

CHAPTER 1

TRADING INCOME AND THE BADGES OF TRADE

Statutory references are to ITTOIA 2005 unless stated otherwise

1.1 Trading Income

The category "trading income" encompasses both **income from a trade**, for example plumbing or building and **income from a profession or vocation**. A profession would include accountancy or law. A vocation includes acting, ballet dancing, theatrical performing, sport etc.

1.2 The definition of trading

Income tax is charged on "the profits of a trade, profession or vocation". A pro forma for the income tax computation showing where trading profits are included is shown at the end of this chapter for reference.

[ITTOIA 2005, s. 5](#)

A trade is defined as including "**any venture in the nature of trade**".

As a "trade" is not fully defined in the legislation, the interpretation of what is meant by the term "trade" has been left largely to the Courts. The Courts have developed a number of tests to determine whether somebody is trading. These tests are known as the "**badges of trade**".

1.3 The Badges of Trade

Profit seeking motive

When a person enters into a transaction, we need to identify whether there is a profit seeking motive. It is not the existence of a profit that is important, it is the motive to earn one. However HM Revenue and Customs (the Revenue) will really be interested in this issue if a profit has **actually** been earned, because then they have something to tax.

A taxpayer may argue that they are trading in order to utilise a loss to reduce their tax bill. The taxpayer must demonstrate the **motive** rather than the existence of profit to establish that a trade is being carried on.

Frequency and number of similar transactions

If we do something once, never to be repeated again, it is unlikely that we would be treated as carrying on a trade. However if we **keep doing it**, it is more likely that we are trading. For instance, assume I sold my car which I had owned for four years. I then bought myself another car and sold that one two years later. It is unlikely that HMRC would consider that I am trading in cars. If, however, I bought and sold cars every month, it is more likely that they will seek to tax the profits as trading income.

The most notable case in this area is *Pickford v Quirke* where a taxpayer purchased a mill with the object of using it for trading purposes. However it turned out that the mill was in a much worse state than they had imagined and the best thing the taxpayer could do was to strip all the items out of it and sell them piecemeal. He made a considerable profit doing this, so he did it again and again and again. As a result of the **repeated number of transactions**, it was held that the profits were taxable as trading income.

Modification of the asset in order to make it more saleable

If we buy something, do nothing to it then sell it, it is unlikely we are trading. However, if we bought a car, put a new engine in it, resprayed the body and made it more attractive to buy, it is possible we would be considered to be trading.

Nature of the asset

We can pin a trading label onto a single one-off transaction simply because we cannot justify that the particular asset was purchased for any other purpose than to resell it. The most notable case in this area is *Rutledge v CIR*.

In this case a taxpayer purchased 1 million rolls of toilet paper in one single transaction. He then sold them on at a profit in another single transaction. This was held to be trading (an "adventure" in the nature of trade) as there was no other justifiable reason to purchase such a large quantity of toilet paper - he could not argue that this was simply overstocking!

Connection with an existing trade

Taking an example of a car, let us say that as a tax accountant I sell a car. It is unlikely that I would be trading in cars because there is no link between selling cars and being a tax accountant. If however I was a car mechanic who occasionally sold a car, HMRC are much more likely to successfully tax the profits on the sale of cars along with my existing trade as there is a **direct link** between repairing cars and selling cars. Other badges of trade would also need to apply, but such a link is something that HMRC will look very closely at.

Financing arrangements

If an asset is purchased on a short term loan which the taxpayer is unable to fund without selling the asset again, then HMRC can successfully argue that the asset was purchased specifically with a view to selling it.

This was cited in the case of *Wisdom v Chamberlain* where the comedian Norman Wisdom bought a mound of silver bullion on a short term loan. He could not service the interest payments from his existing money, but as soon as he sold the bullion and repaid the loan he found he had made a substantial profit. This profit was taxed as trading income.

Length of ownership

If you have owned something for a long time, it is much easier to justify that you bought it for its enjoyment or for your own private consumption. A profit on sale would not therefore be treated as a trading profit. If however you have only owned it for a **short period** it is much more likely that HMRC could successfully argue that it was purchased with the aim of selling it at a profit.

The existence of a sales organisation

In the case of *The Cape Brandy Syndicate*, a syndicate of chartered accountants distilled brandy. They distilled far more than they could actually drink themselves and sold the surplus. HMRC sought to tax them as trading income. They argued that they were simply selling what they could not physically drink themselves. However as they had set up a special phone line and information desk and published brochures and adverts advertising their brandy, HMRC successfully argued that they had commenced a trade.

Reason for the acquisition/sale

Finally, we will look at **how the asset was acquired** - i.e. whether purchased or otherwise acquired by gift or inheritance - and what is the **reason for the sale** of the asset? By way of an example, consider Maud who inherits a wardrobe full of fur coats from her late mother. She does not want to wear them, so she puts an advert in the local paper to sell them. HMRC spots this advert and seek to tax Maud for any profits earned. As Maud **inherited** the coats it is highly unlikely that a trading label can be pinned to these transactions. However, if Maud had **purchased** a wardrobe full of fur coats, advertised them and then sold them at a profit, it is much more likely that she would be held to be trading. Simply realising an inheritance for cash is not the commencement of a trade.

In some circumstances, the existence of one single badge is enough to show trading (as in the case of *Rutledge v CIR*). However **in other cases we need to look at a combination** of the badges of trade. The trigger to get HMRC interested in the transaction in the first place is the existence of a **profit**.

1.4 Land transactions

HMRC often looks closely at the purchase and sale of land and buildings, simply due to the size of the profits involved. It is in the area of land transactions that the most cases involving the badges of trade have been taken to the Courts.

One of the important questions to ask is whether the taxpayer is "**investing in land**" or "**dealing in land**" - "dealing" is trading. This question which was posed in the case of *Marson v Morton*. Here a taxpayer purchased some land with the intention of holding on to it as an **investment** for at least two years. In order to increase the value of the land, the taxpayer applied for planning permission. Looking at the badges of trade, this will be regarded by HMRC as a **modification to an asset to make it more saleable**.

It was held in this case that because **the original intention was the purchase of an investment**, no trade was being carried on. It is not what the taxpayer **says** which determines intentions, it is what the **surrounding evidence supports**. Documented intentions made the difference.

Another question that we must ask is, is whether our taxpayer is a **resident in the property**, or a **developer who is refurbishing a property for onward sale**. In the case of *Kirkby v Hughes*, a builder purchased a run-down house. He carried out a lot of repair and refurbishment work and sold the house at a healthy profit. He then purchased a strip of land and built a house on it, again selling it at a substantial profit. He then purchased a barn and converted it into a house.

The Courts believed that he was trading because they could apply **enough of the badges of trade** to him. There clearly was a profit seeking motive, he had modified the assets he purchased, there was a connection with an existing trade, and the length of ownership in each case was fairly short. The profits on the first house were held to be taxable as trading income along with all of the other properties he had bought and sold.

Looking specifically at **one** of the badges of trade we should also identify a **reason for the purchase and a reason for the sale**. In the case of *Taylor v Good*, a husband purchased a property to be used as a family home. However on seeing the house, his wife refused to live in it. As a result he had no option but to sell the house. Despite it being a one-off transaction, HMRC felt that the badges of trade applied because the asset was only owned for a very short period of time. However, there was clearly **another reason for the acquisition and subsequent sale** - there was a **genuine intention** by the taxpayer to live in the house rather than simply to make a quick profit. therefore the transaction was held **not** be a trading transaction.

1.5 Frequency of transactions

Michael buys unprofitable restaurants, turns the businesses around and sells them at a profit. He has done this 12 times. The idea came to him when he sold his first restaurant which he had run as the owner and manager for 10 years.

The question we are asking is whether he is chargeable to tax on trading income, first in respect of the restaurants in general, which he had run for a short period, but also in respect of the first restaurant which he had run for a long period.

We must look closely at the badges of trade. Clearly there is a profit seeking motive which is readily identifiable. The frequency of transactions which Michael is undertaking points towards a trade. Modifications to the asset purchased (taking an unprofitable restaurant and turning it around), the length of ownership (he owns them for a relatively short period of time) and the reason for the sale (to make money) lead us to draw the conclusion that these transactions will clearly be trading transactions.

The next question is - **do the future transactions taint the first one?** Unfortunately the answer to this question is **yes**. In the case of *Leach v Pogson*, an individual had owned a driving school for a long period of time before he sold it at a profit. He then purchased, turned around and sold numerous other driving schools in the future. It was held by the Courts that not only were profits from sales of the **later** driving schools charged to tax as trading income, but the **original disposal, although originally treated as a capital transaction, will be turned into a trading transaction because of later events**.

1.6 Share Dealing

Muriel thinks she has an infallible system to predict share price movements. Over a two year period she entered into over 100 transactions buying and selling shares. She made a profit on some but overall she made a loss, so her system was not as infallible as she thought! Will she manage to obtain loss relief against her general income?

In order to set a loss against other income the **loss must be a trading loss** - we will come to losses later in this course. The question is whether Muriel is **dealing or investing**. In the case of *Salt v Chamberlain* it was held that **all share transactions are capital** in their nature unless they are undertaken by a properly registered share dealer. Therefore if a private individual (not a share dealer) buys and sells shares many, many times, he can never have the badges of trade pinned on to those transactions. Such profits will be taxable as **capital gains**.

1.7 Anti-avoidance Provisions

Anti-avoidance provisions apply specifically to the largest type of trading transaction, those involving land. When dealing with a land transaction, the first thing that we need to look at is whether the badges of trade apply. If the badges of trade apply to the transaction it will be treated as trading income. If the badges of trade do not apply then the transaction will be treated as a capital transaction and, in most cases, be charged to capital gains tax.

However, **the transaction could be taxed as miscellaneous income**. This will only apply when a taxpayer has **deliberately taken steps** to turn a trading transaction into a capital one.

For example, if a taxpayer thinks he can buy and sell land and buildings at a profit, the profit is likely to be taxed as trading income. If, however, he has the brilliant idea of setting up a limited company, putting the property in the company then selling the shares at a profit, following *Salt v Chamberlain* the sale of the shares cannot be treated as a trading transaction.

In this scenario we shall tax the profit as **miscellaneous income**. Therefore profits will become taxable as income, which denies the CGT exemption.

1.8 Taxable and Non-Taxable Receipts

If receipts are **wholly unexpected and unsolicited**, they are **not taxable**. This is highlighted in the case of *Simpson v John Reynolds & Co*, in which a taxpayer received a voluntary payment from an ex-customer when they were asked to cease to act as their insurance broker. Because the payment was not invoiced, not expected and was purely an unsolicited gift, it was not held to be part of the taxable trading income.

In *Murray v Goodhews*, an ex-gratia payment given to a pub landlord as a result of the cancellation of his pub tenancy was held not to be taxable. The reason for this was that the receipt of the compensation had nothing to do with him buying and selling alcoholic drinks and running a pub - it was as a result of the termination of the pub tenancy.

However, if amounts are **expected** then they will be **taxable**. In the case of *Creed v H & M Levinson Limited*, a taxpayer was offered an ex-gratia amount from an ex-customer and successfully sued for more. As the receipt was clearly solicited and expected, it was taxable. In the case of *McGowan v Brown & Cousins*, an estate agent who received compensation for not being appointed as letting agent, was taxed on the income as it related specifically to the trade and was solicited and expected.