonymous with self-employment to activities not immediately identifiable as associated with either incorporated or unincorporated business.

The term "self-employed" seems a better one than "unincorporated business", although these two expressions neatly illustrate how the self-employed lie between companies and employees. The tag "self-employed" recognises that we are dealing with individuals who seek to earn their living just as any employed individual does, whilst "unincorporated business" suggests that their activities in doing so may be more akin to those of a company.

### The self-employed and employees

The borderline between employees and the self-employed is based on the legal distinction between a "contract of service" and a "contract for services": an employee is engaged under a contract of service while the self-employed individual may fulfil a very similar role but under a contract for services. This borderline can be a vague one and gives rise to considerable difficulties.<sup>2</sup>

Particularly where the individual works for a single person, the Inland Revenue has an incentive to seek to classify the individual as an employee if it can. The Inland Revenue finds this attractive because tax liabilities can be controlled more easily through the PAYE system, with employers responsible for identifying employees and for deducting and

<sup>2</sup> A recent example in a long line of cases is *Hall v Lorimer* [1992] Simon's Tax Cases 599. This involved a freelance vision mixer who always worked at the production companies' premises and with their equipment but who was held to be self-employed (entering into contracts for services) rather than employed under a series of contracts of service.

accounting for tax on any salary. Understandably, the Inland Revenue has not been quick to reclassify groups of individuals as *self-employed*.<sup>3</sup>

The distinction between self-employment and employment will always remain of legal significance because it regulates the relationship between two individuals or bodies, whether as employer and employee or as self-employed and customer or client. However, is it necessary, sensible or fair that the legal distinction should affect the way in which people are taxed?

Suggestions have been made from time to time that individuals should be free to "elect" to be treated as self-employed or as employed. However, the loss of control over tax collection that this would entail and the other tax distinctions that currently exist between employed and self-employed taxpayers effectively rule out an election procedure. In any reform, it might be sensible to think about reducing the distinction in tax treatment between employment and self-employment, on simple equity grounds as much as for any other reason. Why should individuals carrying on essentially the same activity and deriving similar income from it, exhibit large differences in liability to income tax just because one does so as a self-employed person while the other is employed?

The difference in the way in which the employed and the self-employed are taxed is first and foremost a practical one. Deduction of tax at source along the lines of PAYE cannot function effectively for the majority of those who are genuinely self-employed since there is more than one person (customers or clients) who would have to make the deductions at source.<sup>4</sup> With graduated income tax rates, it would be impossible to operate such a system with any degree of accuracy. A second and potentially more important

<sup>3</sup> The statutory reclassification of North Sea divers as self-employed for tax purposes is an exception.

<sup>4</sup> The Construction Industry Tax Deduction Scheme is an example of a deduction scheme for the self-employed which has been imposed to secure compliance within that area. The agency workers scheme is another example. It would not, however, be possible to extend that scheme in a practical manner to all those who are self-employed, neither would it be desirable to do so where net profits are taxed.

distinction is where it is only possible to tax someone fairly on the basis of *net* receipts.<sup>5</sup>

There are two aspects to this: the first aspect is linked to the matter of deduction at source since in this case it would *over-deduct* tax payments. The second aspect relates to the way in which employment and self-employment income is calculated for tax purposes: under current rules business income is calculated on a substantially different basis to employment income. In this respect, the distinction on which most attention is focussed is the difference in rules for deducting expenses. The Schedule E rules for employees are significantly more restrictive than those under Schedule D for the self-employed.<sup>6</sup>

This distinction came about largely as a result of a legislative accident in 1922, when employments generally were transferred from Schedule D Case II to Schedule E. The narrow Schedule E rule that had made some sense when applied to a limited number of public offices suddenly came to apply to all employments.<sup>7</sup> Nevertheless, the narrow Schedule E rule is too well established and covers too many taxpayers for us now merely to correct this legislative accident.

The rules for Schedule D and Schedule E expenses were examined by the 1955 Royal Commission which recommended the reform of the Schedule E rule.<sup>8</sup> Change, however, has yet to happen and the nature and sense of any change is beyond the scope of this Report. However, these differences reflect a more material difference that is bound to separate the computational rules for employments and self-employments: business profits are dependent to a material degree upon the ordinary rules of commercial

<sup>5</sup> The operation of the PAYE system is facilitated by the highly restrictive rules for the deduction of employee's expenses under ICTA 1988, s.198.

<sup>6</sup> An expense may only be deducted from earnings under Schedule E if it is incurred wholly, exclusively and necessarily in the performance of the employment duties, ICTA 1988, s.198. An expense may be deducted in computing business profits if incurred wholly and exclusively for the purposes of the business, ICTA 1988, s.74.

<sup>7</sup> See H H Munroe, *Intolerable Inquisition? Reflections on the Law of Tax*, Hamlyn Lecture, 1980, Chapter 2, page 25.

<sup>8</sup> Royal Commission on The Taxation of Profits and Income, Final Report, Cmd 9474, (June 1955), Chapter 5.

accounting which can have no application to the determination of employment income.

Finally, there clearly is a difference between the self-employed and employees in terms of risk. Employees enjoy the security of an agreed wage but risk losing their jobs; the self-employed earn what they can and run the risk of incurring losses (negative income). It is difficult to make a qualitative assessment of these different risks: employee have their wages but their services may be dispensed with first; the self-employed face the uncertainty of profit but may remain gainfully occupied for longer. Ultimately, however, the self-employed risk their savings through the capital that they have invested in their businesses.

In short, the true self-employed *are* different, for a mixture of economic and administrative reasons. However, this should not prevent us from moving towards a system that exhibits a greater degree of horizontal equity between those who are taxed as employees and those taxed as self-employed.

#### The self-employed and incorporated businesses

A second borderline is that between incorporated and unincorporated businesses. A proprietor of a small business, whether incorporated or not, is likely to regard the business as his or her "own" property. Nevertheless, there remains the obvious distinction that an incorporated business provides a recognisable legal form which allows us to observe what goes in and what comes out. On the other hand, when a shareholder in a company is also a director or employee of the company, he or she could be taxed as if they were a partner in an unincorporated business rather than as an employee and shareholder in an incorporated business. This approach is adopted in other jurisdictions: in the US, for example, S-Corporations are companies which elect to be taxed as partnerships.

A major distinction between companies and unincorporated businesses is the fiscal treatment of retained profits. In the case of companies, these are taxed at the corporate rate rather than at personal tax rates. Taxing profits retained in an unincorporated business at a single rate rather than the proprietor's own personal tax rate would raise two related

administrative difficulties. First, record-keeping would have to be sufficiently sophisticated to allow withdrawals to be identified and taxed. Second, some procedure would be needed to prevent abuses such as the withdrawal of profits at the beginning of an accounting period and their re-investment at the end, which would give the appearance of the business being capitalised by more retentions than was actually the case. Arguably, Companies Acts and tax rules similar to those regulating the relationship of a company and its proprietor-directors would have to be extended in some way to the unincorporated sector.

However, a reason why companies are taxed differently on retentions and distributions is the perception that it is often difficult to identify the individuals to whom the retentions belong. The essential quality of shares is that they are freely transferable. The facility to pass on the whole or a part of a business (including accumulated and undistributed profits) by transferring the shares in a company is one of the major benefits of the corporate form of organisation. Shareholders may come and go and may face a variety of marginal tax rates, but the company goes on. Integrating the taxation of retentions with the personal tax system is therefore very difficult. Furthermore, the individuals who own the company when profits are earned may not be the same individuals as own it when those profits are distributed. In the case of a partnership, it is much easier to identify the beneficiaries of retained profits which strengthens the case for an integrated approach. Indeed, the way forward may be to tax small companies in the manner of partnerships rather than partnerships as if they were companies.

#### **Tax treatment and legal form**

The current system taxes employees, the self-employed, unincorporated businesses and companies in different ways according to the differences in their legal form rather than according to their commercial and economic similarities. It is beyond the scope of this Report to consider these differences in detail. Those relating to the taxation of business profits and the relationship between corporate and shareholder taxation are the subject of a final Report from the Capital Taxes Group of The Institute for Fiscal Studies, which will be published shortly.

As a general matter, however, if individuals have a choice as to the legal form they can adopt and those different legal forms have very different tax treatments, the tax system will influence the decisions that individuals make. In that case, we must be clear that valid practical reasons or deliberate policy objectives lie behind the differences. Otherwise, the tax system is likely to be particularly distortive and give rise to economic inefficiencies.

Some of the self-employed are little different from employees: they have no business capital, few expenses and their gross receipts are very close to their disposable income. Ideally, we would like to tax their earnings as similarly as possible to those of employees. Other self-employed individuals, with capital requirements, stocks and work-in-progress, need a more complex calculation of profits and are equivalent to incorporated businesses. Again, the tax treatment should be as close as practically possible.

#### **1.3. INCOMES FROM SELF-EMPLOYMENT**

##### **The growth in numbers of the self-employed**

The population of self-employed is now a large one and was still growing in 1990. After a mild decline in the 1970s, the number of people in self-employment grew from under 2 million in 1979 to nearly 3.5 million in 1990 - a growth rate of some 5.5 per cent per annum. The self-employed now represent some 13 per cent. of the workforce and changing work patterns, including technological advances and the greater ease of home-working, suggest that this trend is likely to continue.

Table 3 shows the distribution of incomes from self-employment in 1988-89. The majority of the self-employed derive only a small income from this source. Around one-half had an annual income from self-employment of less than £6,000 and one quarter earned less than £3,000. There are relatively few with particularly large incomes.

##### **Income from other sources**

Many of the self-employed, particularly those with small self-employment incomes, derive income from other sources: 16 per

cent. also had employment income taxed under PAYE, 5 per cent. other earned income, 6 per cent. had money from a pension and 81 per cent. some other form of investment income. Table 4 breaks down these total proportions to look at the percentage of the self-employment with incomes from other sources for the ranges of self-employment income used in Table 1. Over 40 per cent. of those with the smallest incomes from self-employment also had employment income taxed under PAYE; it is only among those with more than £4,000 that relatively few are also taxed under PAYE.

Table 5 extends the analysis in Table 4 to look at the relative importance of different sources of income for self-employed taxpayers, again dividing them by range of self-employment income. The Table confirms that the majority of those with small earnings from self-employment are "topping-up" incomes from other sources. For those with under £1,000 of self-employment income, earnings from employment are the dominant source of income. It is only those with £3,000 or more of self-employment income who on average derive the majority of their income from this source. Beyond £5,000, almost 90 per cent. of income on average comes from self-employment.

### Implications

The population of Schedule D taxpayers is a large one. At 3.5m in 1990-91, they represented 13 per cent. of the workforce and in 1990 total income from self-employment was some £56bn. Nevertheless, the majority derive small incomes from this source - less than one third had or declared self-employment incomes above £10,000. Any proposal for reform must recognise that most of the people we are trying to tax have small incomes and are likely to be relatively unsophisticated and unable to afford professional advice.

The majority of those with self-employment incomes also derive income from employment or investments, in many cases moving between periods of employment and periods

<sup>9</sup> Self-employment income is defined as total assessable profits chargeable under Schedule D, Cases I and II, after accounting for losses and capital allowances. Those whose profits are entirely offset by allowable deductions are counted as "negligible".

**TABLE 3  
DISTRIBUTION OF INCOMES FROM  
SELF-EMPLOYMENT 1988-89<sup>9</sup>**

Range of Income (£ per annum)	Numbers (000s)	Percentage
Negligible	52	1%
1 - 500	135	4%
500 - 999	131	4%
1000 - 1999	260	8%
2000 - 2999	316	9%
3000 - 3999	297	9%
4000 - 4999	282	8%
5000 - 7499	623	18%
7500 - 9999	409	12%
10000 - 14999	472	14%
15000 - 19999	185	5%
20000 - 29999	162	5%
30000 +	131	4%
<b>Total</b>	<b>3460</b>	<b>100%</b>

Source: Inland Revenue (1992)

of self-employment. Employment income, as we have noted, is taxed on an entirely different basis to self-employment profits. But so is investment income: usually at source as it arises.

For these people deriving income from several sources, the system is still more complex than for those to whom just the current preceding year basis applies. Each tax return must contain information relating to two fiscal years, complicating and delaying the process of agreeing the liability for a particular fiscal year. This is particularly difficult in a system with a progressive income tax, as total income must be aggregated to compute final liability. In many cases the problem is made still worse, as different types of income are dealt with by different tax offices. On the other hand, larger and more sophisticated unincorporated businesses have both the expertise and the advice to deal with almost anything.

### 1.4. PREPARATION OF BUSINESS ACCOUNTS

Among the principal factors that lie behind the choice of business form is the way in which a company's financial statements are regulated by Companies Acts requirements and are subject to financial reporting standards and, in particular, are subject to statutory audit. The statutory accounts and other information relating to the company is also open to public inspection at the

Range of Income (£ per annum)	PAYE (% cases)	Pension (% cases)	Investment (% cases)
1 - 500	44	21	73
500 - 999	43	18	59
1000 - 1999	31	15	61
2000 - 2999	26	9	63
3000 - 3999	17	8	69
4000 - 4999	9	2	71
5000 - 7499	9	4	86
7500 - 9999	6	2	90
10000 - 14999	6	2	94
15000 - 19999	7	3	95
20000 - 29999	10	3	97
30000 - 49999	12	2	98
50000 +	29	3	100

Source: Inland Revenue (1992)

Companies' Registry. By way of contrast, a partnership's financial affairs (let alone those of a sole trader) are merely governed by whatever agreement is reached between the partners, its financial statements are not subject to legal requirements and information about the partnership's affairs remains confidential.

For the majority of the self-employed, therefore, the preparation of accounts and the ascertainment of profits is a matter of great informality. The form of financial statements that they adopt are likely to be dictated by such matters as good business practice and financial control, the need to obtain bank finance and to meet any regulatory requirements that apply to the business in question. In particular, the financial statements must be capable of meeting the Inland Revenue's requirements to identify the profits in accordance with the applicable tax rules and for whatever period the profits are required to be stated for tax purposes.

<sup>10</sup> Percentage of total cases in each income range with income from additional specified source. Self-employment incomes are as defined in the note to Table 3. Pension income includes occupational and national insurance pensions. Investment income includes rents taxed under Schedule A, investment income chargeable under Schedule D, Cases III to VI, dividends from UK companies, interest subject to composite rate tax and interest from which basic rate tax has been deducted at source.

To recognise this greater informality, the lack of statutory regulation and the variety of forms that may be involved, we have referred throughout this Report to the financial statements of the business rather than its accounts and to the statement of profits rather than the preparation of accounts.

### 1.5. THE STRUCTURE OF THE REPORT

Having outlined the characteristics of the self-employed, we now turn specifically to how they are taxed. Chapter 2 starts by discussing the present system, looking at how liabilities are calculated and seeing how the system operates. We then draw out of that discussion a number of reasons for reform, highlighting the complexity and inequity of current procedures. Finally in Chapter 2, we return to first principles and consider the theoretical problems inherent in taxing self-employment income.

In Chapter 3 we examine the proposals that have been made by the Government in its two Consultative Documents for changing the system of taxing the self-employed to a current year or "CY" basis of assessment. We turn in Chapter 4 to our preferred proposal for a fiscal year basis of assessment and compare this with the proposed CY basis. Thereafter, we look at two specific issues that arise from the proposals to change the basis upon which the self-employed are taxed: in Chapter 5, we look at the timetable for

Range of Income (£ per annum)	Self- Employment (% income)	PAYE (% income)	Pension (% income)	Investment (% income)
1 - 500	3	67	9	18
500 - 999	13	57	9	18
1000 - 1999	27	45	10	16
2000 - 2999	49	32	5	12
3000 - 3999	66	15	4	13
4000 - 4999	78	11	1	9
5000 - 7499	82	8	2	8
7500 - 9999	88	5	1	6
10000 - 14999	88	3	1	8
15000 - 19999	87	4	1	8
20000 - 29999	88	4	1	8
30000 - 49999	88	3	0	8
50000 +	85	3	0	12

Source: Inland Revenue (1992)

reporting and paying tax; in Chapter 6, we examine the transitional problems that arise in changing the basis.

In Chapter 7 we look briefly at the broader issues of self-assessment which are the subject of the proposals contained in the Government's second Consultative Document. In Chapter 8 we consider a number of other issues which may merit future attention affecting the relationship between the taxation of the self-employed, employees and companies. A summary of our conclusions on the basis of assessment is contained in Chapter 9.

Finally, Appendices A to C provide detailed examples of the workings of the preceding year, current year and fiscal year bases. Appendices D and E summarise the responses from both taxpayers and tax practitioners of the questionnaires we circulated on the proposals made by the Consultative Documents.

<sup>11</sup> See footnote 10.

## CHAPTER 2.

## THE DIFFICULTIES OF TAXING THE SELF-EMPLOYED

## 2.1. THE CURRENT SYSTEM

## The preceding year basis of assessment

Two principles apply to the taxation of the self-employed's profits. The first is the so-called "source doctrine": a self-employed person is only taxed on the profits of self-employment in a particular tax year if the business is carried on in that year. The second principle is that in that tax year, the individual is taxed by reference to the income earned in the accounting period ending in the previous tax year. This is the "preceding year" or "PY" basis of assessment.

The preceding year basis of assessment was introduced by Winston Churchill in the Finance Act 1926, with effect from the tax year 1927-28. Prior to that, the basis of assessment had been the average profits of the three accounts years preceding the year of assessment. The three year average had been reviewed by a Departmental Committee in 1905 but the Committee, by a small margin, came out in favour of retaining this system in preference to a preceding year basis. However, when the Royal Commission on *The Income Tax* reported in 1920, it recommended the adoption of the preceding year basis.<sup>1</sup> The Royal Commission was attracted to the adoption of a current year basis as being in conformity with the basis adopted for the majority of other forms of income but concluded that the practical difficulties of assessment and of dealing with the year of change precluded its adoption. The 1920 Royal Commission concluded that the preceding year basis would nevertheless make the amount of profits assessed correspond more closely in point of time to the amount of profits earned and would be "a very important step in the direction of uniformity and simplicity".

The matter was next considered by the Committee on *The Taxation of Trading Profits* in 1951 which noted that the majority of witnesses favoured a change from the preceding year basis to some form of current year basis.<sup>2</sup> In the event, it made no recommendation for change. Its conclusion was as follows:

"We began our consideration of the problem with a strong predilection for a change to some form of current year basis, and with the help of the Board of Inland Revenue we laboured long in an attempt to find a solution. In the end we were driven to the conclusion that, whatever may be the experience of other countries whose size and circumstances differ greatly from those of our own, a current year basis is impractical in this country."

At that time all businesses, whether incorporated or unincorporated, were on a preceding year basis. When it came to consider the matter, the 1955 Royal Commission on *The Taxation of Profits and Income* concluded that while unincorporated businesses should remain on the preceding year basis, companies could be transferred to a current year basis.<sup>3</sup> Companies were already assessed to profits tax by reference to accounting periods rather than years of assessment and, in 1965, became subject to corporation tax on a current year basis. The last vestiges of the preceding year basis of assessment for companies was brought to an end in the Finance Act 1987 which dispensed with the extended payment dates for companies trading before the financial year 1965.<sup>4</sup>

<sup>1</sup> Report of the Royal Commission on *The Income Tax*, Cmd 615 (1920), para. 479.

<sup>2</sup> Report of the Committee on *The Taxation of Trading Profits*, Cmd 8189 (April 1951), Chapter II.

<sup>3</sup> Report of the Royal Commission on *The Taxation of Profits and Income*, Cmd 9474 (June 1955), Chapter 26.

<sup>4</sup> FA 1987, s.36 & Schedule 6.



In the 1970s and 1980s there was continuing criticism of the PY basis of assessment from the Public Accounts Committee and the National Audit Office. A number of internal Governmental reviews and working parties considered the options for changing to a current year basis and informal consultation was conducted. There has, therefore, been a long-standing desire to achieve a current year basis but for a variety of practical reasons it has never been considered a feasible option. Why is this so and why is change to a current year basis desirable?

The practical effects of the preceding year basis

*The continuing business*

For a continuing business, the effect of the "source doctrine" and of the preceding year basis is that profits which are earned in an accounting year ending in a particular tax year are taken as the measure of the profits taxable in the following tax year. In Figure 1, profits are stated for the year to 30th June. Profits earned in the year ending 30th June 1991 form the basis of assessment in the following tax year, 1992-93, if the business is a continuing one. That does not, however, mean that no profits are taxed in the current year, 1991-92. Tax will be paid in 1991-92 but by reference to the profits earned in the accounting year to 30th June 1990. The effect of the PY basis (assuming profits are made rather than losses) is that tax is paid for every tax year for which the business is carried on, but the measure of the profit taxed in any year may not correspond to the profit actually earned in that year. Thus, for an on-going business, profits for the accounting year to 30th June 1991 are earned in parts of the tax years 1990-91 and 1991-92 but are taxed as the income of the tax year 1992-93, with reference to the rates, allowances and reliefs that apply to that year.

If the profits earned by the business are the same in each year, the measure of taxable income for the year will correspond to the profits earned in that year. However, profits are rarely flat and are more likely to fluctuate to some degree. The PY basis is, therefore, generally regarded as conferring an advantage on the self-employed because tax is only paid in respect of profits some time after they are

earned. However, care needs to be exercised not to overstate this advantage. For a continuing business with a 30th June year end, the profits are earned on average on 31 December. With tax paid in two instalments on 1st January in the year and 1st July after the end of the year, the average date of paying the tax is 1st April.

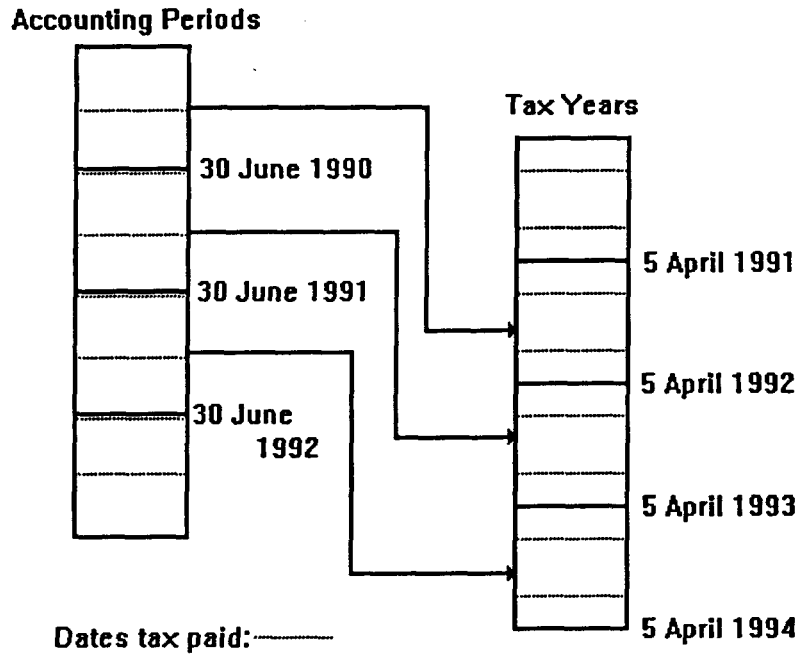
Where profits are static, tax is deferred on average by three months. This still represents an advantage over the employee who suffers tax at source under PAYE. In addition, there is a longer deferral on any *increase* in profits in a year. This element of the deferral represents the true advantage of the PY basis but, at the same time, may obviously be of importance in cushioning the impact of inflation where nominal profits are taxed without any other adjustment for the impact of inflation on those profits. At the same time, what goes up may come down and, if profits are falling, the reverse is true: there is actually an advancement of the tax liability.

Whilst the preceding year basis for an on-going business may look fairly simple, it is nevertheless a more difficult concept for taxpayers to grasp than the notion of paying tax this year on this year's profits. However, the need to adopt a PY basis of assessment is largely driven by the administrative convenience of being able to assess for the current year by reference to a figure that is ascertained, namely last year's profits. As we shall see in Chapter 5 and Appendix A, even under a current year basis, it is impossible to get away entirely from the preceding year system if interim payments of tax are to be made. The only reliable figures on which such instalments can be based are those of the preceding year.

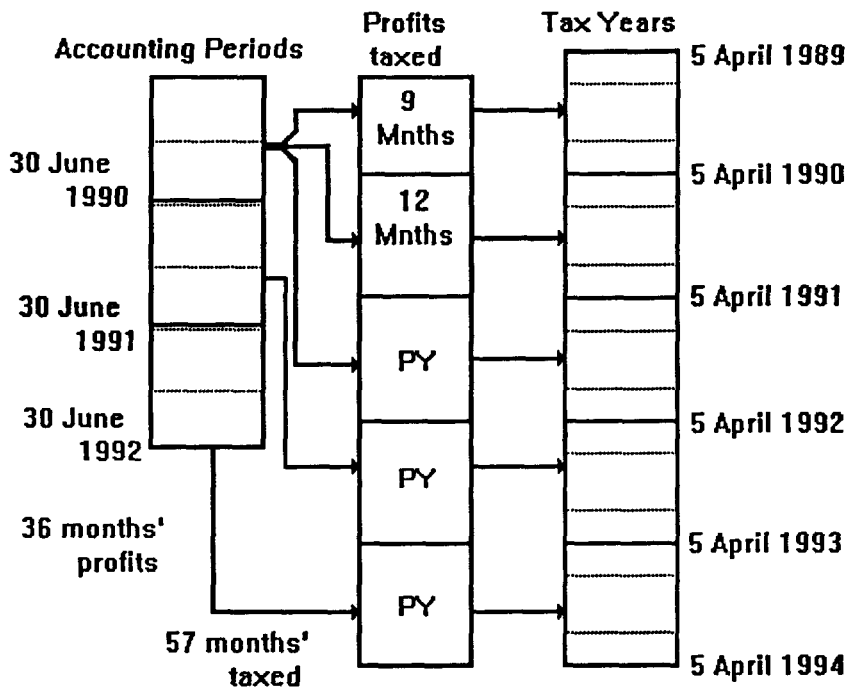
*The opening years of a business*

On the other hand, as soon as something other than current profits is used as the basis for the current year's income, modifications are needed for the opening and closing years of assessment. Under present rules, this occurs for businesses in the first three and last three years of their lifetime, for up to nine years in the case of a partnership when partners are added or withdrawn and up to three years on a change of accounting date. In the first year of a business, there are no profits on which it can pay tax since there is no accounting year ending in the previous tax

**FIGURE 1  
PRECEDING YEAR BASIS - CONTINUING BUSINESS**



**FIGURE 2  
PRECEDING YEAR BASIS - UNADJUSTED OPENING YEARS**



CHAPTER 2 : THE DIFFICULTIES OF TAXING THE SELF-EMPLOYED

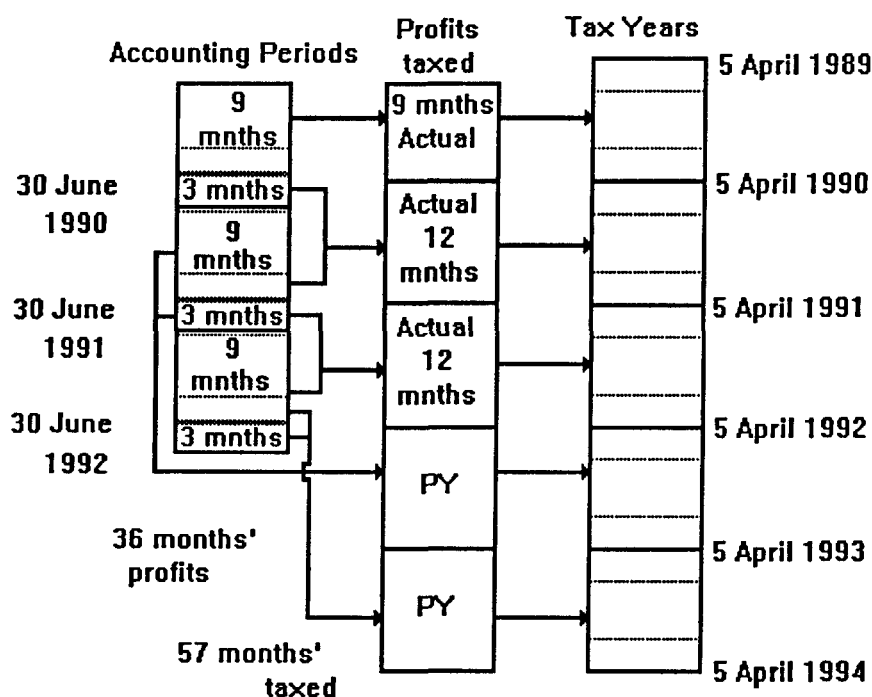
year. The business is therefore assessed for tax more than once on the profits earned in its first accounting year. Figure 2 illustrates the tax treatment of the opening years of a business and this can also be seen from Table A1 in Appendix A.

In Figure 2, the taxpayer is again assumed to prepare the financial statements to 30th June 1990, having commenced trading on 1st July, 1989. For the tax year 1989-90, there is no preceding year on which to base an assessment for tax. Self-employment income is, therefore, taxed on the *actual* profits of the year. In this case, the business was set up three months into the tax year. The tax liability is therefore computed on three-quarters of the profits earned in that year. In the second tax year (1990-91), these profits again form the basis of assessment. In the next tax year (1991-92), the preceding year principle comes into operation, so that the profits for the first year of trading again form the basis of assessment.

The extent to which the first year's profits are taxed more than once depends upon the date on which the business commences. In Figure 2, it is 1st July 1989, so that those profits are taxed for of nine months in 1989-90, 12 months in 1990-91 and 12 months again in 1991-92. The profits of the first 12 months accordingly get multiplied two and three-quarter times and are taxed as the profits of the first 33 months of the business' existence. In Figure 2, 36 months' profits translates into 57 months' taxed profits.

A taxpayer is, however, entitled to elect that he be taxed on the actual profits of the first three years, so that here he would be taxed from 1st July 1989 to 5th April 1992 on the actual profits earned in that period. However, in 1992-93 he will be taxed on the profits of the accounting year ended 30th June 1991 and in 1993-94 on the profits of the accounting year ended 30th June 1992. Accordingly, in this case, the profits from 1st July 1990 to 5th April 1992 (21 months) are taken into account twice. This is illustrated in Figure 2A.

FIGURE 2A  
PRECEDING YEAR BASIS - ADJUSTED OPENING YEARS



*The closing years of a business*

To compensate for this repeated assessment in the opening years, the reverse adjustment is made when the business ceases trading. This is illustrated in Figure 3. Here, the business is assumed to state its profits to the 30th June each year and closes down on 30th June 1993. For the tax year 1992-93, the tax is computed on the preceding year basis. Thus, the profits earned in the accounting year ending 30th June 1991 are taken as the taxable income for that tax year. The business closes three months into the tax year 1993-94. This leaves the profits that have been earned between 1st July 1991 and 30th June 1993 to be dealt with. The tax liability for 1993-94 is not computed on a preceding year basis (that is on income in the accounting year to 30 June 1992), but switches to an *actual* year basis. The 1993-94 liability is assessed on one quarter of the profits for the year to 30 June 1993. Profits earned from 1 July 1991 to 5 April 1993 do not form the basis of assessment for any year.

If, however, we look at both opening and closing years we can see that, overall, 36 months profits are earned - 12 in the first year and 24 in the last two years - and 36 months are taxed. However, what is taxed is arrived at by taking the first 12 months profits as equivalent to 33 months (an addition of 21 months) and taking only three of the last 24 months (with 21 of them being ignored). Thus, in Figures 2 and 2A, 36 months' profits were taxed as 57 months' and in Figure 3, 48 months' profits are taxed as 27 months'. This is also illustrated in Appendix C in relation to the transition to the current year basis.

Clearly, if profits are being earned at a different rate at the outset of the business to the rate at which they are being earned on cessation, the two 21 month periods will not match and the individual will be taxed on more or less profits than are actually earned over the life of the business. Further, if the individual has scope to influence the level of his profits in the first 12 months and in the last years of the business, he may be able to ensure that the variance is in his favour. To limit the scope for the manipulation of profits on a cessation, The Inland Revenue can tax the actual profits earned in the last two tax years prior to that in which the business

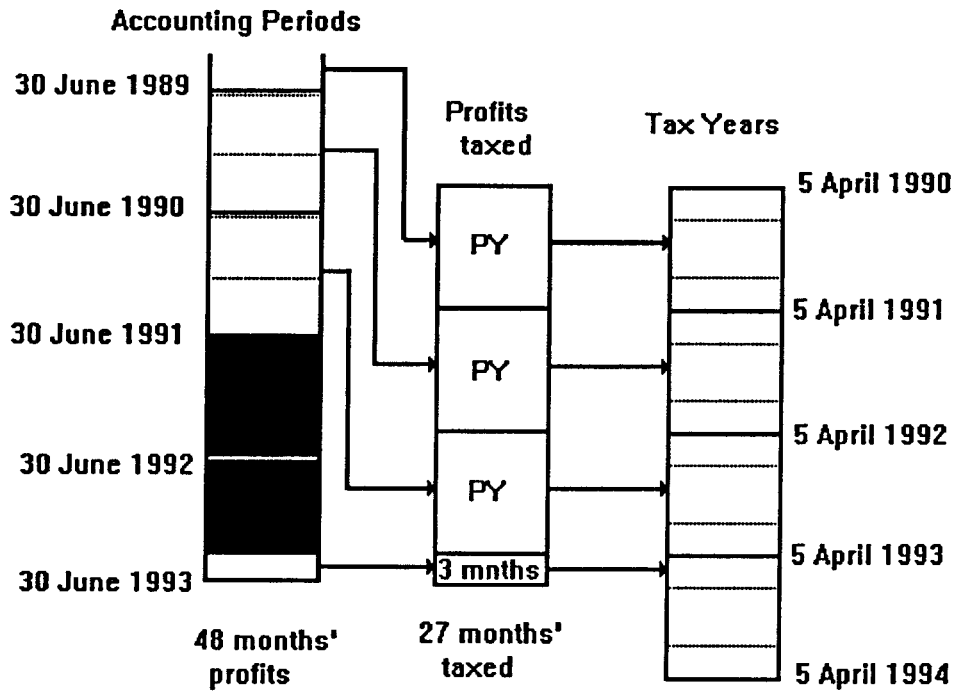
ceases if this basis produces larger profits than the normal preceding year basis.

The effect of this is shown in Figure 4. The final year, 1993-94 remains the same, based on one quarter of the profits earned in the final accounting year. The taxable profits for 1992-93 become one-quarter of the profits earned in the year to 30 June 1996 and three-quarters of those earned in the year to 30 June 1997. The computation for 1991-92 is carried out in a similar manner by apportioning the results of the years to 30 June 1991 and 30 June 1992. However, 21 months of profits are still ignored to match the 21 months of additional profits that were taxed on commencement. This is because the taxable profits for 1990-91 are those of the accounting year ended on 30th June 1989. The profits earned from 1st July 1989 to 5th April 1991 no longer form the basis of assessment of any year. Finally, in both opening and closing years there is the added complication of allocating the individual's entitlement to capital allowances for expenditure on business assets for those periods that would otherwise fall out of assessment.

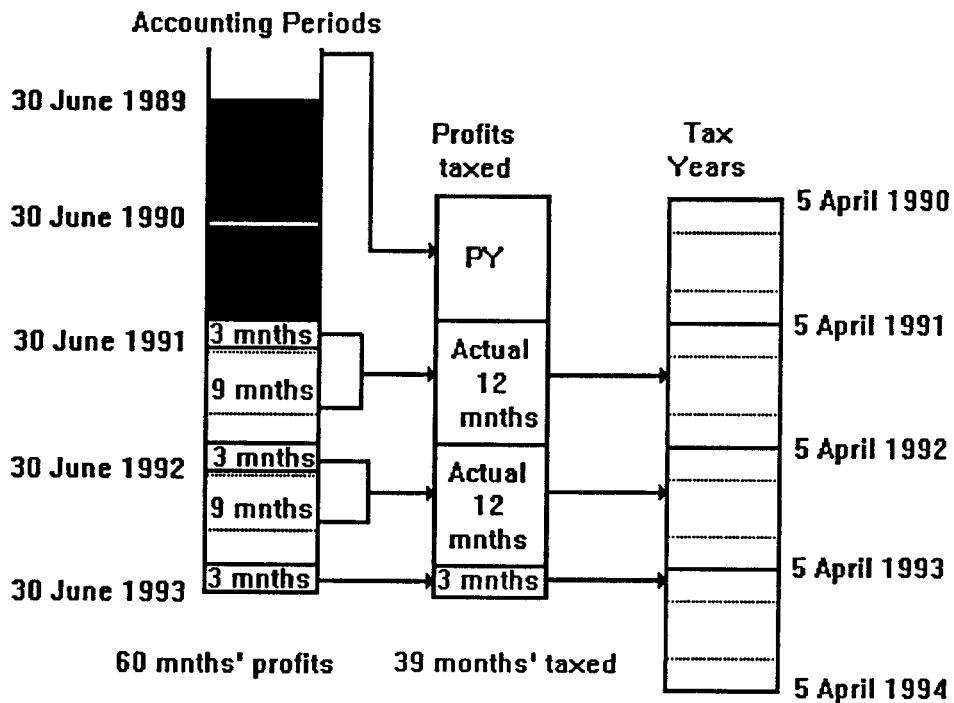
*The overall effect of opening and closing year adjustments*

Under the PY basis of assessment, an individual is taxed for every year in which he or she carries on business. Although reference is frequently made to a year "dropping out of assessment", this does not imply that the self-employed individual enjoys a tax holiday that is denied to an employee or a company. On the other hand, it would be accurate to say that, if a business continues for more than four years, it would be a matter of happy accident if the individual were taxed in aggregate on a sum equal to the actual profits earned in the business. As many individuals will have a degree of freedom to determine when to start and when to stop business, as well as when to prepare their financial statements and in certain cases when profits accrue for tax purposes, there is clearly scope for taking the maximum advantage of these rules.

**FIGURE 3**  
**PRECEDING YEAR BASIS - UNADJUSTED CLOSING YEARS**



**FIGURE 4**  
**PRECEDING YEAR BASIS - ADJUSTED CLOSING YEARS**



The result of the preceding year basis and the opening and closing provisions is that Schedule D, Cases I and II contravene some central principles of the income tax as applied to other sources of income: liability to income tax under Schedule D, Cases I and II in a particular tax year is not normally based on the profits earned in that year; the PY basis results in profits earned in one tax year being taxed using the rates, allowances and reliefs applicable to the following one or two tax years. While this is normally thought of as conferring an advantage on the self-employed as compared with employees and companies, it is counter-balanced to a degree by the significantly higher compliance costs the self-employed faced, certainly as compared with employees. Higher compliance costs are, indeed, inevitable with a system that is barely comprehensible to anyone other than those who regularly have to prepare the tax returns of the self-employed.

#### Administration

For the vast majority of individuals, paying income tax is straightforward. The deduction of tax at source from investment income and the PAYE system seek to ensure that the right amount of tax is levied as income arises. If too much tax is paid, the procedures for obtaining a repayment are relatively simple. For the self-employed, the system of taxing by assessment is a good deal more complex. The first Inland Revenue consultative document, *A Simpler System for Taxing the Self-Employed*, (1991), uses the example of Jim Smith, a grocer, to illustrate how the present system operates. Jim prepares his financial statements for the year to 31st August, and shows profits of £20,000 for the accounting year 1994-95. He also has £400 per month of rental income, and pays gross interest of £3,000 in the tax year 1996-97 on a mortgage not in the MIRAS scheme. Income tax is assumed to be levied at a 25 per cent. rate and the personal allowance is assumed to be £4,200. Table 6 summarises Jim's dealings with the Inland Revenue for his affairs in the tax year 1996-97.

In 1989-90, the Inland Revenue raised around three million assessments on self-employed taxpayers for that tax year. Two million of the initial assessments used estimated figures as taxpayers had not filed their return and financial statements. If the

taxpayer feels the estimate is too high, then within thirty days he or she may appeal for a postponement of part of the tax. About 600,000 appeals were listed for hearing by the Appeal Commissioners in 1989-90. Once the return and financial statements are submitted, they are considered by the inspector who may require further information or explanations. The assessment is amended when figures are finally agreed and the balance outstanding is paid or repaid.

As we explain below, this manner of proceeding is not a necessary consequence of the PY basis. Nevertheless, it is the one that has developed over the years and the nature of the PY basis is a fundamental issue in deciding whether it is possible to administer the system in a more satisfactory manner, bearing in mind the increase in the number of the self-employed and their characteristics, as outlined in Chapter 1. Having described the way in which the system operates currently, we now consider its more unsatisfactory characteristics and the reasons for reform.

## 2.2. REASONS FOR REFORM

### Complexity and cost

The process that we have just described is undoubtedly onerous: on self-employed taxpayers who have to try and apply the rules, on their professional advisers who have to try and explain them and on Inland Revenue staff who have to try and implement them. In particular, the reliance on estimated assessments and the resulting deluge of appeals and postponements is both complicated and costly in terms of compliance and administration. There is little incentive to submit returns and settle the final tax liability promptly. We should, however, take care not to lay the blame for the current system of administration at the door of the PY basis of assessment. Estimated assessments are not a necessary feature of the PY basis. Indeed, a reason for adopting a PY basis under an assessed system of taxation, rather than a current year or "CY" basis, is to reduce the need for estimated assessments within a given collection time-frame by ensuring that assessments can be made by the Inland Revenue on known figures. Under the proposed CY basis, instalments of tax will still be paid by reference to the preceding year's profits and it is anticipated that this can be achieved without difficulty.

**TABLE 6**  
**THE OPERATION OF THE PRESENT SYSTEM:**  
**DEALINGS WITH THE AUTHORITIES FOR 1996-97**

1st September 1996	The Inspector of Taxes makes an assessment for 1996-97. He estimates profits of £25,000 from Jim's grocery business. With the £4,800 of rent, he calculates that the tax due is £6,400.
15th September 1996	Jim decides to appeal against the estimated assessment. He applies to postpone £2,500 of the tax.
1st October 1996	The inspector agrees to the postponement application, leaving Jim with a bill for £3,900.
1st January 1997	Jim pays the first instalment - £2,050 - to the Inland Revenue.
1st July 1997	Jim pays a second instalment of £1,850.
1st August 1997	The inspector asks Jim for his return and financial statements for the accounting year ending 31st August 1995.
1st September 1997	The inspector writes again warning that Jim's return and financial statements are now overdue.
1st October 1997	Jim is summonsed to appear before the General Commissioners on 1st November 1997.
1st November 1997	The General Commissioners adjourn the hearing of Jim's appeal for one month to allow time for the return and accounts to be produced.
30th November 1997	Jim submits his return for tax year 1996-97 to the Inspector accompanied by his financial statements for the accounting year ended 31st August 1995.
1st March 1998	The inspector finally agrees Jim's figures. He sends Jim a revised assessment for 1996-97 showing income of £24,800. Mortgage interest paid (£3,000) and personal allowances (£4,200) are deducted to arrive at taxable income of £17,600. The tax due (£4,400) is above the amount Jim paid in instalments earlier. The assessment therefore includes a demand for the balance of tax due (£500) and interest.

One solution to the present difficulties would, therefore, be for the Inland Revenue to enforce the existing rules more effectively to ensure that taxpayers submitted their returns and financial statements on time. However, this raises the question of whether it would be appropriate to adopt that course when the existing PY system has reached its present state. Is this in fact a 'chicken and egg' situation? Is the lack of a simple, easily understandable basis a factor that lies behind the current difficulties in securing compliance by taxpayers and a reason why stricter

enforcement of the system would be unacceptable to many taxpayers? Would it be acceptable, for example, if the self-employed's high compliance costs were increased further by more aggressive policing of the PY system by the Inland Revenue?

**Inequities**

The system results in two sets of inequities in the treatment of tax liabilities: first as between Schedule D taxpayers and, second, as between the self-employed, employees and incorporated businesses. The rules for

commencements and cessations almost invariably ensure that firms are not charged on their actual profits over the lifetime of the business. In general, the rules favour the taxpayer because any firm with higher profits in money terms at cessation than at commencement will gain. The Public Accounts Committee of the House of Commons estimated in 1976 that the average partnership had paid tax on only 76 per cent. of its profits during the period under investigation. The proportion of profits on which businesses are assessed is likely to be higher now, as the generosity of treatment is dependent on the rate of growth of *nominal* profits and so is greater in periods of inflation. However, on average it remains the case that the self-employed are treated more generously by the income tax system than employees, who pay tax on their full income as it is earned.

Some businesses with high profits in their opening year and depressed profits at cessation may find themselves being assessed for tax on more profits than the business has actually made. So although the system is more generous *on average* to the self-employed, there are cases where individuals who are ill-advised or unfortunate are treated less generously than employees. There is, therefore, an inequity in the tax treatment among the self-employed, as well as between the self-employed and employees.

The complexity of the rules also provides opportunities for tax avoidance, although these have been considerably reduced following the 1985 Finance Act. The choice of accounting date, manipulating the pattern of profits over time and making particular choices at the time of commencement and cessation can affect tax liabilities substantially. There are two groups who are the principal beneficiaries of this. First, sole traders are able to invoke a cessation without triggering the special re-commencement rules introduced in 1985 (which are relatively onerous). By taking on and then dropping a single partner they are treated as starting a new business with the benefit of the ordinary commencement rules that we have already explained. Second, small, rapidly growing partnerships have the benefit of being assessed on preceding year profits and dividing the tax liability among a larger number of partners up to two years later. Again, this results in an

inequity both among the self-employed and between the self-employed and employees.

The self-employed also gain due to the delays in tax payment. Payments on account of the tax liability arising for the accounting year ending in the tax year 1996-97, for example, are due on 1st January and 1st July 1997. The "average" of these two dates is the 1st April 1997. Thus, tax payments on account of the liability for a particular tax year are on average due at the end of that year. By the same token, companies are treated more generously because tax is only due nine months after the company's year end, unless its profits are distributed and advance corporation tax has to be paid earlier. In comparison, PAYE income has only a half month deferment and the employee has none, always receiving his salary under deduction of tax. Comparing a stream of income accruing to a self-employed person and the same stream taxed under PAYE, at a five per cent. discount rate, the present value of the tax paid is some 2.5 per cent. lower as a result of delays in payment.

This example assumes that business profits are constant over time. If profits are rising in money terms then payments on account will reflect only part of the eventual liability. Payments on account are based on reported results for an earlier period, so tax payments on increments in profits are deferred further. However, for the reasons we have already explained, while schemes can be devised to reduce the deferment involved, it is unlikely that the self-employed can in practical terms ever be required to pay tax on a comparable basis to employees: both because of the difficulty of deducting tax from their receipts at source and because instalments can at best only be based on the profits of the preceding year.<sup>5</sup>

As well as the differences that arise from payment lags between self-employment income and income where tax is deducted at source, there are also inequities between Schedule D taxpayers arising from the potential to delay payment. Variations in the chosen accounting year end are not matched by equivalent variations either in the reporting

<sup>5</sup> It is always possible to require that instalments based on the preceding year's profits are marked up in some way to anticipate increasing profits.



period or tax payment. An advantage is conferred on those choosing an accounting date early in the tax year, who may have up to twelve months longer delay from commencement to making their first tax payment, and twelve months longer each year to submit a return.

### Objectives for reform

The reforms proposed in the two Consultative Documents appear in the main to be directed towards reducing the costs of administering the system. The stated aim of the first Consultative Document is to "simplify and streamline the system for taxing the self-employed". The rapid growth in self-employment in the 1980s has given a greater urgency to the reform to this part of the income tax. Reform of the PY basis of assessment for the self-employed is a prerequisite for any further movement towards self-assessment within the income tax system. The first Consultative Document asserts that administrative improvements are incompatible with the preceding year basis. However, it is not clear whether inefficiencies stem from the basis of assessment or from the way that the system "works". The rules for commencements and cessations are responsible for much of the complexity.

Reform of the PY basis, then, may well not be a necessary condition for improvements to the system. The PY basis at least has the advantage of nearly 70 years' familiarity and the Consultative Document places great faith in the ability of taxpayer compliance to improve when the basis of assessment is reformed. With the system it proposes, Jim Smith whose affairs are illustrated in the first Consultative Document, reproduced in Table 6, miraculously becomes a reformed character. It is far from clear, however, that reforming the basis of assessment would have such an effect; changing the PY basis is unlikely to be a sufficient condition for administrative improvements. However, if the ultimate objective is to be the removal of the Schular system, as more explicitly espoused in the second Consultative Document, then altering the existing basis of assessment appears more obviously necessary.

Removing the inequities inherent in the current income tax, both among the self-employed and between employees and the self-employed, is an important objective. The

first Consultative Document frequently mentions "fairness", and states that "the system for collecting tax from the self-employed needs to be aligned more closely with the system for collecting tax from employees". As a matter of principle, self-employed taxpayers should be liable to tax on the whole of their profits over the lifetime of a business. Furthermore, tax liabilities and the benefits of deferral of payment should not vary arbitrarily among the self-employed, for example, with the choice of accounting date. With these objectives in mind, we now turn to a discussion of the particular theoretical difficulties in taxing the self-employed.

### 2.3. PROBLEMS IN TAXING THE SELF-EMPLOYED

#### Matching accounting years with tax years

The main difficulties in taxing the self-employed arise from the fact that, unlike PAYE and the deduction of investment income at source, Schedule D income is measured on by reference to the financial statements of the business whilst most other forms of income are taxed on a receipts basis. This raises two immediate problems. First, it results in an unavoidable delay between the time at which taxable profits are earned and the time at which they can finally be taxed. This is very largely an administrative problem because tax can always be paid on account of the eventual liability. However, it will only be possible to see whether such instalments of tax are adequate or not, or too much, some time after the end of the period for which the business chooses to state its profits.

The second problem with the need to use an accounts rather than a receipts basis compounds the first problem: accounting years do not necessarily align themselves with the tax year. While the first of these problems is unavoidable, the second is not, but stems from the desire not to force businesses to state their profits for the tax year when they might otherwise choose some other period to do so. The best way of dealing with the problem of misalignment of accounting years and tax years is merely to prohibit it. The self-employed would be compelled to state their profits by reference to the year to 5th April or 31st March.

However, if we wish to allow the self-employed a choice of accounting dates we must face up to the fact that choosing a basis of assessment involves a decision as to how the profits earned in an *accounting* year are matched up with the elements of the income tax that are based on *tax years*. The rates, allowances and reliefs of the income tax are all defined on a tax year basis. Thus, if a business states its profits to the 30th June, the accounting year to 30th June 1991 starts in the tax year 1990-91 and ends in the tax year 1991-92. Three-quarters of the accounting year falls into the first of these years and one-quarter into the second.

The tax base (business profits) is known for accounting years and the tax schedule (rates, allowances and reliefs) is defined for tax years. These two elements make up the information needed to compute tax liability and, given this information, the calculation of liability is merely a mechanical procedure. Nevertheless, the two sides of the tax computation - the tax base, defined over accounting years, and the tax schedule, defined over tax years - have to be matched in some way. In the following paragraphs we consider two principal procedures, each of which has an alternative way of matching the two.

#### Deeming bases of assessment

A "deeming" system in essence ignores the fact that tax and accounting years are not aligned, by treating the profits earned in a particular accounting year to be the taxable income of a particular tax year. The present preceding year basis is a form of deeming procedure: for a continuing business, the taxable income of the tax year 1992-93 is taken to be the profits earned in the accounting year to 30th June 1991.

Other deeming procedures are possible. The current year basis of assessment put forward in the first Consultative Document *deems forward*: in our example profits earned in the accounting year to 30th June 1991 would be treated as the taxable income for the tax year 1991-92. It is also possible to *deem backwards*, and assign the income for a particular accounting year to the tax year in which it began rather than ended. Thus, in our example, profits earned in the accounting year beginning on 1st July 1990 and ending

on 30th June 1991 would be taxed as the taxable income of the tax year 1990-91. Finally, and perhaps intuitively most attractive, would be to deem to the nearest the tax year. Thus, profits earned by businesses drawing up their accounts to dates before the 30th September 1991 would be treated as the taxable income of the tax year 1990-91, and those with accounting dates after 30th September would have their profits treated as taxable income for 1991-92.

In a continuing business a deeming basis can be straightforward: there is a pattern to it that may present few problems. However, there are disadvantages. First, treating for tax purposes the profits earned in one period as the taxable income of another contravenes the principle that the tax liability for a particular tax year should be related to income earned in that year. This problem is particularly extreme in the current system, where there is no congruence whatsoever between tax and accounting years. Second, in devising a deeming system it is all too easy to create opportunities for manipulation, by shifting profits between tax years, especially through changes in accounting dates and in the opening and closing years of a business.

Under the current system, the choice of an accounting date early in the tax year (for example, 6th April), means that profits earned between 7th April 1990 and 6th April 1991 are treated as the taxable income of the tax year 1992-93, with tax paid in respect to those profits on 1st January and 1st July 1993. Certainly, tax is still paid in respect of both 1990-91 and 1991-92 on the 1st of January and July 1991 and 1992. However, another taxpayer who earns the same profits but states them for the year to 5th April 1991 will find that the profits form the income of the tax year 1991-92, with tax paid with respect to those profits on 1st January and 1st July 1992. The scope for a divergence in treatment between the two - both favourable and unfavourable to the second taxpayer - are considerable. Irrespective of the tax outcome, the first taxpayer also has an extra eleven months lag in which to prepare his financial statements and submit returns.<sup>6</sup> Under a deeming procedure, variation in payment lags seems a necessary result of having a system of

<sup>6</sup> Although a life works in annual cycles this advantage should not be overstated.

dates for submission of returns fixed chronologically with reference to the calendar year.

#### Apportionment bases of assessment

Apportionment is an attempt to align tax years more closely with the profits earned within the tax year. There are two alternative possible schemes: apportioning profits to two tax years or apportioning the rates, allowances and reliefs for two tax years to one accounting year. In the case of a business making up its accounts to 30th June each year, the first procedure would apportion three-quarters of profits earned in accounting year ended 30th June 1991 to the tax year 1990-91 and one-quarter to the tax year 1991-92.

The second procedure would compute the tax due with reference to accounting years. Thus, for the accounting year to 30th June 1991, the computation would involve calculating the tax due on those profits at the tax rates for the tax year 1990-91 and that due at the tax rates for 1991-92. The tax liability would be computed on three-quarters of the former and one-quarter of the latter. This is the "accounting period" basis proposed in the first Consultative Document.

If profits are apportioned, the calculation for the tax due in each tax year is based on two accounting years. This results in longer delays in finalising tax liabilities than under a system where the rates, allowances and reliefs of two fiscal years are apportioned. The liability for the tax year 1991-92 cannot be finally settled until the financial statements for the year ending in 1992-93 are agreed. This would be most acute where profits are stated for the accounting year ending just before the tax year. An accounting year to 28th February would mean that the final liability for the tax year 1991-92 would not be finalised until the financial statements for the accounting year to 28th February 1993 are complete. This makes it difficult to assess total income, except after some delay, but presents rather fewer problems under a self-assessment system.

In contrast, apportionment of rates, allowances and reliefs rather than profits minimises the time between the accrual of profits, the submission of accounts and the agreement of the liability. However,

apportionment of the income tax rates, allowances and reliefs is probably more difficult to understand, and causes problems for individuals with multiple sources of income. Employment and investment incomes would either have to be taxed on a different basis (tax years rather than accounting years) or they too would have to be apportioned, with some allocated to one accounting year and some to another.

#### Delays in assessment

One option for dealing with the unavoidable delays in finalising tax liabilities as a result of using an accounts rather than a receipts basis for tax is merely to ignore them. Under such a system, the self-employed would pay tax when income was reported. Tax on the self-employed's profits would, therefore, be paid considerably in arrears. This option does not seem desirable. First, it would add to the current deferral of tax payments. The different treatment of self-employed and employed taxpayers would be made still worse. It would also create difficulties when people moved between employment and self-employment. Sometimes they would receive a tax holiday and at other times they would pay simultaneously tax on current employment income and on previous self-employment income. Finally, this extended deferral would involve foregoing substantial revenues at the transition to the new basis, with a significant effect on exchequer cash flow. It is not a feasible system.

A more satisfactory procedure would be to operate some kind of preliminary tax assessment and payment system. The current practice is to make an initial, usually estimated, assessment with tax payable around the time that income accrues. These payments on account are then deducted from the assessment when returns are submitted and a balancing payment or repayment made.

Against the background of these problems we turn in the next Chapter to the proposals made in the two Consultative Documents. Thereafter, in Chapter 4 we set out our preferred solution for dealing with the basis of assessment.

## CHAPTER 3.

## CURRENT YEAR TAXATION OF THE SELF-EMPLOYED

## 3.1. INTRODUCTION

Our clear view is that the existing PY basis of assessment is in need of reform and the overwhelming majority of the practitioners who responded to our questionnaire shares this view. We also believe that any reform should aim to reduce the differences that currently exist between the taxation of the self-employed, employees and incorporated businesses, so far as that is achievable in the light of the factors mentioned in Chapter 2. In terms of the basis of assessment this would imply a move from the present PY basis of assessment to some form of current year assessment of the self-employed.

This conclusion is not a new one. The Millard Tucker Committee<sup>1</sup> took the same view in 1951 but despite the assistance it enjoyed from the Inland Revenue, was unable to come up with a practical way of achieving this result. Any change from the existing PY basis to a current year basis brings three inter-related considerations into play -

- the need to identify a practical basis for taxing the self-employed on current year profits;
- the need to provide for a satisfactory timetable for filing returns and financial statements and paying tax based on the chosen current year basis, and
- the need to be able to move from the existing PY basis to the chosen current year basis without imposing undue administrative or financial burdens on the self-employed (or presenting them with an undue windfall in the form of untaxed profits) while maintaining the flow of tax to the Treasury.

<sup>1</sup> Report of the Committee on the Taxation of Trading Profits, Cmd 8189, April 1951; see Chapter 2, page X above.

In the course of our discussions we considered a variety of deeming and apportionment approaches and the implications for each of these considerations. We have not sought to set out all of these different approaches in this Report but concentrate on the proposals that are put forward by the Government in its two Consultative Documents and on our preferred solution

The first Consultative Document put forward for discussion two possible bases of assessment: the "CY basis", which is an example of the "deeming" system that we discussed in Chapter 2, and the "AP basis" which is an example of an apportionment basis. We start, therefore, by considering these two bases. In Chapter 4 we turn to our preferred option. Our examination of the basis of assessment cannot be divorced from consideration of the appropriate payment schedule for tax and of the transition from the existing PY to the proposed current year basis. We accordingly refer to these in this Chapter although more detailed consideration of those topics may be found in Chapters 5 and 6 and the Appendices.

## 3.2. ACCOUNTING PERIOD BASIS

Under the AP basis discussed in the first Consultative Document taxpayers would have been assessed for all their income in the accounting year ending with their chosen accounting date. The tax computation in this type of system is complex, since it involves apportioning tax rates, allowances and reliefs for two tax years to one accounting period. The Consultative Document suggested that if this system were to be adopted, the Inland Revenue would have to require smaller taxpayers to choose the tax year as their accounting date. The Document suggested that the income limit for moving off the tax year could be aligned with the maximum business turnover permitting the submission of three line accounts, currently £15,000. When the limit was raised to this level, the

Chancellor of the Exchequer suggested that 1.5 million taxpayers would be below this limit.

The AP basis is a logical basis in that income accruing in a particular period is taxed using the income tax schedule for that period. However, we do not on balance believe that a move towards an apportionment system would represent a simplification when compared with the current system. The AP basis has a number of other problems, for example in dealing with taxpayers who shift between employment and self-employment, with those with more than one source of self-employment income and those with both PAYE and Schedule D income. We have accordingly rejected this proposal as a basis for reform. As respondents to the first Consultative Document also did not support the adoption of the AP basis, we have not considered it further.

### 3.3. THE PROPOSED CURRENT YEAR BASIS OF ASSESSMENT

#### Profits assessable in ordinary years

The other proposal in the first Consultative Document was for a CY basis and this was preferred (subject to a number of reservations) to the AP basis by those who responded to that Document. The proposed CY basis is a deeming procedure which taxes income accruing in a particular accounting period as if it were earned in the tax year in which the accounting period *ends*. This is illustrated in Figure 5. From that we can see that if Mr Brown adopts an accounting year to 30th June, he will be taxed in the tax year 1996-97 on the profits he earns over the period 1st July 1995 to 30th June 1996.

We further illustrate the operation of the proposed CY basis in Appendix B. The examples we give there and in Appendix A demonstrate the principal advantage of the CY basis over the present PY basis: over the life of the business it ensures that profits earned and profits taxed coincide. It may not, however, accelerate payment of tax significantly. This will depend upon the pattern of profits. If year-on-year profits are static the PY and CY bases are broadly similar but the CY basis may favour the taxpayer in the early years of the business. On the other hand, as profits rise, tax on the increase is accelerated. To the extent that

under the PY basis the deferral of tax payments on any increased profits provided some compensation for the taxation of increases in profits due to inflation, that compensation is reduced. At the same time when profits fall, there is an earlier reduction in the business's tax payments.

#### Opening years

The Consultative Document envisages that the proposed CY basis would have no special rules for opening and closing years.<sup>2</sup> The date on which the individual considers that he or she sets up in business appears to be one of the main factors that leads to the choice of accounting date. If this continues to be the case, the opening period is more likely than not to straddle a tax year. 34 out of 103 respondents to our questionnaire indicated that their accounting date was chosen because it was the anniversary of their starting in business. This finding has been supported by other empirical work on small businesses.

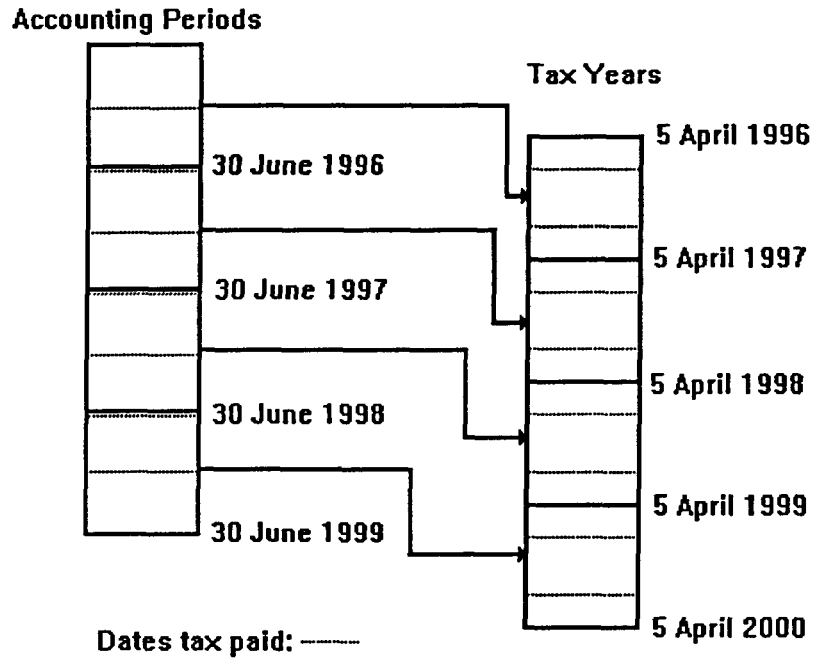
This means that Mr Brown in our example will have no *taxable* profits for the first tax year in which he trades. If he starts his business on 1st July 1995 and prepares his first financial statements to 30th June 1996, his taxable income for the tax year 1995-96 will be limited to his investment income and any earnings from other sources for the year. None of the profits that he earns in his first trading period to 30th June 1996 will be taxed in the tax year 1995-96. Those profits will be taxed in the year 1996-97 and he will pay tax on those profits for the first time on 1st January 1998, some two and a half years after starting up in business. This is illustrated in Figure 6.

#### Closing years

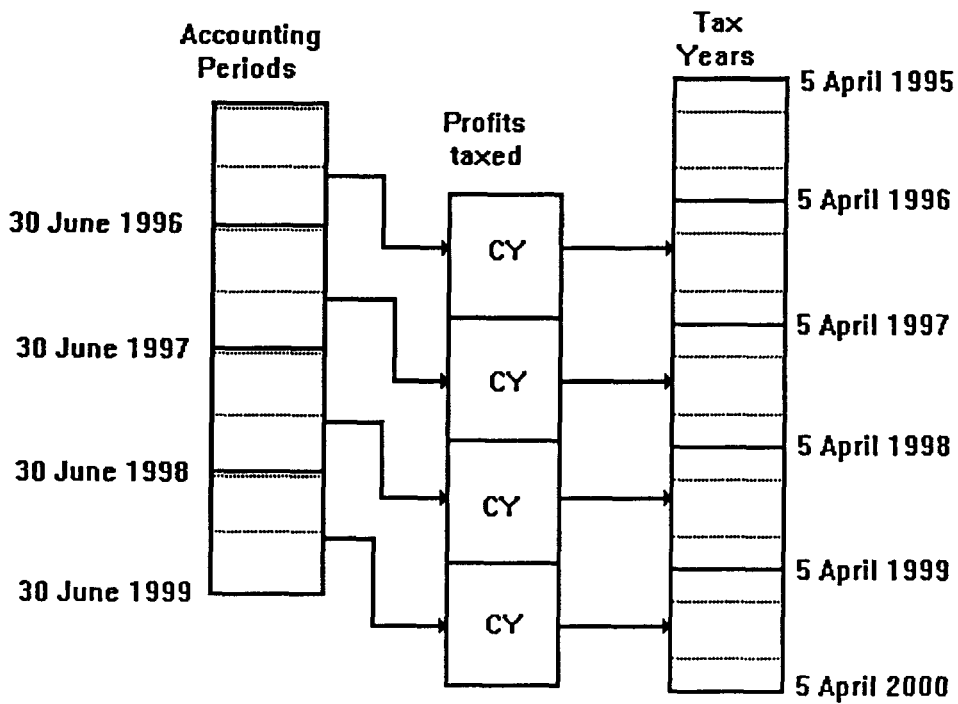
The effect of this opening year treatment may be reversed in the final year: there may then be a bunching of income in the year of cessation. If Mr Brown continues in business until he retires on 30th June 2005, his taxable

<sup>2</sup> This is sometimes referred to as "simple deeming". We noted in our discussions that Ireland, which inherited the UK's system for taxing the self-employed but moved from the PY basis to a CY basis in 1990-91, still adopts special opening and closing year rules. This is known as "complex deeming" and ensures that the actual profits of those years are taxed for the year. We did not favour this basis over our own proposals for solving the problems of the CY basis.

**FIGURE 5  
CURRENT YEAR BASIS - CONTINUING BUSINESS**



**FIGURE 6  
CURRENT YEAR BASIS - OPENING YEARS**



income for the tax year 2005-06 will include the profits earned in the 12 months from 1st July 2004. However, if he starts to draw his pension immediately, his total income for that year will include his pension income for the nine months to 5th April 2006. Effectively, he is taxed on 21 months' income in the final year to make up for the fact that he was only assessed on three months' income in 1995-96. The same result would arise if Mr Brown, instead of retiring, incorporated his business or gave it up and took employment.

If Mr Brown actually retires<sup>3</sup> on 31st December 2005 and prepares financial statements for the six months from 1st July 2005, the CY basis will apply to both the accounting year and half-year ending in the tax year 2005-06. This is merely a particular instance of the problem described in the previous paragraph and is illustrated in Figure 7. However, the second Consultative Document suggests that to mitigate the bunching effect of the CY basis, Mr Brown might be allowed to elect to be taxed as if he had continued his business. If a continuation election were introduced, then in our example, Mr Brown's income for the tax year 2005-06 would comprise the profits he earns in his accounts year to 30th June 2005 while the profits he earns in the remaining six months to 31st December 2005 would be taxed in the tax year 2006-07. Effectively, his income for 2005-06 comprises 12 months' profits plus three months' pension and that for 2006-07 comprises six months' profits and 12 months' pension. Thus, 2006-07 is on a PY basis and, in the absence of special provisions (as would be appropriate in the case of emigration, bankruptcy or death), Mr Brown would make the final tax payment in respect of his business profits on 1st January 2008, two years after retirement. This is illustrated in Figure 8.

This proposal for a continuation election may reflect the view that in the case of many sole-traders and other self-employed people, it is very difficult to judge precisely when the business has ceased. An individual who is alert to the possible bunching of profits in the final year could "self-elect" by contriving to

continue his business into the following year to mitigate the problem. Even so, there seems little point in favouring taxpayers who continue their business over a short trading period as against others who, for example, give up their business at their normal accounting year end and take employment or retire. Bunching then affects those who were either ill-informed, whose cessation is involuntary, as for example on death or other adversity, or who otherwise had no flexibility as to when to give up the business. Mr Brown, for example, might continue his business until he can find a buyer or until he can find alternative employment.

#### 3.4. PROBLEMS OF THE PROPOSED CURRENT YEAR BASIS

Although the CY basis is more attractive than the AP basis for reasons of simplicity, it has a number of problems. The principal of these is that, like the PY basis, when combined with fixed payment dates unrelated to the accounting period, it encourages taxpayers to choose accounting dates early in the tax year in order to maximise the advantage of tax deferral and the length of reporting period. This can be seen from Tables B1 and B2 in Appendix B. New businesses and their advisers would tend to favour year-ends of, for example, 30th April, as with the present PY basis. Virtually all the practitioner respondents to our questionnaire believed that they had a significant influence in advising clients on the choice of accounting date and indicated that the tax impact of that choice was an important factor. This was confirmed by the responses from the business respondents. Accounting dates early in the tax year were not the invariable choice. Tax considerations also resulted in the choice of accounting dates coincident with the tax year. However, the CY basis would have the effect of maximising the difference in time between the period in which income was accrues and the tax year over which the tax schedule is defined.<sup>4</sup>

Certainly for the larger and more sophisticated unincorporated businesses, the choice of accounting date for tax purposes would be likely to continue to feature as part

<sup>3</sup> Alternatively, Mr Brown might die suddenly or be unable to carry on his business through accident or illness.

<sup>4</sup> As is noted in Chapter 5, it also improves the time at which instalments of tax can be reduced to take account of a reduction in profits.

of the advice received by the self-employed, and in the choices they make, although to a much lesser extent than under the PY basis. The CY basis would also retain the tax system's existing discrimination based on accounting dates between different self-employed taxpayers as well as retaining an advantage for the self-employed over employees. In short, the CY basis would retain some of the less desirable features of the present PY basis which we would like to remove.

The advantage of an accounting date early in the tax year is particularly emphasised for a profitable business in the first year. Certainly, the bunching effect on cessation may counter-balance this to some extent but this may not be of immediate concern to the individual. The effect of the CY basis on commencement and cessation may also present problems for those taxpayers who transfer from self-employment to employment or who change their accounting date. As illustrated in Appendix B, in the year of cessation or on a change of accounting date, more income would be taxed than actually arose in that year.

The proposed continuation election to eliminate some of the bunching of profits on a cessation may appear a simpler option than some form of "top-slicing" relief. However, for the reasons we have discussed to limit any relief to business profits rather than income generally does not seem appropriate. In addition, unless the bunching of profits made a difference to the taxpayer's tax liabilities in the year of cessation or the following year, the election might merely offer the taxpayer the opportunity to defer payment of part of the tax bill.

An election might, therefore, be restricted to those cases in which bunching had a material effect on the taxpayer's liabilities. Mr Brown in our previous example might initially pay tax for the tax year 2005-06 on the profits earned in the 18 months from 1st July 2004 to 31st December 2005. He would, however, be entitled to elect for a continuation basis and obtain a tax repayment if a material difference were to result from that election. As we have noted, however, there is little justification for favouring Mr Brown in these circumstances when others, who derive income from other sources obtain no equivalent relief. What also is Mr

Brown's position if he prepares a single set of accounts for the 18 months to 31st December 2005? May he apportion the 18 months' results and make a continuation election?

Finally, as the first Consultative Document noted, special rules are needed under the CY basis to ensure that a business could not reduce its tax charge for a particular year by changing its accounting date. A business could manipulate the tax that it paid in any year by shortening or lengthening its accounting period as appropriate to take account of variations in its profits or changes in tax rates, reliefs and allowances. Any rules need to ensure that at least 12 months' profits are taxed in each year and, under self-assessment, there might have to be some restriction on taxpayers reducing their interim payments to take advantage of any change in accounting date that had not been agreed with the Inland Revenue.

These rules are illustrated in Appendix B together with the proposed tapered relief that would attach to them on a cessation within six year of a change in the accounting date. Their result may be that more profit is taxed over the life of the business than is earned where full cessation relief is not available

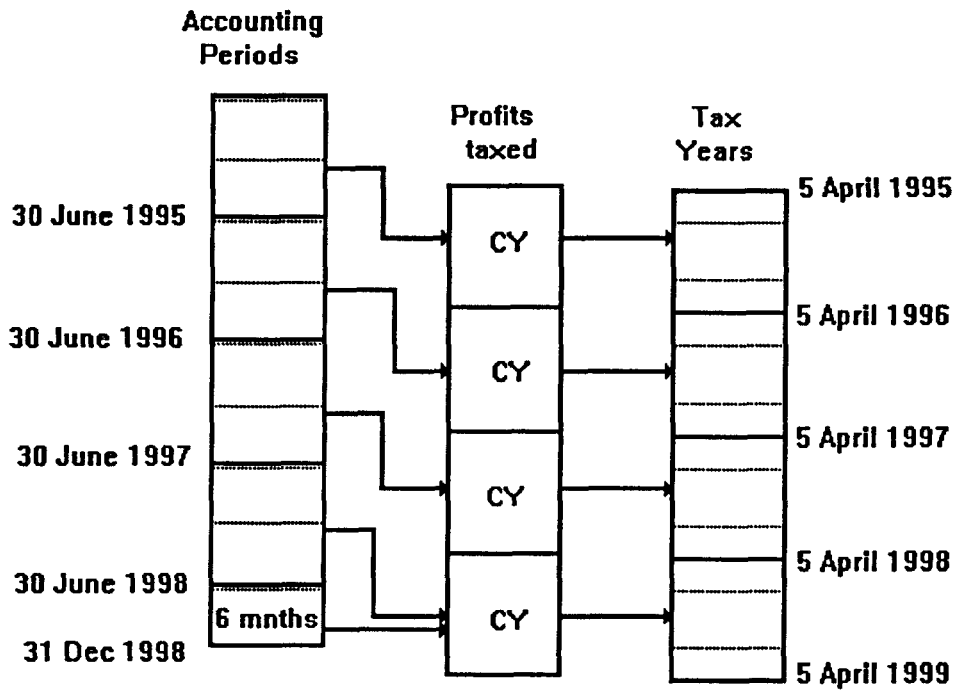
The net effect (as illustrated in Appendix B) of the rules for changes in accounting date, is to allow a business to extend its accounting date within the tax year. However, a penalty is incurred if the accounting date is shortened or extended beyond the end of year so that no financial statements are prepared to a date that ends within the tax year. On this basis the scope to manipulate the profits that fall within a tax year has a limit to it and the number of firms seeking to change their dates for tax reasons may be relatively few. Nevertheless, this is a further complication on the CY basis and it may be precisely those who *do* have good reason for changing their accounting date who may find their flexibility restricted by these rules.

### 3.5. CONCLUSIONS ON THE CURRENT YEAR BASIS OF ASSESSMENT

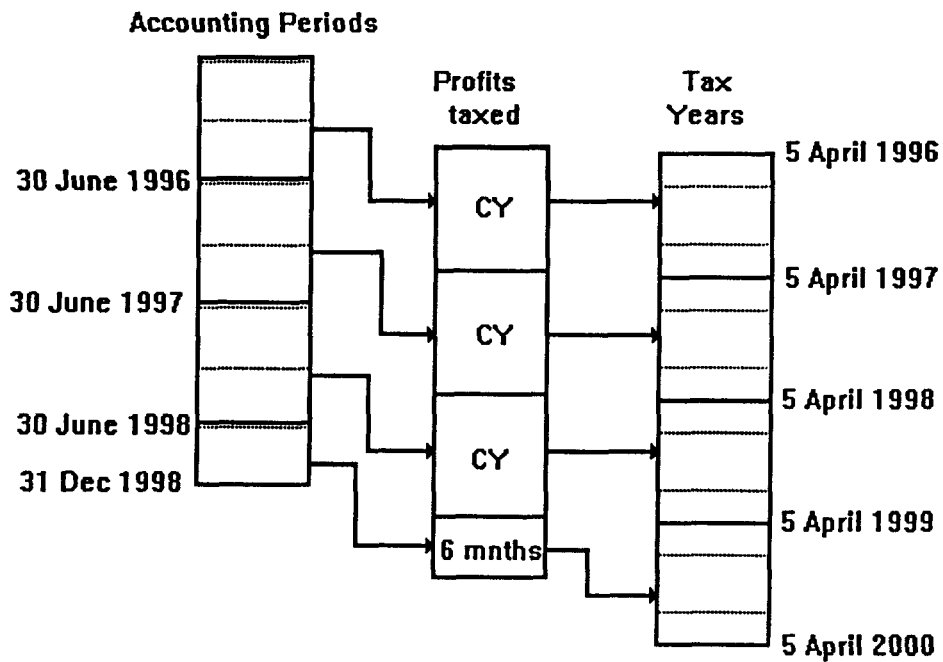
Any compromise in the basis of assessment such as that which is implicit in the proposed CY basis, particularly when coupled with any taxpayer election, provides scope for the well advised to take maximum advantage of the



**FIGURE 7**  
**CURRENT YEAR BASIS - UNADJUSTED CLOSING YEARS**



**FIGURE 8**  
**CURRENT YEAR BASIS - CLOSING YEARS WITH CONTINUATION ELECTION**



system and for the ill-advised or unfortunate to be penalised by it. In addition, although under the existing PY system there may be a considerable time lag between setting up in business and making the first payment of tax, we do not think that it is satisfactory for the CY basis to reproduce this result. The first Consultative Document suggested that the cash flow benefits to the business from deferring the payment of tax in the opening year "could be of benefit to new businesses and help to encourage more new businesses to be set up." However, a majority of the business respondents to our questionnaire wished to pay tax at *more regular* intervals rather than less frequently.<sup>5</sup> We doubt whether many unincorporated businesses make adequate provision for their eventual tax liabilities and an undue delay in establishing any pattern of tax payments may merely be laying the foundation for future cash flow problems. Some delay in the payment of tax at the outset of a business may be unavoidable. However, it seems to us unfortunate if this is a feature that is encouraged by the system.

As the Tables in Appendix B demonstrate, the CY basis may also prove less satisfactory than the present PY system for short-lived businesses. Under the PY basis with opening and closing year adjustments, a business that exists for four years would be taxed each year

on an actual profits earned in that year. This would apply in particular to those who move between periods of employment and self-employment. While this result is achieved through the use of opening and closing year adjustments, which represent much of the difficulty of the present system, it seems to us unsatisfactory to move onto a less accurate basis of assessment of such individuals. It might, therefore, be appropriate under the CY basis to allow taxpayers who start and close a business within a specified period to be free to elect to be taxed on an actual basis in each year. On the other hand, a CY basis with opening and closing year adjustments calls into question whether the CY basis is the most satisfactory alternative to the present PY basis.

For these reasons, whilst we recognise the CY basis is simpler than the AP basis and among the best options for a deeming basis, we have rejected it as failing to deal effectively with the problems of taxing the great majority of the self-employed. Possibly the least attractive course would be to undergo the upheaval of reform and yet end up with a system that is only marginally more understandable to the majority of taxpayers and that leaves in place a number of the problems presented by the current PY system. What then is our preferred solution?

<sup>5</sup> We also have noted that most other countries require tax to be paid at more frequent intervals than half-yearly.



## CHAPTER 4.

### THE FISCAL YEAR BASIS

#### 4.1. THE ADVANTAGES OF THE FISCAL YEAR BASIS

We believe that the most satisfactory basis of assessment for the majority of Schedule D taxpayers is one based on the tax year. We refer to this basis as the "fiscal year" or "FY" basis. It is probably the option most comprehensible to the majority taxpayers: a self-employed individual would be taxed on the profits that are actually earned in each tax year. This basis has the benefit of the apportionment systems described in Chapter 2 in that profits are taxed at the tax rates and with the allowances applicable at the time the profits were earned, and the advantage of the deeming system in that the necessary calculations are relatively simple.

The first Consultative Document summarised the advantages of the FY basis in the following terms:

"This basis is used for most taxpayers in the USA. It is in many ways the ideal technical solution. It is readily understood and would be very easy for the taxpayer to get right. It produces no problems with, nor does it require special rules for, commencements and cessations. It lends itself readily to reduced Revenue involvement and to greater unification of the personal tax system."

If a fiscal year basis were able to realise these advantages, it would seem the obvious candidate for adoption. However, before turning to an examination of how a fiscal year basis might work in practice, we consider the counter-arguments to it.

#### 4.2. A COMPULSORY FISCAL YEAR BASIS?

##### Compulsory accounting dates or apportionment?

Given that many of the self-employed currently state their profits to different dates

in the tax year, a fiscal year basis is often alleged to restrict a self-employed person's freedom to choose the accounting date best suited to his business. All self-employed persons would have to adopt a fiscal year accounting date. In practical terms, if a fiscal year basis were introduced, many of the self-employed would choose a fiscal year accounting date because that is the easiest option and they have no good commercial reason for choosing otherwise. However, as we discuss below, it is unnecessary to *impose* a fiscal year accounting date on all businesses. All that is required is that business profits are taxed by reference to fiscal years so that the results of any accounting period that straddles a tax year would have to be apportioned. An individual who chooses a 31st December date would accordingly be taxed on three-quarters of the profits of one period and one-quarter of the profits of the next period.

A fiscal year basis is dictated for other sources of income and gains and this does not appear to arouse objection. In addition, while there is no current requirement to account to any particular date, it is clear that the tax system exerts a strong influence both on the advice given and on the choices made. A compulsory fiscal year basis (with limited exceptions) also appears to work satisfactorily for the majority of businesses in a number of other jurisdictions. Those jurisdictions may seek to accommodate the needs of those businesses who for commercial reasons prepare their accounts to dates other than the tax year but those businesses are the exception rather than the rule. In this respect the UK, for historical reasons stemming from the change from the Julian to the Gregorian calendar, has the unusual tax year date of 5th April and very few businesses would naturally choose to prepare their accounts to that date. Nevertheless, we see no difficulty in deeming any accounting date around the end of the tax year to be coincident with the tax year so that, for example, a 31st March accounting date would be satisfactory for an FY basis.

A number of businesses may reasonably be able to argue that it is appropriate for them on commercial grounds to draw up their accounts to a different date. However, what evidence there is tends to suggest that the accounting dates chosen are usually either 12 months after commencement, are dates aligned with the tax year or are dates early in the tax year. The choice of the last of these is normally to take advantage of the deferral of the payment of tax on *rising* profits.

In response to the question "Are there any particular reasons for choosing your accounting date?" 24 of the business respondents indicated that there were none, 23 said that it had been chosen in the light of advice from their accountant (which responses from practitioners would suggest was heavily influenced by tax considerations), 36 had chosen a date based on when the business had started and 14 specifically indicated that it was dictated by the tax advantages. In response to the question of whether they would be willing to change their accounting date to a date aligned with the tax year 46 responded that they would and 20 that they would not. Of the 20 negative responses, 5 indicated that there were no specific reasons that would make it difficult to change their accounting date and 3 others indicated that they were unwilling to make a change for tax reasons. Only 12 gave reasons that suggested that the business was seasonal and 4 of those were prepared to change their year end although two preferred the calendar year end. Details of the responses to the questionnaire are given in Appendix D.

In general, therefore, we do not find the argument that imposing the fiscal year as the accounting year is objectionable a convincing one. We do not believe that there are many taxpayers who choose their accounting date for compelling commercial reasons and this appears to be borne out, so far as they go, by the responses to our questionnaires from both practitioners and the self-employed. In any event, we do not envisage that the legislation need specifically require taxpayers to adopt a fiscal year accounting date:<sup>1</sup> it merely needs

<sup>1</sup> However, as stated below, our preference is to require profits to be stated for the fiscal year unless a positive election is made to do otherwise.

to state that businesses are to be taxed on their profits for the fiscal year.

### Reporting profits and paying tax

For simplicity's sake, the majority of the self-employed would choose to prepare their accounts for the tax year (or to dates around the end of the tax year). Those that did not wish to do so, however, would be free to choose a different date but would have to apportion their profits. Whether apportionment is a practical option depends upon the rules for reporting profits and paying tax. The system for taxing unincorporated business profits would be similar to the existing corporation tax system, under which corporation tax is charged by reference to Financial Years but tax is based on the apportioned profits of the company's accounting periods falling within a Financial Year.

Unlike companies, however, the self-employed would report their profits and pay tax by reference to the tax year rather than their chosen accounting period.<sup>2</sup> A business which wished to adopt an accounting date which did not coincide with the tax year would therefore need to have the financial and accounting information that enabled it to meet whatever reporting and payment requirements were imposed, given that it might have to apportion the results of an accounting period that did not end until sometime after the end of the tax year.

Under a system that requires Revenue assessment of profits for the year, the adoption of a fiscal year basis with apportionment for non-fiscal year accounting dates does present practical problems. It breaks the link for those businesses between the tax return and the accounts and the profits that have to be assessed. This means that profits cannot finally be assessed in agreed figures until the accounts for the year ending after the tax year in question have been received. Assume that a taxpayer prepares accounts up to 31st December each year; an agreed assessment on his business profits (and therefore on his total income) for the tax year 1994-95 cannot be issued until he has

<sup>2</sup> Assessment of the self-employed's profits by reference to accounting periods was the AP basis proposed in the first Consultative Document that we rejected.

prepared and submitted his accounts for the year ended 31st December 1995. This complicates Revenue administration.

However, these objections fall away under a *self-assessed* system. The responsibility is now the taxpayer's to estimate accurately his profits for the tax year and to pay tax on them at the due date. Many of those who may want to adopt an accounting date different from the fiscal year are likely to be professionally advised and may be larger businesses. As such they will have better financial information and calculation of their profit will be more complex, requiring Inland Revenue audit and adjustment after submission in any event. Nevertheless, unincorporated businesses need not be required to prepare their financial statements in any particular form as part of the tax return. The return need merely state the figure of taxable profits for the tax year. Accordingly, the return of the individual's total income and gains, including a profits figure, can be submitted on the same date as that adopted for taxpayers generally.

Thereafter, the taxpayer may have to file an amended return and pay further (or reclaim) tax if taxable profits finally turn out to be different.<sup>3</sup> However, in doing this, the taxpayer is in no different position to one whose profits are adjusted voluntarily or following an Inland Revenue audit, or who is unable to finalise any other item of income or gains by the return date, as may well be the case where capital gains are dependent on valuations or foreign income is received subject to foreign tax credits. We return to the procedures for deal with this in Chapter 5 below.

### Bunching of work

A third argument against a compulsory FY basis is that this would result in bunching of work for professional advisers. This could result in serious problems particularly for sole practitioners and small firms of accountants whose client bases may be dominated by the self-employed. With the majority of their clients on a fiscal year basis, their workload would be uneven throughout the year. There

would be crowding of work near deadlines, with the concomitant of penalties. Certainly, 33 of the practitioners responding to our questionnaires were against (with 11 in favour) the imposition of a compulsory fiscal year basis because of the bunching problem they foresaw, together with the difficulty of extracting the necessary information from their clients. One of the business respondents did not believe that his accountant could cope if a large number of his clients changed their accounting dates to the fiscal year.

If difficulties arising from bunching are to be a valid counter-argument, we need to be satisfied that alternative proposals for the basis of assessment would not have similar bunching effects. Bunching is likely to occur in any regime which has a tax advantage attached to the choice of a particular accounting year. For example, if taxpayers gain by choosing an accounting date early in the tax year, then accounting dates will be bunched. This would be offset to an extent by the longer reporting period available when an early accounting date is chosen. However, given that the practitioners' concerns stem largely from the difficulty they foresee in getting information from their clients, the benefit of the extended reporting period may well not materialise: it may still all be a last minute rush, especially if the clients do not sense any degree of urgency in the matter.

On this basis it would be no solution under a compulsory FY basis to offer substantially longer time limits for the submission of information following a change to the FY basis. This might encourage continued late reporting even if, as familiarity with the new procedures grew over time, the reporting period was gradually reduced. In addition, extended reporting periods would be likely to present problems in maintaining the flow of tax payments to the Treasury and to involve added end-of-year adjustments. In our discussions, we formulated a proposal for a compulsory FY basis which provided for a period for the submission of returns of at least 12 months after the end of the tax year. This was coupled with three interim payments of tax and a final payment. While more complicated than the system proposed in the first Consultative Document (which we consider below), it was designed to overcome the perceived bunching problems of the FY basis. However, a majority of the practitioner respondents felt that the added

<sup>3</sup> The filing of an amended return would restart the time limits for audit in respect of those items, including business profits, in respect of which a change had been made.

complexities involved in this system outweighed any benefits it might confer in managing their workload.

On the other hand, practitioners could regard a change to the FY basis as a business opportunity which enabled them, for example, to offer attractive rates to those clients who were prompt in delivering their information and premium rates to those who were not.<sup>4</sup> Given that any change in the basis of assessment, especially if accompanied by a change to more general self-assessment of income and gains from all sources, is designed to bring about a change in reporting attitudes by taxpayers, the bunching problem may in fact be more of a transitional problem as professional advisers change their internal procedures and taxpayers are educated in the need to deal with their tax affairs more promptly. Certainly taxpayers and professional advisers in other countries cope with a compulsory fiscal year basis under a self-assessment regime and subject to stricter time limits than are proposed in the second Consultative Document.

Finally, we believe that the proposals in the second Consultative Document for continuing Revenue assessment may alleviate the bunching problem in any event. It is proposed that taxpayers can continue to have their tax liabilities assessed by the Inland Revenue provided that they submit their returns by 1st October following the end of the tax year. Most of the business respondents to our questionnaire who already had professional assistance with their tax returns envisaged that they would continue to seek professional assistance and would not take advantage of this facility. Several expressed the view that they would not trust the Inland Revenue to get it right.

However, many *practitioners* may see an advantage in assembling details of the individual's income and gains in time to submit them by 1st October for Inland Revenue assessment. The practitioners would have to check the resulting assessment but may be saved some work in the process and can use this as an incentive to obtain information from their clients in time. This

<sup>4</sup> We have not overlooked the point that those who are bad at providing information on time might also be bad at settling their bills!

may also appeal to taxpayers and practitioners alike if Revenue assessment provides any degree of protection against penalties or interest if the wrong amount of tax is paid.

Apart from this, if, as we suggest, there is some discount for early payment of tax, practitioners would have a further carrot with which to persuade their clients to submit details of income and gains early in the year. The more complicated cases, including those businesses with an accounting date other than the fiscal year, would be left for self-assessment by 1st February followed, under our preferred option by the preparation of amended returns, any Inland Revenue queries or audits, all of which should ensure a spread of work throughout the year.

### 4.3. OUR PREFERRED FISCAL YEAR BASIS

#### A fiscal year basis for new businesses

For the majority of self-employed taxpayers, a fiscal year basis is the most attractive solution. Our preferred solution for new businesses is, therefore, for a fiscal year basis. All new business would be required to state their profits for the tax year subject to the right to make an election for a different date. In practice, we believe that there could be some flexibility in the dates that were regarded as coincident with the tax year.

Of those business respondents to our questionnaire who were registered for VAT, 58 out of 88 felt that it would be helpful if they could have the option to prepare their accounts to the same date as that on which they submitted their VAT returns. 39 already had their accounting dates and VAR return dates aligned, although 5 of these thought it was not helpful to be aligned in this way. Nevertheless, there would be no compulsion on the matter. If any accounting date between 28 February and 30 April were regarded as coincident with the tax year, that would ensure that any business that wished to could prepare its financial statements in line with a VAT return date.<sup>5</sup>

Any flexibility over accounting dates, other than a week or so, raises questions as to the treatment of changes in accounting dates

<sup>5</sup> This, however raises transitional issues that are considered in Chapter 6 and Appendix C.

within that period. However, we feel that the circumstances in which a business wishes to change from one accounting date within this period to another also within the period will be rare. An election, as explained below, would be required to change to an accounting date outside this period. Neither event should, however, present significant practical difficulties if a fiscal year basis applies by apportionment to businesses adopting non-fiscal year accounting dates.

#### Election for a non-fiscal year accounting date

We accept, however, that a minority of businesses will have valid commercial reasons for choosing an accounting date that does not fall within whatever range of dates is treated as being coincident with the tax year. We envisage, therefore, that those businesses should be entitled to adopt a different accounting date by election.

To provide some control over this election, we think that it might be similar to the existing procedure for making an election to pay dividends and interest gross within a group of companies: an individual would be entitled to submit an election to the inspector and, in the absence of any objection, the election would have effect. The election would, however, be ineffective if the inspector refused it, subject to a right of appeal to the General Commissioners on the matter. Some criteria would be required, such as the need to show genuine commercial reasons for the desired accounting date, for deciding whether to allow or refuse the election.

Whether such an election is really necessary depends upon whatever basis of assessment is adopted for businesses not adopting a fiscal year accounting date. If the basis of assessment for those not adopting a fiscal year accounting date offered tax advantages, the degree of control needed over the election would be greater. We have already expressed a strong preference for apportioning profits to fiscal years for those businesses that elect not to adopt a fiscal year accounting date. This would permit minimal control over the election. However, is there a case for allowing *existing* businesses to retain their present accounting dates and to be taxed on a CY basis? We consider this below.

#### Extended reporting date

We envisage that the larger businesses, (and thus those most likely to be professionally advised), may be disproportionately represented among those who choose an accounting date other than the fiscal year. Professional advisers will, therefore, be able to maintain some spread in accounting dates among their client base. However, we also envisage that the current 1st January reporting date be moved to 1st February, as is now proposed in the second Consultative Document. This extends the reporting period to 10 months and moves it away from the Christmas and New Year holiday period.

#### Retention of existing accounting dates at the transition

If the bunching problem of the FY basis is largely a transitional problem, as we believe is the case, one solution would be to look for ways in which not all self-employed individuals are immediately moved onto an FY basis. The obvious method of doing so is to allow existing businesses to retain their present accounting dates if they wish and to be taxed on a CY basis. However, those businesses that do choose to retain a non-fiscal year accounting date and adopt the CY basis may under the present proposals in the Consultative Document lose out under the tapered transitional relief from doing so.

We consider this in Chapter 6. For present purposes we need merely note that there is a strong incentive for the self-employed to move at or before the transition onto a fiscal year basis. Nevertheless, there will be those that have good commercial reasons for retaining their existing accounting date, or who are subject to other constraints that prevent them from changing their accounting date.<sup>6</sup> It then seems unfair that they should suffer a loss of transitional relief as a result of commercial factors or other constraints, while those who adopted particular accounting dates for the tax advantages that they offered are free to maintain their advantage at the transition by changing onto a fiscal year basis.

<sup>6</sup> Where, for example, accounts have to be submitted for Regulatory reasons.



It may be that we are unconcerned at these effects at the transition on the basis that they are temporary and affect a small number of the total self-employed population. On the other hand, if following consultations the transitional relief is altered so that there is no disadvantage to an existing business retaining its present accounting date and being on a CY basis, a much larger number of businesses may adopt that basis.

#### CY basis for existing businesses

There are some attractions to allowing existing businesses to retain their present accounting dates and being taxed on the CY basis. As noted above, it may assist any bunching problem at the transition. In addition, even if existing businesses are free to adopt a fiscal year accounting date and are prepared to do so, there may well be some upheaval and cost associated with that change that they would prefer to avoid and which might outweigh the benefit of the transitional relief. While existing businesses would continue to benefit under the CY basis from a longer payment interval than new businesses on the FY basis, they would still be paying tax on any increase in their profits earlier than they currently do under the PY basis.

Provision could be made that an existing business was not entitled to change its existing accounting date other than to adopt the FY basis, subject to its right to elect otherwise as explained above. That election might be available if two existing businesses with different accounting dates were merged and the partners had valid reasons to adopt one of the previous dates for the merged firm rather than be transferred to a fiscal year basis.

When in 1965 companies ceased to be liable to income tax and profits tax and became liable to corporation tax, existing trading companies were entitled to retain their long income tax payment date for corporation tax purposes so long as they continued to carry on the same trade. This led to a certain amount of tax planning under which income and gains were transferred into pre-1965 trading companies to benefit from the deferred corporation tax payment date available to such companies. In its extreme form tax on the profits of large domestic and multi-national groups could be deferred by acquiring a pre-

1965 trading company - including such examples as a small High Street chemist or tobacconist - and transferring the group's trade and assets to that company.

We do not, however, believe that allowing existing unincorporated businesses to retain their existing accounting dates and to use a CY basis would lead to the same tax planning results. This is for two reasons: first, the scope to amalgamate an existing unincorporated business with a new unincorporated business is clearly far more limited than it is to transfer new businesses and assets into an existing company. The merger of two existing businesses, one pre-self-assessment and one post-self-assessment might in any event be regarded as an occasion on which the FY basis had to be adopted, subject to the right to elect otherwise as explained above.

Second, the ability to use pre-1965 companies arose from the fact that *all* corporate income and gains benefited from the deferred payment date and not merely the profits of the trade that was being carried on before the introduction of corporation tax. For the self-employed only the profits of the pre-self-assessment business would benefit. If the addition of new activities to that trade in fact brought into existence a new trade, it would be possible to require the adoption of the FY basis at that stage.

#### Alternative apportionment basis

However, if a large number of existing businesses could adopt the CY basis the advantages of the FY basis for new businesses will be dissipated and some of the problems that we foresee in the CY basis may re-emerge. If existing businesses retained their present accounting dates and were taxed on a CY basis, it would be unnecessarily complicated to use a different basis for those new businesses which can justify a non-fiscal year accounting date. If existing businesses can use a CY basis, therefore, new businesses should be entitled to elect for a CY basis. However, in that case there would be an incentive for a new business to come up with some commercial reason for adopting a non-fiscal year accounting date in order to gain the benefit of the tax deferral as well.

In the end, therefore, we have concluded that the FY basis with apportionment of

profits for non-fiscal year accounting periods should apply to all businesses. Existing business would be entitled to retain their existing accounting dates if they wished without making any election or having to justify their reasons for an existing non-fiscal year date. Both existing and new businesses with accounting dates other than the fiscal year (or those treated as coincident with the fiscal year) would compute their tax liability by dividing the profits from two accounting periods between the tax years they span. This has the advantage over the AP basis of the first Consultative Document, since apportioning profits to two tax years involves a more elementary computation than apportioning income tax rates, allowances and reliefs and all other sources of income to the accounting year chosen. The principal issue with this basis is how to deal with returns and the payment of tax.

It will be difficult to fit those businesses with an accounting date late in the tax year in with the 1st February reporting and settlement date that we propose for businesses adopting the FY basis. If there is no flexibility on reporting and payment, this could effectively limit the choice of accounting date to a period of, say, 1st May (assuming dates to 30th April are treated as coincident with the fiscal year) to 30th September. To open the whole year as a possible choice of accounting date, we considered the adoption of a minimum reporting period of six months from the end of the second accounting period. However, under a self-assessment system this need not require the adoption of different filing dates for tax returns, as we outlined above and explain further in Chapter 5.

#### 4.4. CONCLUSION: THE BASIS OF ASSESSMENT

Before turning to the requirements under different bases for filing returns and paying tax, it may be helpful to summarise the proposals we recommend for reforming the basis of assessment -

- We propose a system under which the profits earned in the fiscal year will form the normal basis of assessment for *new* businesses. This appears the solution most readily suited to gains in compliance and administrative costs and reduction in complexity.

This is most certainly the case for the vast majority of self-employed taxpayers, who receive only a relatively small income from this source and often have other income from which tax is deducted at source. For these purposes consideration could be given to treating dates between 28 February and 30 April as coincident with the fiscal year.

- *New* businesses which have good commercial reasons not to draw up their accounts to a fiscal year date will be allowed to elect to state their profits to another date.
- Existing businesses will be entitled to retain their present accounting date if they wish, although we anticipate that many of them will choose to move to a fiscal year basis, and will be encouraged to do so if the proposed transitional relief remains in its present form.
- While there are arguments to allow existing businesses to be put onto a CY basis, this basis presents a number of difficulties which may not be as important if a limited number of taxpayers are concerned but which are still important enough for us to reject it.
- For any business (existing or new) that does not have a fiscal year accounting date, we believe the correct basis is a fiscal year basis with the profits of accounting years straddling the fiscal year being apportioned to each fiscal year. This maintains the consistency that the tax due for a particular tax year is related as closely as possible to income accruing in that year, avoids all the problems of opening and closing years and changes in accounting dates and, with self-assessment, requires minimal modification in the reporting and tax payment procedures for such businesses.

We consider the administrative aspects of these proposals further in the next section.

## CHAPTER 4 : THE FISCAL YEAR BASIS

We would emphasise that the difference between the CY basis proposed in the Consultative Documents and our proposals represent a circle that cannot be squared. Our choices are, however, clear. If some businesses are not to be on a fiscal year basis, it is easier to maintain common reporting and payment dates if we adopt a CY basis. But we must then accept the deficiencies that a CY basis has in terms of deferring payment of tax and in dealing with opening and closing years and changes in accounting dates and, depending upon the relief, the transition.

Alternatively, all businesses can be taxed on the profits earned in a tax year, as we propose. In principle, if a profit apportionment basis is adopted there is no compulsion on individuals to adopt a fiscal year date. Individuals can adopt whatever accounting date they pleased, so long as they are prepared to cope with the reporting and payment requirements for a non-fiscal year date. There should be little or no tax advantage in choosing a non-fiscal year date and any tax advantage there is may be outweighed by the benefits of simplicity from being on a fiscal year date. Only those businesses with a genuine commercial need would be likely to choose a non-fiscal year date. In addition, there is no need for any transitional relief under our proposals.

We believe that it is more important that all businesses should essentially be taxed on a common basis at the expense of a small modification in the reporting and payment rules than that they should be taxed on a different basis but subject to the same reporting and tax payment rules. While administrative requirements are important, they should not dictate the shape of the tax system unless that is unavoidable. The intelligibility of the tax system, and the perceptions of its fairness, come from ensuring that all taxpayers are taxed on as similar a basis as possible.

A fiscal year basis with an election to apportion the profits for non-fiscal year accounting dates ensures that all taxpayers are taxed on what they earn in the tax year. The reporting and payment requirements flow on from that. Our system should ensure that the great majority of the self-employed, many of whom may deal with their own tax affairs, are on a fiscal year basis. Those who choose not to adopt the fiscal year are more likely to be professionally advised and can use the benefit of that advice to ensure that profits are reported and paid correctly, rather than ensuring that they extract the maximum tax benefit from the system. Once such businesses have established their pattern of reporting and payment of tax with the Inland Revenue we do not envisage any particular difficulty in the operation of the system.

CHAPTER 5.

FILING RETURNS AND PAYING TAX

5.1. THE PRECEDING YEAR BASIS

Payment and reporting under the PY basis

The self-employed at present pay tax for any tax year in two instalments: the first instalment is due on 1st January in the relevant tax year and the second on 1st July following the end of that year. As tax for the year is based on the profits of the trading period ending in the preceding year, the theory of the preceding year basis is that for the majority of the self-employed the tax due on each date should reflect the actual liability for the year. Thus, the first instalment of tax on the profits of an unincorporated business that prepares its profits' statement to 31st December is due twelve months after the end of the trading period.

As businesses normally work in cycles no longer than a year, we can assume that whatever financial statements are required will have been prepared by the time the first instalment of tax is due. If the business prepares its accounts to 30th April, it will have 20 months until the first instalment based on the profits of any period is due, by which time it should be well into the preparation of profits' statement for the next trading period. The shortest delay between the end of the trading year and the due date for the first instalment of tax is then just under nine months, from 5th April to the following 1st January.

As the present system works on an assessed basis, the time available for the preparation and submission of any statement of profits is somewhat shorter if the correct amount of tax is to be paid by 1st January: the statement needs to be received by the Inland Revenue in time for it to raise an assessment in the correct amount at least one month (under present rules) before the due date. However, even if in the time available it is impossible to get the first instalment right in every case, there should be little difficulty in getting it

right by the time of the second instalment on the following 1st July.

That does, however, necessitate issuing an estimated assessment and then a revised assessment to correct the position. The inefficiencies of the present system in the case of an on-going business arise from the failure, not so much of the PY basis, but of taxpayers to report their profits on time and the Inland Revenue to take steps to enforce those time limits. As a result, the Inland Revenue are forced to assess profits initially on an estimated basis and to adjust the position once the missing information is supplied.

"Pay and File" with the PY basis

One solution would therefore be to require the self-employed to file their returns and pay their tax without prior assessment. This system will operate for companies under the "Pay and File" system for accounting periods ending after 1st October 1993. Under the PY basis, a self-employed person whose trading period ends on 31st December would have to file his profits' statement by the following 1st January and pay one-half of the tax on the profits he or she declares. The Inland Revenue would have until the following 1st July when the next instalment must be paid to check the calculation and to indicate whether they thought that more or less tax was due or whether they had any specific enquiries to make relating to the computation of profits. We illustrate how such a system might work in Table A1 in Appendix A.

The problem with this arrangement is that tax on the trading profits must be calculated and paid before the end of the tax year. Thus, in Table A1, the statement of profits to 31st December 1993 are filed on 1st January 1995 and the profits returned form the basis of the instalments of tax paid then and on 1st July 1995. Those profits are part of the individual's total income for 1994-95. However, the individual's other income and reliefs for that year are not known at that

time. By 1st January 1995 only the return for the year 1993-94 will have been submitted and it may, therefore, be impossible to achieve an accurate result even if the accounts are submitted on time. It is also confusing for the taxpayer who is returning and paying tax on most other income and gains for one tax year but submitting and paying tax on his trading profits for the following tax year. The position may be even less intelligible in the opening and closing years of the business, especially once the complications of dealing with capital allowances are included.

## 5.2. THE PROPOSED CURRENT YEAR BASIS

### Interim payments under the CY basis

These problems are largely resolved with a CY basis, as Table A2 in Appendix A illustrates. Now the profits for the year to 31st December 1993 are treated as income of the tax year 1993-94. The statement of the individual's profits is still filed on 1st January 1995, as under the PY basis. However, those profits now form part of the individual's return of total income and gains for the tax year 1993-94, filed on the same day. The difficulties that we identified in the previous paragraph - of submitting information relating to two tax years on a single date - disappears.

However, it is impossible to escape entirely from reliance upon the preceding year basis. If interim payments on account of the final liability for the year are still to be made during or shortly after the tax year, the only ascertained profits upon which such instalments can be based are those of the preceding year. If profits are unchanged from year to year, the pattern of tax payments is identical on a CY basis to those made under a PY basis. The effect of the CY basis is to accelerate tax paid on any year-on-year *increase* in the business' profits and to lower the tax charge at an earlier stage if profits decline.

Tables A1 and A2 in Appendix A, and the comparison in Table A5, illustrate these points. The overall effect on the figures we have chosen is that *less* tax is paid in the early years under the CY basis as compared with the PY basis, although this is reversed once the profits begin to climb steadily in the later years. Table A5 summarises the pattern of tax payments over the business's life under both the PY and CY bases.

Table A5 also demonstrates that over the life of the business the self-employed individual pays tax under the CY basis on the *actual* profits that he or she makes, whereas on the chosen figures, taxed profits under the PY basis are marginally less than the actual profits earned. This is even after the adjustments that are made by the inspector on cessation and which can be seen in Table A1. It would be equally possible to devise an example under which the business paid tax under the PY basis on *more* profits than it generates. The important point, however, is that as soon as the profits upon which tax is borne diverge from the actual profits earned, there is scope for well-advised taxpayers to turn that to their advantage.

### Reducing profits under the CY basis

The Consultative Document proposes that a taxpayer may claim to reduce his or her interim payments where the profits decline from one year to the next, or a loss is incurred after a year of profit. The first interim payment could not, however, be less than half the expected current year liability nor the aggregate of the first and second instalments be less than the whole liability for the year. This facility enables account to be taken of reducing profits at an earlier time than under the present PY basis, as a comparison of Tables A1 and A2 reveals. However, it also favours those who choose accounting dates that end early in the tax year.

Under the CY basis, the profits for the year ended on 30th April 1995 will be taxed as part of the individual's income for 1995-96. The two instalments on account of that year's liability will be due on 1st January and 1st July 1996, based on the results of the preceding year, that is the year to 30th April 1994. If profits have fallen between 1994 and 1995, the taxpayer should be aware of it by 1st January 1996 and will be able to claim a reduction in the instalment of tax he is then liable to pay.

On the other hand, if he prepares accounts for the year to 31st March, the first interim payment based on the preceding year's profits will be due before the end of the current period and it may not be possible at that stage to judge whether the interim payment can be reduced and, if so, to what. The earliest time

at which any reduction may be claimed would then be 1st July after the end of the tax year, provided the fall in profits could accurately be estimated within three months of the year end, given that the two instalments must not be less than the whole liability for the year if an interest charge is to be avoided. Otherwise, the individual is left to claim a repayment of tax on the following 1st January, or at whatever earlier time at which he can submit his tax return.

Overall, therefore, an individual who prepares his profits' statement to the end of the tax year pays tax earlier and gets relief through a reduction in interim payments later as compared with an individual who prepares his profits' statement to a date early in the tax year. At the same time, the ability to reduce interim instalments provides an incentive for all taxpayers to ascertain the outcome of the most recent trading period at the earliest point in time unless it is absolutely clear that profits have increased. This underlines the point made in Chapter 4 that the CY basis does not necessarily imply a longer period in which to prepare the financial statements for their eventual return.

#### Payment and reporting in the opening years

Under the CY basis, an individual who chooses not to prepare any statement of his profits during the tax year in which he or she starts in business will pay no tax on the profits attributable to that year. No restriction appears to be proposed on the length of the first trading period so that, for example, an individual starting in business on 1st May 1995 need only prepare a first profit statement for the 23 months to 5th April 1997. The first tax payment that the individual would be liable to make would be due on 1st January 1998, some 32 months after the start date.

We do not think that this would be a desirable state of affairs. It would be better if self-employed individuals starting in business were encouraged both to prepare their initial financial statements at the earliest point in time and to pay or provide for tax as they go. Some delay in the first payment of tax may be inevitable but to devise a system that unduly extends the time of first payment may merely be a recipe for unrecovered tax or for causing the business a temporary cash flow problem if

provision has not been made for tax from the outset.

It also seems sensible to us if an individual starting in business is required to notify his presence to the Inland Revenue at the earliest point in time. We think that this could most easily be achieved by requiring any self-employed individual to submit a tax return for the year in which he commences business. However, in the absence of special provision, there would presumably be no obligation on him to do so if he had no taxable profits for the first year.

Although not stated in the Consultative Document, we assume that it will not be possible to extend the first trading period into the third tax year after commencement before preparing the initial financial statements. Thus, if the individual were to start in business on 1st March 1995 and wishes to adopt a 30th April date, he or she will need to prepare the first profits' statement for the two months to 30th April 1995 rather than the fourteen months to 30th April 1996. Were the individual to adopt the latter course, the initial profits would presumably be taxed twice: the first 12 months' profits being taxed as income of 1995-96 and the fourteen months' profits being taxed as income of 1996-97. Partial relief from that double taxation would then only be available if the business ceased within six years.

#### Initial losses

The Tables in Appendix A are predicated on the basis that the individual makes profits from the outset. Under the present PY basis, there is an advantage for the taxpayer if losses are incurred in the first year as that year forms the basis of assessment for the first three tax years. While he may not obtain relief for the same loss more than once, an initial loss at least ensures that he has no liability for those three years and, over the lifetime of the business, may reduce considerably the aggregate profits that are taxed if the years that do not form the basis of assessment on cessation are profitable years.

Under the CY basis, there will be an incentive to prepare the initial financial statements to a date within the first tax year if a loss is made. This will ensure that relief for that loss can be given against other income and gains a year earlier than would otherwise

be the case. The price of doing so, however, will be the general advancement of tax liabilities in future years. If the opening loss is reported for the period to 31st March, a subsequent change in the accounting date to 30th April once the business has become profitable could result in profits being taxed more than once, as explained in Chapter 3 above.

### 5.3. THE FISCAL YEAR BASIS

#### Payment and reporting in the opening years

The operation of the FY basis is demonstrated in Tables A3 and A4 of Appendix A. In contrast to Table A2 for the CY basis, the taxpayer would be required to submit a tax return in respect of the year in which he commences trading because he would normally have a liability to tax for that year. In the Table it is assumed that he prepares a statement of his profits for the first three months. For many self-employed whose profits are no more than the difference between cash in and expenses out over the period this should not be unduly onerous. However, there will be those businesses which would prefer not to have to prepare accounts for such a short opening period. We envisage, therefore, that under the FY basis, the profits of any business starting on or after 1st January in any tax year might be deemed to be nil, unless the individual chose to submit a statement showing his actual profits or losses for the period between 1st January and 5th April. Anyone starting in business between 6th April and 31st December would have to prepare a profits' statement to the following 31st March unless he made a valid election to use some other accounting date.

If this rule were adopted, an individual who starts up in business between 1st January and 5th April would still have to submit a tax return on the following 1st January but would enter nil as the taxable profits for that short period. This would at least ensure that the business's existence was recorded with the Inland Revenue at an early point.<sup>1</sup> We envisage that the obligation to file a tax return in these circumstances would arise automatically and would not depend upon a tax return being issued to the individual in

<sup>1</sup> We assume for present purposes that there is no general obligation on the individual to notify the Inland Revenue when he or she starts up a business.

question. The profits taxed in the following year would, however, include anything earned in the initial 15 months of trading. If the individual incurs a loss in the opening period, it is likely to be advantageous for him to prepare a statement showing the loss so that he can claim immediate relief against tax paid on any other income or gains for the tax year.

#### Non-fiscal year accounting dates

Where the individual elects to adopt a non-fiscal year accounting date, the profits of each period will have to be apportioned to the relevant tax years. The operation of the system is demonstrated in Table A4 in Appendix A. The individual's tax return must still be submitted no later than 1st February after the end of the tax year. Where the second accounting period does not end until shortly before that date, the bulk of the profit for the relevant tax year will be known well in advance of the filing date but the balance may not and individual may only be able to include an estimate of the proportion of profits attributable to the second period.

How quickly and accurately the individual (or his professional advisers) would be able to produce the final figures for this second period would depend upon the nature of the business and the sophistication of its accounting procedures. The largest and most sophisticated unincorporated businesses may be producing monthly management accounts that enable them to estimate with a fair degree of accuracy the profits of the period within a fairly short time of the end of the period. Smaller less sophisticated businesses may have less up-to-date financial information but their businesses may be less complex and so permit a quicker estimate to be prepared.

It will always be possible for a business that wishes to adopt a non-fiscal year accounting date to incorporate and bring itself within the corporation tax accounting periods regime. However, we would not wish to see businesses adopt a corporate form merely to escape the straight-jacket of the fiscal year basis for unincorporated businesses. Accordingly, there needs to be a straightforward rule that allows those individuals who have a commercial need to prepare accounts to a non-fiscal year date to submit their returns and pay tax on a satisfactory basis. We believe that this would be achieved by allowing such individuals to file an

<b>TABLE 7</b>				
<b>TIMETABLE FOR FILING RETURNS &amp; PAYING TAX UNDER FISCAL YEAR BASIS</b>				
DATE	TAX YEAR LAST ENDED		CURRENT TAX YEAR	
	RETURN	PAYMENT	RETURN	PAYMENT
1st February	Tax return filed covering all income and gains and including profits for the year (estimated as necessary).	Final balance after deducting payments on account on previous 1st Feb and 1st August.	N/A	Payment on account equal to half of the tax shown in the tax return for the year last ended unless relief for falling profits is claimed.
1st August	Amended tax return filed giving final profits figures for the year	Any additional tax paid together with ordinary commercial interest from 1st February OR tax repayment claimed	N/A	Payment on account equal to balance of last tax year's liability as finally shown in amended return unless relief for falling profits is claimed

amended tax return to report the final taxable profits for the tax year at any time on or before 1st August, 16 months after the end of the tax year in question. The timetable under which such businesses would file their returns and pay tax would be as appears in Table 7.

If desired, the number of businesses entitled to file amended returns on this basis could be limited by extending that entitlement only to those who prepared their accounts to a date

later in the tax year. If, for example a cut-off date of 31st August were adopted, the timetable for the submission of tax returns and payment of tax would then be as set out in Table 8. In the opening year of such a business, a similar rule to that previously suggested could also operate where the business was started between 1st January and 5th April.

<b>TABLE 8</b>			
<b>FILING OF RETURNS &amp; AMENDED RETURNS FOR NON-FISCAL YEAR ACCOUNTING DATES</b>			
DATE ACCOUNTS PREPARED TO	TAX RETURN SUBMITTED BY	AMENDED RETURN SUBMITTED BY	NUMBER OF MONTHS FROM END OF 2ND PERIOD TO FINAL RETURN DATE
Year to between 1st May and 31st August	1st February after the end of the tax year	N/A	Between 9 and 5 months
Year to between 1st September and 28th February	1st February after the end of the tax year	1st August, 16 months after the end of the tax year	Between 11 and 5 months



**TABLE 9**  
**TAX CONSIDERATIONS AFFECTING CHOICE OF ACCOUNTING DATE**

FACTOR	FAVOURS DATE EARLY IN TAX YEAR	FAVOURS FISCAL YEAR
1. Payment of tax	1. Yes	1. No
2. Reduction in interim payments	2. Probably Yes	2. Maybe No
3. Relief for losses	3. No	3. Yes
4. Transitional relief for existing business	4. No	4. Yes
5. Length of reporting period	5. Yes subject to 2.	5. No
6. Bunching of profits on cessation	6. No	6. Yes
7. Freedom to change accounting date	7. Yes but only forwards until fiscal year end is reached	7. No
8. Overall ease of operation and understanding	8. No	8. Yes

#### Bunching of compliance work

One of the main reasons for proposing the CY basis of assessment is to allow for a greater spread of accounting dates across the year, so allowing compliance work to be managed more easily. We have previously referred to the arguments against the adoption of the fiscal year basis in Chapter 4. What is apparent from the proposed CY basis is that for those who have no commercial reason to use a particular accounting date for whom the tax consequences of their choice is therefore important, there are a range of contradictory factors to be taken into account. These are summarised in Table 9.

The clearest advantage to an accounting date early in the tax year is the deferral in tax payments, especially in the opening years and many new businesses may choose this option. On the other hand, many existing businesses will be brought onto a fiscal year basis to avoid the problems of the transition relief to which we refer in the next Chapter. It is far from clear, therefore, that a bunching of compliance work - if it is a problem - will be

avoided under the CY basis. As we noted, a longer reporting period for those businesses with an accounting date early in the year is to an extent illusory, as work for those businesses must start immediately and may in any event be driven by the need to estimate current profits to decide whether a reduction in interim payments out to be claimed.

Under our preferred fiscal year basis, there is no tax advantage attached to using a non-fiscal year accounting date. We might anticipate, therefore, that more businesses will adopt the fiscal year. On the other hand, work for those that do elect for a different date will be spread because of the ability to file an amended tax return up to 1st August.

#### 5.4. PAYMENTS ON ACCOUNT AND EARLY PAYMENT OF TAX

A clear majority of those responding to our questionnaire believed that they should be able to pay tax more frequently than at present. A 25 per cent. wished to pay tax monthly and 38 per cent. quarterly. Only 13.5 per cent. would prefer to pay their tax

annually. There is some attraction in the idea of the self-employed being able to maintain a budget account with the Inland Revenue to which regular instalments can be paid. This would, however, involve a greater degree of administration by the Inland Revenue and can probably be achieved in a more straightforward manner by providing individuals with the facility to acquire certificates or stamps, for example at Post Offices, which can then be used to pay the instalments of tax as they fall due. We believe that the possibility of introducing of such a scheme should be investigated.

Under the present proposals, tax returns and tax payments would be made at the same time. There are obviously administrative issues involved in this: for example, as to whether in fact both cheque and return should actually be sent to a single point within the Inland Revenue or to different locations. However, the practical consequence of this approach seems to us to result in all tax returns being despatched at the same time of the year even though they may have been prepared at an earlier time. If compliance work is genuinely spread across the year we see little point in completed returns gathering dust in a corner of a tax adviser's office waiting for the 1st February to arrive. We believe, therefore, that taxpayers should be encouraged to submit their returns as soon as they are ready to do so.

In part this will be achieved where Revenue assessment is required given the deadline of 1st October for the submission of the return. Thereafter, however, for those that choose to self-assess, we believe that there should be an incentive to file and pay tax as soon as they are able to do so. We recommend, therefore, that those who choose to self-assess should be free to submit their returns and pay the final tax for the last tax year at any time after 1st October. For those concerned a simple lump sum rebate would be allowed from the tax liability to reflect the number of complete months before the final 1st February filing date that the return was submitted.

## 5.5. CONCLUSION

We accept that the administrative arrangements that we have described in this Chapter for our preferred fiscal year basis are more complicated than those proposed for the CY basis where a business chooses an accounting date other than the fiscal year. If a fiscal year date is adopted, the two bases are the same. However, a business will only choose a non-fiscal year date where it has real commercial reasons for doing so and therefore feels that its choice is justified. Under the CY basis, taxation considerations are a relevant factor in the choice of accounting date for all businesses.

The CY basis dispenses with the need for amended returns in most cases. We anticipate that the self-assessment rules will require some facility for amended returns, to deal with cases in which the individual discovers that his previous return was wrong in some respect. However, to adopt the CY basis of assessment, which ensures that tax considerations will feature as a significant factor in what should be commercial decisions, merely so that the need for amended returns in a *minority* of cases can be avoided, appears to us to be undesirable.

At the same time, we do not believe that our preferred fiscal year basis will give rise to any greater bunching problems for compliance work. Inevitably work procedures both in the Inland Revenue and in tax practitioners' offices will need to adjust and this may not be a comfortable experience at first. However, once new routines have been established and taxpayers have come to recognise their obligation to submit tax returns and pay tax on time, we believe that a reasonable spread of work will be achieved. So long as tax is charged by reference to a specified tax year, there will always be peaks and troughs in the work load. However, the system we prefer offers considerable opportunities for work to be spread and for practitioners to offer their clients the incentive to fit in with a reasonable work schedule.

## CHAPTER 5 : FILING RETURNS AND PAYING TAX

## CHAPTER 6.

## THE TRANSITION

## 6.1. TRANSITIONAL ISSUES

The transition from the existing preceding year basis to a new basis gives rise to a number of difficult issues. Principal among them are the following -

- the need to maintain the flow of revenue to the Exchequer over the transitional period;
- the need to ensure that the transition is fair to those affected; and
- the need to see that those affected will not unduly benefit from the transition, for example through any scope to manipulate the rules to their advantage.

We do not consider the first of these issues in this Chapter. Although it featured in our discussions of alternative bases, our final proposal should ensure that there is no interruption in the flow of revenue to the Exchequer. As we saw from Chapter 5, the Government at present receives tax payments from the self-employed on 1st January and 1st July in each year. Under the proposed CY basis this pattern of payments will continue without break. The second Consultative Document envisages that if fiscal year accounting were adopted it would be appropriate to move the payment dates back to 1st February and 1st August each year. This fits in with our conclusions for a fiscal year basis.

## 6.2. THE BASIS PERIOD FOR THE TRANSITION

The first Consultative Document proposed that the transition should occur in a single year. If the CY system were introduced on 6th April 1995, a self-employed individual's income for the tax year 1995-96 would comprise the profits for the trading period ending in that year while those for the

previous tax year, 1994-95, would comprise the profits for the trading period ending in the *preceding* year. Accordingly, if we take an individual who prepares his profits' statement to 30th June in each year, the profits earned between 1st July 1992 and 30th June 1993 would be treated as income of 1994-95 and the profits earned between 1st July 1994 and 30th June 1995 would be treated as income of the year 1995-96. Superficially, this looks very good for the individual: profits earned between 1st July 1993 and 30th June 1994 are not taxed at all. Compared with the unfortunate employee, the self-employed individual is laughing all the way to the bank having enjoyed a large tax holiday.

This perception of the transition is entirely misconceived. As we explained in Chapter 2, the normal rules on a cessation under the PY basis require that a number of months go untaxed on cessation to correspond exactly with the number of months that were taxed more than once on commencement. However, once the CY basis is adopted, *all* profits earned after the transition up to and including cessation will be taxed. An adjustment has to be made on the transition to compensate the individual for the fact that, having started under the PY basis, his opening profits will have been taxed more than once but, by ending under the CY basis, no profits will fall out at the end. Without that adjustment, the balance previously achieved under the PY basis will be disrupted and more profits may be taxed over the lifetime of the business than have been earned by the individual.

In our present example, the straight change from PY to CY disadvantages the individual because only 12 months go untaxed. If the individual started in business on 1st July under the PY basis, the first 12 months' profits would have been taxed two and three quarter times, that is equivalent to 33 months. On the change to the CY basis, however, 24 months, rather than 33 months, are taxed as 12 months. The individual will accordingly

have paid tax on 9 months' more profit than he has earned. This can be seen from Figure 9 when compared with those in Chapter 2. It can also be seen from Table C1 in Appendix C, where on the figures taken the individual ends up paying tax over the life of the business on £109,940 while the actual profits only amount to £99,360.

Whether in actual fact an individual does end up paying tax on more profits than he earns over the life of the business depends upon what the first 12 months' profits were and what profits are earned in the period that drops out on the transition. If the first twelve months' profits escalated to 33 months in our example are still less than the profits taxed in the first year on the CY basis, the transition may prove less favourable than if the business were closed under the PY basis, but the individual would not, overall, be overtaxed. On the other hand, he or she would suddenly find that provision had to be made from current profits for nine months' additional tax that was not otherwise chargeable.

### 6.3. TRANSITIONAL RELIEF

It would clearly be impractical to conduct an investigation into the affairs of every single self-employed person to see whether and to what extent he or she would be prejudiced by the change from the PY to the CY basis with no transitional relief. On the basis that individuals can at present expect that the PY basis will fully adjust their position on a cessation, it seems to us that they ought to be able at the transition to secure the same result. To achieve this, one of two approaches could be adopted -

- the number of months' profits that fall out of account on the transition, as on a cessation under the PY basis, needs to be equivalent to the number of times the first 12 months were taxed, or
- the number of months profits that are taxed under the CY basis after the transition needs to be reduced by the number of months that do not fall out on the transition.

In our example, either 33 months need to be taxed as 12 on the transition, or the nine months' profits that do not fall out on

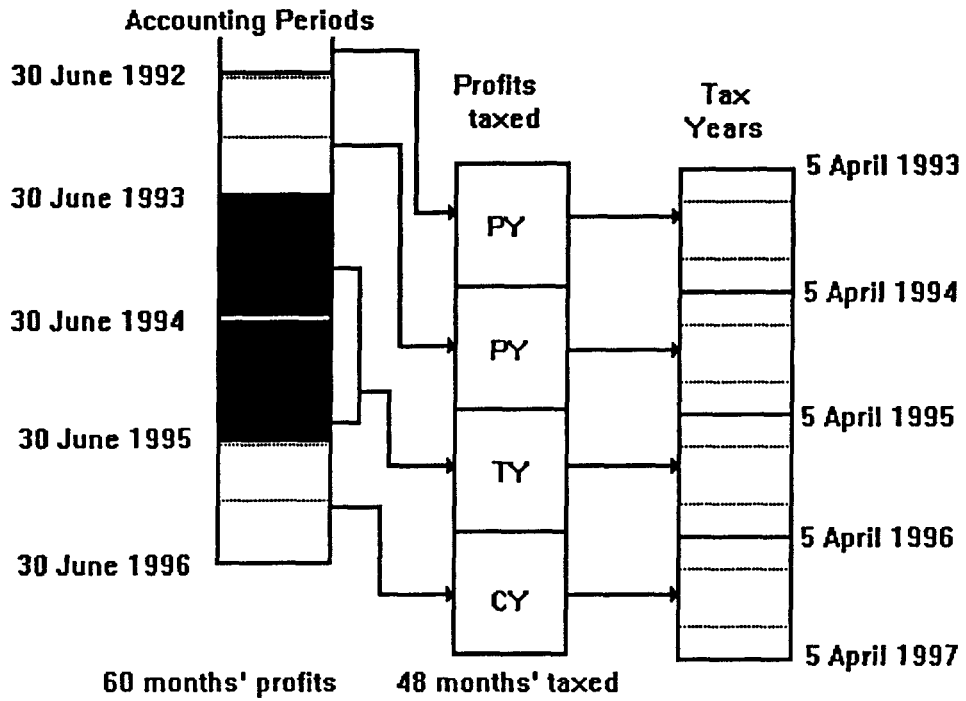
transition need to be deducted from the profits taxed under the CY basis.

The Consultative Documents propose that transitional relief is given through the second of these methods. To the extent that the profits for the first CY year comprise profits that were earned before the start of that year, those profits may be deducted on cessation. Thus in our example, the profits from 1st July 1994 to 5th April 1995 may be deducted when the business ceases. While a straight deduction of that nine months' profits would correct the position the Consultative Document proposes that the deduction should be tapered over six years, so that on a cessation after that time no adjustment is made. The tapering of the relief can clearly result in the over-taxation of an individual, as Table C1-A in Appendix C illustrates: the individual after tapered transitional relief is still taxed on £102,240 as compared with the profits earned of £99,360.

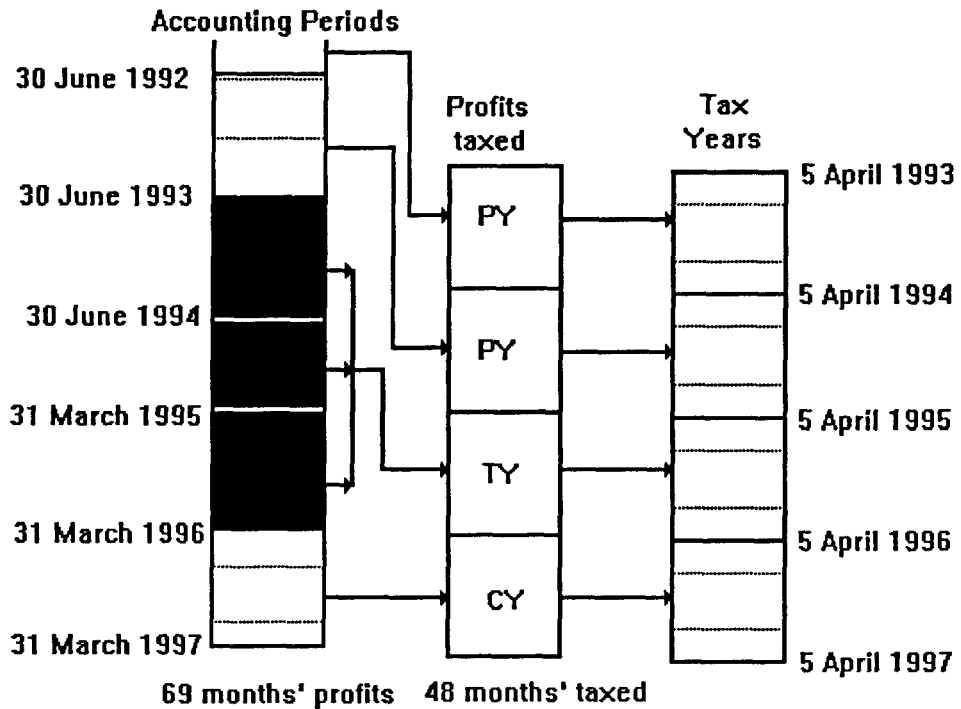
The tapering of relief in this way will produce entirely arbitrary results: some will be over-taxed in absolute terms (as in Table C1). Others will be over-taxed as compared with what they could have expected under the PY basis, even though over the life of the business they may not pay tax on more than they have earned. As such we can see little justification in tapering the transitional relief, especially as the profits deduction it offers will not be indexed for inflation so that its value will be eroded over time in any event. However, those affected by the limited transitional relief offered are free to resolve this problem by changing their accounting date.

If in our example the individual prepares his accounts for 1995 to the 31st March instead of the 30th June, the first profits to come within the CY basis will be those for the year ended 31st March 1996. The profits from 1st July 1993 to 31st March 1995 will not form the basis of assessment for any year. Accordingly only 12 months profits over a 33 month period will be taxed, correcting precisely for the 33 months based on the first 12 months profits of the business. As no part of the profits taxed in 1995-96 have accrued prior to the introduction of the CY system (ignored the five days in April), no transitional relief is needed or given. This is illustrated by Table C2 in Appendix C and by Figure 10.

**FIGURE 9**  
**TRANSITIONAL YEAR WITH 30TH JUNE ACCOUNTING DATE THROUGHOUT**



**FIGURE 10**  
**TRANSITIONAL YEAR WITH CHANGE OF ACCOUNTING DATE TO 31ST MARCH**



If the objective of limited transitional relief is to encourage businesses to adopt a fiscal year basis for the future, we believe that it will have that result in many cases. However, we do not regard this as a satisfactory method of proceeding. New businesses that are free to adopt any accounting date can obtain an advantage in terms of the timing of their future tax payments by adopting a date early in the tax year as compared with existing businesses that have moved onto a fiscal year accounting date to ensure that they are not prejudiced by the transition.

As any existing business will need to consider whether it is prejudiced on the transition, the relief favours the well advised as against those who are not or who do not appreciate the problem until it is too late to do anything about it. It also assumes that those affected are free to change their accounting date. This may be true of the majority but there will be those who are either unable to change their accounting date or who would prefer not to do so for commercial reasons. The very category whom the Consultative Document wishes to accommodate - those with seasonal trades or other commercial reasons for a particular accounting date - are prejudiced by the transitional rules.

#### 6.4. CALCULATION OF TRANSITIONAL PROFITS

A straight-forward switch from the PY basis to the CY basis would result in the profits of some period not forming the income of any year. There would, therefore, be scope to manipulate the results of the business to ensure that the profits of that period were increased and the profits of others reduced. This is the same problem that arises on an ordinary cessation for which the Inland Revenue have power to make adjustments by basing the last three tax years on the actual profits earned. Anti-avoidance rules would accordingly be needed to counter the manipulation of the profits.

The second Consultative Document proposes, however, that there should be a transitional year between the last PY year and the first CY year, and that a 12 month average of the profits for the intervening period should form the income of that transitional year. This is illustrated in Tables C1 and C2 of Appendix C and seems to us to

be the best approach to adopt in the circumstances. If the correct relief is to be given on the transition the number of months from which the 12 months' average is produced for the transitional year must equal the number of months that represent profits taxed more than once on the commencement. Thus in our example, if the transitional year averages the profits of 33 months to arrive at the figure chargeable for 12 months, the correct transitional relief will have been given. This can be seen in Appendix C.

#### 6.5. THE FISCAL YEAR BASIS

Our preferred fiscal year basis avoids all of these problems of over-taxation at the transition. Whether the individual changes his accounting date to coincide with the fiscal year or not, the profits of the transitional year are calculated by reference to the 12 month average of the correct number of months' profits to adjust for the profits that were taxed more than once at the start of the business. This is illustrated by Tables C3 and C5 in Appendix C. No transitional relief is required under our preferred system.

We do not envisage that existing businesses should be required to adopt a fiscal year date after the transition, although if they do not their profits for any trading period for the transitional year and thereafter will have to be apportioned to arrive at the profits that are taxable in the tax year.

If our proposal is adopted for a range of dates between, say, 28th February and 30th April to count as a fiscal year date, there will be a discrepancy of up to one month in favour of businesses with accounting dates after 6th April and against those with dates between 28th February and 5th April. This is illustrated in Tables C4 and C6. In the former case one more month than should do falls into the transitional average and in the latter case one month too few falls into the average.

We can tackle this issue in a number of ways -

- we can ignore it on the basis that only one month's profits are involved;
- we can add one month's profit on the cessation of a 30th April

## CHAPTER 6 : THE TRANSITION

business and deduct one month's profit from a 28th February business - effectively giving a permanent transitional relief along the lines proposed in the Consultative Documents;

- in calculating the transitional average for such businesses we can take 11 months' average profits for those with 28th February date and 13 months' average for those with 30th April dates;
- we can apply the extended fiscal year end rule only to new businesses (for whom the problem does not exist) and require all existing businesses which have and maintain a 28th February or 30th April date to apportion their profits.

Of these, the last produces the right answer - as Tables C3 and C5 illustrate. Thereafter, a deduction or addition on cessation produces the next most accurate result and then the adjustment of the average transitional year profits.

Nevertheless, there are arguments for ignoring the problem and leaving those affected by it to change their accounting date

if they wish to 31st March. The prejudice in this case applies to a more limited number of businesses than those affected by the tapered transitional relief proposed for the CY system. We do not believe that there will be many seasonal businesses that are stating their profits to 28th February or 30th April that cannot change their accounting date to 31st March. The additional computational difficulty of apportioning profits over a single month when many of the businesses concerned have no real commercial reason for adopting their accounting date, may not be justified.

However, as many of those who have adopted a 30th April accounting date may have done so for tax reasons, the benefit of which have been realised to some extent, it seems unfortunate that they should be the principal beneficiaries from ignoring this issue by being taxed on one month's profit less than have been earned. On the other hand, those who have derived little tax benefit from their accounting date of 28th February are penalised by paying tax on one month's extra profit. A simple adjustment at the transition, therefore, to tax a 13 or 11 months' average of profits, may be the appropriate answer even though this does not adjust perfectly for the position. Those not wishing to suffer this form of averaging would have the option to change their accounting date to 31st March.



## CHAPTER 6 : THE TRANSITION

## CHAPTER 7.

### THE SELF-ASSESSMENT OF TOTAL INCOME & GAINS

#### 7.1. INTRODUCTION

The focus of this Report has been almost exclusively on the basis of assessment for self-employed incomes. However, the second Consultative Document is concerned with the broader issue of requiring returns of total income and gains, the abolition of the separate assessment under the Schedular system and the self-assessment of tax by individuals. The proposals made in the second Consultative Document were discussed by the Working Party but we did not consider it necessary to respond directly to the many points of detail covered by it, or to make recommendations in respect of the subjects it covers.

We see the reform of the basis of assessment for the self-employed as a necessary pre-condition for these changes. At the same time, we believe that the adoption of self-assessment, or at the least some system of "Pay & File" for the profits of the self-employed, as a necessary administrative reform for achieving a satisfactory basis of assessment. A Pay & File system not only dispenses with the unnecessary administrative burden of estimated assessments, it can also improve the speed of collection of tax from the self-employed and accordingly goes some way towards putting them on a more equitable basis as compared with the employed taxpayer.

We accordingly support the concept of self-assessment contained in the second Consultative Document, and this was evident also from the tax practitioners who responded to our questionnaire. When asked "Do you support the move towards self-assessment" only five out of 47 responded "No". There was significant support from these respondents to a series of questions based on the summary of proposals for comment contained in Chapter 9 of the second Consultative Document.

We should emphasise that respondents were only asked for an initial reaction to the proposals and significant reservations were expressed by some on the detail of a number of them. We are clear that the second Consultative Document does no more than indicate a *frame-work* within which more detailed proposals can be worked up. As such, a great deal more flesh will need to be placed upon those bones before a final judgment can be made as whether the proposals are satisfactory or not.

#### 7.2. LIMITED SELF-ASSESSMENT

##### PAYE, deduction at source and exemption of income and gains

Any system of self-assessment in the UK is likely to differ from the systems found in many other countries. The UK operates a cumulative PAYE system that is designed to collect the right tax from employees over the course of the year. When this is coupled with a wide basic rate tax band and the collection of tax at source at the basic rate in many cases, the need for universal self-assessment is greatly reduced. Most other countries operate a system for collecting tax from employee salaries over the course of the year, but these do not aim to collect the final liability or incorporate mechanisms under which any under-payment of tax in one year can be taken into account in collecting tax for the following year. A taxpayer in those other countries accordingly needs to submit a tax return to have his or her final liability for the year determined and adjusted.

With the system of PAYE coding, this is unnecessary in the UK. Even over- or underpayments of tax under the PAYE system, together with tax on benefits and expenses, can be coded in or out to ensure that adjustments are made with the minimum of fuss and with a minimum of payments and repayments as between the Revenue and employees outside the PAYE system. For

other income the extended basic rate band and the deduction of tax at the basic rate at source from interest and, in effect, dividends, ensures that tax is collected without the need for returns even where income is received from a variety of sources. The impact of capital gains tax is substantially mitigated by its large annual exemption for individuals. Its complexities, including the indexation of gains, are limited to a small number of taxpayers. In the year to 31st October 1991, only around 160,000 capital gains tax assessments were issued.

Finally, a combination of specific exemptions, such as that for certain National Savings products, and special savings schemes, such as Personal Equity Plans and Tax Exempt Special Savings Accounts, ensure that an increasingly small number of taxpayers have additional tax liabilities in respect of their investment income and gains.

#### Issue of tax returns

At present a taxpayer's principal reporting obligation is to notify new sources of income and disposals of capital assets about a specified threshold. As we understand the proposals made in the second Consultative Document, self-assessment will be limited to those taxpayers to whom a tax return is issued - principally the self-employed and higher rate taxpayers. There will still be no universal obligation on taxpayers to submit a tax return where they have income or gains that are subject to further tax that has not been collected under the PAYE system or by deduction of tax at source.

We believe that this approach requires further consideration. While in the light of the factors that we have identified a system of universal tax returns is unlikely to be necessary, we think that the opportunity could be taken with the introduction of self-assessment to heighten taxpayers' awareness of their obligations under the tax system. If a taxpayer has an obligation to report new sources of income or gains, and is expected to comply with it, he or she might be expected to report that new source by submitting a tax return after the end of the tax year containing details of the income derived from that source.

In this respect we have supported the proposal that the Inland Revenue should

continue to calculate and notify the tax payable by an individual for a tax year provided details of his income and gains are submitted by 1st October following the end of the tax year. We envisage that those who do not regularly submit tax returns but who receive income from a new source during the tax year would avail themselves of that facility. Simplified tax return forms for such taxpayers might be available at Post Offices or other public places. As a step towards increasing general taxpayer awareness and drawing taxpayers' attention to the major changes that the abolition of the Schular system of assessing entails, we believe that the opportunity should be taken on the introduction of the new system to ask all taxpayers to complete a simplified statement setting out their sources of income.

#### 7.3. THE CALCULATION OF INCOME & GAINS

As we noted in Chapter 1, the Schular system has two facets: first, it is the basis for assessing income; second, the Schedule and Cases contain the rules for calculating taxable income in its different forms. In addition, capital gains are calculated under separate provisions. The proposal to abolish the Schular system only affects the mechanism by which tax is assessed on individuals. The Schedules and Cases will continue to form the basis for calculating income for tax purposes.

Complex calculations of taxable income and gains can co-exist with self-assessment where those calculations can be dealt with in a simple manner within the tax return. For example, within reason, a taxpayer need not understand precisely why he is instructed to multiply a figure in one or other column of the return by a particular factor, or why he should add or subtract one figure from another, so long as his instructions to do so are clear. Nevertheless, we believe that there are aspects of the system that will need to be reviewed in the light of a change to self-assessment. This is beyond the scope of this Report but the complexities lie very largely in the area of the taxation of savings and profits and employee benefits. The taxation of savings and profits is the subject of a separate Report by the Capital Taxes Group established by The Institute for Fiscal Studies that will be published shortly.

**7.4. ENFORCEMENT AND REVENUE AUDIT**

The effectiveness of any self-assessment system must ultimately depend upon the Inland Revenue's powers to exact penalties and interest for non-compliance and to audit taxpayers' returns, both in cases where further enquiry is thought to be merited and on a random basis. In relation to Revenue audit, we believe that it is important that taxpayers should be made aware of the reasons why an audit is being conducted into their affairs.

Any system will operate more successfully if it has the support of taxpayers. This requires that it be seen to balance satisfactorily and fairly the interests of tax-

payers and those of the Revenue Department. This in turn means that taxpayers should have adequate rights of appeal or independent review of any administrative action that is taken by the Revenue Department to enforce or secure compliance with the system. We believe that it is also important that taxpayers should be clear as to when their tax affairs for a year have been finalised and that those affairs should not thereafter be subject to later review unless they have been guilty of some irregularity.

Translating these general principles into a satisfactory system that works requires time and detailed public consultation.

## CHAPTER 7 : THE SELF-ASSESSMENT OF TOTAL INCOME & GAINS

## CHAPTER 8.

### EMPLOYEE AND CORPORATE TAXATION

#### 8.1. INTRODUCTION

Chapter 1 outlined the differences and the similarities between the self-employed and employees and businesses carried on in unincorporated and incorporated form. The recommendations of this Report, if implemented, would ensure that all self-employed are taxed equally but do not go a long way to reduce the distinctions that exist between these three categories of taxpayer. A wider review of the tax system would be needed to achieve this. Accordingly, in this Chapter we summarise some of the issues that we believe still arise for consideration

#### 8.2. THE SELF-EMPLOYED & EMPLOYEES

The practical difficulties of devising for the majority of the self-employed something equivalent to the current PAYE system will always mean that the self-employed enjoy an advantage over employees in the timing of payment of tax.<sup>1</sup> The self-employed are also likely to do better through the basic rules for computing income. In theory, expenses which involve an element of personal benefit for the individual should not be deducted in calculating income, whether the income is in the form of business profits or salary. However, the personal element of expenditure may always be a matter of dispute.

In practical terms, it will always be more difficult to monitor and disallow deductions in calculating a self-employed person's profits than it is to disallow expenses incurred by employees. The self-employed person is his own judge of what expense he needs to incur in carrying on his activities. The employer's judgment may be interposed in the case of an employee. In effect, profits under Schedule

D are calculated on the assumption that expenses can be deducted unless they are specifically disallowed. Only such items as entertainment expenditure are subject to a form of blanket disallowance.

On the other hand, under present rules, Schedule E disallows virtually everything unless the expense can be shown to fall within the very narrow compass of section 198 of the Income & Corporation Taxes Act 1988, as interpreted and extended by Inland Revenue practice statement and concession. The maintenance of so strict a Schedule E expenses rule is important for the ease of operation of a PAYE system which is designed to collect the right amount of tax over the year and to limit year-end adjustments for expense claims.

These differences of treatment are not manufactured by the tax system: they arise because the tax system has to recognise and cope with the practical distinctions that exist as between those who are employed and those who carry on a genuine business on their own account. In other respects, however, the tax system must take a greater responsibility for introducing distinctions in the taxation of the two categories that then lead to the distortion of individual choices. The different liabilities that employed and self-employed individuals have under the National Insurance system may stem originally from the different benefit entitlements and the different social protection accorded to each. However, as the benefit principle is eroded and the system of National Insurance Contributions for employees become less distinguishable from ordinary income tax, the advantages to being self-employed in terms of the reduction in National Insurance liabilities becomes greater.

<sup>1</sup> We recognised in our discussions that a closer equivalence could be achieved either by requiring a larger number of payments on account, as is the case in a number of other countries, or by adjusting the tax paid by an interest factor to recognise the delay in payment as compared with the PAYE system. We have not, however, pursued these options in this Report.

### 8.3. INCORPORATED AND UNINCORPORATED BUSINESSES

Companies pay corporation tax by reference to their accounting periods at the corporation tax rate set for the financial year, that is the year to 31st March. Where a company's accounting period straddles two financial years, its profits must be apportioned between the two years and corporation tax calculated accordingly. In this respect, our preferred fiscal year basis would operate in a similar way where an unincorporated business chose a non-fiscal year accounting date.

The important difference that makes it easier to tax company profits as compared with those of unincorporated businesses, is that companies pay tax on *all* their profits to a uniform date after the end of their accounting period rather than on dates fixed by reference to the tax or financial year. Under the Pay & File system of corporation tax, effective in relation to accounting periods ending after 30th September 1990, a company will pay its corporation tax nine months' after the end of the accounting period. No payments on account of that corporation tax liability are made during the accounting period unless the company pays a dividend to its shareholders. In that event, it must account for advance corporation tax ("ACT") at the rate of one-third of the amount of the dividend. ACT must be paid within 14 days of the end of the calendar quarter in which the dividend is due and payable, or 14 days after the end of the accounting period if sooner.

This system works for companies because all corporate income and gains are taxed by reference to accounting periods and companies do not benefit from the same personal allowances and reliefs (ascertained by reference to the tax year) as do the individual proprietors of unincorporated businesses. The AP basis proposed in the first Consultative Document was its equivalent for unincorporated businesses but the practical difficulties of implementing this basis for the self-employed generally led to the AP basis being proposed only for larger businesses which had the size and degree of financial sophistication to operate the basis.

If our proposals are implemented will the balance swing against unincorporated businesses and in favour of the incorporation

of businesses? Ideally, we would like businesses to adopt whichever form is most suited to the needs and efficient functioning of the business. If companies are now taxed more favourably than unincorporated businesses, we may be encouraging the incorporation of businesses that would more sensibly be carried on in unincorporated form. If this is so, it does not arise solely from our own proposals but is inherent also in the proposals made by the Consultative Documents.

To the extent that the change in the basis of assessment for unincorporated businesses accelerates the time at which the individual proprietors pay their income tax, any advantage previously conferred on an unincorporated business in terms of the time of payment of tax is removed and the balance is shifted in favour of incorporation. Under the preceding year basis, careful planning could ensure an advantage for the minority of businesses which could start in unincorporated form, take advantage of the opening year rules and then grow to a size at which it was appropriate to incorporate. If incorporation was judiciously timed, the maximum advantage could be taken of the closing year rules under the preceding year basis.

Our preferred fiscal year basis would make the timing of incorporation unimportant and existing reliefs limiting chargeable gains and preserving losses on incorporation would presumably remain. Nevertheless, there are still many detailed differences between the taxation of companies and of unincorporated businesses that will lead to tax (as well as commercial considerations) being a factor in the decision as to whether to incorporate or not. These distinctions raise broader issues as to the taxation of business profits and, in particular, the retention and distribution of profits by companies and the integration of company and shareholder taxation. These subjects will be dealt with in the final Report by the Capital Taxes Group established by The Institute for Fiscal Studies, whose proposals for the ACE system of corporation tax would reduce the differences that currently exist between the taxation of incorporate and unincorporated businesses.<sup>2</sup>

<sup>2</sup> Equity for Companies: A Corporation Tax for the 1990s, IFS Commentary No.26, April 1991.

## CHAPTER 8 : EMPLOYEE AND CORPORATE TAXATION

The Ruding Committee proposed that unincorporated businesses should be entitled to elect to be taxed as companies.<sup>3</sup> However, now that those professions most closely associated with unincorporated form - solicitors and Chartered Accountants - are entitled to incorporate, most businesses are able to secure corporate taxation by the practical expedient of incorporation. More importantly, however, for the reasons given in Chapter 1, we believe that it would be better to allow closely-held companies to be able to elect for taxation as partnerships if they wish.

There is some evidence that many close-held companies, rather than elect for taxation as partnerships, would prefer to disincorporate. At present, however, there are a series of commercial and tax impediments to such a step. This area was subject to review in 1986 through a joint Department of Trade & Industry and Inland Revenue Consultative Document and it seems appropriate that further consideration should now be given to this subject.

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<sup>3</sup> Commission of the European Communities, Report of the Committee of Experts on Company Taxation, March 1992.





## CHAPTER 9.

## CONCLUSION

## 9.1. THE PRECEDING YEAR BASIS OF ASSESSMENT

Can we now draw together the threads of all the different arguments on the basis for taxing the self-employed and make sense of them? The recommendations that we have made in this Report for a new basis for taxing the self-employed are clear: we favour the adoption of a fiscal year basis. There appears to be widespread agreement that the present preceding year basis assessment has unsatisfactory results. The fact that an individual may be taxed on more or less than he earns over the life of his business and that two individuals with the same income can be liable to pay different amounts of tax is unsatisfactory. The current state of the administration of the self-employed's tax affairs is no cause for satisfaction. Indeed, the argument surrounding the PY basis of assessment is not whether it is a satisfactory way to tax the self-employed in the twenty-first century, but whether what is proposed to be put in its place is a sufficient improvement to warrant the upheaval of change. We have no doubt that our preferred fiscal year basis would represent a sufficient improvement. But does the proposed current year also represent a similar improvement?

Leaving aside the question of whether two individuals with the same profits are taxed equally under the PY basis, the PY basis could be more effectively policed so as to deal with the current administrative state of affairs. Much of the delay on the taxpayers' side may be rather less to do with the PY basis of assessment and rather more with to do with the knowledge that the current time limits are not enforced anyway. However, the retention of the PY basis would clearly be incompatible with any move towards self-assessment, with a single return covering all income. If the objective of changing the system of taxing the self-employed is only concerned with moving to self-assessment, then a change from the preceding year basis to the current year basis probably represents the simplest option: CY is the recognisable off-spring of its rather elderly parent, the PY basis of assessment.

## 9.2. THE RATIONALE FOR THE CURRENT YEAR BASIS

If, however, as the first Consultative Document noted, a fiscal year basis is "the ideal solution" that can be "readily understood and would be very easy for the taxpayer to get right",<sup>1</sup> why should we settle for less if we are to go through the upheaval of changing the system anyway? If there is agreement that the fiscal year basis is the easiest solution which brings the least problems, why adopt a basis of assessment that encourages the self-employed to choose some other accounting date? And yet this is the effect of the CY basis.<sup>2</sup>

The CY basis may ensure that in nearly all cases (but not in every case), the profits taxed over the lifetime of the business will correspond to the profits that are earned, but the tax liabilities of two individuals with the same profits may still differ depending upon how the CY basis spreads those profits across tax years and upon when tax is paid. Under the fiscal year basis the two individuals are always taxed equally on the profits they earn. Indeed, the attraction of the fiscal year basis is recognised by the CY proposals. While the CY basis encourages the adoption of an accounting date early in the tax year, it may involve the bunching of profits on cessation that can be avoided by adopting a fiscal year date. At the same time, the proposed transitional relief provides an incentive for existing businesses to change their accounting date to coincide with the fiscal year.

We can draw two conclusions from this: first, the real concern is the basis of assessment that applies to the minority of businesses that *for genuine commercial reasons* would like to adopt an accounting date different from the tax year. We should

<sup>1</sup> See Chapter 4 above.

<sup>2</sup> The CY basis under which a taxpayer adopts a 31st March or 5th April accounting date produces the same result as our preferred fiscal year basis, but the FY basis offers no tax incentive to be on a different accounting date.

certainly try to accommodate those businesses within the system, but why should we do so in a way that may distort the choices made by *all* businesses? This is the effect of the CY basis: even if an individual eventually decides to adopt a fiscal year date, it seems clear that he should only do so after taking into account the differing tax considerations that arise under the CY basis from that choice. The second conclusion we draw is that the CY basis recognises a concern for the "bunching effect". Here we refer not to the bunching of profits on cessation, but to the bunching of compliance work for the tax professions if the majority of the self-employed who seek professional assistance adopt March or April accounting dates.

In the light of this, we might summarise the net effect of the CY basis as being -

- to accommodate those businesses that need to adopt an accounting date different from the tax year, and
- to offer some continuing tax benefits (albeit reduced as compared with the PY basis) to the self-employed who are professionally advised so that there is a spread of accounting dates and compliance work does not become unduly bunched,
- while at the same time injecting into the system sufficient potential tax disadvantages to a non-fiscal year accounting date as to encourage many to choose the easier option of a fiscal year accounting date.

Is such a balancing act really justified?

### 9.3. THE FISCAL YEAR BASIS

As we have argued in this Report, our preferred fiscal year basis allows an individual to adopt whatever accounting date he likes but offers him no tax advantages for doing so. His choice should, therefore, be based entirely on the commercial requirements of the business.

We may anticipate that on our preferred fiscal year basis there are likely to be more businesses on a fiscal year accounting date

than there would be under the CY basis. We do not under-estimate the problems that this will bring to the tax profession in terms of the organisation of their work and, more particularly, of their clients. However, we think that this problem is very largely an inevitable *transitional* one that any major change of this nature - whether to a CY basis or to our preferred FY basis - will involve. So long as income tax is charged and must be reported by reference to tax years there will be an inevitable bunching of compliance work at certain times of the year. With time, the appropriate work routines and taxpayer discipline will be established. Indeed, we believe that the tax profession should see this as an *opportunity* rather than a problem.

We have concluded that our preferred fiscal year basis is no worse for the bunching of compliance work, and may be better, than the proposed CY basis. The immediate tax compliance task after the end of the tax year is to deal with the reporting of employees' income and benefits under the PAYE system. Thereafter, the 1st October provides a deadline for work on the affairs of those individuals whose tax can still usefully be assessed by the Inland Revenue. Other tax returns must be dealt with by the following 1st February with, under our proposal, an incentive to submit them early to obtain a discount on tax liabilities. Thereafter, there remains the preparation of any amended returns for those businesses whose accounting dates occur between 1st October and 28th February and whose profits must under our system be apportioned. Although amended returns need only be submitted by 1st August, the fact that interest must be paid on any under-estimate of tax (or that tax overpaid can be reclaimed) provides an incentive to deal with these as soon as possible. Then the cycle begins again on 6th April.

That brings us, finally, to the question of amended returns. The fiscal year basis involves a single return of all income on 1st February, but with the prospect that for some an amended return will be needed by 1st August. Does this factor alone justify the rejection of our basis and the adoption of a CY basis? We believe not. To conclude so, despite all else, would be to allow the administrative tail to wag the dog of a sensible tax system.

APPENDIX A :

THE DIFFERENT BASES OF ASSESSMENT  
UNDER PAY & FILE SELF-ASSESSMENT

Overview of Tables A1 to A4

In this Appendix we illustrate the way in which the different bases of assessment that we discuss in our Report would work under a Pay and File system of self-assessment. The bases we consider are the existing preceding year basis, a current year basis as proposed in the Consultative Documents, a compulsory fiscal year basis and a fiscal year basis with apportionment of profits where they are stated for periods other than the tax year.

In each case we have taken as our example a business which commences on 1st January 1991 and continues until 31st December 1996. The business states its profits to 31st December in each year, except under the compulsory Fiscal Year basis. In that case it prepares initial financial statements to 31st March 1991 and thereafter states its profits to 31st March each year while the business continues and to 31st December 1996 in the final year.

The results under each basis are shown in Tables A1 to A4 below. The pattern of profits over the lifetime of the business is shown in columns 1 and 2 and total £74,500. The taxable profit for the relevant tax year is shown in column 4. Under all bases other than the existing PY basis, taxable profits and accounts profits are the same. The difference under the PY basis arises because the profits that are not taxed on cessation are greater than the profits that are taxed three times on commencement.<sup>1</sup> With the adjustment of the final three years of the business to tax the actual profits of those years, £1,500 of the profits escape tax over the lifetime of the business.

Although each of the three other bases tax the whole of the profits earned by the business over its lifetime, the distribution of those profits between tax years differs as between the CY basis, the compulsory FY basis and the FY basis with apportionment. If tax rates, reliefs and allowances fluctuate over the life of the business the outcome of these bases may accordingly differ.

The compulsory FY basis and the FY basis with apportionment produce identical results in terms of the distribution of profits across tax years and the tax liability in each year. The pattern of tax payments may, however, be slightly different depending upon how accurately the business proprietor estimates the profits for the tax year when submitting his or her tax return under the FY basis with apportionment.

The aggregated tax payments for each tax year are shown in column 10 in Tables A1 to A3. This is the aggregate of the figures appearing in columns 6, 7 and 9 which are due on 1st January or February and 1st July or August in the relevant tax year. If the taxpayer accurately estimates his profits for the tax year, the tax payments made for each year under the FY basis with apportionment should be the same as under the compulsory FY basis. We have assumed that under both the compulsory FY basis and the FY basis with apportionment, the reporting and payment dates are put back by one month as compared with the existing PY and proposed CY basis.

From columns 10 in Tables A1 and A2, we can see that, on this pattern of profits, less tax is paid under the CY basis in the initial years as compared with the tax paid under the existing PY basis. Column 9 in Table A2, however, shows the tax payment of which is accelerated under the CY basis. Nevertheless, it is not until 1st January 1997 that the cumulative tax paid under the CY basis (£16,625) exceeds the cumulative tax paid under the PY basis (£16,250).

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<sup>1</sup> On commencement the opening profits of £10,000 are taxed two-and-a-quarter times, so that the "over-taxing" of those profits is equal to £12,500 or £3,125 in tax. On cessation, after adjustment, the profits for the period from 1st January 1993 to 5th April 1994 are untaxed. These amount to £14,000 or £3,500 in tax.

**APPENDIX A :**  
**THE DIFFERENT BASES OF ASSESSMENT UNDER PAY & FILE SELF-ASSESSMENT**

Table A5 summarises the timing of tax payments under each basis. This reveals that tax is paid earlier under either FY basis than under the other two bases. The difference between either FY basis and the CY basis illustrates the advantage under the latter basis of stating profits to a date early in the tax year where the business is profitable and paying tax.

A brief explanation of Tables A1 to A4 is given below.

**Table A1: The PY Basis**

The profits of the first year's trading to 31st December 1991 form the basis of taxable profits for the first three tax years. The accounts must be filed on 1st January 1993 with the individual's tax return for the tax year 1991-92. At the same time tax is paid in respect of the three tax years. We have assumed that tax for both 1990-91 and 1991-92 can still be paid in two instalments to allow for equal payments on 1st January 1993 and 1st July 1993. If the first two years' tax had to be paid in a single instalment, the tax paid on 1st January 1993 would rise to £4,375 and the payment on 1st July 1993 would fall to £1,250.

Although the tax paid on 1st January and 1st July 1993 has been calculated by the individual on final profits figures, the two instalments of £1,250 in respect of the year to 1992-93 may have to be adjusted in the light of other income and gains for the year. The return for 1992-93 will be filed on 1st January 1994, at which date the balance of any tax due on total income (including business profits) will be paid. No figure enters column 9 of Table A1, however, as the balancing payment forms part of the general return of income and gains. This pattern is followed in each year, with the instalments in each year being paid by reference to the reported final profits figures and any adjustment being effected through the general tax return for the year.

In the final years of the business, it is assumed that the in-year instalments continue to be paid by reference to the preceding year's accounts. Thus although 1994-95 and 1995-96 are eventually adjusted to an actual basis, the in-year instalments of tax are made by reference to the preceding year's profits. After the cessation of the business on 31st December 1996, the taxpayer could seek to have the instalment of tax on 1st July 1997 reduced if he could show to the inspector that together with the payment on 1st January 1997 the tax otherwise paid would exceed his final liability. This would not be the case on the present figures.

Following submission of the final accounts on 1st January 1998, the inspector would be required to adjust the final years on to an actual basis as higher taxable profits result from doing so. We have assumed that the final tax liability in respect of these profits is paid on 1st July 1998.

**Table A2: The CY Basis**

Although the business is established in 1990-91, the return for that year which is filed on 1st January 1992 need not include any estimate in respect of the profits earned in that year from the commencement of the business.<sup>2</sup> If the taxpayer has not previously self-assessed and is not otherwise issued with a tax return, no return may actually be filed for this year. Accounts for the first year will be filed on 1st January 1993 together with the individual's tax return for 1991-92. In this respect the CY basis does not differ from the PY basis. At the same time, tax will be paid in one instalment on the profits for the first trading year together with tax on any other income or gains.

Under the CY basis in-year instalments of tax are based on the taxable profits of the preceding year. If columns 6 and 7 of Tables A1 and A2 are compared, it can be seen that the pattern of in-year payments is the same in each of the years 1993 through to 1997 with the exception of the payment on 1st July 1994. Here, it is assumed that the taxpayer makes a claim to reduce the payment of £1,562.50 to take account of the fall in profits in the year to 31st December 1993. If no claim is

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<sup>2</sup> The return might still require the taxpayer to say whether he has started any business in that year and will need him to indicate whether he is conducting any business which started before that tax year (ie before 6th April 1990) in respect of which he has yet to prepare any accounts.

**APPENDIX A :**  
**THE DIFFERENT BASES OF ASSESSMENT UNDER PAY & FILE SELF-ASSESSMENT**

made £1,562.50 will be paid on 1st July 1994 (as it is under the PY basis) and on 1st January 1995 a repayment of £375 will be claimed.

**Table A3: The Compulsory FY Basis**

Under the compulsory FY basis the taxpayer is required to file a tax return in respect of 1990-91 to report the commencement of the business and to submit a statement of the profits for the initial trading period. Tax in respect of those profits is paid on 1st February 1992 together with the first in-year instalment in respect of the tax year 1991-92.

For the majority of taxpayers the preparation of a simple income and expenditure statement, in this example for the first three months of the business, is unlikely to present significant problems. There is, however, clearly some compliance cost involved in having to do so. It might, therefore, be thought appropriate to introduce a special rule enabling an individual starting up in business between 1st January and 5th April in any year to report nil profits for that first period so that no actual statement of profits is required. In the Table, however, we have applied the compulsory FY basis strictly. Even without any "nil profits" rule, taxpayers might, if they wished, prepare their initial financial statements for a period in excess of a year, in this example for the fifteen months to 31st March 1992, but would still be required to submit a return for 1990-91 on 1st February 1992. In that return they would have to estimate their profits for the initial three months and this estimate would form the basis of their tax payment on 1st February. Any under-estimate would form the basis of an amended return which would have to be made by 1st August 1992.<sup>3</sup>

Thereafter the pattern of returns would continue without interruption until cessation, with in-year payments on account being based upon the taxable profits of the preceding year. The payment on 1st August 1994 is again claimed to be reduced following the fall in profits. In the absence of any claim the full instalment of £1,515.62 would be due with a repayment of £218.75 being claimed on 1st February 1995.

**Table A4: The FY Basis with Apportionment**

The taxpayer elects to state profits to 31st December in each year. As a result the profits of each accounting year have to be apportioned as to one-quarter to the first tax year up to 5th April in the period and as to three-quarters for the second tax year starting on 6th April. The individual still has to submit a tax return, including the business profits for the tax year, on 1st February following the end of the tax year. No financial statements are likely to be available for the immediately preceding year to 31st December in time for a 1st February return. Accordingly, the individual will enter an estimated figure in the return, being the *actual* figure for the first nine months' of the tax year and an estimate for the last three months, and pay tax by reference to the aggregate figure. The figure will also form the basis of the first in-year payment for the next tax year.

In the Table we have assumed that the individual is able to estimate the profits accurately and pay tax accordingly. The figures correspond to those appearing in Table A3. However, the individual will have until the following 1st August to file an amended return to adjust the profits shown by reference to the final results for the second accounting year. In this Table the individual has seven months from the end of the second accounting year to check the accuracy of his estimate. Any underestimate must be paid at the latest on 1st August together with interest from 1st February to the date of payment. On 1st August the second interim instalment of tax will take account of any adjustment made in the amended return.

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<sup>3</sup> This would provide a better spread of work for professional advisers as they would review the accounts and prepare the amended return in the period from 1st February to 1st August, before dealing with the returns that are to be submitted by 1st October for Revenue assessment and then moving on to self-assessment returns for the following 1st February.

**TABLE A1  
SUBMISSION OF RETURNS AND PAYMENT OF TAX UNDER A PAY & FILE SYSTEM  
WITH EXISTING PRECEDING YEAR BASIS**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25 %	6. First instalment	7. Second instalment	8. Accounts & tax return	9. Final balance of tax	10. Tax paid in tax year
31.12.91	£10,000	1990-91	£2,500	£625	£312.50 on 1.1.93	£312.50 on 1.7.93	1.1.93	N/A	£NIL
		1991-92	£10,000	£2,500	£1,250 on 1.1.93	£1,250 on 1.7.93	1.1.93	N/A	£NIL
		1992-93	£10,000	£2,500	£1,250 on 1.1.93	£1,250 on 1.7.93	1.1.93	on 1.1.94 with 1992-93 tax return	£2,812.50
31.12.92	£12,500	1993-94	£12,500	£3,125	£1,562.50 on 1.1.94	£1,562.50 on 1.7.94	1.1.94	on 1.1.95 with 1993-94 tax return	£4,375
31.12.93	£11,000	1994-95	£11,000 (adjusted to £12,500 on 1.7.98)	£2,750 (adjusted to £3,125 on 1.7.98)	£1,375 on 1.1.95	£1,375 on 1.7.95	1.1.95	on 1.1.96 with 1994-95 tax return	£2,937.50
31.12.94	£12,000	1995-96	£12,000 (adjusted to £14,250 on 1.7.98)	£3,000 (adjusted to £3,562.50 on 1.7.98)	£1,500 on 1.1.96	£1,500 on 1.7.96	1.1.96	on 1.1.97 with 1995-96 tax return	£2,875
31.12.95	£14,000	1996-97	£14,000	£3,500	£1,750 on 1.1.97	£1,750 on 1.7.97	1.1.97		£3,250
31.12.96	£15,000		adjusted to £11,250	adjusted to £2,812.50	£NIL on 1.1.98	£250 on 1.7.98	1.1.98		
-	-	1997-98	-	-	-	-	-	-	£1,750
-	-	1998-99	-	-	-	-	-	-	£250
<b>TOTAL</b>	<b>£74,500</b>	-	<b>£73,000</b>	<b>£18,250</b>	-	-	-	-	<b>£18,250</b>

**TABLE A2.**  
**SUBMISSION OF RETURNS AND PAYMENT OF TAX UNDER A PAY & FILE SYSTEM**  
**WITH A CURRENT YEAR BASIS**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
		1990-91	£NIL	£NIL	-	-			
31.12.91	£10,000	1991-92	£10,000	£2,500	£NIL on 1.1.92	£NIL on 1.7.92	1.1.93	£2,500 on 1.1.93	£NIL
31.12.92	£12,500	1992-93	£12,500	£3,125	£1,250 on 1.1.93	£1,250 on 1.7.93	1.1.94	£625 on 1.1.94	£3,750
31.12.93	£11,000	1993-94	£11,000	£2,750	£1,562.50 on 1.1.94	£1,187.50 on 1.7.94	1.1.95	£NIL on 1.1.95	£3,437.50
31.12.94	£12,000	1994-95	£12,000	£3,000	£1,375 on 1.1.95	£1,375 on 1.7.95	1.1.96	£250 on 1.1.96	£2,562.50
31.12.95	£14,000	1995-96	£14,000	£3,500	£1,500 on 1.1.96	£1,500 on 1.7.96	1.1.97	£500 on 1.1.97	£3,125
31.12.96	£15,000	1996-97	£15,000	£3,750	£1,750 on 1.1.97	£1,750 on 1.7.97	1.1.98	£250 on 1.1.98	£3,750
-	-	1997-98	-	-	-	-	1.1.99	-	£2,000
<b>TOTAL</b>	<b>£74,500</b>	-	<b>£74,500</b>	<b>£18,625</b>	-	-	-	-	<b>£18,625</b>



**TABLE A3.**  
**SUBMISSION OF RETURNS AND PAYMENT OF TAX UNDER A PAY & FILE SYSTEM**  
**WITH A COMPULSORY FISCAL YEAR BASIS**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in the tax year
3 months to 31.3.91.	£2,500	1990-91	£2,500	£625	£NIL on 1.2.91	£NIL on 1.8.91	1.2.92.	£625 on 1.2.92	£NIL
31.3.92.	£10,625	1991-92	£10,625	£2,656.25	£312.50 on 1.2.92	£312.50 on 1.8.92	1.2.93	£2,031.25 on 1.2.93	£937.50
31.3.93	£12,125	1992-93	£12,125	£3,031.25	£1,328.13 on 1.2.93	£1,328.12 on 1.8.93	1.2.94	£375 on 1.2.94	£3,671.88
31.3.94	£11,250	1993-94	£11,250	£2,812.50	£1,515.63 on 1.2.94	£1,296.87 on 1.8.94	1.2.95	£NIL on 1.2.95	£3,218.75
31.3.95	£12,500	1994-95	£12,500	£3,125	£1,406.25 on 1.2.95	£1,406.25 on 1.8.95	1.2.96	£312.50 on 1.2.96	£2,703.12
31.3.96	£14,250	1995-96	£14,250	£3,562.50	£1,562.50 on 1.2.96	£1,562.50 on 1.8.96	1.2.97	£437.50 on 1.2.97	£3,281.25
9 months to 31.12.96	£11,250	1996-97	£11,250	£2,812.50	£1,781.25 on 1.2.97	£1,031.25 on 1.8.97	1.2.98	£NIL on 1.2.98	£3,781.25
-	-	1997-98	-	-	-	-	1.2.99	-	£1,031.25
<b>TOTAL</b>	<b>£74,500</b>	-	<b>£74,500</b>	<b>£18,625</b>	-	-	-	-	<b>£18,625</b>

**TABLE A4**  
**SUBMISSION OF RETURNS AND PAYMENT OF TAX UNDER A PAY & FILE SYSTEM WITH A FISCAL YEAR BASIS AND**  
**APPORTIONMENT OF PROFITS STATED FOR PERIODS OTHER THAN THE TAX YEAR**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25 %	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	Adjusted return with tax & interest
31.12.91	£10,000	1990-91	£2,500	£625	£NIL on 1.2.91	£NIL on 1.8.91	1.2.92	£625 (estimated) on 1.2.92	By 1.8.92
31.12.92	£12,500	1991-92	£7,500 <u>3,125</u> 10,625	£2,656.25	£312.50 (one-half of estimate) on 1.2.92	£312.50 (balance of final PY tax) on 1.8.92	1.2.93	£2,031.25 (estimated) on 1.2.93	By 1.8.93
31.12.93	£11,000	1992-93	£9,375 <u>2,750</u> £12,125	£3,031.25	£1,328.13 (one-half of estimate) on 1.2.93	£1,328.12 (balance of final PY tax) on 1.8.93	1.2.94	£375 (estimated) on 1.2.94	By 1.8.94
31.12.94	£12,000	1993-94	£8,250 <u>3,000</u> £11,250	£2,812.50	£1,515.62 (one-half of estimate) on 1.2.94	£1,515.63 (balance of final PY tax) on 1.8.94	1.2.95	£NIL (estimated) on 1.2.95	£(218.75) repaid by 1.8.95
31.12.95	£14,000	1994-95	£9,000 <u>3,500</u> £12,500	£3,125	£1,406.25 (one-half of estimate) on 1.2.95	£1,406.25 (balance of final PY tax) on 1.8.95	1.2.96	£312.50 (estimated) on 1.2.96	By 1.8.96
31.12.96	£15,000	1995-96	£10,500 <u>3,750</u> 14,250	£3,562.50	£1,562.50 (one-half of estimate) on 1.2.96	£1,562.50 (balance of final PY tax) on 1.8.96	1.2.97	£437.50 (estimated) on 1.2.97	By 1.2.97
-	-	1996-97	£11,250	£2,812.50	£1,781.25 (one-half of estimate) on 1.2.97	£1,031.25 (based on final PY accounts)	1.2.98	£NIL	-
<b>TOTAL</b>	<b>£74,500</b>	-	<b>£74,500</b>	<b>£18,625</b>	-	-	-	-	-

APPENDIX A :  
THE DIFFERENT BASES OF ASSESSMENT UNDER PAY & FILE SELF-ASSESSMENT

<b>TABLE A5</b>						
<b>SUMMARY OF TAX PAYMENTS UNDER DIFFERENT BASES OF ASSESSMENT</b>						
<b>DATE</b>	<b>PY BASIS</b>		<b>CY BASIS</b>		<b>FY/APPORTIONMENT BASIS <sup>4</sup></b>	
	<b>Tax paid</b>	<b>Cumulative tax</b>	<b>Tax paid</b>	<b>Cumulative tax</b>	<b>Tax paid</b>	<b>Cumulative tax</b>
1.1.92	-	-	-	-	£937.50	£937.50
1.7.92	-	-	-	-	£312.50	£1,250
1.1.93	£2,812.50	£2,812.50	£3,750.00	£3,750.00	£3,359.38	£4,609.38
1.7.93	£2,812.50	£5,625.00	£1,250.00	£5,000.00	£1,328.12	£5,937.50
1.1.94	£1,562.50	£7,187.50	£2,187.50	£7,187.50	£1,890.63	£7,828.13
1.7.94	£1,562.50	£8,750.50	£1,187.50	£8,375.00	£1,296.87	£9,125.00
1.1.95	£1,375.00	£10,125.00	£1,375.00	£9,750.00	£1,406.25	£10,531.25
1.7.95	£1,375.00	£11,500.00	£1,375.00	£11,125.00	£1,406.25	£11,937.50
1.1.96	£1,500.00	£13,000.00	£1,750.00	£12,875.00	£1,875.00	£13,812.50
1.7.96	£1,500.00	£14,500.00	£1,500.00	£14,375.00	£1,562.50	£15,375.00
1.1.97	£1,750.00	£16,250.00	£2,250.00	£16,625.00	£2,218.75	£17,593.75
1.7.97	£1,750.00	£18,000.00	£1,750.00	£18,375.00	£1,031.25	£18,625.00
1.1.98	£NIL	£18,000.00	£250.00	£18,625.00	-	-
1.7.98	£250.00	£18,250.00	-	-	-	-

<sup>4</sup> Payment dates will be 1st February and 1st August in each year.

APPENDIX B :

THE CURRENT YEAR BASIS OF ASSESSMENT

In this Appendix we illustrate the way in which we understand that the CY basis of assessment as proposed in the Consultative Documents would operate. We do so by reference to Tables B1 to B10 and the principal features of these Tables are explained below. We have assumed that the first year in which the CY basis would apply to *new* businesses is that beginning on 6th April 1995. For *existing* businesses we assume that 1995-96 will be the transitional year. The tax rate throughout is taken to be 25 per cent. and no account is taken of any allowances or reliefs that may be available to the taxpayer in any year.

Opening Years of Assessment

Tables B1 and B2 compare the position of two taxpayers, both of whom start in business on 1st August 1995. The first (Table B1) prepares his first financial statements to 31st March 1996 and to 31st March thereafter. The second (Table B2) states her profits to the following 30th June. Column 10 indicates the degree to which payment of tax is deferred where the accounting date is delayed until a date within the following tax year.

It seems that no specific restriction is proposed to prevent an individual choosing to state his opening profits to a date more than 12 months after commencement. Thus, rather than prepare his first financial statements to the 31st March 1996, we imagine that the individual featured in Table B1 could choose the 31st March 1997 instead. In that case, no tax would be paid on the initial profits of £10,500 until 1st January 1998. This may encourage taxpayers to defer preparing any statement of business profits until the second tax year, if profits arise. If initial losses are incurred the opposite incentive applies. Taxpayers will presumably wish to ensure that their income for 1995-96 from other sources is adequate to cover whatever allowances and reliefs they have for that year.

We assume, however, that taxpayers will be required either to prepare their first financial statements to some date in the tax year after that in which the business is started or to make a return of their profits for that second tax year. Thus, a taxpayer who starts in business on 1st March 1996 and who states her or his profits for the first time to 30th April 1997 would presumably be taxed in the tax year 1996-97 by reference to the first 12 months' profits. If not, the first 14 months' profits will not be taxed until 1997-98 and no tax would be due until 1st January 1999, nearly three years after the commencement of business. If this is correct, however, the initial profits of the business will be taxed twice: under the CY basis, the period ended 30 April 1998 will also form the basis of assessment for 1998-99. We assume that "cessation relief" (see below) would then be given.

The Continuing Business

The instalments of tax paid on account of the current year's liability are shown in columns 6 and 7 of each of the Tables. These are based on one-half of the preceding year's liability. The first tax payment after commencement should always be one-and-a-half times the first year's liability. This can be seen from the first figure in column 10 of Tables B1 and B2. Thereafter, the tax paid on 1st January in each year is the *balance* of the tax for the preceding year plus *one-half* of the preceding year's liability. Provision is proposed to be made to enable a taxpayer to claim to reduce the instalments of tax where income for the current year is reduced.

Changes in Accounting Year

Tables B4 and B5 examine the consequences that would flow from a change in the date to which the financial statements are prepared. The Tables take their figures from Table B2 and assume that in 1998-99 the individual concerned decides to alter her accounting year from 30th June to 31st December. Table B4 illustrates the effect on profits and tax payments where this is achieved by stating profits for the 18 months to 31st December 1999 and Table B5 indicates the results of stating

APPENDIX B :  
THE CURRENT YEAR BASIS OF ASSESSMENT

profits for the six months to 31st December 1998. The results are compared below. While the total profits taxed under each scenario are the same, the distribution of those profits over the three tax years varies considerably. The tax paid, on our assumptions, is the same in each case but the time at which that tax is paid differs and, in practice, the tax paid will differ where there are changes in tax rates, allowances and reliefs between the three tax years.

COMPARISON OF TABLES B2, B4 & B5						
TAX YEAR	NO CHANGE (TABLE B2)		18 MONTHS' PROFITS (TABLE B4)		6 MONTHS' PROFITS (TABLE B5)	
	Profits (Col.4)	Tax paid (Col.10)	Profits (Col.4)	Tax paid (Col.10)	Profits (Col.4)	Tax paid (Col.10)
1998-99	£9,750	£2,343.75	£9,750	£2,343.75	£16,000	£2,343.75
1999-00	£12,500	£2,671.88	£19,625	£2,671.88	£13,375	£5,015.63
2000-01	£21,750	£3,468.75	£14,625	£6,140.63	£14,625	£3,015.63
2001-02	-	£3,875	-	£1,203.12	-	£1,984.37
<b>TOTAL</b>	<b>£44,000</b>	<b>£12,359.38</b>	<b>£44,000</b>	<b>£12,359.38</b>	<b>£44,000</b>	<b>£12,359.38</b>

Tables B6 and B7 take their figures from Table B1 and consider what happens if the individual represented in Table B1 decides in 1997-98 to change his accounting year from 31st March to 31st December. In Table B6 he prepares his financial statements for the nine months from 1st April 1997 to 31st December 1997. As this leaves only nine months' profits in charge for the tax year 1997-98, the profits for that year are adjusted to ensure that a full 12 months' profits are still taxed. This results in the first three months of the profits for the accounting year to 31st December 1998 being taxed twice. To adjust for this, a "cessation relief" is proposed. This relief involves deducting at the time of a cessation within six years the profits that have been taxed twice over. The deduction is proposed to be tapered over the six year period. The taper is as follows:

CESSATION RELIEF	
Years following change of accounting year	Amount of profits taxed twice to be deducted
1	Full amount
2	Five-sixths
3	Two-thirds
4	One-half
5	One-third
6	One-sixth
7 +	Nil

Thus in Table B6, profits of £2,250 attributable to the period from 1st January 1998 to 31st March 1998 are taxed in both 1997-98 and 1998-99. If the cessation had occurred during the tax year 1998-99, the taxpayer would have been taxed on the actual profits from 1st April 1998. As the cessation occurs in the second year thereafter, only two-thirds of £2,250 can be deducted from the profits of 2000-01. In Table B7, we compare the position if the individual chooses to state profits for a 21 month period from 1st April 1997 to 31st December 1998. We compare the results of Tables B1, B6 and B7 below.

**APPENDIX B :  
THE CURRENT YEAR BASIS OF ASSESSMENT**

COMPARISON OF TABLES B1, B6 & B7						
TAX YEAR	NO CHANGE (TABLE B1)		9 MONTHS' PROFITS (TABLE B6)		21 MONTHS' PROFITS (TABLE B7)	
	Profits (Col.4)	Tax paid (Col.10)	Profits (Col.4)	Tax paid (Col.10)	Profits (Col.4)	Tax paid (Col.10)
1997-98	£9,000	£2,437.50	£9,562.50	£2,437.50	£10,286	£2,437.50
1998-99	£12,000	£2,437.50	£11,250	£1,875	£18,000	£1,875
1999-00	£14,000	£3,375	£13,500	£3,796.87	£13,500	£6,509
2000-01	£11,250	£3,750	£12,875	£3,656.25	£7,892.67	£2,812.50
2001-02	-	£1,062.50	-	£1,531.25	-	£285.67
<b>TOTAL</b>	<b>£46,250</b>	<b>£13,062.50</b>	<b>£47,187.5</b>	<b>£13,296.8</b>	<b>£49,678.6</b>	<b>£13,919.67</b>

### Closing Years of Assessment

Tables B1 and B2 also illustrate the position that arises on the cessation of the business. The advantage gained by the individual in Table B2 may be compensated for by the bunching of profits that occurs in the final year. Table B3 indicates how that individual's position would be affected if a cessation election were to be introduced, enabling her to have the profits from 1st July 2000 to 31st December 2000 taxed as income of the tax year 2001-02 rather than as income of the year 2000-01.

### Short-life Self-employments

Finally, Tables B8, B9 and B10 illustrate the position under these rules of an individual who switches between employment and self-employment over the space of two tax years. The individual's total income over the two tax years is assumed to be £18,500. In Table B8 the individual is employed until 30th June 1995 and then becomes self-employed. He reverts to employed status on 1st March 1996, having earned income of £6,000 over the previous eight months. His total Schedule E income for 1995-96, all taxed under the PAYE system, is £3,300. He earns £9,200 from the employment in 1996-97, again taxed under the PAYE system.

In Table B9, the individual is self-employed for 13 months from 1st July 1995 and chooses to prepare a single statement of income and expenditure for that period. This shows profits of £9,750. Her Schedule E income, all taxed within the PAYE system, is £2,500 for 1995-96 and for 1996-97 is £6,250. Table B10 contrasts this individual's position if she prepares two statements of income and expenditure: the first to 31st March 1996 and the second to 31st July 1996. The tax paid in each year is summarised below.

COMPARISON OF TABLES B8, B9 & B10						
TAX YEAR	TABLE B8		TABLE B9		TABLE B10	
	Income (Col.4)	Tax paid (Col.10)	Income (Col.4)	Tax paid (Col.10)	Income (Col.4)	Tax paid (Col.10)
1995-96	£9,300	£825	£2,500	£625	£9,250	£625
1996-97	£9,200	£3,800	£16,000	£1,562.50	£9,250	£3,625
1997-98	-	-	-	£2,437.50	-	£375
<b>TOTAL</b>	<b>£18,500</b>	<b>£4,625</b>	<b>£18,500</b>	<b>£4,625</b>	<b>£18,500</b>	<b>£4,625</b>

**TABLE B1**  
**CY BASIS OF ASSESSMENT - 31ST MARCH ACCOUNTING DATE**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
8 months to 31.3.96	£3,000	1995-96	£3,000	£750	£NIL on 1.1.96	£NIL on 1.7.96	1.1.97	£750 on 1.1.97	£NIL
31.3.97	£7,500	1996-97	£7,500	£1,875	£375 (half of PY 1995-96 tax) on 1.1.97	£375 (half of PY 1995-96 tax) on 1.7.97	1.1.98	£1,125 on 1.1.98	£1,125
31.3.98	£9,000	1997-98	£9,000	£2,250	£937.50 (half of PY 1996-97 tax) on 1.1.98	£937.50 (half of PY 1996-97 tax) on 1.7.98	1.1.99	£375 on 1.1.99	£2,437.50
31.3.99	£12,000	1998-99	£12,000	£3,000	£1,125 (half of PY 1997-98 tax) on 1.1.99	£1,125 (half of PY 1997-98 tax) on 1.7.99	1.1.00	£750 on 1.1.00	£2,437.50
31.3.00	£14,000	1999-00	£14,000	£3,500	£1,500 (half of PY 1998-99 tax) on 1.1.00	£1,500 (half of PY 1998-99 tax) on 1.7.00	1.1.01	£500 on 1.1.01	£3,375
9 months to 31.12.00	£11,250	2000-01	£11,250	£2,812.50	£1,750 (half of PY 1999-00 tax) on 1.1.01	£1,062.50 (balance of CY tax due) on 1.7.01	1.1.02	£NIL on 1.1.02	£3,750
-	-	2001-02	-	-	-	-	-	-	£1,062.50
<b>TOTAL</b>	<b>£56,750</b>	-	<b>£56,750</b>	<b>£14,187.50</b>	-	-	-	-	<b>£14,187.50</b>

APPENDIX B :  
THE CURRENT YEAR BASIS OF ASSESSMENT

TABLE B2 CY BASIS OF ASSESSMENT - 30TH JUNE ACCOUNTING DATE WITH NO ELECTION ON CESSATION FOR CONTINUATION TREATMENT									
1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
-	-	1995-96	£NIL	£NIL	-	-	-	-	£NIL
11 months to 30.6.96	£4,875	1996-97	£4,875	£1,218.75	£NIL on 1.1.97	£NIL on 1.7.97	1.1.98	£1,218.75 on 1.1.98	£NIL
30.6.97	£7,875	1997-98	£7,875	£1,968.75	£609.37 (half of PY 1996-97 tax) on 1.1.98	£609.38 (half of PY 1996-97 tax) on 1.7.98	1.1.99	£750 on 1.1.99	£1,828.12
30.6.98	£9,750	1998-99	£9,750	£2,437.50	£984.37 (half of PY 1997-98 tax) on 1.1.99	£984.38 (half of PY 1997-98) on 1.7.99	1.1.00	£468.75 on 1.1.00	£2,343.75
30.6.99	£12,500	1999-00	£12,500	£3,125	£1,218.75 (half of PY 1998-99 tax) on 1.1.00	£1,218.75 (half of PY 1998-99 tax) On 1.7.00	1.1.01	£687.50 on 1.1.01	£2,671.88
Year to 30.6.00 6 months to 31.12.00	£14,250 £7,500	2000-01	£21,750	£5,437.50	£1,562.50 (half of PY 1999-00 tax) on 1.1.01	£1,562.50 (half of PY 1999-00 tax) on 1.7.01	1.1.02	£2,312.50 on 1.1.02	£3,468.75
-	-	2001-02	-	-	-	-	1.1.03	-	£3,875
TOTAL	£56,750	-	£56,750	£14,187.50	-	-	-	-	£14,187.50

APPENDIX B :  
THE CURRENT YEAR BASIS OF ASSESSMENT



APPENDIX B :  
THE CURRENT YEAR BASIS OF ASSESSMENT

<b>TABLE B3</b>									
<b>CY BASIS OF ASSESSMENT - 30TH JUNE ACCOUNTING DATE WITH ELECTION ON CESSATION FOR CONTINUATION TREATMENT</b>									
1. Accounts year	2. Profits	3. Tax Year	4. Taxable profits	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
31.6.00	£14,250	2000-01	£14,250	£3,562.50	£1,562.50 (Half of PY 1999-00 tax) on 1.1.01	£1,562.50 (half of PY 1999-00 tax) on 1.7.01	1.1.02	£437.50 on 1.1.02	£3,468.75
6 months to 31.12.00	£7,500	2001-02	£7,500	£1,875	£937.50 (half of CY 2001-02 tax) on 1.1.02	£937.50 (half of CY 2001-02 tax) on 1.7.02	1.1.03 <sup>1</sup>	£NIL on 1.1.03	£2,937.50
-	-	2002-03	-	-	-	-	-	-	£937.50
<b>TOTAL including Table B2</b>	<b>£56,750</b>	-	<b>£56,750</b>	<b>£14,187.50</b>	-	-	-	-	<b>£14,187.50</b>

<sup>1</sup> We assume that the profits for the six months to 31st December 2000 would still be returned on 1st January 2002 with an election to have them treated as income of the year 2001-02. At the same time half the tax in respect of those profits would presumably still be payable with that return.

**TABLE B4**  
**CY BASIS - CHANGE OF ACCOUNTING DATE**  
**18 MONTHS' ACCOUNTS 1ST JULY 1998 TO 31 DECEMBER 1999**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
30.6.98	£9,750	1998-99	£9,750	£2,437.50	£984.37 (half of PY 1997-98 tax) on 1.1.99	£984.38 (half of PY 1997-98 tax) on 1.7.99	1.1.00	£468.75 on 1.1.00	£2,343.75
18 months to 31.12.99	£19,625	1999-00	£19,625	£4,906.25	£1,218.75 (half of PY 1998-99 tax) on 1.1.00	£1,218.75 (half of PY 1998-99 tax) on 1.7.00	1.1.01	£2,468.75 on 1.1.01	£2,671.88
31.12.00	£14,625	2000-01	£14,625	£3,656.25	£2,453.13 (half of PY 1999-00 tax) <sup>1</sup> on 1.1.01	£1,203.12 (balance of CY tax) on 1.7.01	1.1.02	£NIL on 1.1.02	£6,140.63
-	-	2001-02	-	-	-	-	1.1.03	-	£1,203.12
<b>TOTAL including Table B2</b>	<b>£56,750</b>	-	<b>£56,750</b>	<b>£14,187.50</b>	-	-	-	-	<b>£14,187.50</b>

<sup>1</sup> It is assumed that the taxpayer is unable to justify a reduction in this payment merely because the preceding year's tax was based on 18 months' profits.

**TABLE B5**  
**CY BASIS - CHANGE OF ACCOUNTING DATE**  
**6 MONTHS' ACCOUNTS FROM 1 JULY TO 31 DECEMBER 1998**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
30.6.98  6 months to 31.12.98	£9,750  £6,250	1998-99	£16,000	£4,000	£984.37 (half of PY 1997-98 tax) on 1.1.99	£984.38 (half of PY 1997-98 tax) on 1.7.99	1.1.00	£2,031.25 on 1.1.00	£2,343.75
12 months to 31.12.99	£13,375	1999-00	£13,375	£3,343.75	£2,000 (half of PY 1998-99 tax) <sup>1</sup> on 1.1.00	£1,343.75 (balance of CY tax) on 1.7.00	1.1.01	£NIL on 1.1.01	£5,015.63
31.12.00	£14,625	2000-01	£14,625	£3,656.25	£1,671.88 (half of PY 1999-00 tax) on 1.1.01	£1,671.87 (balance of CY tax) on 1.7.01	1.1.02	£312.50 on 1.1.02	£3,015.63
-	-	2001-02	-	-	-	-	1.1.03	-	£1,984.37
<b>TOTAL including Table B2</b>	<b>£56,750</b>	-	<b>£56,750</b>	<b>£14,187.50</b>	-	-	-	-	<b>£14,187.50</b>

APPENDIX B :  
THE CURRENT YEAR BASIS OF ASSESSMENT

<sup>1</sup> It is assumed that the taxpayer is unable to justify a reduction in this payment merely because the preceding year's tax was based on 18 months' profits.

**TABLE B6**  
**CY BASIS - CHANGE OF ACCOUNTING DATE**  
**9 MONTHS' ACCOUNTS 1ST APRIL TO 31ST DECEMBER 1997**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Return filed	9. Balance of tax	10. Tax paid in tax year
8 months to 31.3.96	£3,000	1995-96	£3,000	£750	£NIL on 1.1.96	£NIL on 1.7.96	1.1.97	£750 on 1.1.97	£NIL
31.3.97	£7,500	1996-97	£7,500	£1,875	£375 on 1.1.97	£375 on 1.7.97	1.1.98	£1,125 on 1.1.98	£1,125
9 months to 31.12.97	£6,750	1997-98	£6,750 (adjusted to £9,562.50 on 1.7.99)	£1,687.50 (adjusted to £2,390.62 on 1.7.99)	£937.50 (half of PY 1996-97 tax) on 1.1.98	£937.50 (half of PY 1996-97 tax) on 1.7.98 <sup>1</sup>	1.1.99	£NIL on 1.1.99 <sup>2</sup>	£2,437.50
12 months to 31.12.98	£11,250	1998-99	£11,250	£2,812.50	£937.50 (half of 1996-97 tax) on 1.1.99 <sup>3</sup>	£1,453.12 (balance of PY 1997-98 tax on account) + £515.62 (balance of 1997-98 tax) on 1.7.99	1.1.00	£421.88 on 1.1.00	£1,875
31.12.99	£13,500	1999-00	£13,500	£3,375	£1,406.25 (half of PY 1998-99 tax) on 1.1.00	£1,406.25 (half of PY 1998-99 tax) on 1.7.00	1.1.01	£562.50 on 1.1.01	£3,796.87
31.12.00	£14,750	2000-01	£14,750 (£ 1,875) <sup>4</sup> £12,875	£3,687.50 (£ 468.75) £3,218.75	£1,687.50 (half PY tax) on 1.1.01	£1,531.25 (half of PY 1999-00 tax) on 1.7.01	1.1.02	£NIL on 1.1.02	£3,656.25
-	-	2001-02	-	-	-	-	1.1.03	-	£1,531.25
<b>TOTAL</b>	<b>£56,750</b>	-	<b>£57,687.50</b>	<b>£14,421.87</b>	-	-	-	-	<b>£14,421.87</b>

<sup>1</sup> We assume that the taxpayer is unable to justify a reduction in this payment merely because the current year's tax returned is based on 9 months' profits.

<sup>2</sup> We assume that a repayment claim could not be made at this time, pending the adjustment for the change in accounting date. We have assumed that the inspector raises an assessment for payment on 1.7.99 of further tax due for 1997-98 and that the taxpayer would be obliged to file an amended return by 1.1.00, and pay any further tax due.

<sup>3</sup> We have assumed that the taxpayer is not entitled to reduce his interim payment to base it on the results of 9 months and that he therefore continues to pay at the previous instalment rate.

<sup>4</sup> Cessation relief; see text for details.

**TABLE B7**  
**CY BASIS - CHANGE OF ACCOUNTING DATE**  
**21 MONTHS' ACCOUNTS 1ST APRIL TO 31ST DECEMBER 1998<sup>1</sup>**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Balance of tax	10. Tax paid in tax year
8 months to 31.3.96	£3,000	1995-96	£3,000	£750	£NIL on 1.1.96	£NIL on 1.7.96	1.1.97	£750 on 1.1.97	£NIL
31.3.97	£7,500	1996-97	£7,500	£1,875	£375 (half of PY 1995-96 tax) on 1.1.97	£375 (half of PY 1995-96 tax) on 1.7.96	1.1.98	£1,125 on 1.1.98	£1,125
-	-	1997-98	£NIL (adjusted to £10,286 on 1.7.99)	£NIL (adjusted to £2,571.50 on 1.7.99)	£937.50 (half of PY 1996-97 tax) on 1.1.98	£937.50 (half of PY 1996-97 tax) on 1.7.97	1.1.99	£NIL on 1.1.00	£2,437.50
21 months to 30.12.98	£18,000	1998-99	£18,000	£4,500	£937.50 (half of 1996-97 tax) on 1.1.99	£1,634 (balance of PY tax on account) + £696.50 (balance of 1997-98 tax) on 1.7.99	1.1.00	£1,928.50 on 1.1.01	£1,875
31.12.99	£13,500	1999-00	£13,500	£3,375	£2,250 (half of PY 1998-99 tax) on 1.1.00	£1,125 (balance of CY tax) on 1.7.00	1.1.01	£NIL on 1.1.01	£6,509
31.12.00	£14,750	2000-01	£14,750 ( 6,857.33) £ 7,892.67	£3,687.50 (£1,714.33) £1,973.17	£1,687.50 (half of PY 1999-00 tax) on 1.1.01	£285.67 (half of CY tax) on 1.7.01	1.1.02	£NIL on 1.1.02	£2,812.50
-	-	2001-02	-	-	-	-	-	-	£285.67
<b>TOTAL</b>	<b>£56,750</b>	-	<b>£60,178.67</b>	<b>£15,044.67</b>	-	-	-	-	<b>£15,044.67</b>

<sup>1</sup> See notes to Table B6 for instalment payments and assessment and reporting of final tax following the change of accounting date.

**TABLE B8  
CY BASIS OF ASSESSMENT - SHORT-TERM SELF-EMPLOYMENT BETWEEN EMPLOYMENTS**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable income	5. Tax due @ 25 %	6. First instalment of Sched D tax	7. Second instalment of Sched D tax	8. Tax return filed	9. Final balance of Sched D tax	10. Tax paid in tax year
8 months to 29.2.96	£6,000	1995-96	£3,300 (Schedule E) £6,000 (Schedule D)	£825 (PAYE) £1,500 (Schedule D)	£NIL on 1.1.96	£NIL on 1.7.96	1.1.97	£1,500 on 1.1.97	£825
-	-	1996-97	£9,200 (Schedule E)	£2,300 (PAYE)	£NIL	£NIL	-	-	£3,800
<b>TOTAL</b>	<b>£6,000</b>	-	<b>£18,500</b>	<b>£4,625</b>	-	-	-	-	<b>£4,625</b>

**TABLE B9  
CY BASIS OF ASSESSMENT - SHORT-TERM SELF-EMPLOYMENT BETWEEN EMPLOYMENTS**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable income	5. Tax due @ 25 %	6. First instalment of Sched D tax	7. Second instalment of Sched D tax	8. Tax return filed	9. Final balance of Sched D tax	10. Tax paid in tax year
-	-	1995-96	£2,500 (Schedule E)	£625	-	-	-	-	£625 (PAYE)
13 months to 31.7.96	£9,750	1996-97	£6,250 (Schedule E) £9,750 (Schedule D)	£1,562.50 (PAYE) £2,437.50 (Schedule D)	£NIL on 1.1.97	£NIL on 1.7.97	1.1.98	£2,437.50 on 1.1.98	£1,562.50 (PAYE)
-	-	1997-98	[Schedule E]	[PAYE]	-	-	-	-	£2,437.50 (Schedule D) [+ PAYE]
<b>TOTAL</b>	<b>£9,750</b>	-	<b>£18,500</b>	<b>£4,625</b>	-	-	-	-	<b>£4,625</b>

**TABLE B10**  
**CY BASIS OF ASSESSMENT - SHORT-TERM SELF-EMPLOYMENT BETWEEN EMPLOYMENTS**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable income	5. Tax due @ 25%	6. First instalment of Sched D tax	7. Second instalment of Sched D tax	8. Tax return filed	9. Final balance of Sched D tax	10. Tax paid in tax year
9 months to 31.3.96	£6,750	1995-96	£2,500 (Schedule E) £6,750 (Schedule D)	£625 (PAYE) £1,687.50 (Schedule D)	£NIL on 1.1.96	£NIL on 1.7.96	1.1.97	£1,687.50 on 1.1.97	£625 (PAYE)
4 months to 31.7.96	£3,000	1996-97	£6,250 (Schedule E) £3,000 (Schedule D)	£1,562.50 (PAYE) £750 (Schedule D)	£375 (half of CY tax) <sup>1</sup> on 1.1.97	£375 (half of CY tax) on 1.7.97	1.1.98	£NIL on 1.1.98	£1,562.50 (PAYE) £2,062.50 (Schedule D)
-	-	1997-98	(Schedule E)	(PAYE)	-	-	-	-	£375 (Schedule D) [ + PAYE]
<b>TOTAL</b>	<b>£9,750</b>	-	<b>£18,500</b>	<b>£4,625</b>	-	-	-	-	<b>£4,625</b>

<sup>1</sup> One-half of the preceding year's liability of £1,687.50 would be £834.75 and it is assumed that the individual claims relief to reduce the interim payment to one-half of the current year's liability.

APPENDIX C :

THE TRANSITIONAL YEAR & TRANSITIONAL RELIEF

In this Appendix we illustrate our understanding of the way in which it is proposed to move existing businesses from the preceding year basis of assessment to the proposed current year basis of assessment. Tables C1 to C6 do this by reference to two individuals who start in business in 1990 under the existing PY system. The transitional year is assumed to be 1995-96 and the tax rate adopted throughout is 25 per cent. No account is taken of any allowances or reliefs available to either individual in any year.

Tables C1 & C1-A

The individual in this case is assumed to have stated his profits to 30th April in each year and he continues on a 30th April accounting year during and after the transition. The accounting year ending on 30th April 1993 is the last full PY basis year. The first full CY year is 1996-97 and the profits of that year are those for the accounting year beginning on 1st May 1995 and ending on 30th April 1996. The transitional year profits accordingly are a 12 month average of the 24 months' profits from 1st May 1993 to 30th April 1995.

Table C1 illustrates that over the life of the business profits of £99,360 are earned but, in the absence of transitional relief, £109,940 of profits are taxed. As we noted in Chapter 2, on cessation under the PY basis profits for a given number of months prior to the year of cessation do not form the basis of any assessment to tax. The number of months that "drop out" corresponds exactly to the number of months that were taken into account *more than once* when the business started. Thus, if on cessation the profits for the first 12 months were taxed two-and-a-half times - equivalent to 30 months profits - then 30 of the months prior to the year of cessation will be covered by the assessment of 12 months' profits. This means that a business carried on under the PY system for six and a quarter years will be taxed on six and a quarter years profits. Tax is assessed for every year of the business's existence. Any mismatch that arises under the PY system is not due to fewer months or years being taxed than the business is actually carried on, but is because the profits of the first months that are taxed more than once are likely to differ from the profits of the final months that are not taxed.

To preserve the equilibrium that exists under the PY system, the same number of months as were taxed more than once on commencement must fall into the transitional year. In Table C1, the profits of the first year's trading to 30th April 1991 were taxed in each of 1990-91, 1991-92 and 1992-93: that is, 35 months. The transitional year, however, only covers 24 months. Accordingly, 11 months of profit - reflected in the profits from 1st May 1995 to 5th April 1996 - are taxed twice. Under the CY basis there is no automatic adjustment for this on cessation. Accordingly, it is proposed that on

cessation within six years of the transition, a transitional relief, equivalent to the cessation relief described in Appendix B, will be given. Under this relief, a proportion of the profits that accrued prior to the introduction of the CY basis but which are taxed on that basis - here the period 1st May 1995 to 5th April 1996 - may be deducted on cessation within six years. The proportion of these profits (£11,550 in Table C1) that may be deducted on cessation is two-thirds. Accordingly the individual will be entitled to reduce the profits of 1998-99 by £7,700 and reduce his tax bill by £1,925. This is shown in Table C1-A.

TRANSITIONAL RELIEF	
Years since transition	Proportion of profits accruing prior to CY basis to be deducted
1 (1996-97)	Full amount
2 (1997-98)	five-sixths
3 (1998-99)	two-thirds
4 (1999-00)	one-half
5 (2000-01)	one-third
6 (2001-02)	one-sixth
7 + (2002 & after)	nil



APPENDIX C :  
THE TRANSITIONAL YEAR & TRANSITIONAL RELIEF

### Table C2

Table C2 demonstrates what happens if the same individual as in Table C1 chooses to change his accounting date to 31st March at the transition. The first full CY year is now based on the profits of the year to 31st March 1997. The transitional year is based on the 12 month average of the 35 months' profits from 1st May 1993 to 31st March 1996. No transitional relief is needed because no part of the profits taxed under the CY basis arose before its introduction (if the 5 days to 5th April 1996 are ignored). At the start of the business the first 12 months profits were taxed to the equivalent of 35 months' profits. In the transitional year 35 months' profits are taxed as the equivalent of 12 months' profits. The individual has accordingly been taxed on the same number of months' profits as he has been in business and this is unaffected on the eventual cessation under the CY basis because tax for final tax year of 1998-99 is now based on the one months' profit to 30th April 1998.

The overall profits earned in the business are £99,360 and the profits actually taxed are £98,447. The discrepancy arises because the profits that are averaged and taxed in the transitional year are higher than those that were taxed more than once at the commencement of the business.

### Table C3

Table C3 adopts our default fiscal year basis, with the apportionment of non-fiscal year accounting periods. We assume that the individual from Table C1 continues to prepare his accounts to 30th April throughout. Our suggestion for treating accounting periods up to 30th April as coincident with the tax year is not adopted in this example. The Table illustrates that the same result is achieved under this basis as in Table C2, but without the necessity for the taxpayer to change his accounting date at the transition. Apportioning the results of the period that straddles the introduction of the CY basis automatically ensures that the 11 months' profits fall into the transitional year.

### Tables C4 & C4-A

Table C4 looks at another individual who earns similar profits but who started in business on 1st March 1990 rather than on 1st May 1990. She accounts throughout to the 28th February. Her position under the CY basis is better than the taxpayer who has accounted to 30th April under Table C1 as her first year's profit under the PY basis was based on only one month of the first 12 months' profits, while under Table C1 it was 11 months. The first 12 months' profits were taxed for 25 months rather than 35 months.

The first CY year 1996-97 is based on the profits of the period ending on 28th February 1997. The transitional year averages the profits of only 24 months rather than 25 months, as the PY basis implies. The change to the CY basis accordingly results in one additional month's profits being taxed - represented by the period from 1st March 1996 to 5th April 1996. Transitional relief may accordingly be claimed in respect of that month's profit, as illustrated in Table C4-A.

### Table C5

Table C5 corresponds to Table C3 but in relation to the 28th February accounting period. It can be seen that the month's profit to 5th April 1996 falls into the transitional year rather than the first CY year and that on cessation 11 months' rather than 12 months' (as under Table C4) is taken into account. No transitional relief is accordingly needed. Under the CY basis, the same result would obtain if the taxpayer changed her accounting date from 28th February to 31st March at the transition, as we demonstrated through Tables C2 and C3 in relation to the first taxpayer.

APPENDIX C :  
THE TRANSITIONAL YEAR & TRANSITIONAL RELIEF

**Table C6**

Table C6 examines the effect of the proposal that accounting dates between 28th February and 30th April should be treated as coincident with the tax year under a default fiscal year basis. From Table C6 it will be noted that one additional month falls into the transitional year where a 30th April year end is used. There is now a mismatch between the number of months for which the first 12 months' profits were taxed on commencement and the number of months that fall into the transitional year: 35 months' profits were taxed on commencement and 36 months' fall into the transitional year. As a result, the profits taxed over the lifetime of the business are reduced from £98,447 in Table C3 to £97,400 in Table C7.

If a 28th February accounting date is treated as equivalent to the fiscal year, the result is the same as that shown in Table C4. One month too few is still taken into account in the transitional year, as compared with that in the opening years of the business. The profits that are taxed are accordingly £98,820 over the life of the business as compared with the £99,360 profits that are earned.

To deal with these mismatches accurately an adjustment needs to be made on cessation: this would tax one *additional* month's profits in the case of Table C6 to ensure that profits for the same number of months are taxed as the number of months the business is carried on. In the case of a 28th February fiscal year equivalent date, one month's profit would be eliminated on cessation: that is, untapered transitional relief would be given. An alternative but less accurate approach is to adjust the position in the transitional year by taxing 13 months' average profits in the case of Table C6 and 11 months' average profits for a 28th February year end. Thus, the profits for 1995-96 in Table C6 would rise from £12,480 to £13,520 and those in Table C4 would fall from £12,540 to £11,495.

**TABLE C1  
TRANSITION TO CY BASIS - 30TH APRIL ACCOUNTING DATE**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
30.4.91	£12,000	1990-91	£11,000	£2,750	£1,375 on 1.1.93	£1,375 on 1.7.93	1.1.93	N/A	£NIL
		1991-92	£12,000	£3,000	£1,500 on 1.1.93	£1,500 on 1.7.93	1.1.93	N/A	£NIL
		1992-93	£12,000	£3,000	£1,500 on 1.1.93	£1,500 on 1.7.93	1.1.94	N/A	£4,375
30.4.92	£12,120	1993-94	£12,120	£3,030	£1,515 on 1.1.94	£1,515 on 1.7.94	1.1.95	N/A	£5,890
30.4.93	£12,240	1994-95	£12,240	£3,060	£1,530 on 1.1.95	£1,530 on 1.7.95	1.1.96	N/A	£3,045
30.4.94	£12,360	1995-96	£12,420	£3,105	£1,530 on 1.1.96	£1,530 on 1.7.96	1.1.97	£45 on 1.1.97	£3,060
30.4.95	£12,480								
30.4.96	£12,600	1996-97	£12,600	£3,150	£1,552.50 on 1.1.97	£1,552.50 on 1.7.97	1.1.98	£45 on 1.1.98	£3,127.50
30.4.97	£12,720	1997-98	£12,720	£3,180	£1,575 on 1.1.98	£1,575 on 1.7.98	1.1.99	£30 on 1.1.99	£3,172.50
30.4.98	£12,840	1998-99	£12,840	£3,210	£1,590 on 1.1.99	£1,590 on 1.7.99	1.1.00	£30 on 1.1.00	£3,195
-	-	1999-00	-	-	-	-	1.1.01	-	£1,620
<b>TOTAL</b>	<b>£99,360</b>	-	<b>£109,940</b>	<b>£27,485</b>	-	-	-	-	<b>£27,485</b>

APPENDIX C :  
THE TRANSITIONAL YEAR & TRANSITIONAL RELIEF

**TABLE C1-A**  
**TRANSITION TO CY BASIS - 30TH APRIL ACCOUNTING DATE**  
**TRANSITIONAL RELIEF ON CESSATION**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
30.4.98	£12,840	1998-99	£12,840 (£ 7,700) £ 5,140	£3,210 (£1,925) £1,285	£1,285 on 1.1.99	£NIL on 1.7.99	1.1.00	£NIL on 1.1.00	£2,890
-	-	1999-00	-	-	-	-	1.1.01	-	£NIL
<b>TOTAL</b>	<b>£99,360</b>	-	<b>£102,240</b>	<b>£25,560</b>	-	-	-	-	<b>£25,560</b>

APPENDIX C :  
THE TRANSITIONAL YEAR & TRANSITIONAL RELIEF

<b>TABLE C2</b>									
<b>TRANSITION TO CY BASIS - 30TH APRIL ACCOUNTING DATE CHANGED TO 31ST MARCH ON TRANSITION</b>									
1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
		1990-91	£11,000	£2,750	£1,375 on 1.1.93	£1,375 on 1.7.93	1.1.93	N/A	£NIL
30.4.91	£12,000	1991-92	£12,000	£3,000	£1,500 on 1.1.93	£1,500 on 1.7.93	1.1.93	N/A	£NIL
		1992-93	£12,000	£3,000	£1,500 on 1.1.93	£1,500 on 1.7.93	1.1.94	N/A	£4,375
30.4.92	£12,120	1993-94	£12,120	£3,030	£1,515 on 1.1.94	£1,515 on 1.7.94	1.1.95	N/A	£5,890
30.4.93	£12,240	1994-95	£12,240	£3,060	£1,530 on 1.1.95	£1,530 on 1.7.95	1.1.96	N/A	£3,045
31.3.94 31.3.95 31.3.96	£11,330 £12,470 £12,590	1995-96	£12,477	£3,119.25	£1,530 on 1.1.96	£1,530 on 1.7.96	1.1.97	£59.25 on 1.1.97	£3,060
31.3.97	£12,710	1996-97	£12,710	£3,177.50	£1,559.63 on 1.1.97	£1,559.62 on 1.7.97	1.1.98	£58.25 on 1.1.98	£3,148.88
31.3.98	£12,830	1997-98	£12,830	£3,207.5	£1,588.75 on 1.1.98	£1,588.75 on 1.7.98	1.1.99	£30 on 1.1.99	£3,206.62
One month to 30.4.98	£1,070	1998-99	£1,070	£267.50	£133.75 on 1.1.99	£133.75 on 1.7.99	1.1.00	£NIL on 1.1.00	£1,752.50
-	-	1999-00	-	-	-	-	1.1.01	-	£133.75
<b>TOTAL</b>	<b>£99,360</b>	-	<b>£98,447</b>	<b>£24,611.75</b>	-	-	-	-	<b>£24,611.75</b>

**TABLE C3**  
**TRANSITION TO FISCAL YEAR BASIS WITH APPORTIONMENT**  
**30TH APRIL ACCOUNTING DATE**

1. Accounts year <sup>1</sup>	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
		1990-91	£11,000	£2,750	£1,375 on 1.1.93	£1,375 on 1.7.93	1.1.93	N/A	£NIL
30.4.91	£12,000	1991-92	£12,000	£3,000	£1,500 on 1.1.93	£1,500 on 1.7.93	1.1.93	N/A	£NIL
		1992-93	£12,000	£3,000	£1,500 on 1.1.93	£1,500 on 1.7.93	1.1.94	N/A	£4,375
30.4.92	£12,120	1993-94	£12,120	£3,030	£1,515 on 1.1.94	£1,515 on 1.7.94	1.1.95	N/A	£5,890
30.4.93	£12,240	1994-95	£12,240	£3,060	£1,530 on 1.1.95	£1,530 on 1.7.95	1.1.96	N/A	£3,045
30.4.94 30.4.95 5.4.96	£12,360 £12,480 £11,550	1995-96	12/35ths of £36,390 = £12,477	£3,119.25	£1,530 on 1.1.96	£1,530 on 1.7.96	1.1.97	£59.25 on 1.1.97	£3,060
6.4.96 to 30.4.96	£1,050	1996-97	£1,050 + £11,660	£3,177.50	£1,559.63 on 1.1.97	£1,559.62 on 1.7.97	1.1.98	£58.25 1.1.98	£3,148.88
30.4.97	£12,720	1997-98	£1,060 + £11,770	£3,207.50	£1,588.75 on 1.1.98	£1,588.75 on 1.7.98	1.1.99	£30 on 1.1.99	£3,206.62
30.4.98	£12,840	1998-99	£1,070	£267.50	£133.75 on 1.1.98	£133.75 on 1.7.98	1.1.00	£NIL on 1.1.00	£1,752.50
-	-	1999-00	-	-	-	-	1.1.01	-	£133.75
<b>TOTAL</b>	<b>£99,360</b>	<b>1999-00</b>	<b>£98,447</b>	<b>£24,611.75</b>	<b>-</b>	<b>-</b>	<b>1.1.01</b>	<b>-</b>	<b>£24,611.75</b>

<sup>1</sup> Throughout the taxpayer uses a 30th April accounting year but from the transitional year onwards the results of each year are apportioned between the relevant tax years. Thus eleven-twelfths of the accounting year to 30th April 1996 is apportioned to the transitional year and one-twelfth to the first CY year, 1996-97. Thereafter, the profits are apportioned one-twelfth/eleven-twelfths between the tax years.

APPENDIX C :  
THE TRANSITIONAL YEAR & TRANSITIONAL RELIEF

<b>TABLE C4</b>									
<b>TRANSITION TO CY BASIS - 28TH FEBRUARY ACCOUNTING DATE</b>									
1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
		1989-90	£1,000	£250	£125 on 1.1.92	£125 on 1.7.92	1.1.92	N/A	£NIL
28.2.91	£12,000	1990-91	£12,000	£3,000	£1,500 on 1.1.92	£1,500 on 1.7.92	1.1.92	N/A	£NIL
		1991-92	£12,000	£3,000	£1,500 on 1.1.92	£1,500 on 1.7.92	1.1.93	N/A	£3,125
29.2.92	£12,120	1992-93	£12,120	£3,030	£1,515 on 1.1.93	£1,515 on 1.7.93	1.1.94	N/A	£4,640
29.2.93	£12,240	1993-94	£12,240	£3,060	£1,530 on 1.1.94	£1,530 on 1.7.94	1.1.95	N/A	£3,045
28.2.94	£12,360	1994-95	£12,360	£3,090	£1,545 on 1.1.95	£1,545 on 1.7.95	1.1.96	N/A	£3,075
28.2.95	£12,480	1995-96	£12,540	£3,135	£1,545 on	£1,545 on	1.1.97	£45 on	£3,090
28.2.96	£12,600				on 1.1.96	on 1.7.96		1.1.97	
29.2.97	£12,720	1996-97	£12,720	£3,180	£1,567.50 on 1.1.97	£1,567.50 on 1.7.97	1.1.98	£45 on 1.1.98	3,157.50
28.2.98	£12,840	1997-98	£12,840	£3,210	£1,590 on 1.1.98	£1,590 on 1.7.98	1.1.99	£30 on 1.1.99	£3,202.50
-	-	1998-99	-	-	-	-	1.1.00	-	£1,620
<b>TOTAL</b>	<b>£99,360</b>	-	<b>£99,820</b>	<b>£24,955</b>	-	-	-	-	<b>£24,955</b>

<b>TABLE C4 - A</b> <b>TRANSITION TO CY BASIS - 28TH FEBRUARY ACCOUNTING DATE</b> <b>TRANSITIONAL RELIEF ON CESSATION</b>									
1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
28.2.98	£12,840	1997-98	£12,840 (£ 883) £11,957	£3,210 (£ 221) £2,989	£1,590 on 1.1.98	£1,399 on 1.7.98	1.1.99	£NIL on 1.1.99	£3,202.50
-	-	1998-99	-	-	-	-	1.1.00	-	£1,399
<b>TOTAL</b>	<b>£99,360</b>	-	<b>£98,937</b>	<b>£24,734</b>	-	-	-	-	<b>£24,734</b>



**TABLE C5  
TRANSITION TO FISCAL YEAR BASIS WITH APPORTIONMENT  
28TH FEBRUARY ACCOUNTING DATE**

1. Accounts year <sup>2</sup>	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25%	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
		1989-90	£1,000	£250	£125 on 1.1.92	£125 on 1.7.92	1.1.92	N/A	£NIL
28.2.91	£12,000	1990-91	£12,000	£3,000	£1,500 on 1.1.92	£1,500 on 1.7.92	1.1.92	N/A	£NIL
		1991-92	£12,000	£3,000	£1,500 on 1.1.92	£1,500 on 1.7.92	1.1.93	N/A	£3,125
29.2.92	£12,120	1992-93	£12,120	£3,030	£1,515 on 1.1.93	£1,515 on 1.7.93	1.1.94	N/A	£4,640
29.2.93	£12,240	1993-94	£12,240	£3,060	£1,530 on 1.1.94	£1,530 on 1.7.94	1.1.95	N/A	£3,045
28.2.94	£12,360	1994-95	£12,360	£3,090	£1,545 on 1.1.95	£1,545 on 1.7.95	1.1.96	N/A	£3,075
28.2.95 28.2.96 5.4.96	£12,480 £12,600 £1,060	1995-96	12/25ths of £26,140 = £12,547.20	£3,136.80	£1,545 on on 1.1.96	£1,545 on on 1.7.96	1.1.97	£46.80 on 1.1.97	£3,090
6.4.96 to 28.2.97	£11,660	1996-97	£11,660 + £1,070	£3,182.50	£1,568.40 on 1.1.97	£1,568.40 on 1.7.97	1.1.98	£45.70 on 1.1.98	3,160.20
28.2.98	£12,840	1997-98	£11,770	£2,942.50	£1,591.25 on 1.1.98	£1,351.25 on 1.7.98	1.1.99	£NIL on 1.1.99	£3,205.35
		1998-99					1.1.00		£1,351.25
<b>TOTAL</b>	<b>£99,360</b>	<b>-</b>	<b>£98,767.20</b>	<b>£24,691.80</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>£24,691.80</b>

<sup>2</sup> Throughout the taxpayer uses a 28th February accounting date but from the transitional year onwards the results of each year are apportioned between the relevant tax years. Thus one-twelfth of the accounting year to 28th February 1996 is apportioned to the transitional year and eleven-twelfths to the first CY year, 1996-97. Thereafter the profits are apportioned eleven-twelfths/one-twelfth between the tax years.

**TABLE C6**  
**TRANSITION TO FISCAL YEAR BASIS**  
**30TH APRIL AS FISCAL YEAR EQUIVALENT ACCOUNTING DATE**

1. Accounts year	2. Profits	3. Tax Year	4. Taxable profit	5. Tax due @ 25 %	6. First instalment	7. Second instalment	8. Tax return filed	9. Final balance of tax	10. Tax paid in tax year
		1990-91	£11,000	£2,750	£1,375 on 1.1.93	£1,375 on 1.7.93	1.1.93	N/A	£NIL
30.4.91	£12,000	1991-92	£12,000	£3,000	£1,500 on 1.1.93	£1,500 on 1.7.93	1.1.93	N/A	£NIL
		1992-93	£12,000	£3,000	£1,500 on 1.1.93	£1,500 on 1.7.93	1.1.94	N/A	£4,375
30.4.92	£12,120	1993-94	£12,120	£3,030	£1,515 on 1.1.94	£1,515 on 1.7.94	1.1.95	N/A	£5,890
30.4.93	£12,240	1994-95	£12,240	£3,060	£1,530 on 1.1.95	£1,530 on 1.7.95	1.1.96	N/A	£3,045
30.4.94 30.4.95 30.4.96 (= 5.4.96)	£12,360 £12,480 £12,600	1995-96	£12,480	£3,120	£1,530 on 1.1.96	£1,530 on 1.7.96	1.1.97	£60 on 1.1.97	£3,060
30.4.97 (= 5.4.97)	£12,720	1996-97	£12,720	£3,180	£1,560 on 1.1.97	£1,560 on 1.7.97	1.1.98	£60 on 1.1.98	£3,150
30.4.98 (= 5.4.98)	£12,840	1997-98	£12,840	£3,210	£1,590 on 1.1.98	£1,590 on 1.7.98	1.1.99	£30 on 1.1.99	£3,210
-	-	1998-99	-	-	-	-	1.1.00	-	£1,620
<b>TOTAL</b>	<b>£99,360</b>		<b>£97,400</b>	<b>£24,350</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>£24,350</b>



APPENDIX D :

ANALYSIS OF RESPONSES TO TAXPAYERS' QUESTIONNAIRE

Approximately 630 questionnaires were distributed to two sample groups of small businesses. The first represented a sample of self-employed individuals who had previously participated in research by the Institute of Advanced Legal Studies. The second sample group comprised small businesses who are members of the London Chamber of Commerce & Industry. This second sample included both unincorporated businesses and companies. Company respondents were asked merely to answer the final three questions on the questionnaire dealing with self-assessment of total income.

Some 145 responses were received of which 106 were received from self-employed individuals and 39 from companies. The variety of occupation carried on by the respondents is illustrated by the responses to our first question

<i>Qu.1: What is the nature of your business?</i>			
Accountants	Solicitors	Shop fitters	Import/export
International courier	Garden supplies	Retailer	Fire extinguisher sales
Security consultant	Surveyors	Printer	Contract toolmakers
Pallet dealer	Builder	Insurance brokerage	Landscape gardener
Financial adviser	Freight forwarding	Consultant	Business gifts
Interior design consultant	Management consultant	European business consultant	Domestic appliance servicing
Architect	Computer consultant	Caterer	Hairdresser
Demolition expert	Employment bureau	Telephone installer	Embroiderer
Yarn processors	Clockmakers	Driving instructor	Wine merchant
Umbrella manufacturer	Garden equipment repairs & service	Air conditioning sales & service	Water treatment sales & service
Pneumatic engineer	Manufacturer	Jewellers	Market research
Suspended ceiling contractors	Exhibition display manufacturers	Human resource consultancy	Employee benefits consultant
Business communications	Import/export representative	Textile machinery exporter	Public relations consultant
Pharmaceuticals exporter	Home insulation consultant	Special effects manufacturer	Primary battery distributor
Ink manufacturer	Metal trader	Gemstone wholesaler	Stationers
Shipping & transport	Computer salesman	Information retrieval	Carpet contractor
Sign maintenance & installation	Interior design consultant	Furniture manufacturer	Civil engineer

The range of dates to which the self-employed respondents prepared their accounts was illustrated by the response to our second question.

<i>Qu.2: What is the date to which you prepare your accounts?</i>											
<i>The year ending in the month to -</i>											
31.1.	28.2	5.4	30.4	31.5	30.6	31.7	31.8	30.9	31.10	30.11	31.12
7	3	23	17	4	11	5	10	6	5	4	11

APPENDIX D : ANALYSIS OF RESPONSES TO TAXPAYERS' QUESTIONNAIRES

Respondents were then asked whether they had particular reasons for adopting their accounting date. (Where more than one response was given, for example "my accountant advised it for tax reasons", the firm has been entered for each response.)

<i>Qu.3: Are there any particular reasons for choosing your accounting date?</i>							
12 months from start	No reason	Accountant advised	Tax reasons	Seasonal business	Aligned with VAT	Associated firm abroad	Other reasons
36	24	22	13	12	2	2	3

Analysis of those who indicated that they took their accountant's advice as to the date on which they should adopt reveals the following choices:

<i>Accounting date adopted on the advice of an accountant</i>											
<i>Year ending within month to -</i>											
31.1	28.2	5.4	30.4	31.5	30.6	31.7	31.8	30.9	31.10	31.11	31.12
2	-	4	9	-	2	-	2	-	1	2	1

A number of those who indicated that they took their accountants advice also indicated that the advice was given for tax reasons. The dates adopted in these cases were mainly those ending on 30th April but with a number to 5th April. Overall, those who indicated that their choice had been made for tax reasons adopted the following accounting dates:

<i>Accounting date adopted for tax reasons</i>											
<i>Year ending within month to -</i>											
31.1	28.2	5.4	30.4	31.5	30.6	31.7	31.8	30.9	31.10	31.11	31.12
-	-	3	7	1	1	-	-	-	-	1	1

We included as "seasonal" any respondent who indicated that the accounts were prepared to a "quieter" time of the year or who indicated that to prepare accounts to the fiscal year would coincide with a particularly busy time of year for his or her type of business.

<i>Accounting date adopted because the business is seasonal</i>											
<i>Year ending within month to -</i>											
31.1	28.2	5.4	30.4	31.5	30.6	31.7	31.8	30.9	31.10	31.11	31.12
1	-	1	-	1	-	1	2	2	2	1	1

**APPENDIX D : ANALYSIS OF RESPONSES TO TAXPAYERS' QUESTIONNAIRES**

The nature of the businesses concerned were as follows:

International couriers	31.3	Insurance brokerage	30.9	Landscape gardener	31.5
Boarding kennels	30.9	Business gift supplier	31.12	Garden machinery sales & service	30.11
Landscape gardener	31.8	Retailer	31.1	Employee benefits consultants	31.8
Air conditioning sales & service	31.10	Special effects manufacturer	31.10	Business communications	31.7

Respondents were then told that any new system would be simpler if businesses prepared their accounts to correspond more closely to the tax year. Individuals who did not already prepare their accounts within the period 1st March to 30th April were asked whether they would be willing to change their accounting date to one within that period.

<b><i>Qu.4: Would you be willing to change your accounting date to a date falling between 1st March and 30th April?</i></b>											
<i>Respondents answering YES - 46 with accounting dates ending within the following months -</i>											
31.1	28.2	5.4	30.4	31.5	30.6	31.7	31.8	30.9	31.10	30.11	31.12
6	3	N/A	N/A	3	9	4	7	1	3	4	6
<i>Respondents answering NO -20 with accounting dates ending within the following months -</i>											
31.1	28.2	5.4	30.4	31.5	30.6	31.7	31.8	30.9	31.10	30.11	31.12
-	-	N/A	N/A	1	2	1	3	5	2	0	5

Question 5 then asked those respondents who answered Question 4 in the negative whether there were particular reasons why it would be difficult to prepare accounts to a date within the period 1st March to 30th April. Of the 12 respondents who indicated that their business was seasonal, six were not prepared to change their accounting date and seasonality featured among their reasons for this response. Four indicated that they would do so, although two stated that if they had to change, it would be preferable to change to a calendar year. Two did not answer Questions 4 and 5.

Of the other respondents concerned, five indicated that they had no particular reasons for their response although there was concern from three of them that their accountants would not cope if all clients were on a fiscal year end. Of those who gave reasons, one objected to having to prepare accounts for either six or eighteen months and another to the loss of convenience as the firm's rent, salaries and insurance policies currently ran to the accounting date in September. The two firms that prepared accounts to coincide with associated firms abroad indicated that it would be inconvenient to have a different date. Another firm had aligned its tax computations with its VAT returns on the calendar year and did not wish to change. Three perceived that they would suffer a tax disadvantage if they changed their accounting date. One did not answer Question 5.

APPENDIX D : ANALYSIS OF RESPONSES TO TAXPAYERS' QUESTIONNAIRES

Respondents were then asked whether they were registered for VAT and, if so, to indicate their VAT return dates. They were then asked whether they thought it would be helpful if their accounting date for income tax purposes could be aligned with their VAT return date. The responses are shown below.

**Qus. 6 & 7: Are you registered for VAT and, if so, what are your VAT return dates?**

*Not registered - 19*  
*Registered - 88*  
*of which VAT return dates are -*

Monthly	Dec/Mar/ June/Sept	Jan/April July/Oct	Feb/May Aug/Nov	Annual	Other	No response
3	23	18	23	1	2	16

**Qu.8: Do you think that it would be helpful if the date to which you prepared your business accounts were the same as a date to which you submit a VAT return?**

*Helpful - 58*  
*Not helpful - 22*

Of those respondents submitting quarterly VAT returns who answered, 39 already had their accounting date aligned with their VAT return date although of these 5 thought it was not helpful to align the two. Two respondents gave the VAT return date as a reason for adopting their particular accounting date, although one of those had a *different* accounting date to his VAT return date. Two others, who did not give VAT reasons for their accounting date, noted that it was easier for them that the VAT date and their accounting date did coincide and another respondent said that this was "essential". One further respondent indicated that he had just changed his VAT return period for this reason.

Those that prepared their accounts to a date in April were least likely to have a VAT return period that coincided with their accounting date. 20 out of 21 respondents with such dates were registered for VAT and 4 had VAT return periods to coincide with their accounting date. Of the remaining 16, 5 thought that aligning the two dates would not be helpful while the rest thought that it would be.

The final question to the self-employed respondents reminded that they currently paid income tax on their profits in two instalments. They were asked whether they would prefer to pay their tax more or less frequently.

**Qu.9: Would you like to be able to pay tax on your business profits more or less frequently?**  
*For example -*

Monthly	Quarterly	Six monthly	Annually
24	36	23	13

Three further questions were included and were directed at all respondents. They asked whether the individual currently used a tax adviser to prepare his or her tax returns. Those who prepared their own returns were then asked whether they would use a tax adviser if self-assessment were to be introduced and, finally, whether they would take advantage of the Inland Revenue's proposal to calculate the tax due provided the tax return were submitted by 1st October following the end of the tax year. The responses are summarised below.

APPENDIX D : ANALYSIS OF RESPONSES TO TAXPAYERS' QUESTIONNAIRES

**Qu.10: Do you use a tax adviser to prepare your tax return?**

YES - 118  
NO - 25

<i>Self-employed</i>		<i>Company Directors/employees</i>	
YES	NO	YES	NO
86	21	32	4

**Qu.11: If no, would you continue to submit your own tax returns if you had to calculate and pay tax yourself?**

YES - 21  
NO - 2  
Don't know - 2

<i>Self-employed</i>		<i>Company Directors/employees</i>	
YES	NO	YES	NO
18	2	3	0

**Qu.12: Would you take up the Inland Revenue's offer to calculate your tax by submitting your return by 1st October?**

YES - 46  
NO - 89

<i>Those responding YES to Question 10 that also answered Question 12</i>		<i>Those responding NO to Question 10</i>	
<i>Self-employed</i>		<i>Self-employed</i>	
YES	NO	YES	NO
27	55	8	13
<i>Company directors/employees</i>		<i>Company directors/self-employed</i>	
YES	NO	YES	NO
11	17	0	4





## APPENDIX E :

### ANALYSIS OF RESPONSES TO TAX PRACTITIONERS' QUESTIONNAIRE

Views were sought from a representative sample group of tax practitioners drawn from small to medium sized firms both in December 1991 in relation to the first Consultative Document and in December 1992 in relation to the second Consultative Document. Individuals within 100 firms were circulated with the questionnaire and the firms were spread throughout the UK. In addition to being Chartered Accountants, all were members of The Institute of Taxation. Their personal views were sought rather than those of either of these professional bodies or of their firms.

The main responses to the first Questionnaire is summarised in this Appendix. However, the value of the responses to this and the second Questionnaire was largely contained in the detailed comments and views expressed by respondents. It is not possible to reproduce those views and comments here. However, even though they may not necessarily be reflected in the conclusions of this Report, they were taken into consideration and discussed by the Working Party in reaching its conclusions.

#### The First Questionnaire - December 1991

57 responses were received to the first Questionnaire circulated in December 1991. The three largest firms in which respondents worked comprised 25 partners and 200 professional staff, 21 partners and 100 professional staff and 17 partners and 180 professional staff. Excluding these three firms, firms ranged in size from sole practitioners to 15 partners. The average size of firm included a total of 28 qualified individuals.

The first Question in the December 1991 Questionnaire was designed to confirm the extent to which the respondents dealt with the self-employed.

<i>Qu.: Estimate the proportion of your clients who have some income within Schedule D Cases I or II</i>				
0 - 20%	21 - 40%	41 - 60%	61 - 80%	81 - 100%
7	12	14	14	6

The responses were not weighted according to the size of the firm. At least 5 per cent. of the clients dealt with by all respondents were the self-employed and the majority of respondents numbered a larger proportion in their client base. Some respondents estimated that up to 95 per cent. of their clients had income within Schedule D Cases I or II.

The second question was designed to give some indication of the spread of accounting dates for the respondents' self-employed clients through the year. Some responses suggested that all the individual's self-employed clients had accounting dates within the period 1st January to 30th June and these have been excluded from the summary to eliminate the possibility of error.

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<i>Qu.: Estimate the proportion of your self-employed clients who have accounting dates (a) in the period 6th April to 30th June and (b) 1st January to 5th April</i>		
Period	Range	Average percentage
6.4 to 30.6	5 - 80%	45%
1.7 to 31.12	10 - 55%	31%
1.1. to 5.4	5 - 75%	24%

These responses can be compared with those given by the self-employed themselves in Question 2 in Appendix D, which indicate that 39 per cent. of accounting dates fell in the period from 1st July to 31st December and 61 per cent. of dates fell in the period from 1st January to 30th June, dividing equally before and after the end of the tax year.

<i>Qu.: To what extent do you find that you can influence the accounting date adopted by your self-employed clients?</i>		
<i>In most cases</i>	<i>Sometimes</i>	<i>Not very often</i>
39	12	1

Several respondents indicated that their reply related to clients setting up new businesses who sought their advice and not to clients with established businesses. The importance of the advice given by the individual's accountant is borne out by the response to Question 3 in Appendix D, although this also suggests that the accountant is not as strong an influence as these responses would indicate. To some extent this probably reflects the time at which a self-employed person seeks advice. If he only does so after the initial trading period, the accountant's advice may obviously be tempered by the fact that the initial trading year has already elapsed.

To get some indication of the advice that might be given to a self-employed person, we asked the following Question:

<i>Qu.: When you can influence a client's choice of accounting date, do you -</i>			
1. <i>Encourage him to use the date best suited to his business?</i>	2. <i>Encourage him to adopt a date early in the tax year?</i>	3. <i>Accept whatever date he suggests?</i>	4. <i>Encourage the adoption of a date to keep tax to a minimum?</i>
36	33	-	3

19 of the respondents answered 'Yes' to both 1. and 2. This was on the basis in most cases that an early date would be favourable for tax purposes and a tax effective date would be beneficial to the business. Many respondents acknowledged, however, that they would not advocate an accounting date early in the year if there were good commercial reasons for adopting a different date, for example if the business was a seasonal one. As we had expected, it was clear that the tax advantages of a particular accounting period featured almost invariably in the advice given by the respondents, even though it might not be the determining factor if there were other commercial considerations.

Respondents were then asked to indicate whether under the proposed CY basis, a nine month reporting period would be sufficient for those of their clients with a 31st March accounting date.

APPENDIX E : ANALYSIS OF RESPONSES TO TAX PRACTITIONERS' QUESTIONNAIRE

*Qu.: If the CY basis were adopted, would a nine month reporting period be sufficient for those clients with a 31st March year end?*

YES - 31  
NO - 20

These responses have to be viewed in the light of the proportion of clients estimated to have year ends in the period 1st January to 5th April (24 per cent.). Several respondents noted that their clients would manage once they had got used to the new system although they would have some difficulty adjusting to it. Others noted that nine months would be sufficient but that there would always be a minority who would be late in producing information, although many of those would still be late even if they were given 12 months.

One of the principal purposes of this first Questionnaire was to put to respondents our proposal for a longer reporting period coupled with four rather than three payments of tax for any year. The responses on this proposal were as follows -

<i>Qu.: Which is more acceptable in terms of reporting and paying tax -</i>	
The shorter reporting period proposed with three payments of tax	A longer reporting period but four payments of tax
31	21

In the event our final proposal does not require the adoption of the system on which respondents were consulted and is not taken further in this Report.

**The Second Questionnaire - December 1992**

47 responses were received to the second Questionnaire of December 1992. Respondents were asked a series of questions related to the summary in Chapter 9 of the second Consultative Document. Not all of these are reproduced in this Appendix as respondents were asked for their initial reaction only and it was accepted that many would not have had the opportunity for longer reflection. As with the first Questionnaire, much of the value of the responses was contained in the fuller comments made by respondents rather than their "Yes" and "No" answers. Even if not always reflected in the conclusions of this Report, the views expressed by respondents were considered and discussed by the Working Party.

*Qu.: Do you support the move towards self-assessment?*

YES - 42  
NO - 5

*Qu.: Do you think that simplification of the tax system (eg loss reliefs) is necessary before self-assessment can be contemplated?*

YES - 26  
NO - 18

*Qu.: Do you think that tax returns should be sent to all taxpayers automatically rather than to those known to have income that may need to be returned?*

YES - 26  
NO - 8

*Qu.: Is a filing and payment date of 1st January satisfactory for investment income?*

YES - 41  
NO - 5

*Qu.: Should the Inland Revenue provide assistance to taxpayers in calculating their tax liabilities as proposed in the Consultative Document?*

YES - 38  
NO - 6

*Qu.: Is a filing date of 1st October satisfactory for those requiring Inland Revenue assistance?*

YES - 31  
NO - 13

*Qu.: Should capital gains be brought within the self-assessment system?*

YES - 31  
NO - 6

*Qu.: Should there be a transitional year between the final PY year and the first CY year, as proposed?*

YES - 43  
NO - 4

*Qu.: Should taxpayers be required to adopt a fiscal year (with or without some election for a different accounting date if they can show good reason)?*

YES - 11  
NO - 33

*Qu.: Is a 1st February & 1st August payment date satisfactory under a fiscal year basis?*

YES - 39  
NO - 5