

CHAPTER 2

ADJUSTMENT OF PROFIT – GENERAL PRINCIPLES

Statutory references are to ITTOIA 2005 unless stated otherwise.

2.1 Introduction

Each year a trader will prepare a set of accounts. Those accounts will (usually) show a profit.

However, in computing this profit the trader could have deducted expenditure that HMRC **does not allow** for taxation purposes. Consequently we are required to make a number of adjustments in arriving at the trader's **taxable** profit.

We **start** with the **profit per the accounts**. We then **add back** certain expenditure which is **disallowable for tax purposes**. Then we deduct receipts in the accounts which are **not taxable as trading income**. Finally we deduct **capital allowances**, which are HMRC's equivalent of depreciation. (We will cover capital allowances in later chapters). This gives the "tax adjusted profit", which is acceptable to HMRC.

| | |
|---|------------|
| Profit per accounts | X |
| Add: Disallowed expenditure | X |
| Less: Items not taxed as trading income | (X) |
| Less: Capital allowances | <u>(X)</u> |
| Tax adjusted profit | <u>X</u> |

It is this "tax-adjusted" profit which is taxable as trading income.

In this chapter we will look at the most common types of expenditure which are not allowed to be deducted for tax purposes, and at receipts which are not taxed as trading income.

2.2 Disallowable expenditure

There are three main categories in this area:

- **Capital expenditure** - expenditure which gives an "enduring benefit" to the business. [ITTOIA 2005, s. 33](#)
- **Expenditure** which has **not been incurred "wholly and exclusively"** for the purposes of the trade. [ITTOIA 2005, s. 34](#)
- **Specific disallowables** given by tax statute and case law.

2.3 Depreciation and amortisation

Depreciation and amortisation are **not usually allowed** for tax purposes. This is because there are many rates and methods of depreciation, and traders may therefore be encouraged to choose depreciation rates which maximise tax relief.

[ITTOIA 2005, s. 33](#)

Instead, businesses are able to claim capital allowances (CAs) on any plant and machinery used in the trade. CAs are covered in later chapters.

2.4 Capital expenditure

The purchase of **capital equipment** should be **included on a trader's balance sheet**, as the balance sheet shows all the fixed assets of the business. These include:

- motor vehicles;
- premises;
- other equipment (photocopiers, computers etc).

These items may be **eligible for capital allowances**.

If the trader has included any **capital additions** in the Profit and Loss ("P&L") Account, they should be **disallowed** and **added back** in arriving at the trading profits.

Profits or losses on the sale of fixed assets are also disallowed. Losses on sales of assets are not allowable expenses and should therefore be **added back**. Profits on sales of assets are not taxable as Trading Income and should therefore be **deducted** in arriving at trading profits.

2.5 Legal fees

A trader may incur **legal fees** on the **acquisition or disposal** of capital assets. These are disallowed as they **relate to a capital item**.

Legal fees incurred on the **renewal of a short lease are specifically allowed**. A "short" lease is a lease of less than 50 years.

2.6 The “enduring benefit” test

In the tax case of *Atherton v British Insulated & Helsby Cables Ltd* (1925), the Judge held that expenditure which provides the business with an **“enduring benefit”** is **not allowable** as a trading expense. By “enduring benefit” we mean that the expense will benefit the business not just in the year in which it is incurred, but also in the years that follow.

For example, if a plumber buys a new van, this is a capital expense as the business will have obtained an enduring benefit as a result of the expense. The van will (presumably) be available for use in the business for several years. The purchase of the van is a one-off “exceptional” expense which the trader will not incur year-on-year. The expense should be **capitalised via the Balance Sheet** rather than deducted as an expense in the P&L account.

However, if a plumber fills his van up with petrol, this does not give an enduring benefit as (a few days later) he may need to do so again. Assuming the van is a business vehicle, petrol costs for the van will **go through the P&L account and will be deductible** for tax purposes.

Tax law does not give any assistance as to how long an asset needs to be owned for it to be classed as “capital”. For example, if a trader buys a computer and intends to replace it in (say) 2 years, is this a “revenue” expense (and therefore deductible) or is 2 years enough to create an “enduring benefit”?

HMRC guidance is that we take a “common sense” approach and that each case will turn on its own merits. As a rule of thumb, assets which are expected to be used in the business for more than 2 years are likely to be capital.

2.7 Repairs

“Repairs” are allowable for tax purposes whereas **“improvements” are capital** expenditure and as such are disallowed.

An expense is a “repair” where it restores an asset to its original condition. Where the expense enhances, expands or improves an asset, HMRC will treat it as a **“sum employed as capital”** in the business and disallow the expense under s.33.

However, the use of modern materials in repairing an old building does not automatically mean that there will be an element of improvement. For example, HMRC accept that replacing old windows with new double-glazed equivalents is a repair rather than an improvement.

Where an expense is a capital improvement, the “notional” cost of what it would have taken to repair the asset, is not allowed.

It is common for HMRC to request a breakdown of the trader's “repair” expenditure in the P&L account as part of an enquiry.

2.8 Initial repairs

If a trader purchases an asset and then spends money on it, is this expense revenue or capital?

In *Law Shipping Company v IRC*, a company purchased a ship which needed some immediate repair work as it did not possess a certificate of sea-worthiness. They spent the money and claimed the repairs as a revenue expense in the P&L account. However, the Courts held that the repairs were part and parcel of the **acquisition costs** of the asset as they **enabled the ship to be used for the very first time**. As a result, these "repairs" were **held to be capital** - i.e. linked to the capital acquisition of the ship.

Could we argue that the costs are revenue?

In the case of *Odeon Associated Theatres Limited v Jones*, a number of cinemas were purchased just after the war in a very run down state. However, Odeon kept them open to the public and continued to show films. Over a period of time they gradually repaired and renovated the cinemas and brought them up to a much smarter state.

As much of the repair work related to dilapidations arising prior to Odeon's purchase, HMRC argued under the *Law Shipping* precedent that the repairs expenses were part and parcel of the acquisition cost - ie, they were capital.

However, as the repairs took place to useable assets, the Court held that the costs were **revenue in nature and therefore allowable**. The most important factor with regard to repairs on newly acquired assets, is whether the asset was purchased in a useable state and was actually used in that state.

This principle **also applies to let properties**. For example, if an individual buys a house, undertakes some "repair" expenditure to make it lettable then subsequently lets out the property to a tenant, HMRC will apply the *Law Shipping* principle and disallow the expense as capital

2.9 Provisions for repairs

Provisions for repairs are allowable provided that they are properly computed in accordance with Financial Reporting Standard 12 (FRS 12) and are in connection with genuine revenue expenditure (not capital).

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FRS 12 requires that a provision can only be made via the P&L account if:

- a) there is a **present obligation** to make a payment as a result of a past event;
- b) a transfer of economic benefit will be required to settle that obligation; and
- c) a **reliable estimate** can be made of that obligation.

Unless you have any information to the contrary, if a P&L account contains a provision for repairs, you should assume that the accounts have been prepared in accordance with FRS 12 and the provision is therefore allowable.

2.10 “Wholly and exclusively”

Expenses are only deductible if they are incurred “**wholly and exclusively**” for the purposes of the trade.

[ITTOIA 2005, s. 34](#)

If an expense is incurred for a “dual purpose” - for example, there is both a business and a private element to the expense - HMRC permits a **tax deduction for the business proportion** of the expenditure. However, HMRC will only allow a proportionate deduction where the **primary purpose** of the expense is of a business nature. If the expense is **materially for a private or non-business purpose**, HMRC interpret the “wholly” test very strictly and will disallow the expense in full.

Illustration 1

Emma is a freelance wedding photographer. She uses her car essentially for business purposes. 80% of her journeys are for the purposes of her trade, but she also uses the car in the evenings for social and domestic use.

Her motor expenses are £4,000 a year and these are deducted via the P&L account.

HMRC will allow a deduction for $80\% \times £4,000 = £3,200$. The non-business element of the motor expense (£800) should be disallowed and added back to the trading profits.

The private use adjustment can apply to **any expenditure**. For example, if a taxpayer uses, say, 25% of his house as an office for the purposes of the trade, he will be able to deduct 25% of the running costs of his home (electricity bills, mortgage interest etc) in arriving at his taxable profit.

2.11 Private expenses of employees

A private use adjustment is only made where the owner of the business (i.e. the trader himself) deducts expenses which wholly or partly relate to his private affairs. Where the business pays a private expense for an employee (e.g. a gym subscription or medical insurance premium):

- 1) the expense is an **allowable deduction for the business**; and
- 2) the employee will (usually) have a **taxable benefit** under the employment income rules.

2.12 Clothing

In *Mallalieu v Drummond*, a barrister claimed that the costs of her dark Courtroom dress were allowable as an expense against her professional income because she was required to wear them in Court and would not otherwise wear such clothing in her everyday life.

However the Courts were not satisfied that this was the case, as they argued that she would be **wearing clothing in Court in any event** in order to provide her with "**warmth and normal decency**". When she bought the clothes, there was a "subconscious duality of purpose". The clothing costs were therefore **disallowed** as they essentially satisfied a private purpose.

Therefore, an accountant who only normally wears his suit when he is acting as an accountant, would **not** be able to claim the costs of that suit as a trading expense because he would have to wear something when meeting clients.

However, HMRC accept that **protective clothing** (hard hats, overalls, chefs aprons etc) is an expense incurred wholly and exclusively for the purposes of the trade and **will allow such items**. The same applies for actors' costumes.

2.13 Salaries and drawings

Salaries or wages are amounts paid by the business to its employees in return for work undertaken. These wages will be taxed as employment income in the hands of the recipient and **will be allowable expenses** for the business. Any employer's national insurance paid by the business (Class 1 secondary and Class 1A NIC) is also an allowable expense.

"Drawings" are monies taken from the business profits by the owner / proprietor to meet his own private expenditure. These drawings are not taxed as employment income and are **not allowable as a trading expense**. If a business deducts the proprietors "wages" via the P&L account, these "wages" are essentially drawings and should be added back. The self-employed proprietor will pay income tax on his taxable trading profits - the amounts he actually draws in the year are irrelevant and can be ignored.

There is no reason why a trader may not employ a family member to assist him in his business. For example, a self-employed husband may employ his wife to work in a full or part-time capacity. The wages paid to the spouse will be a **bona fide deductible expense** provided that:

- a) the wages are actually paid (and are not just a "book entry");
- b) the wife plays a part in the business; and
- c) the wages are not excessive in relation to the work undertaken (ie, they are of an amount which a third party might pay in return for the same services provided).

The employment of the proprietor's children in the trade is a more controversial issue. All individuals (even young children) have a personal allowance for income tax purposes, and without rules to prevent exploitation, many traders would pay their children a "wage" to use their personal allowance and thereafter claim a tax deduction for the expense.

Children's wages will only be allowable if:

- a) it is **not unreasonable for a child to be employed** to undertake the particular work; and
- b) the payment is in fact **in the nature of a wage** and is not merely "pocket money".

In *Dollar & Dollar v Lyon (1981)*, a farmer "employed" his 4 children aged 14, 11, 9 & 7 on the farm, and paid each a wage. The Courts held that the payments to the 14 year old were allowed as genuine wages, but the payments to the younger children were pocket money in nature and did not therefore satisfy the "wholly & exclusively" test. The Court also took into consideration that it was illegal to employ the 3 younger children.

2.14 Accrued wages

Salaries and wages are usually deducted in the period in which the wages are actually paid. However relief is given for accrued wages as long as the wages are **actually paid within 9 months of the end of the accounting period**.

[ITTOIA 2005, s. 36](#)

If the accrued wages are NOT paid within 9 months of the end of the period:

- a) the accrued amount is added back; and
- b) relief is given in the period in which the wages are physically paid.

2.15 Goods for own use

A trader will buy trading stock. The cost of the stock will be a deductible expense in his P&L account.

The trader will later sell his trading stock (presumably for more than he bought it for!). The sale will form part of trading income in the P&L account. The difference between the cost of the stock and the selling price will be the gross profit of the business.

Occasionally the trader may decide to take some of the trading stock for his own personal use. In this case we need to **make an adjustment** to the accounting profit.

The principle established in the case of *Sharkey v Wernher* is that we assume that the trader has bought the stock at cost then **sold it to himself for its retail selling price** - ie, we assume that the "business" has made an unconnected third party sale to the individual owner in his personal capacity. Consequently we **add the sales price** of the stock to the accounts profit.

This principle was established by case law but was given statutory authority in Finance Act 2008.

[ITTOIA 2005, s. 172B](#)

This principle only applies for goods (i.e. completed trading stock). It does not apply for services or raw materials which have not yet become stock.

2.16 Appropriations to trading stock

[ITTOIA 2005, s. 172C](#)

If a trader takes an asset which is used in his trade but isn't part of his trading stock, and he then **brings it into the business as trading stock**, then the "cost" of the stock for the purpose of the accounts is the **market value at the time it was introduced**. This may be the case where a property developer has a fixed asset which he uses in his trade (e.g. a building), and then he takes that building as part of his trading stock to be developed.

For CGT purposes, the trader will also be deemed to have disposed of the fixed asset (to himself) at market value so a **capital gain will arise**. In this instance the trader can elect not to have a CGT disposal but instead to have the **cost of the stock reduced by the chargeable gain**. This will reduce the gain to nil but will result in the stock having a lower cost (and therefore a higher trading profit when the stock is eventually sold).

[TCGA 1992, s. 161](#)

Illustration 2

Sarah runs a small property development business from an office in St Albans. The office building cost £100,000 in June 2001.

On 15 August 2010, Sarah moved her business to a larger office in Watford and decided to redevelop the St Albans office in order to sell it to a commercial buyer. The St Albans office was worth £250,000 in 2010.

Sarah has taken a fixed asset used in her business (the St Albans office) and has appropriated this to her trading stock. Therefore:

1. She is deemed to have sold the office to herself for its market value (£250,000). This gives her a capital gain of £150,000; and
2. She has "bought" trading stock for her property development business for £250,000.

Alternatively Sarah can make an election under s.161(3) TCGA 1992, in which case:

1. The gain of £150,000 is reduced to nil; and
2. The cost of the stock in her property development business is reduced by £150,000 and will now be £100,000.

Given that capital gains are charged at 18% and 28% and that trading profits are likely to be taxed in the future at 40% and 50%, Sarah may not wish to make the election but may instead simply pay the CGT on the disposal of the fixed asset.

2.17 Items not taxed as trading income

Not all receipts which a trader includes in his business accounts will be taxed as trading income. Traders might include income in their accounts which is not derived from their trade. Typical examples of non-trading income are:

- rental income;
- bank interest;
- profits on sale of fixed assets;
- sundry miscellaneous income.

Any non-trading **income is deducted** in arriving at the taxable profit figure.

| | |
|--|------------|
| Profit per accounts | X |
| Add: Disallowed expenditure | X |
| Less: Items not taxed as trading income | (X) |
| Less: Capital allowances | <u>(X)</u> |
| Tax adjusted profit | <u>X</u> |

This other income will then be brought back in the main income tax computation and taxed accordingly.

In exceptional circumstances, rental income from the letting of surplus business accommodation can be **treated as arising from the trade** as opposed to being treated as property income.

[ITTOIA 2005, s. 21](#)

This will be the case where:

- a) the premises being let are **temporarily surplus** to requirements;
- b) the let premises are part of a building in which **another part is being used in the trade**; and
- c) the letting receipts are **relatively small**.

2.18 Compensation receipts

The way in which compensation receipts are taxed depends on what the compensation relates to.

Any compensation received for damages to or depreciation of an asset is a capital receipt and is not taxed as trading income. Such receipts may be subject to CGT.

However, compensation received for the cancellation of a trading contract will generally be taxed as trading income if the contract receipts would themselves have been trading receipts had the contract been completed.

Example 1

State whether the following expenses incurred by a sole trader are allowable or disallowable for tax purposes:

| | <i>Disallow</i> | <i>Allow</i> |
|--|-----------------|--------------|
| a) Loss on sale of a computer | | |
| b) Amortisation of goodwill | | |
| c) Purchase of a new photocopier | | |
| d) Legal fees incurred on purchase of a new building | | |
| e) Legal fees on acquisition of new 20 year lease | | |
| f) Legal fees on renewal of 20 year lease | | |
| g) Repairs to photocopier | | |
| h) Wages to his secretary | | |
| i) New suit to wear for client meetings | | |

Example 2

Tony runs a shop selling garden furniture. His accounts show the following:

| | |
|---------------------------------------|-----------------|
| | £ |
| Sales | 100,000 |
| Less: cost of sales expense | <u>(40,000)</u> |
| Gross profit | 60,000 |
| Less: office expenses (all allowable) | <u>(10,000)</u> |
| Net profit | <u>50,000</u> |

During the year Tony took home a new set of tables and chairs for his garden. The furniture cost £500.

Calculate the taxable trading profit.

Example 3

Alicia is a self-employed interior designer. Her accounts for the year ended 30 June 2010 show the following:

| | |
|---|---------------|
| | £ |
| Sales | 89,500 |
| Add: interest on business deposit account | <u>250</u> |
| | 89,750 |
| Less: expenses: | |
| Depreciation | (3,000) |
| New computer | (2,000) |
| Wages for employee (1) | (20,000) |
| Car running costs (2) | (2,500) |
| Loss on sale of old computer | (650) |
| Accountancy fees | <u>(400)</u> |
| Net profit | <u>61,200</u> |

Notes:

- (1) The wages include an accrued bonus of £5,000. The bonus was actually paid to the employee on 30 April 2011.
- (2) Alicia's car is used 70% for business purposes.
- (3) Capital allowances in the year were £4,000.

Calculate Alicia's taxable trading profit.

Answer 1

| | | <i>Disallow</i> | <i>Allow</i> |
|----|---|-----------------|--------------|
| a) | Loss on sale of computer (Capital) | X | |
| b) | Amortisation of goodwill (Depreciation) | X | |
| c) | Purchase of a new photocopier (Capital) | X | |
| d) | Legal fees incurred on purchase of a new building (Capital) | X | |
| e) | Legal fees on acquisition of new 20 year lease (Capital) | X | |
| f) | Legal fees on renewal of 20 year lease | | ✓ |
| g) | Repairs to photocopier | | ✓ |
| h) | Wages to his secretary | | ✓ |
| i) | New suit to wear for client meetings | X | |

Answer 2

| | |
|------------------------------------|----------------|
| | £ |
| Profit per accounts | 50,000 |
| Add; selling price of stock | |
| $£500 \times \underline{£100,000}$ | |
| £40,000 | <u>1,250</u> |
| Taxable trading profit | <u>£51,250</u> |

Tutorial note

Alternatively you could use a "mark-up" on cost calculation to arrive at the selling price of the stock.

If cost of sales expense is 100%, then sales income must be 250% since it is 2.5 times bigger than the cost of sales.

The selling price of the garden furniture taken out of the business by Tony is therefore:

$$£500 \times 250\% = £1,250$$

Answer 3

| | | £ |
|----------------------------------|--------------|----------------|
| Profit per accounts | | 61,200 |
| Add: | | |
| Depreciation | 3,000 | |
| New computer | 2,000 | |
| Wages (not paid within 9 months) | 5,000 | |
| Motor expenses (30% x £2,500) | 750 | |
| Loss on sale of old computer | <u>650</u> | |
| | | <u>11,400</u> |
| Less: | | 72,600 |
| Deposit interest | 250 | |
| Capital allowances | <u>4,000</u> | |
| | | <u>(4,250)</u> |
| Taxable trading profit | | <u>68,350</u> |