CHAPTER 4

ADJUSTMENTS – STOCK AND WORK-IN-PROGRESS

Statutory references are to ITTOIA 2005 unless stated otherwise

4.1 Valuation of stock

Stock should always be properly valued - if it is not, an adjustment must be made.

ITTOIA 2005, s. 173-175

Stock is valued at the end of an accounting period, at **the lower of cost or "net realisable value".**

Cost is normally determined on a "**first in/first out** basis" – this means that the older stock is always deemed to be sold first, which leaves the newer stock in hand at the year-end.

The "net realisable value" is normally the **sale price less costs to completion.**

Normally "net realisable value" will be higher than cost, but in some cases it may produce a lower figure, in which case this lower figure must be used.

The value of closing stock appears as an asset in the Balance Sheet and is deducted from purchases in the Profit and Loss Account. This is logical because the purchases figure includes all the stock purchased in the period, and if there is any stock in hand at the year-end, this should be deducted to leave the cost of stock actually consumed in the period.

4.2 Stock adjustments under s.173

Stock valuations are particularly important on the **cessation or transfer of trade**.

S.173 ITTOIA 2005 dictates how stock should be valued on a cessation or transfer of trade. If the accounts valuation is different to the s.173 valuation, a tax adjustment must be made.

ITTOIA 2005, s. 173

The valuation of stock **depends on the identity of the buyer**. The buyer could be:

a) a non-trader or a non-UK trader;
b) a UK trader who is not "connected" with the vendor; or
c) a UK trader who is "connected" with the vendor.

ITTOIA 2005, s. 175-178

We will look at each of these in turn and identify how stock is valued in each instance.

© Reed Elsevier UK Ltd 2010

4.3 Stock transfers to a non-trader or a non-UK trader

If stock on cessation or transfer of trade is being sold to somebody who is **not a UK trader**, the stock must be **valued at its market value**.

ITTOIA 2005, s. 175(4)

HMRC see this as the last opportunity to tax the stock, because once it has left the UK tax net, HMRC is unlikely to get the opportunity to tax the stock again. The stock could be going to a foreign party or it could be going to a UK individual for their own personal consumption. Consequently HMRC **uplifts the price of the stock to its market value** at the date of transfer.

Illustration 1

Jonathan is in business selling garden furniture. He ceases trading on 31 December, and still has some garden chairs left in stock.

The chairs cost £1,000 and have a retail selling price of £1,500.

Jonathan agrees to sell the chairs to his friend Steve for £1,100. He duly records this sale in his final accounts.

Under s.175, as the sale on cessation of trade is not to a UK-based trader, the sales figure that should be recorded in the accounts is the amount that the stock would have realised had it been sold for its **market value**.

Therefore Jonathan is treated as having sold the chairs for £1,500 (not for the £1,100 actually received). This will give us an **adjustment of £400** which must be **added to the profit** in order to arrive at the tax adjusted profit.

The same principle would apply if Jonathan ceased trading and took the chairs for his own personal use.

4.4 Stock transfers to an unconnected UK trader

Where the purchaser of the stock is a **UK trader**, the position is different.

If the vendor is **not connected** with the buyer (ie, we have a commercial "arms length" sale), HMRC are normally happy to take the **actual sales consideration** to be the tax value of the stock – i.e. the price the stock was actually sold for.

ITTOIA 2005, s. 176(2)

In theory the sales price should be approximately market value, as it is unlikely that a vendor would sell stock to an unconnected party at a value significantly different to the stock's true market value.

As the trader will include actual consideration within sales, **no adjustment will be required** for tax purposes.

4.5 Stock transfers to an unconnected trader – "just & reasonable" provisions

There have been occasions when unconnected parties have manipulated the consideration to be paid and received for stock to obtain a tax advantage. Consequently HMRC introduced the **"just and reasonable" provisions within s.176 ITTOIA 2005**.

S.176 contains a "just and reasonable" apportionment provision in instances where **stock is transferred along with other assets**. Under s.176, the value placed on stock has to be "just & reasonable"- ie, an artificially higher or lower value cannot be placed on the stock to obtain a tax advantage.

ITTOIA 2005, s. 176(3)

Typically s.176 will apply where a vendor **sells the whole of his business** to a purchaser and accepts an "all inclusive" price for his stock, plant & machinery, goodwill and business premises. Where stock is **sold on its own, these "just and reasonable" provisions will not apply.**

Illustration 2

Colin wants to sell his sole trader business. He has trading losses brought forward of £100,000. These can only be offset against profits from the same trade. If the trade ceases, these losses will be wasted.

Colin has found a buyer (Tony) and they have agreed a price of £800,000 for the whole of the business.

The seller and buyer have agreed an overall price of £800,000, but they have not yet agreed a breakdown of the sales price, e.g. what proportion of the £800,000 was for stock, what proportion of it was for premises, goodwill, machinery etc.

The approximate value of Colin's assets are as follows:

	Market value
	£
Business premises	480,000
Goodwill	200,000
Stock	50,000
Plant & machinery	70,000
	£800,000

The cost of the stock was £40,000. If both parties agree this breakdown of the sales consideration, this would give Colin a trading profit on the sale of the stock of £10,000 (£50,000 - £40,000). Tony would then acquire the stock at a cost of £50,000.

However, it would be beneficial here for both parties for a higher value to be put on the stock - say £100,000. In Colin's books, a trading profit of £60,000 (£100,000 - £40,000) would then be created on the transfer of the stock. Colin can then offset the brought forward trading losses against this profit, so even though there is a profit on the sale of the stock, there will be no tax to pay.

© Reed Elsevier UK Ltd 2010

On the other hand the buyer (Tony) will now have bought the stock for £100,000 – this is artificially higher than its "real" value, thereby decreasing Tony's trading profits when he eventually sells the stock.

The manipulation of sales consideration in this way is not allowed. Under the "just and reasonable" provisions in s.176, we must **reduce the price of the stock for tax purposes to its fair market value of £50,000**.

4.6 Stock transfers between connected UK traders

Where there is a transfer of stock between "connected" UK traders, under s.177 the transfer **takes place at market value** for trading income purposes. The seller is treated as **selling the stock for its market value** and the buyer is treated as **buying the stock for that same value**. Actual consideration is therefore ignored.

ITTOIA 2005, s. 177

A "connected person" here means one's spouse or civil partner, a relative (brother, sister, parent, children etc), relatives of spouses (e.g. brother-in-law), spouses of relatives (e.g. son-in-law) and fellow business partners.

ITA 2007, s. 993, 994

Where the transfer is by or to a company, that company is connected to any persons who control it (i.e. persons owning over 50% of the shares).

On a transfer of stock between connected persons, if the vendor's accounts do not include the market value of stock within the sales figure, a tax adjustment will need to be made.

4.7 Stock transfers between connected UK traders – S.178 elections

On a transfer of stock between connected UK traders **a joint election is possible between buyer and seller**.

ITTOIA 2005, s. 178

The election **substitutes the higher of either cost or actual consideration** in place of market value.

This election **can only be made if the market value of the stock is higher** than both cost and actual consideration.

You will often see this election in instances where a sole trader business becomes a company – i.e. on an incorporation.

Illustration 3

David Hodges is a sole trader. He runs a hardware shop. On 1 July 2010, David transferred his business to a newly formed company called "Hodges Hardware Ltd". David owns all the shares of Hodges Hardware Ltd and is managing director.

David's final Balance Sheet as a sole trader is as below:

	Cost	Market value
	£	£
Business premises	150,000	280,000
Goodwill	NIL	100,000
Stock	15,000	40,000
Plant & machinery	120,000	80,000
		£500,000

David and Hodges Hardware Ltd agree to transfer the stock for **nil consideration** – effectively David agrees to give the stock to the new company free of charge. No amount is therefore included within sales in David's final sole trader accounts.

We need to consider whether a tax adjustment should be made.

David and Hodges Hardware Ltd are "connected persons" as David owns both the sole trade business and more than 50% of the shares in the company. Therefore under s.177 ITTOIA 2005, David should be selling the stock to the company for its **market value of £40,000**, and should reflect this in his final accounts.

As no figure has been included within sales for the transfer of the stock, David's **final trading profits should be uplifted by £40,000**. Hodges Hardware Ltd is also treated as buying the stock for £40,000.

However, under s.178 ITTOIA 2005, David and the company can make an election to treat the stock as being sold for the higher of:

a) its acquisition value, ie cost (£15,000); and

b) the amount actually realised on sale (£NIL).

If the parties make an election:

1) **David sells the stock to the new company for £15,000**. This will therefore need to be reflected in his sales, so a tax adjustment of £15,000 is required; and

2) Hodges Hardware Ltd is treated as **buying the stock for £15,000**.

This election will be advantageous for David as it **reduces his final trading profits** (an upward adjustment of £15,000 is better than one of £40,000). On the other hand, the election reduces the base cost of the stock for the new company.

If, however, David had trading losses in his final year to wipe out any profits, it may be beneficial **not to make an election**. In the absence of an election, the transfer will take place at market value and the higher profit on the transfer of the stock will be wiped out by trading losses.

© Reed Elsevier UK Ltd 2010

4.8 Stock adjustments - Summary

To summarise, the way we value stock on a cessation or transfer of trade **depends on the identity of the buyer**:

Buyer	*Stock Valuation*
Non-UK trader / Non-trader	Open market value
UK trader (not connected)	Actual consideration (bearing in mind the "just and reasonable" provisions)
UK trader (connected)	Market value of the stock at the date of the transfer (subject to an election to transfer at higher of cost or actual selling price).

4.9 UITF 40

In March 2005 the Accounting Standards Board issued Urgent Issues Task Force Abstract 40 ("UITF 40") which sets down the rules for the recognition of income on long term service contracts. UITF 40 changed the way that service providers must **account for uncompleted (and unbilled) work** at the end of their accounts year.

Income must be recognised as the contract progresses rather than when contracts are completed. Essentially this means that **businesses must recognise their work-in-progress (WIP)** within their accounts and **pay tax on it as the work arises**, not when the work is finally completed and billed.

UITF 40 required all financial statements to adopt this new accounting treatment in all accounting periods **ending after 22 June 2005.**

For most businesses the application of UITF 40 resulted in a **one-off uplift of income** in the 2005 or 2006 accounts. This thereafter impacted on the tax position as it brought additional profits into the charge to tax.

We will look at **how we deal with the adjustment for tax purposes**. The way in which businesses actually arrive at the accounting adjustment will not be considered.

4.10 UITF 40 – the "spreading" provisions

FA 2006, Sch 15

Finance Act 2006 introduced rules allowing the impact from the change of accounting policy (the "adjustment income") to be **spread over three to six years**.

The rules apply to sole traders, partnerships and companies which adopt UITF 40.

Rather than being wholly taxed in the year in which the adjustment arises, FA 2006 allows for the adjustment income to be **spread forward and taxed "bit-by-bit" over up to six years**. This way, the whole of the adjustment income is taxed, but it does not have the penal impact of giving the trader an artificially high tax bill in one year.

The spreading is **automatic** and does not require any claim or election to be made.

The adjustment income is spread as follows:

a) In Years 1 to 3, the amount brought into charge to tax is the **lower** of:

   i. 1/3 of the amount of the adjustment income; or
   ii. 1/6 of the "taxable profits" of the business for that year.

   "Taxable profits" are after the usual tax adjustments, but **before capital allowances**.

b) In Years 4 and 5:

   If the whole of the adjustment income has not been charged in the previous tax years, the amount brought into charge to tax is the lower of:
   i. The amount remaining untaxed; or
   ii. 1/3 of the amount of adjustment income; or
   iii. 1/6 of the taxable profits of the business for that tax year.

c) In Year 6:

   The amount taxed is simply the remaining amount (if any) of the adjustment income that has not thus far been taxed.

If a business ceases within the six years, the adjustment income continues to be spread forward (but without the alternative "1/6 of business profits" rule).

If a business has an accounting period of less than 12 months, the fraction of 1/3 is scaled down. However the adjustment can still be spread over six years irrespective of the number of accounting periods this covers.

It is possible for a trader to **elect to be taxed on a higher amount** than that given by the calculations above. This may be advantageous if the trader has losses in a year which will mop-up the adjustment income, or if profits in a year will be taxed at the basic rate rather than at the higher or additional rates of income tax.

If such an election is made, calculations for subsequent tax years will be amended to take account of any amounts accelerated. If income is accelerated, the **maximum amount to be brought into charge in subsequent years** is calculated as below:

£(Adjustment income – amount accelerated) x 1/3

The election must be in writing, stating the additional amount to be taxed. The election must be made by the first anniversary of the normal self-assessment filing date.

Illustration 4

Ben is a self-employed architect. He draws accounts annually to 31 May. In the year ended 31 May 2006, Ben adopted UITF 40 and valued his work-in-progress at 31 May 2006. This gave rise to adjustment income of £75,000.

His taxable trading profits (before capital allowances) are as follows:

	Taxed in	£
Year ended 31 May 2006	2006/07	45,000
Year ended 31 May 2007	2007/08	60,000
Year ended 31 May 2008	2008/09	165,000
Year ended 31 May 2009	2009/10	51,000
Year ended 31 May 2010	2010/11	105,000
Year ended 31 May 2011 (estimated)	2011/12	240,000

We will show how the adjustment income will be taxed.

1/3 of the adjustment income (£75,000 x 1/3) = £25,000

			Taxable adjustment £
Year 1	2006/07		
		Lower of: £25,000	
		1/6 x £45,000 = £7,500	7,500
Year 2	2007/08		
		Lower of: £25,000	
		1/6 x £60,000 = £10,000	10,000
Year 3	2008/09		
		Lower of: £25,000	25,000
		1/6 x £165,000 = £27,500	
		Taxed in first 3 years	£42,500

As not all of the adjustment income has been taxed, spreading will continue into Year 4.

			Taxable adjustment
			£
B/fwd		Taxed so far	42,500
Year 4	2009/10		
		Lower of: £25,000	
		1/6 x £51,000 = £8,500	8,500
		Balance not yet taxed = £32,500	
Year 5	2010/11		
		Lower of: £25,000	
		1/6 x £105,000 = £17,500	17,500
		Balance not yet taxed = £24,000	
Year 6	2011/12		
		Balance not yet taxed = £6,500	6,500
		Total	£75,000

Ben's revised taxable profits (before capital allowances) are now:

	Profits	Adjustment	Taxable
	£	£	£
2006/07	45,000	7,500	52,500
2007/08	60,000	10,000	70,000
2008/09	165,000	25,000	190,000
2009/10	51,000	8,500	59,500
2010/11	105,000	17,500	122,500
2011/12	240,000	6,500	246,500

The adjustment income is treated as earnings for pension purposes, but is not subject to national insurance contributions.

© Reed Elsevier UK Ltd 2010

Example 1

Tara owns a jewellery shop. She is shortly to have a baby and has therefore decided to sell the business to an unconnected buyer, Connie. Connie will pay Tara £500,000 for the business and the two parties have agreed that this be broken down as follows:

	£
Business premises	275,000
Goodwill	125,000
Stock	60,000
Plant & machinery	40,000
	£500,000

Tara's final accounts include £60,000 in respect of the stock. The stock cost £35,000 and has an estimated market value of £100,000.

Show the adjustment, if any, which should be made to Tara's final trading profits.

Example 2

Conrad is a self-employed interior designer. In the year ended 30 April 2006, Conrad adopted UITF 40. This gave rise to adjustment income of £90,000.

His taxable trading profits (before capital allowances) are as follows:

		£
Year ended 30 April 2006	= 2006/07	96,000
Year ended 30 April 2007	= 2007/08	(5,000)
Year ended 30 April 2008	= 2008/09	120,000
Year ended 30 April 2009	= 2009/10	150,000
Year ended 30 April 2010	= 2010/11	180,000

Due to a car accident, Conrad had a small trading loss in 2007/08 so he elected to accelerate £18,000 of the adjustment income into 2007/08.

Show how the adjustment income will be spread.

Answer 1

As stock is transferred along with other assets, under s.176 ITTOIA 2005, the value placed on stock has to be "just & reasonable".

HMRC will therefore expect the value to be placed on the stock at cessation to be its market value of £100,000.

As £60,000 has been accounted for in respect of the stock, **£40,000 will therefore need to be added** to the trading profit.

Answer 2

1/3 of the adjustment income (£90,000 x 1/3) = £30,000

			Taxable adjustment £
Year 1	2006/07		
		Lower of: £30,000	
		1/6 x £96,000 = £16,000	16,000
Year 2	2007/08		
		Lower of: £30,000	
		1/6 x £NIL = £NIL	NIL
		Add; amount accelerated	18,000
			18,000

The maximum amount to be brought into charge is now amended as follows:

1/3 x £(90,000 - 18,000) = £24,000

			Taxable adjustment £
B/fwd		Taxed so far	34,000
Year 3	2008/09		
		Lower of: £24,000	
		1/6 x £120,000 = £20,000	20,000
Year 4	2009/10		
		Lower of: £24,000	24,000
		1/6 x £150,000 = £25,000	
		Balance remaining = £36,000	
Year 5	2010/11		
		Lower of: £24,000	
		1/6 x £180,000 = £30,000	
		Balance not yet taxed = £12,000	12,000
			90,000

© Reed Elsevier UK Ltd 2010