

INCOME TAX (TRADING AND OTHER INCOME) ACT 2005

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 2: Trading income

Chapter 17: Adjustment income

Overview

921. This Chapter sets out the rules for dealing with two sorts of changes in the way profits of a trade are calculated.
922. The first sort of change is in the way the accounts are drawn up. The general rule is that profits must be calculated on the basis of accounts drawn up in accordance with generally accepted accounting practice (see section 50 of FA 2004 and section 25 of this Act). There is an exception to this general rule for some barristers and advocates (see section 160 of this Act), who may calculate their profits on a cash basis.
923. If there is a change from the cash basis to the earnings basis, some receipts and expenses may fall out of account. This sort of change was dealt with originally in the rules that became section 104(4) to (7) of ICTA. Those rules were replaced by the rules in section 44 of and Schedule 6 to FA 1998. The 1998 rules were replaced by section 64 of and Schedule 22 to FA 2002.
924. The second sort of change is in the way tax adjustments are made. These are the adjustments “required or authorised by law in calculating profits for tax purposes” (section 25). This sort of change was dealt with for the first time by the 2002 legislation.
925. [Section 860](#) of this Act applies the rules to trades carried on in partnership.

Section 226: Professions and vocations

926. This section makes it unnecessary to specify repeatedly that the rules in this Chapter apply to a profession or vocation as well as a trade. It is new.

Section 227: Application of Chapter

927. This section sets out the circumstances in which an adjustment may arise. It is based on section 64 of FA 2002.
928. Section 64 of FA 2002 refers to a change of the basis on which profits are calculated. This might mean *any* change of basis. But paragraph 3(2) of Schedule 22 to FA 2002 makes clear that it does not include a change which occurs on a change of ownership of a trade.

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

929. The trading income rules in this Part are generally “person-based”. So this section applies when *a person* changes the basis. That person must be the same before and after the change of basis. So this section reproduces the effect of paragraph 3(2) of Schedule 22 to FA 2002.
930. An adjustment has to be made if:
- the “old basis” accorded with the law *or* practice at the time; and
 - the “new basis” accords with the current law *and* practice.
931. The difference in wording is to cater for a case in which a decision of the Courts makes it clear that a previously accepted view of the law was wrong. In that case, the old basis accorded with the practice but not the law. The 1998 rules did not cater for this. But the 2002 rules (and the rules in this Chapter) do.
932. Section 64(1)(a) of FA 2002 refers to “a change of basis in computing the profits for the purposes of Case I or II of Schedule D”. So the change of basis rules are “rules applicable to Cases I and II of Schedule D” (section 65(3) of ICTA) and apply to foreign trade profits assessed under Schedule D Case V.
933. This conclusion is reinforced by the fact that, if the adjustment is negative, any relief under paragraph 5 of Schedule 22 to FA 2002 is given by way of “a deduction in computing profits”.
934. The section refers to “a trade”. So the rules apply to trades carried on wholly outside the United Kingdom as they apply to trades carried on at least partly in the United Kingdom.
935. There is a transitional rule in paragraph 59 of Schedule 2 to this Act. An adjustment arising from a change of accounting basis before 6 April 1999 is not charged to tax if the recipient was born before 6 April 1917.

Section 228: Adjustment income and adjustment expense

936. This section sets out the treatment of the adjustment. It is based on paragraphs 4 and 5 of Schedule 22 to FA 2002.
937. If the adjustment is positive it is called adjustment income. Adjustment income is charged as trading income under section 229. Section 64 of and Schedule 22 to FA 2002 create a charge under Schedule D Case VI if there is a positive adjustment on a change of basis. This Act deals with the income where it logically belongs. In this case, the income is trading income.
938. In the case of foreign trades, a positive adjustment on a change of basis is charged to tax under Schedule D Case VI in the source legislation even though the profits of the trade are chargeable under Case V. This Chapter treats trades carried on wholly abroad in the same way as trades carried on wholly or partly within the United Kingdom (unless the income is assessable on the remittance basis).
939. The charge in the source legislation under Schedule D Case VI has consequences for loss relief and the charge to Class 4 national insurance contributions. This Chapter preserves the position for loss relief in section 232(3). This Act preserves the position for Class 4 national insurance contributions because the consequential amendments to the social security legislation ensure that those contributions are charged only on profits chargeable under Chapter 2 of Part 2 of this Act.
940. If the adjustment is negative it is called an adjustment expense. An adjustment expense is dealt with in sections 233 and 234.

Section 229: Income charged

941. This section sets out the amount charged to tax. It is based on section 69 of ICTA. Adjustment income is charged to tax separately from the profits of a trade (see section 5).

Section 230: Person liable

942. This section states who is liable for any tax charged. In FA 2002 the charge is under Schedule D Case VI. So section 59(1) of ICTA applies.

Section 231: Calculation of the adjustment

943. This section contains the main rules for calculating the adjustment. It is based on paragraph 2 of Schedule 22 to FA 2002. The section presents the rules as a method statement.
944. The 2002 legislation introduced three new rules.
945. The first new rule concerns a change in the basis of valuing stock. The rule is in item 3(b) of step 1 of the method statement. For instance, in Period 1 the accounts show closing stock of £1200. That is reduced for tax purposes, in accordance with the practice then prevailing, to £1000. In Period 2 the opening stock in the accounts is £1200. So there is no adjustment within item 3(a). But if a new practice allows the opening stock value to stand for tax purposes there is an adjustment within item 3(b). There is a corresponding rule in item 3 of step 2.
946. The second new rule concerns a change in the way that depreciation is recognised. This rule is in item 4 of step 1. The expression “for accounting purposes” is defined in section 832(1) of ICTA – see Schedule 4 to this Act.
947. The third new rule restricts the circumstances that can give rise to a deduction in step 2 to those that are purely a matter of timing. For instance, in Period 1 the accepted view was that an item of expenditure was capital and it was “added back” in the tax computation. After a Court decision, that view changes and, if the expenditure had been incurred in Period 2, no tax adjustment would have been required. Without item 2(b) of step 2, item 2(a) would give a deduction.

Section 232: Treatment of adjustment income

948. This section sets out two special rules for the treatment of adjustment income. It is based on paragraph 4(2) of Schedule 22 to FA 2002.
949. *Subsection (1)* establishes when the adjustment income arises, so that it is charged to tax for the appropriate year under section 229.
950. *Subsection (3)* treats the income as trade profits for the purpose of loss relief. So, for example, any losses of the same trade brought forward can be set against the income.
951. *Subsection (4)* preserves the treatment of adjustment income as earned income.
952. It also makes clear that adjustment income is relevant UK earnings for the purpose of making pension contributions.
953. FA 2004 made significant changes to the taxation of pension schemes. The changes take effect from 6 April 2006. This Act deals with this by including the new rules in section 232. The commencement issue is then dealt with as a transitional measure in paragraph 57 of Schedule 2 of this Act. The old rules apply until 5 April 2006.

Section 233: Treatment of adjustment expense

954. This section treats an adjustment deduction as a trading expense. It is based on paragraph 5 of Schedule 22 to FA 2002.

Section 234: No adjustment for certain expenses previously brought into account

955. This section deals with the case where the old basis of calculation allowed a tax deduction but the new basis requires the deduction to be spread over several periods. It is based on paragraph 6 of Schedule 22 to FA 2002.

956. In the absence of this section there would be a positive adjustment within item 2 of step 1 of the calculation of the adjustment in section 231. That would produce the right result overall but the rule would take effect too early. Instead, no adjustment is calculated but no deduction is allowed in future for expenses that have already been taken into account.

Section 235: Cases where adjustment not required until assets realised or written off

957. This section is a timing rule for an adjustment which results from any of the three new rules in section 231. It is based on paragraph 7 of Schedule 22 to FA 2002.

958. These new rules are the ones mentioned in the commentary on section 231. The general timing rule is that any adjustment is made at the end of the first period of account on the new basis (see section 232(1) and section 233(1)). But any adjustment income for stock, work in progress or depreciation is charged when the asset is realised or written off.

Section 236: Change from realisation basis to mark to market

959. This section is concerned with a change from the realisation basis to “mark to market” accounting. It is based on paragraph 8 of Schedule 22 to FA 2002.

960. “Mark to market” is a basis of accounting used by traders in financial assets. Instead of carrying the assets in the books at cost, financial traders draw up accounts to show the assets at a fair value at the accounting date. But for tax purposes the realisation basis may have been used.

961. In the first period in which mark to market is adopted for tax purposes, the opening stock may be valued at a higher (market) value than the closing stock of the previous period. Or a financial asset may have been carried in the accounts at cost but appear as a deduction in a later period at fair value. In either case, there is an adjustment within section 231.

962. As in section 235, the charge on adjustment income is postponed until the asset is realised.

Section 237: Election for spreading if section 236 applies

963. This section provides for an election to be made if there is a charge (following a change to mark to market) under section 236. It is based on paragraph 9 of Schedule 22 to FA 2002.

964. The election is to spread the adjustment charge over six periods of account beginning with the first one in which the new basis is adopted. As the charge is postponed under section 236 until the asset is realised, this first period is not necessarily the one in which the charge would be made without the election.

965. “Period of account” is defined in section 832(1) of ICTA.

966. *Subsection (2)* sets out the usual Self Assessment time limit for an election.

Section 238: Spreading on ending of exemption for barristers and advocates

967. This section sets out a special rule for spreading adjustment income in the case of barristers and advocates. It is based on paragraph 11 of Schedule 22 to FA 2002.
968. The income is spread over ten years, subject to a maximum charge in any one year.
969. In paragraph 4 of Schedule 6 to FA 1998 there was another rule for spreading adjustment income. Spreading was available to a person who changed accounting basis to comply with section 42 of FA 1998 (generally accepted accounting practice). Such a change would have taken effect by 5 April 2000.
970. In accordance with paragraph 17 of Schedule 22 to FA 2002 the repeal of Schedule 6 to FA 1998 takes effect only in relation to a change of basis on or after 1 August 2001. So the transitional rule in paragraph 4(2)(a) of Schedule 6 to FA 1998 may continue to affect current liabilities if they include part of a pre-2001 adjustment.
971. The rules in paragraph 13(3) and (4) of Schedule 22 to FA 2002 apply only if an election is made under paragraph 11 by a partner. As barristers and advocates do not carry on their professions in partnership, these rules are not needed.

Section 239: Election to accelerate charge under section 238

972. This section sets out the election that is available if adjustment income is spread under section 238. A taxpayer may choose to have any part of the outstanding adjustment income taxed earlier than would otherwise be the case. The section is based on paragraph 12 of Schedule 22 to FA 2002.
973. *Subsection (2)* sets out the usual Self Assessment time limit for an election.
974. The effect of an election is set out in paragraph 12(4) of Schedule 22 to FA 2002. It is not clear what the “additional amount” referred to in the sub-paragraph is. In some cases more than the total adjustment income could be charged to tax within the period of ten years over which it is spread. *Subsection (4)* of this section sets out the effect of an election. See *Change 62* in Annex 1.

Section 240: Liability of personal representatives if person liable dies

975. This section makes it clear that a taxpayer’s personal representatives take over from the taxpayer both the liability to tax on adjustment income and the right to make any election. It is based on paragraph 14 of Schedule 22 to FA 2002.