RELEVANT TO ACCA QUALIFICATION PAPER P6 (UK)

Taxation of the unincorporated business
Part 2 – the existing business

This is the Finance Act 2012 version of this article. It is relevant for candidates sitting the Paper P6 (UK) exam in 2013. Candidates sitting Paper P6 (UK) in 2014 should refer to the Finance Act 2013 version of this article, to be published on the ACCA website in 2014.

This is the second article on the unincorporated business. It covers some of the issues relating to extraction of profits, change of accounting date and the final years of a business. Part 1 – The new business covers some of the issues relating to a new business including the choice of business vehicle and the first years of trading. The articles cover a selection of issues – there are other matters that, while not featuring in these articles, may still be the subject of a question in the exam.

The taxation of the unincorporated business is an important part of the Paper P6 (UK) syllabus and is examined regularly. All of the relevant technical rules relating to income tax and National Insurance contributions are covered in the Paper F6 (UK) syllabus such that there is nothing new at Paper P6 (UK). However, these rules continue to be of vital importance to Paper P6 (UK) candidates – a sound knowledge of them will enable candidates sitting the advanced taxation paper to identify the relevant issues and taxes from the information provided and to consider the implications of alternative courses of action.

This is not an introductory article; it is relevant to students coming to the end of their studies and finalising their preparations to sit the exam. It is intended to be read proactively – ie statements made should be confirmed as true by reference to the reader's understanding of the rules or to a relevant study text. This approach will enable future situations to be analysed from first principles rather than by reference to a rigid set of memorised planning points.

What is required at Paper P6 (UK)?

Questions in the exam are likely to be based around the commercial decisions of the taxpayer. They will require candidates to have a strong knowledge of the technical rules and an ability to apply those rules briskly and accurately. Candidates may be required to identify options that are obviously advantageous, disadvantageous or irrelevant, without preparing detailed calculations – for example by recognising that a particular strategy relating to the use of losses would simply result in a waste of the personal allowance.

SOME FUNDAMENTALS

The basis of assessment

The taxable profits of an unincorporated business are determined in two stages:

1. The profits per the accounts are adjusted for tax purposes – for a partnership, the tax adjusted profits are then divided between the partners in accordance with the profit sharing arrangements of the trading period.

2. The basis of assessment rules are then applied to the sole trader or partner's tax adjusted profits of the trading periods – unrelieved overlap profits are deducted from the taxable profits of the final tax year.

Example 1 – Basis periods in the closing years
Abel has always prepared accounts to 30 June. What are the basis periods for the final two tax years if he ceased to trade on either:
(i) 28 February 2013; or
(ii) 31 May 2013?
The solutions are provided at the end of this article.

Trading losses
Where there is a tax adjusted trading loss in a basis period, the trader's taxable income for the related tax year will be zero. There will also be a loss available for offset against income and/or capital gains. There are two main issues that candidates need to be sure of in order to be able to calculate the potential tax saving from the offset of the losses.

1. The precise income and/or capital gains that the losses can be offset against and
2. The periods in which the offset can occur.

Candidates must then take care to consider all of the relevant possibilities in the detail necessary to provide the advice requested.

Example 2 – Losses in the closing years
Duncan ceased trading and realised a loss in his final trading period.
What alternative reliefs are available in respect of this loss?
The solution is provided at the end of this article.

TOTAL TAX – COMPARISON WITH COMPANY
The total tax paid on the profits generated by a business will vary depending on whether the business is unincorporated or is owned by a company. This is a significant issue and will be considered, together with legal and commercial issues, when deciding on a business vehicle prior to commencing to trade and also when considering the desirability of transferring an existing unincorporated business to a company.

The calculations necessary to compare the alternative business structures must be performed with care if they are to be accurate. They require a sound knowledge of income tax, National Insurance and corporation tax.

Illustration 1
Sammy's business has an annual tax adjusted profit of £46,000. This figure is prior to any payments being made to Sammy. Sammy is considering three strategies: Strategy A, where the business is unincorporated, and Strategies B and C, where the business is incorporated.

Under Strategy A, where the business is unincorporated, the net income available to Sammy for the year ended 31 March 2013 is calculated as follows.

	Strategy A Unincorporated £
Income tax:	
Trading income	46,000
Personal allowance	(8,105)
Taxable income	37,895
£34,370 x 20%	6,874
(£37,895 – £34,370) x 40%	1,410
Income tax payable	8,284
Class 4 National Insurance contributions:	
(£42,475 – £7,605) x 9%	3,138
(£46,000 – £42,475) x 2%	70
Class 2 National Insurance contributions:	
52 x £2.65	138
Total tax payable	11,630
Net income for Sammy (£46,000 – £11,630)	34,370

Under Strategies B and C, the business will be operated via Wilson Ltd, a company owned 100% by Sammy. In these circumstances, the net income available to Sammy will depend on the mix of salary and dividends paid by the company. The calculations set out below show the income available to Sammy where the company's profit after tax is paid to Sammy as a dividend in addition to a salary of either £36,000 or £9,000.

	Strategy B Salary £36,000 £	Strategy C Salary £9,000 £
Wilson Ltd		
Trading profit pre salary	46,000	46,000
Salary	(36,000)	(9,000)
Employer's class 1 National Insurance contributions		
(£36,000/£9,000 – £7,488) x 13.8%	(3,935)	(209)
Taxable total profit	6,065	36,791
Corporation tax at 20%	(1,213)	(7,358)
Available for dividend	4,852	29,433
Sammy		
Employment income	36,000	9,000

Dividend income		
(£4,852/£29,433) x 100/90)	5,391	32,703
Personal allowance	(8,105)	(8,105)
Taxable income	33,286	33,598
(£33,286/£33,598 – £5,391/£32,703) x 20%	5,579	179
£5,391/£32,703 x 10%	539	3,270
Tax credit on dividend income	(539)	(3,270)
	5,579	179
Salary	36,000	9,000
Dividend	4,852	29,433
Income tax	(5,579)	(179)
Employee's class 1 National Insurance contributions		
(£36,000/£9,000 – £7,605) x 12%	(3,407)	(167)
Net income for Sammy	31,866	38,087

Summary – Net income for Sammy

	Strategy A Unincorporated	**Strategy B Salary £36,000**	**Strategy C Salary £9,000**
	£	**£**	**£**
Net income for Sammy	34,370	31,866	38,087

The net income available to Sammy is, of course, simply the difference between the profit of the business and the total tax payable under each of the alternatives.

	Strategy A Unincorporated	**Strategy B Salary £36,000**	**Strategy C Salary £9,000**
	£	**£**	**£**
Profit of the business	46,000	46,000	46,000
Corporation tax		(1,213)	(7,358)
Income tax	(8,284)	(5,579)	(179)
National Insurance contributions:			
Employer's class 1		(3,935)	(209)
Employee's class 1		(3,407)	(167)
Class 2	(138)		
Class 4 (£3,138 + £70)	(3,208)		
Net income available to Sammy	34,370	31,866	38,087

A comparison of Strategy A with Strategies B and C illustrates that being self-employed does not necessarily result in more income being available to the individual.

A comparison of Strategy B with Strategy C illustrates the tax that can be saved when a dividend is paid in place of salary.

CHANGE OF ACCOUNTING DATE

The rules used to determine the basis periods on a change of accounting date are not easy to learn. In addition, the application of the rules to a particular situation can also cause difficulties. Accordingly, it is important to learn and practise the rules as part of the revision process.

It may be helpful to note the following points and to use them as a check once the calculations have been prepared.

1. Where a trader has traded for the whole of a tax year, he will be taxed on 12 months of profits in that tax year – the only issue is determining which 12 months. (Note – this rule also applies in the opening and closing years of a business – the number of months that a trader is taxed on in a tax year is equal to the number of months that he traded in that year. For example, a trader who ceases trading on 31 October 2012 will be taxed on seven months of profits in 2012/13 once relief has been given for overlap profits.)
2. The length of a trader's overlap period is equal to the number of months from the accounting reference date to the end of the tax year. For example, a trader with a 30 November year end will have four months (1 December to 5 April) of overlap profits.
   Accordingly, on a change of accounting date, the length of the overlap period will change. Note that this method merely determines the number of months in the overlap period; it does not identify the overlap period itself.

Illustration 2

James has always prepared accounts to 31 December. He has changed his year end to 30 September and prepared accounts for the nine months ended 30 September 2012.

Prior to the change of accounting date, James had an overlap period of three months (1 January to 5 April). Following the change of accounting date he will have an overlap period of six months (1 October to 5 April).

CESSATION

A cessation occurs when the individual *sole trader* is no longer carrying on the business; the business itself may have been sold (or gifted) such that it is being carried on by someone else.

Choice of date of cessation

The date of cessation determines the tax year in which the business ceases and the calculation of the taxable trading profits for the final tax years under the closing year rules. A trader may be in a position to choose the most beneficial date of cessation from a tax point of view.

For example, where a taxpayer is about to retire and has little or no other income, it may be beneficial to cease trading at the start of a tax year (say, 2012/13) rather than at the end of the previous year – this would enable the offset of the personal allowance for 2012/13, which would otherwise be wasted.

The tax year in which a business is sold will also determine the availability of the annual exempt amount and, where entrepreneurs' relief is *not* available, the rate at which capital gains tax will be paid.

Trading losses on cessation
On the cessation of a business, the loss relief position is made more complicated by the availability of terminal loss relief in respect of the loss of the final 12 months of trading. Accordingly, there are two alternative reliefs available (or even three if the business is transferred to a company in exchange for shares). Each alternative may need to be considered in detail in order to determine the potential tax saving. As always, it is important to be sure of the precise income and/or capital gains that the losses can be offset against – and the periods in which the offset can occur.

Illustration 3
Haile ceased trading on 30 June 2012. His results in the final periods of trading were:

- Year ended 30 September 2011 £11,400 profit
- Nine months ended 30 June 2012 £11,250 loss

Haile had unrelieved overlap profits of £2,700 as at 30 June 2012.
Haile's terminal loss is calculated for the final 12 months of trading by reference to tax years.

	£	£
2012/13 (6 April 2012 –30 June 2012)		
3/9 x £11,250 loss		3,750
Overlap profits		2,700
		6,450
2011/12 (1 July 2011 – 5 April 2012)		
1 July 2011 – 30 September 2011		
(3/12 x £11,400 profit)	(2,850)	
1 October 2011 – 5 April 2012		
(6/9 x £11,250 loss)	7,500	
		4,650
		11,100

Relieving the terminal loss
The terminal loss can be offset against trading profits of 2012/13 (the final tax year of trading) and 2011/12, 2010/11 and 2009/10 (the three preceding tax years, later years first).

The loss of the final trading period that does not form part of the terminal loss (£2,850) is available for offset against general income and capital gains of 2012/13 (the year of the loss) and/or 2011/12 (the previous year).

Relieving the trading loss of 2012/13 against general income
The trading loss of 2012/13 of £13,950 (£11,250 + £2,700) is available for offset against general income and capital gains of 2012/13 (the year of the loss) and/or 2011/12 (the previous year).

Value added tax (VAT)
When considering the 'tax implications' of a particular commercial transaction or situation it is important to consider all of the possible taxes unless they are specifically excluded by the question.

On the cessation of trading a taxpayer is treated as having made a supply of all inventory, equipment and other items in respect of which input tax was claimed. The output tax in respect of this deemed supply is payable to HM Revenue & Customs unless it is less than £1,000.

SALE OF A BUSINESS

General

The sale of a business is a cessation of trade for the purposes of income tax. Accordingly, the issues set out above in relation to date of cessation are also relevant on a sale.

A succession election is available for the purposes of capital allowances provided the business has been sold to a connected person – for example, a company controlled by the sole trader. Under a succession election, assets are transferred at tax written down value, thus avoiding balancing adjustments.

The conditions relating to entrepreneurs' relief are of crucial importance because of the potential significance of the relief.

VAT should be charged on the sale of a business unless it is a qualifying transfer of a going concern. Where it is such a transfer, VAT must still be charged on any taxable buildings (for example, where an option to tax has been made) unless the purchaser also opts to tax the building.

There may be a Stamp Duty Land Tax (SDLT) liability on the sale of any land or buildings. Any liability to SDLT will be payable by the purchaser.

Sale of a business to a company
A business can be sold to a company controlled by the trader or one that is independent of the trader. The consideration for the sale may consist of cash and/or debt and/or shares.

Where part of the consideration is in the form of shares in the company, incorporation relief will be given automatically (provided the relevant conditions are satisfied), such that some or all of the capital gains on the disposal of the business assets can be rolled over against the base cost of the shares. The starting point for the base cost of the shares is the market value of the assets sold in exchange for shares. Note that the base cost of the shares is not determined by the number of shares or their par value.

Illustration 4
Emmanuel sold the whole of his business as a going concern to Patrick Ltd for £800,000. The capital gains on the assets sold were £340,000. The consideration consisted of £240,000 in cash with the balance (£560,000) in shares in Patrick Ltd. The conditions for both incorporation relief and entrepreneurs' relief were satisfied.

	£
Capital gains	340,000
Incorporation relief (£340,000 x £560,000/£800,000)	(238,000)
Taxable capital gains to be reduced by the annual exempt amount	102,000

The base cost of the shares acquired is calculated as follows.

	£
Market value of the assets sold in exchange for shares	560,000
Incorporation relief	(238,000)
Base cost of the shares	322,000

A taxpayer can choose to disapply incorporation relief if it is advantageous to do so. The advantage of this is that the taxpayer's base cost in the shares will be greater, such that any future capital gain on the disposal of the shares will be smaller. The disadvantage of disapplying the relief is that the unrelieved capital gains in the year of incorporation will be greater (although capital losses or the annual exempt amount may be available).

It is particularly relevant to consider the conditions in respect of the availability of entrepreneurs' relief here. The relief may be available on the sale of the unincorporated business to the company, but may not be available on the eventual sale of the shares depending on whether or not the conditions are satisfied.

Any unrelieved trading losses of the sole trader can be carried forward for offset against employment income and dividend income derived from the company in the future (provided the relevant conditions are satisfied). Note that the losses cannot be transferred to the company.

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Written by a member of the Paper P6 (UK) examining team

SOLUTIONS TO EXAMPLES

Example 1

(i) Cease trading on 28 February 2013

2011/12	Year ended 30 June 2011
2012/13	1 July 2011 – 28 February 2013 (the end of the basis period for the penultimate tax year until the date of cessation)

(ii) Cease trading on 31 May 2013

2012/13	Year ended 30 June 2012
2013/14	1 July 2012 – 31 May 2013 (the end of the basis period for the penultimate tax year until the date of cessation)

Example 2

The trading loss of the final tax year can be offset against the general income and capital gains of the final tax year and/or the previous tax year.

The loss of the final 12 months of trading, known as the terminal loss, can be offset against the trading profits (note, not general income) of the final tax year of trading and the three preceding tax years, later years first.