

Chapter 4

TAX ADJUSTED TRADING PROFIT – INDIVIDUALS

1 Badges of trade

The following tests are used to establish if a transaction(s) should be treated as trading and taxed as income under tax adjusted trading profit rules or whether they should be treated as capital transactions and treated as capital gains.

1.1 Subject matter

Whether a person is trading or not may sometimes be decided by looking at the subject matter of the transaction.

1.2 Frequency of transactions

Transactions of a capital nature will be interpreted as trading transactions where their frequency indicates the carrying on of a trade.

1.3 Length of ownership

Where items purchased are sold soon afterwards, the transactions are likely to be treated as a trade.

1.4 Profit motive

The presence of a profit motive will be a strong indication that a person is trading.

1.5 Supplementary work and marketing

When work is done to make an item more marketable, or attempts are made to find purchasers, the transactions are more likely to be treated as a trade.

1.6 Manner in which assets were acquired

If acquired unintentionally (e.g. by inheritance) and then sold, it is unlikely that trading has taken place.

2 Adjusting the accounting profit

2.1 Introduction

- (a) The tax adjusted trading profit for inclusion within the income tax computation is not the same as the profit shown in the individuals statement of profit or loss. Accounting profits before tax are adjusted to arrive at tax adjusted trading profit. The main adjustments are to disallow for tax certain non-allowable expenses debited in the accounts and to exclude from the assessment any non-trading income credited in the accounts

(b)		£
	Net profit per accounts	X
	ADD BACK: Expenditure not deductible for tax	<u>X</u>
		X
	LESS: items not assessed as trading profit	
	- Income assessable elsewhere (eg property income, interest income)	X
	- Non-taxable (exempt) income	<u>X</u>
		(X)
	Adjusted profits	X
	LESS: Capital allowances	<u>(X)</u>
	Tax adjusted trading profit	<u>X</u>

Note:

When preparing this calculation, be careful to start with the NET profit per accounts.

2.2 Typical expenditure by a business

- (a) Capital expenditure including depreciation is not allowable
- » repair to an asset is revenue expenditure and is allowable
 - » improvement to an asset is capital expenditure and is not allowable
- (b) Reliefs, such as qualifying loan interest payments (see chapter 2) are not allowable as they are dealt with as a deduction from total income
- (c) Patent royalties payable are an allowable deduction for adjusted trading profit.
- (d) Irrecoverable / Impaired Debts (Trade debt write offs & allowances)
- » These are allowable; the tax treatment follows the accounting treatment
 - » However non trade write offs are not allowable and so the expense is added back.
- (e) Entertaining and gifts
- » entertaining is disallowed, unless entertaining employees
 - » gifts to employees are allowable
 - » gifts to customers are only allowable if
 - they cost less than £50 per person per year, and
 - the gift is not food, drink, tobacco or vouchers exchangeable for goods and services
 - the gift carries a conspicuous advertisement for the business.
- (f) Subscriptions and donations
- » trade or professional association subscriptions are allowable
 - » charitable donation (Not made under Gift Aid)
 - if it is small and made wholly and exclusively for trading purposes (eg promoting business' name), and it is to a local charity then it is allowable
 - National / international charity donations are not allowable
 - » charitable donations (made under Gift Aid) are not allowable - see tax treatment in chapter 2.
 - » Political donations - these are not allowable
- (g) Legal and professional charges
- » allowable if connected with the trade and are not related to capital items
 - » specifically **allowed** by statute:
 - costs of obtaining loan finance
 - costs of renewing a short lease (50 years or less)
- (h) Interest payable
- » interest paid on borrowings for **trading purposes** is allowable on an accruals basis therefore no adjustment is needed.

- (i) Lease rentals on cars with CO₂ emissions exceeding 110g/km
 - » the disallowed amount is 15% of the leasing charges p.a..
- (j) Premium paid for the grant of a lease (see chapter 3).
 - » the premium itself is disallowed as is any amortisation of the premium
 - » the allowable amount to be computed is:

$$\frac{\frac{51 - n}{50} \times \text{Premium}}{n}$$

where n is the number of years of the lease.

- (k) Fines and penalties - Disallowed unless a parking fine paid on behalf of an employee and incurred whilst on business
- (l) The accounting profit must be adjusted for the private expenditure of the business owner. If the owner uses a car in the business and 20% of his mileages private, then only 80% of motor expenses are allowable. - thus add back 20% in the adjustment of profit
However if the owner provides an employee with a car, and 20% of the mileage is for private use by the employee, then the full amount of motor expenses is allowable. (The employee is then taxed on the private use as employment income - see chapter 9).
- (m) Any deduction described as the owner's salary, or drawings or interest on capital invested in the business is disallowed.
- (n) Interest paid on overdue tax is not deductible and interest received on overpaid tax is not taxable
- (o) Any salary paid to the family of the owner of the business must not be above the normal commercial rate for the job
Only salary at the commercial rate for the work done is allowable.
- (p) If an owner removes goods from the business for his own use he must add back the item as a sale at market value, unless the owner accounts for the cost of the goods in the business accounts then they need only add back the lost profit on the item.
- (q) Pre-trading expenditure – allowable if it is expenditure incurred in the seven years before a business commences to trade then it is treated as an expense incurred on the day the business starts trading and follows the above rules.
- (r) The general rule is that expenditure not wholly and exclusively for the purpose of the trade is not allowable

EXAMPLE 1

On 1 June 2017 Jeremy commenced in self-employment running a retail shop. Jeremy's statement of profit or loss for the year ended 31 May 2018 is as follows:

	£	£
Gross Profit		140,880
Expenses:		
Depreciation	4,760	
Light and heat (Note 1)	1,525	
Motor expenses (Note 2)	4,720	
Professional fees (Note 3)	2,300	
Rent and rates (Note 1)	3,900	
Repairs and renewals (Note 4)	5,660	
Sundry expenses (Note 5)	2,990	
Wages and salaries (Note 6)	84,825	
		<u>110,680</u>
Net profit		<u>30,200</u>

Notes

Note 1: Private accommodation

Jeremy and his wife live in a flat that is situated above the clothing shop. Of the expenditure included in the statement of profit or loss for light, heat, rent and rates, 40% relates to the flat.

Note 2: Motor expenses

During the year ended 31 May 2018, Jeremy drove a total of 12,000 miles, of which 9,000 were for private journeys.

Note 3: Professional fees

Professional fees are as follows:

	£
Accountancy	700
Legal fees in connection with the purchase of the clothing shop	1,200
Debt collection	400
	<u>2,300</u>

Included in the figure for accountancy is £250 in respect of a capital gains tax computation.

Note 4: Repairs and renewals

The figure of £5,660 for repairs and renewals includes £2,200 for decorating the clothing shop during July 2017, and £1,050 for decorating the private flat during August 2017. The building was in a usable state when it was purchased.

Note 5: Sundry expenses

The figure of £2,990 for sundry expenses, includes £640 for gifts to customers of food hampers costing £40 each, £320 for gifts to customers of pens carrying an advertisement for the clothing shop costing £1.60 each, £100 for a donation to a national charity, and £40 for a donation to a local charity's fete. The fete's programme carried a free advertisement for the clothing shop.

Note 6: Wages and salaries

The figure of £84,825 for wages and salaries includes the annual salary of £15,500 paid to Jeremy's wife. She works in the clothing shop as a sales assistant. The other sales assistants doing the same job are paid an annual salary of £11,000.

Note 7: Goods for own use

During the year ended 31 May 2018, Jeremy took clothes out of the shop for his personal use without paying or accounting for them. The cost of these clothes was £460, and they had a selling price of £650.

Note 8: Plant and machinery

The capital allowances available for the year ended 31 May 2018 are £13,060.

(In the actual examination you will be required to prepare a capital allowances computation and work out this figure. - see chapter 5)

Calculate Jeremy's tax adjusted trading profit for the year ended 31 May 2018.

In Exam questions in Section C on this topic to ensure that students deal with all the items on the statement of profit or loss, students are required to put in a zero adjustment for any items that do not require an adjustment - see reference below to ACCA examining team technical article on adjustment of profit.

After completing this chapter you may now attempt Practice Question 10 and review the following technical articles written by the ACCA examining team

Finance Act 2018 - Leased motor cars and work example 17

Adjustment of Profit