These notes refer to the Income Tax (Trading and Other Income) Act 2005 (c.5) which received Royal Assent on 24 March 2005

INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 2: Trading income

Chapter 12: Trade profits: valuation of stock and work in progress

Overview

718. This Chapter sets out the rules for valuing stock and work in progress when a person ceases to carry on a trade, profession or vocation. The rules for trading stock are in sections 173 to 181. The rules for work in progress are in sections 182 to 185.

Section 173: Valuation of trading stock on cessation

719. This section sets out two general propositions based on section 100(1) and (1ZA) of ICTA. First, a valuation has to be made. Second, that valuation has to be made in accordance with the rules set out.

720. *Subsection (1)* restricts the operation of the section (and the other valuation rules) to the calculation of the profits of a trade when a person ceases to carry it on. It includes a signpost to the detailed valuation rules in sections 175 to 178.

721. *Subsection (2)* makes it clear that any transfer-pricing adjustment takes precedence over the rules for trading stock in this Chapter.

722. *Subsection (3)* is the rule for trades carried on in partnership. The general rule in ICTA is that a change in the person carrying on a trade is treated as the cessation of the trade. But, in the case of a trade carried on in partnership, section 113(2) of ICTA provides that there is a cessation only if there is a complete change in the persons (the partners) carrying on the trade.

723. *Subsection (4)* ensures that the special rules for the valuation of stock in this Chapter do not apply when the trader dies.

Section 174: Meaning of "trading stock"

724. This section defines trading stock. The definition applies:

- in this Chapter;
- in sections 135 and 136 (films and sound recordings);
- in section 236 (adjustment income); and
- in section 252 (post-cessation receipts).

725. The section is based on sections 100(2) and 101(3) of ICTA.

726. Section 101(3) of ICTA is invoked by section 100(2) and is concerned with valuation of incomplete services at the time of "discontinuance". So the definition in this section refers to incomplete services at the "time of the cessation".

Section 175: Basis of valuation of trading stock

727. This section introduces the five sections that follow. It is based on section 100 of ICTA. The five sections (including section 179 which defines "connected persons") deal with valuation of stock that is transferred to another trader. Subsection (4) of this section deals with valuation in any other case.

Section 176: Sale basis of valuation: sale to unconnected person

728. This section sets out the rule for the common case where the trading stock is transferred to an unconnected trader. It is based on section 100(1A)(a) of ICTA. It leads directly to the use of the sale price of the stock as the basis of valuation. If the transfer is other than by sale, section 181 explains how the expressions used in this section are to be interpreted.

Section 177: Sale basis of valuation: sale to connected person

729. This section sets out the rule for the case where the stock is transferred to a connected person. It is based on section 100(1A)(b) of ICTA.

730. The section preserves the concept of an arm's length price. This will usually be the same as the open market value (see section 175(4)) but sometimes there will be a difference.

731. For example, in an inheritance tax case, IRC v Spencer-Nairn [1991], STC 60, the Court of Session considered the meaning of an arm's length price and distinguished it from open market value. This was on the basis that the seller in that case had imperfect information. A sale at arm's length by that seller would not assume that the seller had better information; a sale in the open market would assume perfect information on both sides of the bargain.

732. Furthermore, in the case of an actual sale to a connected trader, there is no need to *assume* there is a sale. It is enough to treat the sale as made at arm's length. This leaves open the possibility that the stock is worth something different from open market value to a person who intends to use the stock in the trade.

Section 178: Sale basis of valuation: election by connected persons

733. This section allows the seller and purchaser of stock that would otherwise be valued at arm's length under section 177 to elect to use instead the price paid for the stock. The section is based on section 100(1C), (1D) and (3) of ICTA.

734. The election cannot be made unless the arm's length value of the stock is greater than its "acquisition value" in the hands of the seller.

735. The "acquisition value" of the stock for the trader who ceases to trade is effectively book value, but the definition in subsection (5) is more complicated than this. In the case where the net realisable value of stock has fallen below cost in the period leading up to cessation, a new period is deemed to start just before the deemed sale. That allows the new, lower, net realisable value to be used. It may be possible to manipulate net realisable value by selling the stock at an undervalue after the accounting date. So paragraph (a) of the definition assumes that the sale is at an arm's length value.

736. The election substitutes the price paid for the arm's length value of the stock. But the price paid must be higher than the acquisition value. Otherwise, the election substitutes the acquisition value for the arm's length value.

737. The time limit for the election in section 100(1C) is two years from the end of the tax year in which the trade ceases. This is inconsistent with most other time limits for income tax payers. The time limit in subsection (4) of this section is the normal time limit for claims and elections in this Act. See *Change 49* in Annex 1.

738. This section does not specify that the election is to be made to "the inspector". Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board".

Section 179: Connected persons

739. This section provides a definition of connected persons for the stock valuation sections. It is based on section 100(1F) of ICTA.

740. This section is one of the exceptions to the general rule in section 847 that a firm is not to be regarded for tax purposes as a separate entity. If a firm is connected with the seller or purchaser of its stock, section 177 (rather than section 176) applies but the firm may make an election under section 178.

741. The definition includes references to bodies corporate because the tax liability of a person charged to income tax may be affected by a transaction involving a company.

Section 180: Cost to buyer of stock valued on sale basis of valuation

742. This section sets out the rule for the buyer of the stock. It is based on section 100(1E) of ICTA. In a "sale basis" case, any value given to the trading stock of the taxpayer whose trade has ceased is also used to calculate the profits of the buyer of the stock.

743. Section 100(1A) to (1C) of ICTA continue to apply for corporation tax. So the reference to those subsections is retained to cater for the case where the stock is acquired from a person liable to corporation tax. In the reverse case, where the stock is transferred from a person liable to income tax to a person liable to corporation tax, the valuation is made in accordance with this Chapter. The consequential amendments to section 100 of ICTA produce the right result for corporation tax (see paragraph 79 of Schedule 1 to this Act).

Section 181: Meaning of "sale" and related expressions

744. The stock valuation sections refer to a sale of stock. This section explains how the sections are to be interpreted if the stock is transferred other than by way of sale. It is based on section 100 of ICTA.

Section 182:Valuation of work in progress on cessation

745. This is the first of four sections that deal with the valuation of work in progress on cessation. The sections are based on section 101 of ICTA.

746. *Subsection (1)* introduces the different bases of valuation in sections 184 and 185. Unlike the corresponding section 173, relating to the valuation of trading stock, this section does not require that work in progress is valued at cessation. But a valuation is usually ensured by the requirement to calculate profits in accordance with generally accepted accounting practice (see section 25 of this Act). The only exception to this rule concerns barristers and advocates (see section 160 of this Act).

747. *Subsection (2)* is the rule for professions carried on in partnership. The general rule in ICTA is that a change in the persons carrying on a profession is treated as the cessation of the profession. But, in the case of a profession carried on in partnership, section 113(2) of ICTA provides that there is a cessation only if there is a complete change of partners.

748. *Subsection (3)* ensures that the special rules for the valuation of work in progress in this Chapter do not apply when the person carrying on the profession or vocation dies.

Section 183: Meaning of "work in progress"

749. This section provides the definition of work in progress. It is based on section 101(3) of ICTA. This definition has a reference to the time at which the valuation is made. This is appropriate because the definition is used only in this Chapter and in section 252 of this Act. In both cases, the statute is concerned with the cessation of a profession or vocation.

Section 184: Basis of valuation of work in progress

750. This section sets out the main rules for the valuation of work in progress. It is based on section 100(1) of ICTA.

751. *Subsection (1)* applies if the work in progress is transferred to a person carrying on a profession or vocation. In that case, it is valued at the sale price.

752. There are no alternatives to the sale price. So there is no need for a rule (such as that in section 180 for stock) about the tax cost to the purchaser of the work in progress. The cost is always the price paid.

753. *Subsection (2)* applies if the work in progress is not transferred to a person carrying on a profession or vocation. In that case, it is valued at an arm's length price. As explained in the commentary on section 177, this Chapter retains the distinction between this basis of valuation and open market value.

Section 185: Election for valuation at cost

754. This section allows an election for work in progress to be valued at cost. It is based on section 101(2) and (2A) of ICTA. If the election is made the profit element in closing work in progress is not assessed until payment is received. If the election is made, the later payment is treated as a post-cessation receipt.

755. This section does not specify that the election is to be made to "the inspector". Section 878(4) of this Act draws attention to the rules in TMA, which apply for the purposes of this Act. Those rules require elections to be made to "an officer of the Board".

Section 186: Determination of questions by Commissioners

756. This section assigns proceedings to Commissioners. It is based on section 102(1) of ICTA. The valuation of trading stock and work in progress on cessation will affect the tax liabilities both of the trader who ceases and of the trader (if any) who takes over the stock (or work in progress). This section gives the rule about which body of Commissioners should resolve any dispute about that valuation.