**Taxation of the unincorporated business**

**Part 1 – the new 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 first of two articles on the unincorporated business. It covers issues relating to a new business including the choice of business vehicle and the first years of trading. Part 2 (The existing business) looks at issues relating to a change of accounting date and the final years of a business. 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, so that there is nothing new at Paper P6 (UK). However, these rules continue to be of vital importance at Paper P6 (UK) – a sound knowledge of these rules 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
2. For a partnership, the tax-adjusted profits are then divided between the partners in accordance with the profit-sharing arrangements of the trading period.
3. The basis of assessment rules are then applied to the sole trader or partner’s tax adjusted profits of the trading periods.

Example 1 – Basis periods in the opening years
Zhou began trading on 1 June 2013. Accounts will be prepared to either:
(i) 31 December, or
(ii) 30 April.

What are the basis periods for the first three tax years and what is the overlap period? The solutions are provided at the end of this article.

Losses
Where there is a 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 opening years
Paula began trading on 1 June 2012. She has a tax adjusted trading loss for the tax year 2012/13.

What are the alternative reliefs available in respect of the trading loss? The solution is provided at the end of this article.

CHOICE OF BUSINESS VEHICLE
A new business can be operated as an unincorporated entity (sole trader or partnership) or as a company. The choice will be made by reference to commercial and legal issues in addition to taking into account the tax implications of the alternative business structures. Commercial issues include the effect of the chosen business vehicle on the ability of the business to raise finance, and the possible belief that a company may be regarded as larger or more financially sound than an unincorporated business. Legal issues include the existence of limited liability.

Taxation of business profits
From a tax point of view, an unincorporated business is a simple structure. The profits of the business, as adjusted for tax purposes, are subject to income tax and Class 4 national insurance contributions in the hands of the sole trader or partners who own the business. There will also be a liability to Class 2 National Insurance contributions.

Where a business is operated via a company, the tax position is more complicated. It is likely that the individual(s) who formed the company and who are running the business will extract profits from the company principally in the form of salary or dividends (they may also be paid rent in respect of a building or pension
The payment of a salary results in a liability to Class 1 employer’s and employee’s National Insurance contributions and a deduction for the purposes of calculating the company’s taxable profits. Dividends do not give rise to a liability to national insurance contributions and are not tax deductible for the company. Any profits retained in the company are subject to corporation tax only.

When comparing alternative strategies, it may be necessary to consider the total tax cost (ie including national insurance contributions) of each of them while recognising that other (non-tax) factors are also relevant. This is covered in more detail in: Taxation of the unincorporated business – Part 2 – The existing business.

In addition to affecting the total tax payable, the choice of business vehicle will also affect the timing of the liabilities with the self-employed making payments on 31 January in the tax year and 31 July following the end of the year and employees making payments monthly. The company’s tax liability will be due nine months and one day after the end of the accounting period, unless it is required to pay its tax in instalments.

**Initial losses**
Where there is an expectation of losses in the early life of the business, there may be a considerable advantage to operating the business as an unincorporated entity. This is because the losses can then be offset against the other income and/or capital gains of the sole trader or partners.

It should be recognised that the relief available here is particularly generous in that, as well as being able to offset the losses in the year of loss and/or the previous year, the losses of the first four tax years can be offset against the income of the previous three years on a first in, first out basis. This means, for example, that where an employee resigns in order to start a new business as an unincorporated trader, any initial losses can be offset against employment income arising prior to the start of the business.

Where losses arise in a new company, the relief available is far less generous. In these circumstances it is likely that the only significant relief available will be against future profits of the same trade. Relief for the losses is therefore dependent on the company eventually making profits (never a certainty!) and, even then, the relief is delayed until such profits are realised.

**Capital gains tax**
An unincorporated business and shares in a company are both potentially qualifying assets for the purposes of gift relief and entrepreneurs’ relief. However, the circumstances and precise conditions must always be considered carefully.

**Inheritance tax**
Business property relief is likely to be available on a future disposal of the business regardless of the choice of business vehicle. However, it is more straightforward to transfer shares in a company than to transfer an interest in an unincorporated business.
**CHOICE OF YEAR END**

The choice of year end affects when the profits of the business will be subject to income tax. For example, where a 31 March year end is chosen, the profits earned in a tax year are taxed in that same tax year (the profits earned in the year ended 31 March 2012 are taxed in the tax year 2011/12). Alternatively, where a 30 April year end is chosen, the majority of the profits earned in a tax year are not subject to income tax until the following tax year (the profits earned in the year ended 30 April 2012 are taxed in the tax year 2012/13).

When a new business begins to trade, the profits assessed to tax in the first two tax years will vary, perhaps considerably, depending on the choice of year end.

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**Illustration 1**

Mizuki began trading on 1 January 2013. Her tax adjusted profits per month are set out below.

<table>
<thead>
<tr>
<th>Period</th>
<th>Amount (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>January to March 2013 (three months)</td>
<td>3,000</td>
</tr>
<tr>
<td>April to September 2013 (six months)</td>
<td>4,000</td>
</tr>
<tr>
<td>October to December 2013 (three months)</td>
<td>8,000</td>
</tr>
<tr>
<td>January 2014 onwards</td>
<td>12,000</td>
</tr>
</tbody>
</table>

If Mizuki adopts a 31 March year end, her taxable trading income for the first three tax years of trading would be calculated as follows:

1. **Profit for each trading period**
   - Three months ending 31 March 2013 (£3,000 x 3) = 9,000
   - Year ending 31 March 2014
     - (£4,000 x 6) + (£8,000 x 3) + (£12,000 x 3) = 84,000
   - Year ending 31 March 2015 (£12,000 x 12) = 144,000

2. **Taxable profit for each tax year**
   - 2012/13 (1 January 2013 to 5 April 2013) = 9,000
   - 2013/14 (Year ending 31 March 2014) = 84,000
   - 2014/15 (Year ending 31 March 2015) = 144,000
   - Total taxable profits for the first three tax years = 237,000

If Mizuki adopts a 30 April year end, her taxable trading income for the first three tax years of trading would be calculated as follows:

1. **Profit for each trading period**
   - Four months ending 30 April 2013
     - (£3,000 x 3) + £4,000 = 13,000
   - Year ending 30 April 2014
     - (£4,000 x 5) + (£8,000 x 3) + (£12,000 x 4) = 92,000

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MARCH 2013

Year ending 30 April 2015
(£12,000 x 12)  144,000

2. Taxable profit for each tax year

<table>
<thead>
<tr>
<th>Tax Year</th>
<th>Profit (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012/13 (1 January 2013 to 5 April 2013)</td>
<td>9,750</td>
</tr>
<tr>
<td>2013/14 (1 January 2013 to 31 December 2013)</td>
<td>74,333</td>
</tr>
<tr>
<td>2014/15 (Year ending 30 April 2014)</td>
<td>92,000</td>
</tr>
<tr>
<td>Total taxable profits for the first three tax years</td>
<td>176,083</td>
</tr>
</tbody>
</table>

With a 30 April year end the taxable profits in the first three tax years are £60,917 (£237,000 – £176,083) less. This is because the profits are increasing and early profits are being taxed twice (giving rise to overlap profits) in place of later, higher profits.

This is a timing difference as opposed to an absolute saving. The profits earned in the period 1 May 2014 to 31 March 2015 of £132,000 (£12,000 x 11) are not taxed in the first three tax years if a 30 April year end is chosen. These profits, as reduced by the overlap profits of £71,083 (£9,750 + £61,333 (8/12 x £92,000)), represent the difference between the total profits taxed.

OTHER MATTERS

Pre-trading expenditure
Expenditure incurred in the seven years prior to the commencement of trade is treated as having been incurred on the first day of trading. Where the first period of trading is the basis period for more than one tax year (as in Illustration 1 above), such expenditure, together with other costs (and capital allowances) of the first period will be counted more than once when calculating taxable profits – see Illustration 2 below.

Capital allowances
The annual investment allowance is reduced for trading periods of less than 12 months. Accordingly, the length of the trading period in which significant capital expenditure is incurred can have an effect on the speed with which a business obtains relief for its capital expenditure.

Illustration 2
Irina began trading on 1 January 2013. In December 2012 Irina spent £16,000 on equipment for use in her business. For the purposes of capital allowances, equipment purchased prior to the commencement of trading is treated as having been purchased on the first day of trading.

The capital allowances claimed by Irina will depend on the date to which she prepares her first set of accounts.
TAXATION OF THE UNINCORPORATED BUSINESS

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Accounts prepared to 31 March 2013

<table>
<thead>
<tr>
<th>Main pool £</th>
<th>Allowances £</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Period ended 31 March 2013</strong></td>
<td></td>
</tr>
<tr>
<td>Additions qualifying for AIA</td>
<td>16,000</td>
</tr>
<tr>
<td>AIA (maximum £25,000 x 3/12)</td>
<td>(6,250)</td>
</tr>
<tr>
<td></td>
<td>6,250</td>
</tr>
<tr>
<td>WDA (18% x 3/12)</td>
<td>(439)</td>
</tr>
<tr>
<td></td>
<td>439</td>
</tr>
<tr>
<td></td>
<td>9,750</td>
</tr>
<tr>
<td></td>
<td>6,689</td>
</tr>
<tr>
<td><strong>Period ending 31 March 2014</strong></td>
<td></td>
</tr>
<tr>
<td>WDA at 18%</td>
<td>(1,676)</td>
</tr>
<tr>
<td></td>
<td>1,676</td>
</tr>
<tr>
<td>Tax written down value carried forward</td>
<td>7,635</td>
</tr>
<tr>
<td>Total allowances for the first two trading periods</td>
<td>8,365</td>
</tr>
</tbody>
</table>

Accounts prepared to 30 September 2013

<table>
<thead>
<tr>
<th>Main pool £</th>
<th>Allowances £</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Period ended 30 September 2013</strong></td>
<td></td>
</tr>
<tr>
<td>Additions qualifying for AIA</td>
<td>16,000</td>
</tr>
<tr>
<td>AIA (maximum £18,750 (£25,000 x 9/12))</td>
<td>(16,000)</td>
</tr>
<tr>
<td>Tax written down value carried forward</td>
<td>—</td>
</tr>
<tr>
<td><strong>Period ending 30 September 2014</strong></td>
<td></td>
</tr>
<tr>
<td>No tax written down value brought forward</td>
<td>—</td>
</tr>
<tr>
<td>Total allowances for the first two trading periods</td>
<td>16,000</td>
</tr>
</tbody>
</table>

The effect of the accelerated capital allowances becomes more marked when the basis of assessment rules are applied to the tax adjusted profits of the business as, with a 30 September year end, the profits of the first nine months (as reduced by the capital allowances) form part of the calculations of the taxable profits for the first two tax years.

**Illustration 3**

Continuing from Illustration 2, Irina’s business has tax adjusted trading profits, before deduction of capital allowances, of £12,000 per month.

If Irina adopts a 31 March year end, her taxable trading income for the first two tax years of trading would be calculated as follows.

<table>
<thead>
<tr>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Profit for each trading period</strong></td>
</tr>
<tr>
<td>Three months ended 31 March 2013: (£12,000 x 3) – £6,689</td>
</tr>
<tr>
<td>Year ending 31 March 2014: (£12,000 x 12) – £1,676</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2. Taxable profit for each tax year</strong></td>
</tr>
<tr>
<td>2012/13 (1 January 2013 to 5 April 2013)</td>
</tr>
<tr>
<td>2013/14 (Year ending 31 March 2014)</td>
</tr>
</tbody>
</table>
Total taxable profits for the first two tax years: £171,635

If Irina adopts a 30 September year end, her taxable trading income for the first two tax years of trading would be calculated as follows.

1. Profit for each trading period
   - Nine months ended 30 September 2013: (£12,000 x 9) – £16,000 = £92,000
   - Year ending 30 September 2014: (£12,000 x 12) = £144,000

2. Taxable profit for each tax year
   - 2012/13 (1 January 2013 to 5 April 2013): 3/9 x £92,000 = £30,667
   - 2013/14 (1 January 2013 to 31 December 2013): £92,000 + (3/12 x £144,000) = £128,000

Total taxable profits for the first two tax years: £158,667

The difference between the total taxable profits for the first two tax years of £12,968 (£171,635 – £158,667) consists of additional capital allowances as follows:

   - 2012/13: (3/9 x £16,000) – £6,689 = (1,356)
   - 2013/14: (£16,000 – £1,676) = £14,324

The speed with which the capital allowances are claimed and the effect of the opening years basis of assessment rules are both timing differences, as opposed to absolute savings. However, the difference can be significant as the time difference may be considerable.

**Employ or form partnership?**

Where two people are to work together in an unincorporated business they may consider operating as a partnership as opposed to one of them employing the other. As always, there are legal and commercial implications as well as tax issues to consider here. In particular, it should be recognised that entering into a partnership is a significant transaction due to the ability of one partner to enter into a contract that binds the other partner.

From a tax point of view, the decision requires a comparison of the tax position of an employee with that of a self-employed person. In addition, where the business is loss-making there is also the issue that the costs of employing someone will create tax and national insurance liabilities despite the business not being profitable. These employment costs will, of course, increase the loss available for relief, but there may be a timing difference between obtaining relief for the loss and paying the employee taxes.
Value added tax (VAT)
The main issue from the point of view of VAT is whether or not the business is required to register, together with the advantages and disadvantages of registering voluntarily. It may also be necessary to consider whether it would be advantageous to operate one or more of the flat rate scheme, the cash accounting scheme or the annual accounting scheme.

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

SOLUTIONS TO EXAMPLES
Example 1
(i) Year end of 31 December
2013/14  1 June 2013 – 5 April 2014
2014/15  1 January 2014 – 31 December 2014 (accounts for the 12-month period ending in the tax year)
2015/16  1 January 2015 – 31 December 2015 (accounts for the 12-month period ending in the tax year)

The overlap period is from 1 January 2014 to 5 April 2014 (three months).

(ii) Year end of 30 April
2013/14  1 June 2013 – 5 April 2014
2014/15  1 June 2013 – 31 May 2014 (first 12 months)
2015/16  1 May 2014 – 30 April 2015 (accounts for the 12-month period ending in the tax year)

The overlap period is from 1 June 2013 to 5 April 2014 and 1 May 2014 to 31 May 2014 (11 months).

Example 2
The loss can be offset against general income of 2012/13 (the year of the loss) and/or 2011/12 (the previous year).

Where a claim has been made against general income, a further claim can be made against the capital gains of 2012/13 and/or 2011/12.

The loss can be offset against general income of 2009/10, 2010/11 and 2011/12 (the three years prior to the year of the loss on a first in, first out basis).

Any loss remaining will be carried forward against future profits of the same trade.