Taxation of Sole traders – Basis of Assessment

Article by David FitzGerald, on behalf of the CPA Examinations Team for Foundation Level Taxation, January 2024.

Exam candidates sometimes struggle to understand the basis of assessment for Sch D Case I & II taxpayers.

The tax year is always a calendar year – whereas a sole trader's year can commence (and end) at any time during the calendar year. So, it is important to be able to identify what profits are assessed in any given a tax year.

The general rule

In general, the rule is quite simple – sole traders typically have a 12-month set of accounts, and the profits taxable in a given tax year are the profits in the 12 months set of accounts ending in that year.

Example 1: Joe, a self-employed architect makes his accounts up to 31 March each year. His accounts for the year ended 31 March 2023 are €50,000. His assessable profits for the tax year 2023 are, therefore, €50,000.

Basis of Assessment

The basis period for each tax year depends on whether:

1. The business is a continuous (ongoing) business with annual accounts.
2. The business has recently commenced trading.
3. The business has ceased trading.
4. The business has changed its accounting period.

1. Ongoing business

For an ongoing business the profits to be taxed are those in a 12-month accounting period ending in the year of assessment. This is the general rule.

See **Example 1** above.

2. Newly Commenced Business

Different rules may apply to the first, second and third year of trading.

First year:

The profits assessable are those from the date the business started trading (or "date of commencement") to 31 December in that year.

> ***Example 2:***
>
> Danielle started a business on 1 April 2023. Her accounts for year ending 31 March 2024 show a profit of €60,000.
>
> The profits assessable for tax year 2023 are €45,000 (9 months from 1 April 2023 to 31 December 2023) - €60,000 x 9/12.

Second year:

If there is only one set of accounts ending in the year, ***and*** that set of accounts covers a full 12 months, then the assessable profits are those in that set of accounts.

> ***Example 3:***
>
> Jimmy started trading on 1 July 2022. His first set of accounts were for 12 months ending on 30 June 2023, and showed a taxable profit of €36,000. His next set of accounts were for 12 months ending 30 June 2024.
>
> In this case, Jimmy's second year of trade is 2023. He has only one set of accounts – for 12 months - ending in 2023. His taxable profits for 2023 are therefore the profits in those accounts i.e. €36,000.

If the accounts are for less than 12 months, or there are more than one set of accounts ending in the year, the profits assessable are the profits for 12 months ending on the latest financial accounting date.

In all other cases, the assessable profits are the actual profits for the year.

> ***Example 4:***
>
> Richard started up a business on 1 July 2022. His first set of accounts are made up to 28 February 2023 show profits of €16,000. His second set of accounts, up to 30 November 2023 show a profit of €52,000.
>
> As per the rule, we take the latest accounts (€52,000 profit). However, these are only for 9 months. We therefore go back into the previous set of accounts for a further 3 months.
> His assessable profits for 2023 are:

	€
9 months ended 30 November 2023	52,000
3 months ended 31 January 2023	
16,000 x 3/8	6,000
Total	**58,000**

***Third year*:**

The profits assessable are those in the 12-month set of accounts ending in the year (normal basis).

There is, however, a provision where the taxpayer may opt to have a review of the ***second years*** profits. Should that review establish that the **actual** profits in year 2 were less than the assessed profits the taxpayer may claim to have their year 3 tax reduced by the excess (and if there isn't sufficient tax in year 3 to absorb the excess, the balance may be carried forward against future profits).

Notes:

- The option to review is only available to the taxpayer, and not to Revenue.
- A common mistake made by students is to reduce the Year 2 tax. While the excess relates to Year 2, it is the **Year 3 tax** that is reduced.

Example 5:

Sandra commenced business on 1 September 2021 and makes her annual accounts up to 31st August each year. Her accounts for the y/e 31 August 2022 show assessable profits of €63,000 and for y/e 31 August 2023 show assessable profits of €24,000.

Therefore, her assessable profits are:

	€
For 2022	63,000
For 2023	24,000

As 2023 is her third year in business, she is entitled to look back at year 2 – (2022) and compare the assessed profits against the actual profits for the year.

Actual Profits 2022

		€
8 months to 31 August 2022 = 63,000 x 8/12 =		42,000
4 months to 31 December 2022 = 24,000 x 4/12 =		8,000
Total actual profits for 2022	=	50,000
Assessed profits for 2022	=	63,000
Excess of assessed profits over actual profits	=	13,000

She is therefore entitled to have her year 3 (2023) profits reduced by the €13,000.

Thus:

		€
Assessed Profits 2023 (Year 3)	=	24,000
Less Year 2 Excess	=	(13,000)
Revised Year 3 assessable profits	=	11,000

3. *Cessation of Business*

Where a business ceases trading there are special rules around the basis of assessment. These are:

Final year of trading:

Profits assessable are actual profits in the year from 1 January to the date of cessation.

> ***Example 6:***
>
> Sally ceased trading on 31 August 2023. Her final set of accounts were for the 12 months ended on 31 August 2023, showing a profit of €12,000.
>
> Her taxable profits for the tax year 2023 are:
>
> 12,000 x 8/12 €8,000 (i.e. profits from 1 Jan to 31 August)

***Penultimate (second last) year of trading*:**
This will have followed the normal assessment rules. However, Revenue, (but **not** the taxpayer), have the right to revisit the penultimate year and revise the assessment. This means they will calculate the actual profits for the year, and if these are greater than the assessed profits they will issue a revised assessment for the second last year to actual profits.

> **Example 7:**
>
> Gene ceased trading on 31 August 2023. He had made up his annual accounts each year up to 31 August.
>
> His annual accounts show assessable profits for each of the final 3 years as follows:

Y/e August 31 2021	€35,000
Y/e August 31 2022	€50,000
Y/e August 31 2023	€60,000.

> Therefore, he was assessed in 2022 (his second last year) on profits of €50,000.
> He was assessed in 2023 on his actual profits for the year i.e. 60,000x8/12 = €40,000.
>
> Revenue has the right to review the second last (penultimate) year (2022) and compare actual profits for that year against the profits which had been assessed profits.
>
> **2022 Actual Profits**

8 months to 31 August = 50,000 x 8/12 =	33,333
4 months to 31 December = 60,000 x 4/12 =	20,000
Total Actual Profits (2022)	53,333
Assessed Profits (2022)	50,000
Excess of actual over assessed	3,333

> Revenue will therefore issue a revised assessment for 2022 of 53,333 in total (an increase of 3,333)

Businesses existing for 3 years or less (Short lived businesses).

Where a business commences and ceases trading within 3 years the treatment is a combination of commencement and cessation rules. This means the assessment for each all years will be on the actual profits in each year.

Example 8:

Mary started trading in 2021 and ceased in 2023. She made her accounts up to 30 September each year, and showed the following assessable profits:

		€
12 months ended 30 September 2022	=	25,000
12 months ended 30 September 2023	=	11,000
2 months ended 30 November 2023	=	2,000

Her assessable profits for each year are as follows:

2021 (Year 1 – Actual)

3 months to 31 December 2021 = 25,000 x 3/12 = 6,250

2022 (Year 2)

12 months accounts in year ending 30 September 2022 = 25,000

2023 (Year 3 Actual)			**€**
9 months to 30 September:	11,000 x 9/12	=	8,250
2 months to 30 November		=	4,000
Total Year 3			**12,250**

Year 2 Lookback Review

Actual Year 2	**€**
9 months to 30 September 2022 = 25,000 x 9/12 =	18,750
3 months to 31 December 2022 = 11,000 x 3/12 =	2,750
Total Year 2 actual	21,500

As actual is less than assessed for year 2, the actual figure replaces the assessed figure by way of reduction of year 3 profits by the excess (25,000 – 21,500 = 3,500).

Summary:

		€
Year 1		6,250
Year 2		25,000
Year 3	12,250	
Less Year 2 excess	(3,500)	8,750

In effect only actual profits are taxed for each of the 3 years.

4. Change of accounting period

Businesses may change their accounting period during the course of their existence, and this can impact on assessable profits. Different scenarios can arise:

- **(a)** There may be no accounting period ending in the year of assessment. In such circumstances the assessable profits are the actual profits in the year of assessment.
- **(b)** There may be an accounting period longer than 12 months ending in the year of assessment. Where this arises, the assessable profits are those in the 12 months to the end of the accounting period.
- **(c)** There may be more than one set of accounts ending in the accounting period. Where this arises, the assessable profits are 12 months profits ending on the date of latest set of accounts.