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 4: Trade profits: rules restricting deductions

Overview

149. This Chapter contains provisions prohibiting various deductions in calculating the profits of a trade or restricting the extent to which such deductions can be made.

Section 32: Professions and vocations

150. This section makes it unnecessary to specify in each section in this Chapter that the section applies to a profession or vocation as well as to a trade. The section is new.

Section 33: Capital expenditure

151. This section is based on section 74(1) of ICTA.

152. Section 74(1) of ICTA prohibits various deductions in computing a trader's profits including:

> (f) "any capital withdrawn from, or any sum employed or intended to be employed as capital in the trade, profession or vocation, …
>
> (g) any capital employed in improvements of premises occupied for the purposes of the trade, profession or vocation.

153. It is a long-established and generally accepted principle that capital items are ignored in calculating the profits of a trade.

154. Section 42(1) of FA 1998 requires that the profits of a trade:

> "must be computed in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in computing profits for those purposes.

155. But the question of whether a sum is income or capital is ultimately a question of law, not accountancy. For judicial authority for this proposition, see, for example the words of Brightman J on page 173 of ECC Quarries Ltd v Watkis (1975), 51 TC 153 CD[1]:

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1 STC [1975] 578

"…unchallenged evidence, or a finding, that a sum falls to be treated as capital or income on principles of correct accountancy practice is not decisive of the question whether in law the expenditure is of a capital or income nature.

156. A sum which is of a capital nature may however be allowed as a deduction in computing the profits of a trade because of a statutory exception to the general rule on the deduction of such items in this section. See, for example, section 89 (expenses connected with patents).

157. Section 74(1)(g) of ICTA is not rewritten as the deduction of capital employed in the improvement of premises is covered by the general prohibition on the deduction of "items of a capital nature". In the absence of general agreement on what constitutes capital expenditure "items of a capital nature" is not defined.

Section 34: Expenses not wholly and exclusively for trade and unconnected losses

158. This section contains rules for the deduction of expenses and losses in calculating the profits of a trade. It is based on section 74(1)(a) (expenses) and (e) (losses) of ICTA.

159. Section 74(1)(a) of ICTA provides that in calculating the profits of a trade no deduction is allowed for expenditure which is not incurred "wholly and exclusively" for the purposes of that trade. This could be construed to mean that if expenditure is incurred partly for trade purposes and partly for some other purposes, no part of that expenditure can be deducted in arriving at the trade profits.

160. But section 74(1)(c) of ICTA, which prohibits any deduction in respect of the rent of premises used for residential or "domestic" purposes, provides for the *apportionment* of rent paid for premises used partly as residential accommodation and partly for the purposes of a trade. And in practice, a deduction is allowed for any expenditure which can be apportioned between trade and non-trade expenditure – for example, expenditure on a car used partly for trade and partly for private purposes.

161. There is judicial support for allowing a deduction where expenditure incurred for more than one purpose can reasonably be apportioned between expenditure incurred for the purpose of the trade and non-trade expenditure. See, for example, Lochgelly Iron and Coal Company Ltd v Crawford (1913), 6 TC 267 CS, in which a deduction was allowed for part of a subscription to a trade association and Copeman v Flood (1941), 24 TC 53 KB, in which the High Court remitted the case to the Commissioners to find as a fact whether the remuneration paid to certain directors who were also shareholders in the family company was wholly and exclusively expended for the purpose of the Company's trade, and if not, how much of the remuneration was so expended.

162. Conversely, the courts have held that if it is not possible to identify any part of the expenditure which is incurred wholly and exclusively for the purposes of the trade, no apportionment is possible. See, for example, Mallalieu v Drummond (1983), 57 TC 330 HL[2] in which no deduction was allowable for professional clothing worn for warmth and decency as well as being required by the taxpayer's profession.

163. So *subsection (2)* of this section provides for the deduction of any part or proportion of expenses incurred partly for the purposes of the trade and partly for some other purpose which can be *identified* as incurred wholly and exclusively for the purposes of the trade. And because rent on dual purpose accommodation can be apportioned under subsection (2) of this section, it is not necessary to rewrite section 74(1)(c) of ICTA.

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2 STC [1983] 665

Section 35: Bad and doubtful debts

164. This section is based on the relief for bad and doubtful debts in section 74(1)(j) of ICTA. It also subsumes the relief in section 89 of ICTA for debts proved irrecoverable after a trade, profession or vocation is deemed to have ceased. See *Change 7* in Annex 1.

165. See section 259 for the meaning of "statutory insolvency arrangement" in *subsection (1)(c)* of this section.

Section 36: Unpaid remuneration

166. This section prevents a deduction for employees' (or an office-holder's) pay until it is paid. It is based on section 43 of FA 1989.

167. Section 43 of FA 1989 was introduced when the assessment of employment income was put on a receipts basis. No deduction is given to the employer for employees' pay until that pay is treated as received by the employees.

168. *Subsection (1)(b)* makes clear that the rule in this section is in addition to any other rules that determine whether or not a deduction is allowable.

Section 37: Unpaid remuneration: supplementary

169. This section provides definitions and further explanation of the main rule in section 36. It is based on section 43 of FA 1989.

170. *Subsection (1)* applies section 36 to provisions made in the accounts in respect of amounts that may become employees' remuneration. An example of such a provision would be an incentive payment that is payable only if the employee remains with the employer for a number of years.

171. *Subsection (3)* deals with the case in which the employer submits his or her tax return before the end of the nine month limit in section 36(2) and all or any of the remuneration is unpaid. The employer must assume the remuneration will remain unpaid. If, subsequently, the remuneration is paid within the time limit the calculation can be adjusted and the return amended. See *Change 8* in Annex 1.

Employee benefit contributions

Overview

172. The next seven sections deal with the deduction allowed in respect of an employer's contribution to an employee benefit scheme. They are based on Schedule 24 to FA 2003.

173. The sections give a comprehensive set of rules for determining when deductions can be made for payments made by an employer to a third party to hold or use to provide benefits for the employer's employees. The rules apply in particular to contributions made to the trustees of an employee benefit trust but are not confined to such contributions. They do not apply to contributions made to certain pension schemes.

Section 38: Restriction of deductions

174. This section sets out the conditions under which a deduction may be allowed. It is based on paragraphs 1 and 8 of Schedule 24 to FA 2003.

175. *Subsection (1)* identifies the conditions for the section to apply. It applies only to deductions that would otherwise be allowed under normal principles. It applies both to contributions made and to provisions in respect of contributions.

176. *Subsections (2)(b)* and *(3)(b)* apply if the benefit is provided by the making of the contribution itself. This may be the case if the employer sets up a trust to meet employees' medical expenses.

177. *Subsection (4)* identifies a number of cases in which employer contributions are not subject to the rules in this Chapter. Significant amendments have been made to this list by section 245(5) of FA 2004. That section is part of the regime for dealing with the taxation of pension schemes. The changes take effect from 6 April 2006.

178. This Act deals with this by including the new rules in this subsection. The commencement issue is then dealt with as a transitional measure in paragraphs 13 to 15 of Schedule 2 to this Act. The old rules apply until 5 April 2006.

Section 39: Making of "employee benefit contributions"

179. This section is based on paragraphs 1 and 9 of Schedule 24 to FA 2003.

Section 40: Provision of qualifying benefits

180. This section sets out what is meant by the provision of qualifying benefits. It is based on paragraph 2 of Schedule 24 to FA 2003. One of four conditions must be met.

181. *Subsection (2)* identifies the general rule, condition A. Subsections (3), (4) and (5) deal with less common cases, conditions B, C and D.

182. *Subsection (3)* applies if the employment income and national insurance contribution charges do not arise because the benefits are provided to an employee who works outside the United Kingdom.

183. *Subsection (4)* applies if the employment income and national insurance contribution charges do not arise because the benefits are provided in connection with the termination of the recipient's employment.

184. *Subsection (5)* applies if the benefit is provided under an employer-financed retirement benefits scheme. This condition will apply with effect from 6 April 2006. See the transitional measure in paragraph 15 of Schedule 2 to this Act. An employer-financed retirement benefits scheme is an arrangement under which the employer will pay pensions outside registered pension schemes introduced by FA 2004. The policy is to tax these benefits in the same way as other employee benefits. The definition of "employer-financed retirement benefits scheme" is given in section 44 of this Act.

Section 41: Timing and amount of certain qualifying benefits

185. This section sets out:

- when benefits in the form of money are treated as provided; and
- how to calculate the value of benefits provided by the transfer of an asset.

186. It is based on paragraphs 2 and 5 of Schedule 24 to FA 2003.

187. Section 245(4) of FA 2004 provides (with effect from 6 April 2006) that these rules do not apply to payments under an "employer-financed retirement benefits scheme".

188. *Subsection (2)* describes how to calculate the value of a qualifying benefit provided by the transfer of an asset. The amount of the benefit is the expenditure incurred on the asset by the third party including both the cost of acquiring the asset and any subsequent expenditure. If the asset was acquired by the employer and transferred to the third party the amount of the benefit is the trading deduction that would otherwise have been allowed to the employer plus any subsequent expenditure incurred by the third party.

189. *Subsection (3)* sets out an exception to the general rule in subsection (2). If the employment income charge is lower than the charge calculated in accordance with subsection (2) the value of the benefit is restricted to the lower amount.

Section 42: Provision or payment out of employee benefit contributions

190. This section sets out the rules for allocating the provision of qualifying benefits, or payment of qualifying expenses, by the third party against the employee benefit contributions received. It is based on paragraph 4 of Schedule 24 to FA 2003.

191. Other receipts and expenses of the third party are ignored. Qualifying benefits and qualifying expenses are treated as paid out of employee benefit contributions in priority to other expenditure and amounts received by the third party.

Section 43: Profits calculated before end of 9 month period

192. This section applies if the taxpayer makes his or her income tax return before the end of the nine month period. It is based on paragraph 6 of Schedule 24 to FA 2003.

193. A deduction is not allowed if the conditions in section 38 are not met at the time the return is made. The normal Self Assessment rules allow the return to be amended if the conditions are met before the end of the nine month period.

Section 44: Interpretation of sections 38 to 44

194. This section is based on paragraphs 3 and 9 of Schedule 24 to FA 2003 and section 245(7) of FA 2004.

195. An "employer-financed retirement benefits scheme" means:

> "a scheme for the provision of benefits consisting of or including relevant benefits to or in respect of employees or former employees of the employer
>
> But neither
>
> a registered pension scheme, nor
>
> a section 615(3) [of ICTA] scheme,
>
> is an employer-financed retirement benefits scheme.

Section 45: Business entertainment and gifts: general rule

196. This section and the following two sections deal with expenditure on business entertainment or gifts. This section is based on section 577(1),(5),(7) and (8) of ICTA.

197. *Subsection (1)* sets out the general rule that in calculating the profits of a trade no deduction is allowed for expenditure on providing entertainment or gifts.

198. *Subsection (2)* says that the general rule applies to sums paid to or on behalf of, or put at the disposal of, an employee (commonly known as an "expense allowance") only if those sums are *exclusively* for meeting expenses in providing business entertainment or gifts.

199. The general rule in subsection (1) does not apply to an allowance made to an employee for meeting expenses which include – but are not restricted to – expenses incurred in the provision of business entertainment or gifts. But section 356 of ITEPA provides that no deduction from the employee's earnings is allowed for expenses incurred in providing entertainment or gifts in connection with the trade, business, profession or vocation of his or her employer.

200. The definition of "employee" in *subsection (4)* of this section covers the application of this section and sections 46 and 47 to a non-resident company liable to income tax in the UK.

Section 46: Business entertainment: exceptions

201. This section is based on section 577(3),(5),(7) and (10) of ICTA.

Section 47: Business gifts: exceptions

202. This section is based on section 577(3),(5),(8),(9) and (10) of ICTA. See *Change 9* in Annex 1 regarding the provision in *subsection (3)* for the monetary limit on the exception in respect of certain gifts to be increased by Treasury order.

Section 48: Car or motor cycle hire

203. This section restricts the amount which a trader can deduct in respect of the cost of hiring certain cars or motor cycles with a retail price (when new) of more than £12,000. The restriction is in inverse proportion to the retail price. The section is based on sections 578A and 578B of ICTA.

204. Section 578B(1) of ICTA says that for the purposes of section 578A of ICTA "car" includes a motor cycle. So this section and section 49 refer to a "car or motor cycle" throughout.

205. Section 578A(4) of ICTA provides for amounts in respect of hire charges brought into account as a receipt of the trade under section 94 of ICTA (debts deducted and subsequently released) to be reduced in the same proportion as the deduction in respect of those charges is reduced under section 578A(3) of ICTA. *Subsection (4)* of this section extends the same treatment to amounts in respect of hire charges taxed as a post-cessation receipt under section 103(4) of ICTA (debts released after cessation). See *Change 10* in Annex 1.

206. Sections 94 and 103(4) of ICTA are rewritten in sections 97 and 249 respectively.

Section 49: Car or motor cycle hire: supplementary

207. This section is based on section 578B of ICTA.

208. Section 578B(2) of ICTA defines "qualifying hire car" for the purposes of section 578A of ICTA as a car hired under a hire-purchase agreement subject to an option to purchase which is exercisable for a nominal amount.

209. Not all hire purchase agreements require the hirer to exercise an option at the end of the hire period. Under some types of agreement, ownership of the vehicle passes automatically to the hirer at the end of the hire period. So *subsection (2)(a)* of this section extends the definition of "qualifying hire car or motor cycle" to include a car or motor cycle where ownership passes without the exercise of an option to purchase. See *Change 11* in Annex 1.

210. *Subsection (2)(c)* defines "qualifying hire car or motor cycle" by reference to the definition of "qualifying hire car" in section 82 of CAA.

211. Section 82 of CAA defines a "qualifying hire car" as follows:

"(1) For the purposes of this Part a car is a qualifying hire car if—

(a) it is provided wholly or mainly for hire to, or the carriage of, members of the public in the ordinary course of a trade, and

(b) the case is within subsection (2), (3) or (4).

(2) The first case is where the following conditions are met—

(a) the number of consecutive days for which the car is on hire to, or used for the carriage of, the same person will normally be less than 30, and

(b) the total number of days for which it is on hire to, or used for the carriage of, the same person in any period of 12 months will normally be less than 90.

(3) The second case is where the car is provided for hire to a person who will himself use it—

(a) wholly or mainly for hire to, or for the carriage of, members of the public in the ordinary course of a trade, and

(b) in a way that meets the conditions in subsection (2).

(4) The third case is where the car is provided wholly or mainly for the use of a person in receipt of -

(a) a disability living allowance under—

(i) the Social Security Contributions and Benefits Act 1992, or

(ii) the Social Security Contributions and Benefits (Northern Ireland) Act 1992,

because of entitlement to the mobility component,

(b) a mobility supplement under a scheme made under the Personal Injuries (Emergency Provisions) Act 1939,

(c) a mobility supplement under an Order in Council made under section 12 of the Social Security (Miscellaneous Provisions) Act 1977, or

(d) any payment appearing to the Treasury to be of a similar kind and specified by them by order.

(5) For the purposes of subsection (2) persons who are connected with each other are to be treated as the same person.

Section 50: Hiring cars (but not motor cycles) with low carbon dioxide emissions

212. This section excludes cars with low CO2 emissions and electrically propelled cars from the restriction in section 48. It is based on section 578A(2A) and (2B) of ICTA and section 60 of FA 2002.

213. Expenditure incurred on hiring a car first registered before 17 April 2002 does not qualify for relief under this section. See paragraph 17 of Schedule 2 to this Act.

214. *Subsection (2)* defines "car with low CO2 emissions" and "electrically propelled car" by reference to section 45D of CAA.

215. Section 45D(2) to (6) of CAA defines a car with low CO2 emissions as follows:

"(2) For the purposes of this section a car with low CO2 emissions is a car which satisfies the conditions in subsections (3) and (4).

(3) The first condition is that, when the car is first registered, it is so registered on the basis of an EC certificate of conformity, or a UK approval certificate, that specifies—

(a) in the case of a car other than a bi-fuel car, a CO2 emissions figure in terms of grams per kilometre driven, or

(b) in the case of a bi-fuel car, separate CO2 emissions figures in terms of grams per kilometre driven for different fuels.

(4) The second condition is that the applicable CO2 emissions figure in the case of the car does not exceed 120 grams per kilometre driven.

(5) For the purposes of subsection (4) the applicable CO2 emissions figure in the case of a car other than a bi-fuel car is—

(a) where the EC certificate of conformity or UK approval certificate specifies only one CO2 emissions figure, that figure, and

(b) where the certificate specifies more than one CO2 emissions figure, the figure specified as the CO2 emissions (combined) figure.

(6) For the purposes of subsection (4) the applicable CO2 emissions figure in the case of a bi-fuel car is—

(a) where the EC certificate of conformity or UK approval certificate specifies more than one CO2 emissions figure in relation to each fuel, the lowest CO2 emissions (combined) figure specified, and

(b) in any other case, the lowest CO2 figure specified by the certificate.

216. Section 45D(7) of CAA provides that the amount specified in section 45D(4) may be amended by Treasury order.

217. Section 45D(9) of CAA defines an electrically propelled car as a car which is:

"(a) …propelled solely by electrical power, and

(b) that power is derived from—

(i) a source external to the vehicle, or

(ii) an electrical storage battery which is not connected to any source of power when the vehicle is in motion.

Section 51: Patent royalties

218. This section is based on section 74(1)(p) of ICTA.

Section 52: Exclusion of double relief for interest

219. This section prevents a deduction for interest paid if the taxpayer claims relief under section 353 of ICTA. It is based on section 368(4) and (6) of ICTA.

220. The section will apply in the limited circumstances in which it is possible to claim relief for interest paid under section 353 of ICTA and as a deduction in calculating trade profits. This is likely only if the claim under section 353 of ICTA satisfies the qualifying conditions in section 359 of ICTA (loan to buy machinery or plant). Such relief is given in the tax year in which the interest is paid.

221. Alternatively, if the normal trade profit rules are met, the interest may qualify as a trading deduction. Such a deduction would be allowed on the normal accruals basis.

222. The section is mirrored by section 368(3) of ICTA which prevents a claim under section 353 of ICTA if the interest has been allowed as a trading deduction.

223. *Subsection (5)* gives the rule for deciding when relief under section 353 of ICTA has been given. It uses the definition of "finally determined" in section 43C(4) of TMA. See *Change 12* in Annex 1.

Section 53: Social security contributions

224. This section prevents a deduction for most social security contributions in calculating trade profits. It is based on section 617 of ICTA.

225. The rule is that there can be no deduction for the trader's own social security contributions. The section achieves this by prohibiting a deduction for any contributions and making an exception for contributions that an employer makes for the trade's employees.

226. The rule in section 617 of ICTA applies generally for tax purposes. This Act splits the rule.

- This section sets out the income tax trading income rule (applied also to property income by section 272).

- Section 868 sets out the income tax rule for non-trading income charged to tax by this Act (including rents from "concerns" charged to tax by Chapter 8 of Part 3 of the Act).
- A new section 360A of ITEPA is introduced by this Act (see paragraph 594 of Schedule 1 to this Act) to set out the rule for employment income.
- Section 617 of ICTA as consequentially amended (see paragraph 262 of Schedule 1 to this Act) continues to apply for corporation tax.

Section 54: Penalties, interest and VAT surcharges

227. This section contains the rule that most tax penalties and interest are not to be deducted for tax purposes. It is based on section 90 of TMA and section 827 of ICTA.

228. The section brings together all the rules prohibiting a trading deduction for penalties, interest and surcharges imposed by statute. So it deals with interest on unpaid income tax (imposed by TMA) as well as the penalties, interest, and surcharges relating to the indirect taxes that are dealt with in section 827 of ICTA. The section is applied to property income by section 272.

229. There is a similar rule for non-trading income in section 869.

230. The table in *subsection (2)* sets out the specific statutory references because a general description of the penalties etc would not be precise enough. But the second column of the table is a description of the tax to indicate what is involved.

Section 55: Crime-related payments

231. This section prohibits any deduction for expenses incurred in making a payment:

- the making of which is a criminal offence, or which would be a criminal offence if the payment was made in the United Kingdom; or
- which is made in response to a demand, the making of which is a criminal offence.

232. The section is based on section 577A of ICTA.

233. It overrides any provision which otherwise allows a deduction to be made in calculating the profits of a trade. See section 31(1)(b) of this Act.