

CHAPTER 8

AVERAGING OF PROFITS

Statutory references are to ITTOIA 2005 unless stated otherwise

8.1 Who can average their profits?

[ITTOIA 2005, s. 221](#)

Special rules apply to certain trades and professions where profits may vary considerably from one year to the next. These special rules apply to **farmers and market gardeners**, where income is variable due to weather and other uncontrollable factors, such as foot and mouth disease.

The special rules also apply to **authors and creative artists** such as painters, sculptors and composers.

The legislation allows profits to be averaged in certain situations.

Averaging is **not possible** in respect of the **first and final tax years** of trading.

[ITTOIA 2005, s. 222\(4\)](#)

8.2 Full averaging

The "full averaging" rules are contained in s.223 ITTOIA 2005. Full averaging is possible where the **profits of the lower of the two consecutive tax years do not exceed 70% of the profits of the higher year.**

[ITTOIA 2005, s. 223\(3\)](#)

The profit we average is **tax adjusted profit**, which is **after deducting capital allowances.**

If there is a loss sustained in any of the years, we take **nil** to be the "profit" figure in any averaging computation.

Illustration 1

Farmer Giles has profits as follows:

	£	Taxed in
y/e 31 December 2008	20,000	2008/09
y/e 31 December 2009	12,000	2009/10

Clearly the lower profits are not more than 70% of the higher profits, so full averaging is possible. When we apply full averaging, we **add the profits together and divide by two:**

$$£(20,000 + 12,000)/2 = \underline{\underline{£16,000}}$$

£16,000 of profits will be taxed in 2008/09 and also in 2009/10. Note that profits have not disappeared - they have simply been spread evenly over 2 years.

This "new" figure of £16,000 for 2009/10 will be used to determine whether averaging is possible between 2009/10 and 2010/11.

8.3 "Marginal" Averaging

[ITTOIA 2005,
s.223\(4\)](#)

Marginal averaging applies where the **profits of the lower tax year are between 70% and 75% of the higher tax year**. In this situation, the profits for the lower year are increased and the profits of the higher year are reduced to bring them closer together.

Illustration 2

Continuing with Farmer Giles, let us assume that in the year ended 31 December 2010 his profits are £11,500. These are subject to tax under CYB rules in 2010/11. From the previous illustration, his averaged profits for 2009/10 are £16,000 and these are brought into the computation in computing averaging for any later year.

In this particular case, the profits of the lower year are 71.9% of the profits of the higher year i.e.

$$\frac{\pounds 11,500}{\pounds 16,000} \times 100 = 71.9\%$$

As this is between 70% and 75%, **marginal averaging** is possible.

Lower profits are increased and higher profits are reduced by the following formula:

$$3 \times (H - L) - \frac{3}{4} H$$

where H is the higher profits and L is the lower profits

This formula is in s.223(4) ITTOIA 2005.

Here there would be an adjustment of:

$$3 \times \pounds(16,000 - 11,500) - \left(\frac{3}{4} \times \pounds 16,000\right) = \pounds 1,500$$

The assessments for Farmer Giles will therefore be revised as follows:

2009/10	16,000 - 1,500 =	£14,500
2010/11	11,500 + 1,500 =	£13,000

Note that the new figure of £13,000 for 2010/11 will be used to determine whether averaging is possible between 2010/11 and 2011/12 and so on.

Example 1

Continuing further with Farmer Giles, his assessable profits in 2010/11 are £13,000. His profit in the year ended 31 December 2011 is £19,000, and his profit for the year ended 31 December 2012 is £22,000.

Assuming that averaging claims are made where possible, compute the assessments for 2011/12 and 2012/13.

8.4 Averaging claims

To apply averaging, a claim must be made by the **31 January** which is **22 months following the end of the second of the two years**. For example, if a farmer wishes to average profits between the tax years 2009/10 and 2010/11, the claim must be made by 31 January 2013.

[ITTOIA 2005, s. 222](#)

Claims must be made in **chronological order**, in other words we cannot make a claim for a later year before we have averaged the year before if we choose to do so. The claim belongs to the later of the pair of years, therefore any **increase or decrease in the previous year's tax liability is adjusted in the balancing payment for the later year**.

Illustration 3

Mrs Blyton is an author. Her accounts show the following results, as adjusted for tax purposes:

	£	Taxed in
y/e 31 March 2011	30,000	2010/11
y/e 31 March 2012	20,000	2011/12

The profits of the lower year are 67% of the profits of the higher year, so full averaging is possible. Assuming that the claim is made, her assessments for both of those years will be:

$$£(20,000 + 30,000)/2 = £25,000$$

Assume for simplicity that all Mrs Blyton's profit is taxed at 20%. In this case her liability on £30,000 worth of profit at 20% is £6,000. The liability will be revised, due to the averaging claim to £5,000, ie, £25,000 at 20%. The difference is £1,000.

This £1,000 is **given as a credit for the later year** (2011/12). The claim does not generate a repayment of tax for 2010/11, the year to which the calculation relates.

Averaging does not affect payments on account. For 2011/12, Mrs Blyton will be required to make payments on account totalling £6,000, based on her liability for 2010/11 **before** the averaging claim. 50% of this (£3,000) is due on 31 January 2012, and the remaining 50% is due on 31 July 2012.

The tax due for 2011/12 is then calculated. Assuming that this is wholly taxed at 20%, the tax liability for the year is £5,000. We deduct the payments on account of £6,000, (two lots of £3,000) and we also give credit for the £1,000 arising as a result of the revision of the 2010/11 assessment due to the averaging claim.

Tax due for 2011/12:

	£
£25,000 x 20%	5,000
Less payments on account	(6,000)
Less "credit" for 2010/11	<u>(1,000)</u>
Refund for 2011/12	<u>(2,000)</u>

Therefore for 2011/12, Mrs Blyton is due a tax refund of £2,000. This will be set off against the payments on account she owes for the next year.

Her payments on account for 2012/13 will be based on £5,000, as the payments on account are computed on the profits **before** the averaging adjustment of £1,000. Half of this will be due on 31 January 2013 being £2,500, and the rest is due on 31 July 2013. The payment due on 31 January 2013 will be reduced by the tax refund due for 2011/12 i.e.

$$£2,500 - £2,000 = \underline{£500}$$

Example 2

Farmer Barlimow, who has been trading for many years, has the following results:

	£
y/e 30 September 2009	21,000
y/e 30 September 2010	15,500
y/e 30 September 2011	(4,000)

Assuming that all averaging claims are made where possible, compute his final assessment for all relevant tax years.

Answer 1

Comparing the two years, 2010/11 (£13,000) and 2011/12 (£19,000), we find that the profits for the lower year are below 70% of the profits for the higher year. Consequently full averaging is possible:

$$£(13,000 + 19,000) / 2 = £16,000$$

The assessable profits (subject to further averaging) will be £16,000 for 2010/11 and 2011/12.

Comparing the two years 2011/12 (£16,000) and 2012/13 (£22,000) we find that the profits of the lower year are 72.7% of the profits for the higher year.

$$\frac{£16,000}{£22,000} \times 100 = 72.7\%$$

This is between 70% and 75%, and therefore marginal averaging is possible.

Applying the formula, the adjustment is:

$$3 \times £(22,000 - 16,000) - \left(\frac{3}{4} \times £22,000\right) = £1,500$$

We therefore add £1,500 to the lower profits and we deduct £1,500 from the higher profit:

2011/12	16,000 + 1,500 =	£17,500
2012/13	22,000 - 1,500 =	£20,500

Answer 2

Taking 2009/10 and 2010/11, the profits of the lower year are 73.8% of the profits of the higher year.

$$\frac{\pounds 15,500}{\pounds 21,000} \times 100 = 73.8\%$$

As this is between 70% and 75%, marginal averaging will apply.

Applying the marginal averaging formula, the adjustment is:

$$3 \times (\pounds 21,000 - 15,500) - \left(\frac{3}{4} \times \pounds 21,000\right) = \pounds 750$$

2009/10	21,000 - 750	=	£20,250
2010/11	15,500 + 750	=	£16,250

In 2011/12 Farmer Barlimow sustained a loss of £4,000 so therefore his Trading Income assessment is **nil**. In these circumstances full averaging applies and we simply insert nil as the profit for the later year.

Applying full averaging:

$$\pounds (16,250 + \text{nil}) / 2 = \pounds 8,125$$

Therefore the final assessment for 2010/11 is **£8,125**.

The assessment for 2011/12 is £8,125 subject to averaging with 2012/13.

Note:

Wherever one of the years is a loss, full averaging will always be possible as profits for the lower year (ie nil) will always be less than 70% of those of the higher year.

The rules for relieving the loss are covered in a later session.