

CHAPTER 3

COMMON ADJUSTMENTS

Statutory references are to ITTOIA 2005 unless stated otherwise.

3.1 Pre trading expenditure

[ITTOIA 2005, s. 57](#)

Expenses incurred in the 7 years before commencement of trade are treated as incurred on the first day of trading. Such expenses will be deducted from profits in the first accounting period, provided they are allowed under normal rules.

3.2 Entertaining and gifts

Costs incurred by a trader in providing **business entertaining are disallowed** for tax purposes. Business entertaining means providing hospitality of any kind.

[ITTOIA 2005, s.45](#)

However costs incurred by an employer in providing entertainment for **members of staff are specifically allowable**.

[ITTOIA 2005, s. 46](#)

Business gifts are also generally **disallowed** unless:

- (i) the assets gifted **cost under £50**; and
- (ii) the gift bears the **business name, logo or a clear advertisement**; and
- (iii) the gift does **not** include **food, drink or tobacco**.

[ITTOIA 2005, s. 47\(3\)](#)

Gifts of items which it is the taxpayer's trade to provide (for example, trade samples) are allowed.

[ITTOIA 2005, s. 47\(2\)](#)

3.3 Interest payments

Provided the loan is taken out for a business purpose (e.g. to buy stock, to pay staff wages or to buy an asset to be used in the trade), interest payments **will be allowable expenses for tax purposes**. This will include overdraft interest (providing the account is a genuine business account and is not used to fund personal expenses).

Where the loan is taken out for a "mixed" purpose (for example, to buy a car where the car is used for both business and personal use), only the **business proportion of the interest is allowed**.

No deduction is allowed for the repayment of the capital part of the loan itself. Monthly loan repayments will therefore need to be split between the interest and the capital repayment elements.

No deduction is available for interest on overdue tax (as this is not an expense incurred in the course of making profits).

[ITTOIA 2005, s. 54](#)

Incidental costs of obtaining loan finance (e.g. loan arrangement fees etc) are allowed.

[ITTOIA 2005, s. 58](#)

3.4 Assets bought on hire purchase

If an asset (eg, a machine, car etc) is acquired via a hire purchase (HP) agreement, legal ownership of the asset passes to the trader at the date the **contract is signed**. The trader will simply pay for the asset over a period of time, normally on a monthly basis.

Monthly HP repayments will contain both an interest and a capital repayment element. The **capital** element is not an allowable deduction. The **interest** is a deductible expense (subject to apportionment if the asset is also used privately by the trader).

Capital allowances may be claimed on the capital cost of the asset from the date the HP contract was signed (see later).

3.5 Leasing costs

Contrast a HP agreement with a leasing arrangement whereby a trader is **borrowing an asset owned by someone else**.

Costs incurred in leasing or hiring an asset to be used in the trade will be allowable.

There are two ways in which a trader will lease an asset:

- 1) *Operating lease* - here the trader simply pays a rental payment (normally monthly) to the owner of the asset and deducts the lease payments via the P&L account; or
- 2) *Finance lease* - under SSAP 21, the lessee (trader) is required to treat a finance lease in the same way as had he bought the asset by way of a loan. The trader will therefore **depreciate the asset** over its normal life and will therefore charge **depreciation and interest payments** through the P&L account.

In both instances, the asset is being borrowed from someone else (ie, no legal ownership changes hands), so no capital allowances can be claimed by the lessee using the asset.

There is therefore a difference between an operating lease and a finance lease in respect of what will be charged to the P&L account.

<u>Operating lease</u>		<u>Finance lease</u>	
Charged to P&L:		Charged to P&L:	
Lease rentals	<u>X</u>	Finance lease interest	X
		Finance lease depreciation	<u>X</u>
		Total P&L charge	<u>X</u>

In both instances, **the amount charged to the P&L account is an allowable expense**. Therefore where an asset is held by a trader under the terms of a finance lease, the **depreciation element is an allowable deduction**. This is the only time that a trader will get a tax deduction for depreciation.

3.6 Long funding leases

From 1 April 2006 a new regime was brought in for "**long funding**" leases, which are leases lasting **more than 5 years**. The rules cover both operating and finance leases.

In summary, it is the lessee (person using the asset) rather than the lessor (person who owns the asset), who is treated as having incurred the capital expenditure when the lease started.

The lessee is treated as if they own the asset throughout the duration of the lease and so it is the **lessee who is entitled to claim the capital allowances**.

Because capital allowances are being claimed by the lessee, any depreciation charge made in the accounts in respect of a long funding lease must be added back for tax purposes.

In addition to the capital allowances that he claims, the lessee can also **deduct part of any rental payments** he makes.

Long funding leases are covered in more detail in Chapter 13.

3.7 Expensive cars

For expensive cars leased before 6 April 2009, HMRC do not give full relief for the leasing costs. An expensive car in this context is a car with a retail price (when new) of **more than £12,000**.

In this instance, the allowable element of the leasing costs is given by the formula below:

$$\text{Allow: } \frac{\pounds 12,000 + P}{2P} \times \text{Lease charge in P\&L account}$$

where P = retail price of the car when new

The restriction does not apply to the leasing of cars which:

- (i) are electrically propelled; or
- (ii) have carbon dioxide emissions less than or equal to 110g/km (120 g/km for contracts entered into before 1 April 2008).

For new leases starting from 6 April 2009, these rules cease to apply. However, existing leases continue to apply these rules until the lease expires.

Illustration 1

Tariq is self-employed. He uses a Mercedes car under the terms of a finance lease which started on 1 January 2009. The amounts charged to the profit and loss account are as below:

	£
Finance lease interest	2,800
Finance lease depreciation	<u>3,200</u>
	<u>6,000</u>

The Mercedes had a list price (new) of £30,000. Tariq's business use of the car is agreed with HMRC at 75%. The amount to be adjusted in the trader's accounts is as follows:

	£	£
Charged to P&L account		6,000
Allowed under s.48:		
£6,000 × $\frac{12,000 + 30,000}{60,000}$	<u>4,200</u>	
Adjust for private use:		
£4,200 × 75%	<u>3,150</u>	
Allowable element of lease costs		<u>(3,150)</u>
Add back to profit		<u>£2,850</u>

3.8 High emission cars

For **new leases** taken out from **6 April 2009**, relief is restricted for the leasing costs of **high emission cars** rather than expensive cars.

[ITTOIA 2005, s. 48](#)

A **flat rate disallowance of 15%** of the leasing costs applies to cars with **CO₂ emissions exceeding 160g/km**.

Therefore the allowable element of the leasing costs is:

$$\text{Allow: } 85\% \times \text{Lease charge in P\&L account}$$

The restriction does not apply to:

- (i) the leasing of cars which are either electrically propelled or low emission; or
- (ii) the leasing of motor cycles.

The disallowance will not apply where the car is only available to the taxpayer for a period of no more than 45 days.

Illustration 2

Tariq also leases an Audi car under the terms of a finance lease which started on 1 July 2010 for use by an employee. The amounts charged to the profit and loss account are as below:

	£
Finance lease interest	1,500
Finance lease depreciation	<u>2,100</u>
	<u>3,600</u>

The Audi has CO₂ emissions of 180g/km. The amount to be adjusted in the trader's accounts is as follows:

	£
Charged to P&L account	3,600
Allowed under s.48:	
£3,600 × 85%	<u>(3,060)</u>
Add back to profit	<u>£540</u>

There is no adjustment for the private usage of the car by the employee since the employee will be taxed to income tax on an employment income benefit

If Tariq, the sole trader, had used the Audi car instead of the employee using it, the allowable amount of £3,060 would have to be adjusted further for Tariq's private use, resulting in a larger add-back.

3.9 Bad debts

Any bad debts **written off** in the year are deductible.

[ITTOIA 2005, s. 35](#)

Any "**specific provisions**" (i.e. where the trader can match the debt with a specific debtor) are also allowable.

However if a trader makes a **general** bad debt provision (e.g. he does not expect 5% of his debtors to pay their bills so he writes this sum off in the P&L account), this is not allowed.

For Trading Income purposes you should adjust for **movements** in the general bad debt provision i.e.

- add back any **increases**;
- deduct any **decreases**.

The above rules relate to trade debts only. If a trader writes off a money debt (e.g. a loan), this is not an allowable deduction as it does not relate to the trade (unless the trader happens to be a bank!).

Loans to employees written off will be allowable deductions, as they will effectively be treated as additional salary on which the employee will be subject to tax under the employment income rules.

3.10 Accountancy fees

Accountancy fees for the **preparation of business accounts** (or for the completion of the self-employed pages of the trader's tax return) **are allowable expenses**.

However, HMRC will not allow a deduction for the cost of preparing an individual's personal tax return (i.e. for the pages which relate to his investment income, capital gains, claims for reliefs etc). This is because the cost is being incurred in the individual's **personal capacity as a taxpayer**, not in his capacity as a trader and such costs do not relate specifically to the **trade**.

It is therefore common practice for accountants to split their bills between work relating to the client's trade and for work relating to his personal affairs.

Accountancy fees incurred in dealing with a **tax enquiry** are usually disallowable. However, HMRC has issued a Statement of Practice stating that if the enquiry relates **specifically to the trading income** and as a result of the enquiry **no additional profits are brought within the charge to tax**, any costs incurred in dealing with that enquiry **will be allowed** for tax purposes.

SP 16/91

3.11 Termination payments

Termination payments are payments made to staff on cessation of their employment contract.

[ITTOIA 2005, s. 76-79](#)

In a continuing trade, a full deduction for termination payments made to staff is given as these expenses will have been incurred **wholly and exclusively for the purposes of the trade**. This is because redundancy payments need to be made to ex-employees in order to retain the support and motivation of the remainder of the staff.

On cessation of trade, we cannot argue that the redundancy expense will be incurred wholly and exclusively for the purpose of the trade because there will no longer be a trade. However, employment law may specifically require the employer to make redundancy payments. Thus the legislation allows a **deduction for statutory redundancy payments** made to members of staff on cessation of the trade.

[ITTOIA 2005, s. 77](#)

If the business wants to be more generous and pay amounts in excess of statutory redundancy levels, a deduction is available under s.79. However relief is limited to **3 x statutory redundancy level**. Therefore when a business is ceasing, it can (in total) obtain a deduction for termination payments up to **4 x the statutory amount** - once under s.77 and three more times under s.79.

[ITTOIA 2005, s. 79](#)

Restrictive covenant payments - ie, payments made to former staff to (say) stop them competing / joining a direct competitor - are always allowed.

3.12 Travel and subsistence

Costs of travelling from **home to the normal place of work are not allowed** as a deductible expense for self-employed individuals as they are not incurred for the purposes of the trade. Other business travel expenses are allowable.

The reimbursement of an employee's home to work expenses will be an allowable expense (although it may give rise to a taxable benefit for the employee).

Subsistence costs are not generally allowable. As a general rule, expenses must be incurred "in the process of making profits" (not in the course of having lunch!). In *Caillebotte v Quinn (1993)*, a subcontractor claimed a deduction for additional costs of lunches whilst working away from home. The claim failed as the Court held that the expense was not wholly and exclusively for the purpose of the trade.

3.13 Training costs

The acquisition of **new expertise is treated as capital**. For example, assume an individual wants to trade as an accountant. The costs incurred by that individual to acquire the relevant expertise and pass the accountancy exams will not be treated as an allowable expense in arriving at his taxable profit. These costs will be **incurred to enable him to trade** in the first place and will therefore give him an "enduring benefit".

Ongoing, update or development training, once qualified, will be **allowed** as a revenue expense because there is a direct link between the expense being incurred and income being received as an accountant.

Staff training costs are always allowable as a trading expense whether this is for the staff to acquire new expertise or simply to keep up to date.

3.14 Premiums on leases

The grant of a lease by a landlord to a tenant for a period of 50 years or less is the grant of a "short" lease. On the grant of a short lease, part of the premium received by the landlord is chargeable to **income tax under property income rules**. The part of the premium which is not charged to income tax will instead be charged to **capital gains tax**.

To calculate the income tax charge we take the premium (P) and we deduct the amount which will be charged to capital gains tax (C).

Premium	P
Less: $2\% \times P \times (n-1)$	<u>(C)</u>
Property income	<u>A</u>

[ITTOIA
2005, s.
277](#)

where, 'n' is the number of years in the lease.

This amount ("A") is chargeable to income tax as property income in the year in which the premium is received by the landlord.

If the lease provides for rent to be paid by the tenant to the landlord for the duration of the lease, these rents are charged on the landlord in the normal way using the accruals basis.

If the tenant is using the property for the purposes of his trade, he will be **entitled to tax relief on part of the lease premium paid** to the landlord.

The part of the lease premium which is **allowable for tax purposes** in each accounting period is calculated as:

$$\frac{\text{Property income assessment on landlord (A)}}{\text{Period of lease}} = \text{Allowable deduction for tenant}$$

Unlike the landlord, who is charged to income tax on the premium in the year that the premium is received, the tenant receives tax relief **over the life of the lease**.

Any rents paid by the tenant to the landlord for the duration of the lease are deductible using the accruals basis.

Illustration 3

Beth owns a property. On 1 January 2010 she grants a 20-year lease on that property to a tenant, Donald. The premium paid by Donald is £30,000. Donald has a year-end of 31 December. As this is a short lease, some of the premium will be chargeable to income tax on Beth as follows:

	£
Premium	30,000
Less: $2\% \times £30,000 \times (20-1)$	<u>(11,400)</u>
Property income	<u>£18,600</u>

All of this £18,600 is taxed in the year of receipt - i.e. in 2009/10 - as non-savings income.

Donald, the tenant, has paid a lease premium of £30,000 to lease a property for use in his trade for the next 20 years.

However, Donald will not receive tax relief on the whole £30,000 of lease premium paid. Instead tax relief is calculated as:

$$\frac{\text{Property income assessed on landlord}}{\text{Period of lease}} = \frac{\pounds 18600}{20 \text{ years}} = \underline{\pounds 930} \text{ p.a.}$$

Donald will obtain tax relief of £930 for the year ended 31 December 2010 and each of the next 19 years for which the lease has been granted.

If instead Donald prepared accounts to 30 September each year, he would only be entitled to 9 months worth of relief in his year ended 30 September 2010:

$$\pounds 930 \times \frac{9}{12} = \underline{\pounds 698}$$

3.15 Fines and penalties

HMRC do not normally offer a tax incentive for breaking the law, so **finances and penalties are generally disallowable**.

Parking fines or speeding fines will be disallowed either under the "dual purpose" principle (i.e. the trader commits an offence in his personal capacity as a motorist rather than in the course of his trade) or because it is not an expense in the course of earning profits.

If a business reimburses personal fines of an employee, the reimbursement will give rise to a taxable benefit for the employee. As this benefit will be taxed as part of the employee's remuneration, the employer will receive a trading deduction.

3.16 Post cessation receipts & expenses

Accounts are prepared on the accruals basis, so any post-cessation receipts are **normally accounted for in the final period of trading**. Such profits have been earned in that final period and therefore they should have been recorded in that final period.

[ITTOIA 2005, s. 242](#)

Occasionally, however, income may be omitted or may arise after the trade has ceased.

If any income arises post cessation, an **Income Tax charge will arise** when the income is received. Relief is available for any post cessation expenses which would have been allowed had the trade continued.

Under s.257, taxpayers can elect to have any post-cessation receipts taxed in the year of cessation rather than the year of actual receipt. This could be helpful where the trader has losses in the final period of trading. If an election is made, these losses can be offset against the post-cessation receipts.

[ITTOIA 2005, s. 257](#)

An election under s.257 must be made within one year of the 31 January following the end of the year in which the income was received. The election only applies to receipts in the six years following the cessation of trade.

Post cessation expenses arise in a variety of circumstances such as:

[ITA 2007, s. 97](#)

- remedying defective work done in the course of the former trade, profession or vocation;
- damages in respect of any such defective work;
- legal or other professional services in connection with any claim that the work done was defective;
- expenses incurred in insuring against any liabilities arising out of any such claim;
- debt collection expenses - these can be deducted as can any bad debts which were not accounted for in the final accounts.

Relief for expenses is **given against income in the year in which the expense is actually incurred**. If the expenses exceed the income for that particular year, the excess can only be **carried forward against future post-cessation receipts**. Unutilised expenses will be **wasted** and may not receive any relief.

[ITA 2007, s. 96](#)

Relief is only available for expenses paid in the 7 years after cessation of the trade. A **claim** must be made for relief within one year of 31 January following the end of the tax year for which the deduction is to be made.

3.17 Pension contributions

The employer will usually obtain relief for contributions in the accounting period that they are **paid**, not accrued.

[FA 2004, s.196](#)

HMRC may seek to **disallow** a contribution where they believe that it is **not a revenue expense or incurred wholly and exclusively** for the purposes of the trade. For example where the contribution is considered to be part of an excessive remuneration package or the contribution is linked to the sale or cessation of a trade.

In addition, where contributions exceed £500,000, there are provisions for **spreading** the expenses over up to 4 years.

Spreading will apply where the increase in contributions is more than 110% of the contributions paid in the previous period ('the excess') and the excess is £500,000 or more.

These are summarised in the table below:

Excess contribution	Spreading
< £500,000	No spreading
£500,000 to £999,999	1/2 in current period, 1/2 in next period
£1,000,000 to £1,999,999	1/3 in current period and each of next two periods
> £2,000,000	1/4 in current period and each of next three periods

[FA 2004,
s.197](#)

3.18 Sundry allowable expenses

Removal expenses

Allowable unless the move is "expansionary" - i.e. the business is moving to significantly larger premises such that the removal costs will be an "enduring benefit" for the trade.

Note that the "£8,000 limit" applies to employees for taxable benefit purposes only - it does **not** affect the Trading Income **deduction** for the payer.

Thefts and defalcations

Allowed as a Trading Income deduction provided such thefts etc are by **employees** (i.e. not proprietors or directors). These expenses are seen as an every day risk of running a business (see *Curtis v J & G Oldfield Ltd (1925)*).

Donations to local charities

Allowed unless a Gift Aid declaration has been made (in which case, add back the donation to profit and obtain relief via the income tax computation by extending the basic rate band).

Other allowable expenses

These include:

- trade subscriptions;
- research and development costs;
- educational courses for trade purposes;
- business rates or business element of council tax;
- costs of registering a patent;
- contributions to local enterprise organisations.

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) Gift of bottle of champagne to customer (cost £20, has business logo on the label) | | |
| b) Costs of dealing with HMRC enquiry into 2009/10 tax return resulting in additional tax payable | | |
| c) 2 year operating lease on new van costing £20,000 | | |
| d) Staff Christmas party costing £250 per head | | |
| e) Specific provision for a bad debt | | |
| f) Subscription to trade association | | |
| g) Interest on loan to buy a new workshop | | |
| h) Loan arrangement fee | | |
| i) Donation to local hospice | | |
| j) £100 penalty for late filing of self-assessment return | | |

Example 2

Jason is self-employed. The following is a breakdown of the motor expenses charged to the profit and loss account;

	£
2 year finance lease taken out on 1 March 2010 on new BMW:	
Finance lease interest	2,000
Finance lease depreciation	1,000
Fuel for BMW	1,800
Repairs to Renault (used by employee)	500
Fuel for Renault	<u>700</u>
Total	<u>6,000</u>

Business use of both cars is 90%. The BMW has a list price of £25,000 and CO₂ emissions of 175g/km.

Calculate the amount to be added back to profits in respect of motor expenses.

Answer 1

	<i>Disallow ?</i>	<i>Allow ?</i>
a) Gift of bottle of champagne to customer (cost £20, has business logo on the label)	X	
b) Costs of dealing with HMRC enquiry into 2009/10 tax return resulting in additional tax payable	X	
c) 2 year operating lease on new van costing £20,000		✓
d) Staff Christmas party costing £250 per head		✓
e) Specific provision for a bad debt		✓
f) Subscription to trade association		✓
g) Interest on loan to buy a new workshop		✓
h) Loan arrangement fee		✓
i) Donation to local hospice		✓
j) £100 penalty for late filing of self assessment return	X	

Answer 2

Lease started after 6 April 2009 so high emission car restriction applies.

	£	£
Finance lease charged in P&L account		3,000
Allowed under s.48:		
£3,000 × 85%	<u>2,550</u>	
Adjust for private use:		
£2,550 × 90%	<u>2,295</u>	
Allowable element of lease costs		<u>(2,295)</u>
Add back		705
Add; private fuel for BMW (£1,800 × 10%)		<u>180</u>
Total add back		<u>£885</u>

Note: no adjustment for employee's private use of car.