Tax and Accounting

A Response to the 2003 Consultation Document on Corporation Tax Reform

Graeme Macdonald
David Martin
Tax Law Review Committee

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A RESPONSE TO THE 2003 CONSULTATION DOCUMENT ON CORPORATION TAX REFORM

DISCUSSION PAPER

by
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for the Tax Law Review Committee of the Institute for Fiscal Studies

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CHAPTER 1

INTRODUCTION

1.1 This paper builds on the earlier discussion paper 'The taxation of business income: aligning taxable income with accounting income' issued by the Tax Law Review Committee of IFS in April 2002, which set out some of the general issues of principle involved in any such alignment.

1.2 The government is clearly attracted to aligning the corporate tax system more closely with accounts, and significant legislative advances in this direction have already been achieved. This is to be welcomed, for reasons which are examined in this paper. However, whilst a period of significant reform is still in prospect, an examination of the principles involved leads us to conclude that now is the time to reflect on where the limits to alignment might lie. To achieve consensus on the ultimate destination, a widespread debate is appropriate, and this paper seeks to make a contribution to this. In the light of two consultative documents on the reform of corporation tax,[1] we also seek to address specific questions raised in the consultation process which relate to the alignment of accounting and taxable profits.

1.3 It is important to rehearse the context in which this debate is taking place. Traditionally, tax statute has provided detailed tax rules but has not made explicit the fundamental principles as to how taxable profit should be measured. Nevertheless, the starting point for calculating trading profit has always been the profit as shown in the accounts of the business, which is subject to any adjustments required by statute or the case authorities.

1.4 However, when tax was first charged on trading profits, accounting was relatively undeveloped, and the taxpayer could easily argue that an accounting treatment that saved or delayed tax was appropriate. Expert accounting evidence before the courts was often unpersuasive, or it was missing entirely, and the courts thus became involved in making their own judgements on which accounting treatments should apply for tax purposes. In so doing, they enunciated those principles that they thought appropriate in balancing the conflicting interests of the taxpayer and taxing authority, such as the principle that neither profit nor loss should be anticipated for tax purposes.

1.5 Since 1971, standard-setters in the UK have sought to limit and rationalise the range of acceptable accounting practices by the issue of accounting standards, initially through an arm of the profession itself, but latterly through the Accounting Standards Board set up under the Companies Act 1989. Increasingly, the courts have recognised the standards issued as authoritative in determining taxable profit, and statute has similarly explicitly relied on either accounting definitions or accounting computations of income.

[1] Inland Revenue / HM Treasury, *Reform of Corporation Tax – A consultation document*, August 2002; Inland Revenue / HM Treasury, *Corporation Tax Reform – A consultation document*, August 2003.

1.6 This role of accounting in general, and of standards in particular, was formalised in FA 1998 s. 42 (requiring trading profits to be computed on an accounting basis which gives a true and fair view) and in FA 2002 s. 103 (replacing 'true and fair view' with 'generally accepted accounting practice', this referring to accounts of companies intended to give a true and fair view). To understand the central role of accounting in the taxation of trading profits, it must be noted that this reliance on accounting practice extends beyond companies to individuals and to other entities.

1.7 Section 42 is subject to an important caveat: the application of accounting practice is 'subject to any adjustment required or authorised by law'. This clearly includes statutory provisions but seemingly also includes case law, so that existing precedents, which may be at variance with current accounting practice, may still hold sway.[2] As argued in Chapter 2, this position seems to have no merit. Consistent with conclusions of the earlier discussion paper, it is suggested that any principles enshrined in case law that it is thought necessary to retain should be codified in statute. This will require a considered response by the policy-makers to the question of how far accounting can be followed for tax purposes. Our view is that it is not for the courts to determine how to measure taxable profits, but neither is it the prerogative of accounting-standard-setters. It is for government to set out the principles that should bound profit measurement and to give the administration powers to respond, within those parameters, in a timely fashion to developments in accounting, possibly through secondary legislation; and for the courts to adjudicate where necessary on the application of legislation to any set of circumstances.

1.8 Further, section 42 only applies to Case I and Case II of Schedule D, and (through ICTA 1988 s. 21A) to the profits of a Schedule A business. It will be argued in Chapter 2 that the same approach should be adopted for all sources of revenue profits, and also (though more complex issues arise) for capital profits.

1.9 Simultaneously, a substantial body of statutory provisions dealing with specific areas has been introduced which attempts to bring tax and accounting measures closer together in these areas. What has necessitated this legislation is that principles of tax law (as opposed to tax policy) formulated in a very different era have militated against alignment with accounting practice as it has developed. We thus have a collection of historical tax provisions pulling in one way and a developing body of statute law pulling in another.

1.10 The latest development completing the contextual picture is the requirement by the European Union (EU) that from January 2005, the consolidated accounts of listed companies be prepared on the basis of International Accounting Standards (IAS) as issued by the IASB. These differ in some respects from UK standards, but since corporation tax is not based on the consolidated accounts, it would be possible to retain reliance on UK standards. However, quite apart from the additional compliance costs that this might involve, it is the case that UK standards are, as a matter of policy, converging with IAS, whilst all companies are to be given the option of preparing their accounts

[2] Or may have to be reconsidered in the light of the different quality of accounting evidence manifest in Financial Reporting Standards; see *Herbert Smith v Honour* (1999) 72 TC 130, for example.

under IAS. This raises a question, probably for the short term, as to which set of standards should apply for tax purposes. For the moment, small unlisted companies covered by the FRSSE have no choice because there is no equivalent under IAS and they cannot be expected to conform with IAS for tax reasons when they are not required to do so for accounting purposes.

1.11 This paper will argue strongly that aiming for a more precise and express relationship between accounting and taxable profit is the appropriate strategy for the development of the corporation tax regime. This does not necessarily equate, however, to aligning accounting and tax profit. Nevertheless, this position does raise two questions in the particular context of IAS: first, should the UK tax base effectively be determined by accounting standards which are the outcome of international negotiation; and second, what should be done now, with standards in a developmental stage, by way of further alignment?

1.12 The answer to both questions lies at the heart of the question as to the extent to which alignment is desirable. Adjustments to accounting profit for tax purposes will always be required. There must, however, be a standpoint or set of principles, determined from a tax policy perspective, by which it can be decided whether, or to what extent, generally accepted accounting practice is suitable for tax purposes. Without this, there can be no coherent response to accounting practices as they evolve. That accounting practice is currently developing is clear, but so too is the direction of that development. Increasingly, the concern of the accounting-standard-setters is with an overall package of information (rather than specifically with a single measure of profit) that is based not only on past transactions but also on current valuations. Now, rather than later, is the time to be considering whether taxable profits will need to diverge from those measured in the future under IAS.

1.13 In Chapter 3, there is therefore a discussion of the nature of present differences between accounting and taxable profit and of what general tax principles should be applied to justify these differences. Anti-avoidance issues are also considered. Statutory provisions that currently give rise to differences between accounting measures of profit and tax measures of income and gains are identified in Appendix B. The purpose here is to analyse these differences in order to understand those that could be removed in a more general alignment with accounting and those that, for policy reasons, might be expected to remain. Simultaneously, we consider whether there are matters, now or prospectively, included in accounting measures of profit that on principle should be excluded from the tax base.

1.14 Chapter 4 then addresses the source doctrine and the issue of schedular reform, and loss reliefs. Chapter 5 addresses the trading and investment company distinctions in tax law, together with the expense rule, and Chapter 6 addresses the taxation of capital assets (so as to match the main headings of the consultative documents).

1.15 Chapter 7 sets out a detailed response to many of the questions raised in the second consultative document, based on the analysis set out in the preceding chapters.

1.16 As is stated in the second consultative document, it will be necessary to move cautiously to a reformed system of corporation tax. This is to ensure that the effect of any changes introduced is well understood before enactment and that difficulties in achieving the transition are minimised. In the course of analysing present statutory differences between tax and accounting, we were reminded that the corporation tax is based heavily on the personal income and capital gains taxes. Some of the differences arise directly from this reliance. Chapter 8 therefore considers, as well as the possible legislative response to specific issues, whether we should, in the interest of clarity and simplification, have a separate corporation tax statute.

1.17 There is a natural tendency in the business world to view regulatory or tax changes as unwelcome, particularly if such changes are seen as unnecessary. This paper makes the case, however, that reform is needed, and that it should result in highly desirable simplification and rationalisation of the corporation tax system. Provided companies understand the broad impact of the changes that will need to be introduced over a period of time, it is considered that such changes should be well received.

CHAPTER 2

TAX AND ACCOUNTS

2.1 As mentioned in the introduction, UK GAAP has been enormously improved through the work of the standard-setters. Their objectives have included codifying best practice and narrowing differences between financial and reporting treatment, in order to provide a true and fair view of the affairs of the company and to restrict the ability to manipulate the results reported by the company. To the extent that accounts now provide a reliable description of the results of the company during the reporting period for the purposes of investors and others, there is strong justification for those accounts to be used as the basis of the tax computation. For this reason, the courts, and indeed the legislators, have become more comfortable in accepting accounting profit determined by accounting principles and practices as the measure of Case I and Case II profit (subject to such adjustments as tax law may provide). It seems sensible to develop this approach more clearly and consistently 'across the board' so as to determine the taxable profits of a company.

2.2 However, it has to be understood that accounts, and the standards that determine their content, are not formulated with the express intention of providing a measure of taxable profit. Their purpose is to provide information for use by investors in making economic decisions. The information required for tax purposes may be the same, but that cannot be assumed. Whether or not it is has to be properly considered as a matter of tax policy in the light of tax objectives and criteria, and we have to be prepared to recognise that the purpose of accounting might result in measures of profit that are not apposite for tax purposes, so that adjustments are required to the accounting measures before using them as a basis for taxation.

2.3 Further, there will always be tax policy reasons to justify departures from the accounting profits. Thus specific tax legislation might deal differently from accounting standards within clearly identified problem areas. Examples would include pensions and share-based remuneration. Policy-makers should recognise, however, that there are considerations that weigh against introducing too many departures – in particular, the considerations of simplicity and the difficulties introduced by determining the boundaries of each tax provision.

2.4 Tax legislation necessarily establishes boundaries that can produce an 'all-or-nothing' result for tax purposes. This may be hard to justify for two sets of circumstances that are not very different but that nevertheless fall on different sides of the boundary. The questions, for example, of whether an expense is capital or income, or whether a capital asset constitutes plant and machinery, can sometimes be very finely balanced. In many cases, where precedent 'on all fours' is not available, considerable tax uncertainty and risk can result. It is considered that the number of occasions on which this 'all-or-nothing' outcome occurs could be reduced by placing greater reliance on reported accounting profit for tax purposes.

2.5 There are other reasons for pursuing an accounts-based approach. With the introduction of International Accounting Standards, it will become easier to assess the similarities and differences between the tax systems of different jurisdictions if those jurisdictions each define taxable profits by reference to adjustments to profits as shown in accounts prepared under those standards. Capitalism is able to operate more efficiently where the parameters that are relevant to business decisions, such as the comparison of the tax consequences of locating business in different countries, can be more clearly understood.

2.6 If an accounts-based approach is to be clear, it is, however, necessary to be clear where departures from the accounting profit are required by tax law. The reference to 'law' in section 42 rather than 'statute' appears to maintain the effect of existing precedents but to leave unclear for the future the court's residual discretion to adjust the accounts for tax purposes.

2.7 In Gallagher v Jones, it was said that 'no judge-made rule could override the application of a generally accepted rule of commercial accounting which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question, and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business'.[3]

2.8 On this basis, and assuming the accounting rule applies to the situation in question and is not inconsistent with the true facts, a difference could only arise if there were two or more rules, or if the rule were 'otherwise inapt to determine the true profits or losses of the business'. The problem with both these formulations, however, (as demonstrated in the Herbert Smith case and other cases) is the impracticability of identifying tax criteria which result in profit different from that arising under accounting rules when such criteria are not set out in statute.

2.9 This is why it is suggested that any departure from accounting profit that can be identified be enacted (such as, for example, the proposal that the rule in Sharkey v Wernher[4] should be given statutory effect in the next Income Tax Bill). Section 42 should then be amended to substitute 'statute' for 'law'.

2.10 Before considering particular issues with regard to the accounting measure of profit, reference has to be made to the more general principles underlying accounting measurement. There are two aspects, particularly in regard to the Gallagher test of 'aptness', that need further consideration. Both relate to the qualitative characteristics that underlie the accounting process. The first is materiality; the second is the requirement that accounting reports the economic substance of a transaction rather than its legal form. The implications of these characteristics need to be considered at an early stage in any discussion since, if they were fundamental to accounting but unacceptable for tax policy reasons, they could potentially prevent a meaningful increase in alignment.

[3] (1993) 66 TC 77 at 123E.
[4] (1955) 36 TC 275.

2.11 For accounting purposes, information need only be reported in accordance with accounting policies or accounting standards if it is material – that is, if its omission or misstatement could influence the users of the accounting reports.[5] This threshold is not a passport to deliberate omission or misstatement with a view to misleading the user – that would offend the requirement that accounting faithfully represent transactions. It is, however, a relative concept, so that its application depends on the size of the transaction affected relative to its context. Further, the degree of approximation or inherent uncertainty is affected by the subject matter. The issued share capital of a company can and should be determined exactly (so that any departure would be material), whereas greater latitude may be permitted for the valuation of closing stock or work in progress where less precision is possible.

2.12 Materiality also arises within tax as a facet of tax administration. The Taxes Acts do not lay down any definition of materiality; rather, it is for the discretion of the Inspector of Taxes whether, as a practical matter, a transaction may be treated other than strictly in accordance with tax provisions on account of the difference being of minimal proportion.

2.13 The Inland Revenue set out its views in a Press Release dated 18 May 1993. Broadly, computations of business profits may be rounded to the nearest £1,000 where turnover exceeds £5 million, provided the basis of rounding is disclosed and it is certified that the basis of rounding is unbiased and fair for tax purposes. Rounding is not, however, permitted in the computations of capital gains, tax credit relief or capital allowances, or in determining whether the de minimis exception of £50,000 for CFC apportionment applies. In relation to capital gains, it is pointed out that precise dates on which expenditure is incurred are needed for indexation purposes, although rounding can be accepted in relation to incidental costs of acquisition and disposal.

2.14 In a meeting between the Tax Faculty of the ICAEW and the Inland Revenue in September 1997, the Revenue said that the usefulness of accounts generally was limited by the application of the concept of materiality in their preparation (see Tax 18/97). On the other hand, it is evident that in practice the Revenue does enquire as to the level of materiality adopted in any particular set of accounts.

2.15 It would seem, however, that the issue of materiality ought not to stand in the way of further alignment between tax and accounts. The application of administrative discretion should remain the prerogative of the administrator, not the taxpayer. Given that the issue of immateriality is likely to arise only in limited situations, and that the administrative bounds of materiality are published, the taxpayer should be required to disclose any transactions outside those bounds not reported according to accounting policies or standards, possibly with a measure of the consequential difference in accounting profits. In short, if accounting profit were used more widely to determine taxable profit, it would only be necessary to extend existing practice.

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[5] See ASB Statement of Principles paras 3.28–3.32 and IASB Framework para. 30.

2.16 The requirement that accounting should faithfully represent the substance or commercial effect of transactions, and not merely their legal form, is a general qualitative characteristic of both UK and international accounting standards under the Statement of Principles and the Framework respectively.[6] It is potentially more problematic than materiality because of the history in tax law of reliance on the legal form of transactions for the purpose of establishing tax liability. However, this need not be a problem for tax policy if it is accepted that the measure of profit provided by accounting is generally in accord with the concept of profit underlying tax policy.

2.17 Furthermore, it should be understood that the concern with substance in accounting is probably more with what is reported on the balance sheet than with the measure of profit, although there may be consequences for the latter. Thus the approach taken is to adopt a robust definition of assets and liabilities such that, in particular, transactions that would otherwise have been treated as off balance sheet are (subject to permitted exceptions) brought onto the balance sheet. This was the rationale for the treatment of assets used under a finance lease,[7] where the concern was to inform the users of accounts that the lessee had effectively used some of its borrowing capacity. As a by-product, it also gave a particular measure of the cost in each accounting period of using the leased asset, when a similar measure could have been arrived at under normal accounting principles. It was of course this very standard which was at issue in Gallagher v Jones, and which was accepted by the court as being applicable to all such transactions and not just those undertaken by companies. Seemingly, the accounting reliance on substance was not an issue for the court.

2.18 In the UK, there is a specific standard on the application of the concept, FRS 5, but there is as yet no corresponding IAS. FRS 5 affects complex transactions, including linked transactions, the commercial effect of which can only be understood by considering them together, transactions in which legal ownership of an asset is separated (in whole or in part) from the risks and benefits of the asset, and the granting of an option in circumstances in which it is highly likely that the option will be exercised. Certain transactions (broadly speaking, futures contracts, swaps, contracts for differences, expenditure commitments and employment contracts) are excluded from FRS 5. Detailed application notes explain how the standard affects other topics, including consignment stock, sale and repurchase agreements, factoring of debts, securitised assets, loan transfers, and PFI and similar contracts.

2.19 As a result of these rules, an asset may be recognised where there is sufficient evidence of a future inflow or outflow of benefit, and an asset previously recognised may cease to be recognised if all significant benefits and risks relating to the asset are transferred to another party. Only if certain conditions are satisfied can limited recourse finance be deducted from the asset to which it relates (‘linked presentation’), rather than being shown as a separate liability. Again, the emphasis is on balance-sheet presentation.

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[6] ASB Statement of Principles paras 3.12–3.14 and IASB Framework para. 35.
[7] SSAP 21.

2.20 By contrast to this approach, the Duke of Westminster v IRC[8] established the tax principle that tax liabilities are calculated on the basis of the application of tax statutes to the legal form of the transaction or transactions that occurred.

2.21 As a consequence of several more recent tax cases, beginning with Ramsay,[9] it can, however, be cogently argued that the 'substance of transactions' is not irrelevant to the tax analysis. In short, Ramsay held that 'circular transactions' could in certain circumstances be ignored for tax purposes, and Furniss v Dawson[10] held that a 'preordained sequence of transactions' could sometimes be treated as a single composite transaction for tax purposes. Lord Hoffmann stated in Westmoreland Investments Ltd v MacNiven[11] that the underlying rationale for this is that one gives effect to the legal position by having regard to the business substance of the matter. He noted that concepts such as profit and loss 'might not be capable of being held within the confines of purely juristic analysis'.[12]

2.22 The difference in the accounting and the tax approach was, however, reflected in an agreed note of meeting between the Inland Revenue and the Tax Faculty of the ICAEW held in September 1997 (see Tax 18/97). 'The Faculty asked whether FRS 5 had implications for the extent to which it was appropriate to reclassify the nature of transactions for tax purposes according to their supposed substance. The Revenue said that they were conscious of the need under FRS 5 to make finely balanced economic judgements. Practitioners would differ on these. The resultant uncertainties in the application of FRS 5 militated against its use as a core feature of the tax system.'

2.23 Whilst one can sympathise with the Revenue, the key issue for present purposes is the greater need, if tax law is to be changed so that accounts are expressly stated to be the starting point for the determination of all taxable profits (not just trading profits), to know when FRS 5 is being applied. As with materiality, this is, however, an issue that already needs to be tackled under current law. There are circumstances in which FRS 5 would not apply (for example, in relation to the consolidation of the results of a quasi-subsidiary). It is suggested (in the interests of clarity and coherence) that other specific cases where FRS 5 should not apply are expressly identified and legislated for appropriately.

2.24 Disclosure would then seem to be the appropriate response where transactions are reported under the general principle of substance rather than some particular standard. The default position in such cases, at the option of the Revenue, would be that accounting standards would be applied to the form of the transactions. However, in many instances, we would expect the profit measurement resulting from the application of the substance principle to provide a perfectly adequate measure for tax purposes, and to render some anti-avoidance legislation unnecessary. The recent case of John Lewis Properties plc[13]

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[8] (1936) 19 TC 490.
[9] (1981) 54 TC 101.
[10] (1984) 54 TC 324.
[11] (2001) 73 TC 1.
[12] Ibid. at 65E.
[13] [2003] STC 117.

provides just such an example. The real issue is whether the accounting result is appropriate as a measure of taxable capacity, not whether it offends a particular legal doctrine.

2.25 We conclude, therefore, that the accounting principles of materiality and substance over form are not fundamental impediments to the further alignment of accounting and taxable profits.

CHAPTER 3

TAX PRINCIPLES

3.1 To argue for the application of tax principles in determining the suitability of accounting measures is not to suggest anything new, but simply to recognise that there are general policy (as opposed to legal) principles commonly accepted as being desirable characteristics for a successful tax. These need to be acknowledged both in determining the response to developments in accounting practice and in understanding and evaluating the existing discrepancies between taxable and accounting profits.

3.2 Policy objectives are primary, and may range from raising revenue (and its corollary of protecting the revenue) to changing economic behaviour. Subject to those objectives, it is desirable to avoid distorting behaviour and to tax those with equal substantive taxable capacity equally. It has also to be recognised that these ideals are subject to what is administratively possible or affordable in terms of both compliance and enforcement. Further, these considerations have to be understood and applied in the context of the structural elements of any tax: the tax base, the tax unit, the rate structure and the jurisdictional limitations.

3.3 Present differences between accounting and tax measures of profit broadly fall into two categories: differences of recognition and differences of timing. Recognition differences generally arise through transactions being either excluded or modified for tax purposes by statute. There may be good policy reasons behind these differences, but where there are not, they are potentially distortive and inequitable in a way that timing differences may not be. Timing differences occur when statute recognises the same transactions as accounting but does so at different times from accounting.

3.4 The timing of the tax burden is an issue that regularly arises in any consideration of the tax system. In particular, it is observed that the taxpayer would always prefer to defer any tax payment, and to this end would prefer to recognise expenditure early and receipts late. Alignment with accounting would, however, limit the ability to do this (see FRS 12, for example, which prevents many kinds of costs being expensed too early), but nevertheless discretion does remain in some areas. Similarly, there may be explicit provisions within the tax code either accelerating or postponing recognition of transactions for tax liability purposes on policy grounds.

3.5 At this juncture, it is worth making a general observation with regard to the issue of timing that has a particular bearing on the relationship between accounting and tax measures of profit. In terms of economic value, taxpayers will indeed prefer to pay tax later than earlier, but this need not be at a cost to the exchequer. Provided that the tax liability is based on accounting entries, and if distribution is limited under company law by reference to the accounting measure of profit, it follows that early recognition of, for example, a depreciation expense will reduce what can be distributed. A higher amount is thus retained within the business. The return on this retention should therefore generate

higher, though later, tax flows than would otherwise have been the case. There are, of course, limits to how far the government might be willing not only to postpone its tax revenues but also to incur the risk associated with reinvestment. Similarly, where the timing difference is in the opposite direction and tax relief is given later, or receipts recognised earlier, than for accounting purposes, the taxpayer is always worse off. By contrast, the government then collects more tax early on, but it may collect less tax overall. This insight does suggest that timing differences between accounting and current tax measures, from the perspective of the government, need not always be the obstacle that is sometimes perceived.

3.6 Both recognition and timing differences may exist for a variety of reasons. Some may exist from legislative inertia – a failure to bring statute up to date, particularly when it was originally enacted either for a different purpose or in a different context. Others may reflect current specific policy objectives: for example, to encourage investment by accelerating depreciation or excluding from the tax base grants given for the same purpose; to ease government borrowing by exempting income and gains on government securities from tax; or to reinforce public policy by disallowing penalties and fines. Structural issues may also account for differences – in particular, the recognition of economic groupings of companies in contradistinction to the formal tax unit of the individual company, the boundary between the corporate and personal tax systems, and exemption of dividend flows within the corporate sector. Finally, there are inevitably differences occasioned by anti-avoidance legislation. In many instances, these differences will arise from the failure to recognise transactions for tax purposes, but they may also stem from timing reliefs given by statute or from jurisdictional considerations.

3.7 In considering differences of recognition, we are, however, primarily concerned with identifying the tax base. Its successful definition is crucial in determining the revenue raised and limiting tax avoided. Inadequate definition will give rise to distortions and inequity, but the very nature of the tax base may be such that it is difficult to legislate for. Income or profit is such a concept: it is notoriously difficult to define even in economic terms, let alone in the context of a tax system in which there are recalcitrant taxpayers wishing to transact outside the base as legislatively defined. That is why avoiding legislative definition and starting with the accounting measure of profit computed in accordance with accounting standards is attractive: leaving aside fraudulent accounting (accounting evasion), the accounts have to be prepared in accordance with standards the very purpose of which is to limit the ability to manipulate the accounting result (accounting avoidance). Further, even where there is legitimate discretion within accounting practice, the pressures of reporting performance may to some extent balance the desire to minimise tax.

3.8 Yet whilst this is seemingly a benefit of following accounting, it is also potentially a weakness, for it cannot be assumed that a measure made for judging economic performance is necessarily suitable for measuring taxable capacity, and that is the function of the tax base – to determine the taxable capacity of the tax unit. Therefore, given that tax policy has determined that profit be the tax base for companies, there has to be some agreement as to what is understood by that concept. Otherwise, there can be no

coherence either in the response to accounting practice or in any legislation modifying its output for tax purposes.

3.9 The idea of business income is generally based on an underlying concept of personal income: the amount that an individual could have consumed in a period whilst remaining as well off as at the beginning of the period. This can be adapted to the business context by regarding the business as an entity separate from the person owning or running it, and substituting distribution or withdrawal for consumption. In either case, income can be measured indirectly as equivalent to consumption or distribution, plus saving, where saving is consumption or distribution forgone. Alternatively, and more commonly, income can be measured directly by computing the potential for consumption or distribution arising in a period. However it is computed, the central idea of income is that it is available for consumption, withdrawal or distribution without reducing the wealth previously available, and given that tax is taken out of what is otherwise available for distribution, it is in effect a distribution of profit itself.

3.10 Traditionally, accounting has been concerned to measure profit as that available for distribution while protecting capital, but that is no longer the case.[14] That objective is now seen as a constraint that should not inhibit the search for more relevant information, in particular in relation to revaluation changes. It is here that we can see that tax law and accounting are out of phase. We have observed that there has been a deliberate policy to bring tax measures of profit into line with accounting measures. This has been evidenced in government statements and in new statutory provisions. But as tax has moved towards accounting, so accounting has itself moved on, arguably in a different direction from that appropriate to tax policy. Accounting profit is computed for the purpose of providing a measure of performance in the context of the financial environment. The issue is whether this measure is also suitable for measuring taxable capacity.

3.11 Whether or not tax should be limited to realised gains is central to this question. The realisation test has traditionally been at the heart of protecting creditors and investors in limiting distributions to those of realised profits, particularly in the context of accrual accounting, so if tax is itself considered to be a distribution of profit to government, then it is perhaps appropriate, in general, to limit what is taxed to realised profits. What constitutes realisation in any particular circumstance needs clarification. The purpose of the test is to achieve an acceptable level of certainty in the measure of profits before permitting the distribution of dividend, or payment of tax. The requirement is not that there should always be a disposal of an asset or liability. Thus the requirement of disposal or maturity for tax purposes in Willingale v International Commercial Bank[15] would be considered too strong, whereas the threshold used in the commercial accounts in that case would be considered acceptable.

3.12 IAS will recognise unrealised gains more extensively than accounting has traditionally done. It will always start from transaction costs in recording an asset or

[14] See para. 1.14 of *Reporting Financial Performance: Proposals for Change*, ASB Discussion Paper, 1999.
[15] (1978) 52 TC 242.

liability, but may subsequently re-measure those transactions to fair value. A consideration of what is meant by fair value will help determine whether gains or losses arising on re-measurement and included in accounting profit should be taxed or relieved.

3.13 The current replacement cost may be a surrogate measure of the fair value of an asset held for use in the business. However, if the future flow of benefits to the particular business holding the asset is not expected to change, notwithstanding that the replacement cost of the asset has increased, it is difficult to see that the change should be recognised as income for tax purposes. Profits arise from outputs, not re-measurements of inputs. Further, to change the carrying value of a depreciating asset will simply result in uprated depreciation charges in the future, so that the issue is one of timing – early recognition of re-measurement gains matched by later increases in expense.

3.14 Alternatively, the fair value of an asset may be measured directly as the amount that could be obtained from its sale to a willing buyer. This basis of valuation ignores any expenses that might arise if the asset were in fact sold, including any loss arising by virtue of it not being available for use in the business.[16] In the case of an asset held for use in the business, therefore, the resultant gain does not accord with the fundamental concept of business income. The amount so calculated is not an amount that could be distributed whilst remaining as well off as before, because consequential liabilities have not been allowed for.

3.15 Further, if roll-over relief were available, it would be strange indeed to give this relief on a disposal but to ignore it when an asset continues to be held; but then, if roll-over were available in respect of re-measurement gains, the base cost of the asset for tax purposes would revert to historical cost. Moreover, were gains taxed, there would undoubtedly be pressure to carry back losses should there prove to be subsequent revaluations downwards. For example, if the change is temporary – say a one-off increase in future cash flows – then the capital value will reduce when the expectation is realised, creating a loss. Again the difference is one of timing, but it would be hard to resist the argument that the later loss should be set back against the earlier revaluation gain. Depending on the nature of the asset, this early recognition of gain followed by later allowance for losses might bring a level of volatility to tax revenues that government might wish to avoid as a matter of policy. Therefore, for assets in use in a business, we argue that gains on revaluation should be excluded from the tax base.

3.16 Downward valuations in accounting may, however, arise in the context of impairment reviews, where assets held for use in the business are found to have lost their productive capacity. Such a revaluation can be distinguished from those considered above in two respects: first, the impairment is usually considered to be permanent; secondly, it is consistent with the general accounting process of determining whether expenditure that has been made in the past will generate future economic benefits. This is to use future economic benefits as a benchmark to determine when expenditure, which has taken place,

[16] Fair value is generally defined in IAS as the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction. See IAS 39 para. 98 for the presumptions involved.

is to be written off. That is very different from taxing now expected future benefits which may in fact never arise.

3.17 On the other hand, there are assets, essentially financial assets, that are readily convertible into cash without attracting significant costs consequent upon sale, and which do represent a store of distribution potential. To follow accounting in those cases where revaluations are included in the profit measure, primarily where there is evidence of value in an active market, would seem perfectly consistent with the underlying income concept. The requirement for an active market is to give certainty at two levels: to provide objective evidence, and to be clear that although the asset is still held, that really does represent a decision by the holder to retain it rather than sell it.

3.18 A particular class of asset potentially giving rise to recognition and timing differences is derivatives, although not all valuation changes will currently necessarily appear as profit in the case of 'available-for-sale' designation of financial assets or under the use of hedge accounting. Their ultimate value is inherently uncertain, although they can be used as a means of covering risk. That they may have a market value at any time before the occurrence of the possible outcome is not questioned, but the outcome arising from the contract is uncertain until either the contract is disposed of or the event covered by the contract materialises. It is suggested that any tax charge on market values of these assets could possibly lead to particularly volatile tax revenues, and, again, pressure for loss carry-backs. Adherence to the realisation principle would mean awaiting outcomes and accruing any costs on normal principles. To tax otherwise would be unsustainable if there were a hedge, and if the underlying assets were held at cost rather than fair value. This, of course, does not apply to traders in such assets, who would continue to be taxed on derivatives in the same way that traders in other financial assets are taxed.

3.19 One of the concerns with limiting the taxation of gains on capital assets to realised gains is that this would lead to the 'cherry-picking' of losses, whereby losses are realised and relieved but gains are postponed and taxed later. However, under the proposals above, those assets that would be taxed on a realisation basis are not those that are readily realisable. For those that are – financial assets traded in an active market – it is proposed that both gains and losses should be taxed on a fair-value basis. To a large extent, therefore, the problem should be avoided, and where it does remain, the problem is one of timing rather than recognition.

3.20 The valuation question also arises in the context of liabilities. A company's loan capital may be quoted at below its nominal redeemable value, perhaps either because of a change in interest rate or because of the company's performance. To account for the loan at its market value would result in a gain. There would be an 'Alice in Wonderland' image given by a tax system that levied tax on a hypothetical gain that arises just because the company is in a parlous financial position, particularly when that position meant that it had neither the cash nor the borrowing power to finance such a buy-back. There is also a principled objection to taxing such a computation. The argument for accepting the market value of financial assets dealt on an active market is that there is a certainty to the

valuation based on the assumption that the holder is a price-taker. This assumption does not hold in the case of a company seeking to purchase the whole of its debt.

3.21 Having determined that the tax base is to be derived from accounts, but subject to the matters discussed above, it is necessary to return to consider the limitations on the base imposed by tax statute or statutory interpretation under the source system. These arose primarily in the context of personal taxation. The strict source doctrine, the limitations on the ambit of Case VI (capturing only matters *eiusdem generis* with other heads of charge, plus a variety of isolated charges), the computational rules for different sources, and limitations on loss relief, for example, result in an income base that is not comprehensive, which is thus both distortive and inequitable and simultaneously open to avoidance.

3.22 Thus, for example, several of the provisions of ICTA 1988 s. 74 are concerned with the distinction between a cost of earning income from a trade and personal consumption.[17] In some cases, this is a particularly difficult line to draw, especially where the nature of the expense inherently involves some personal benefit. As a reaction to this, there are specific rules prohibiting, for example, the deduction of business entertaining expenses[18] and limiting the relief for expensive cars.[19] Whether these provisions are appropriate to companies is debatable. The optimum approach is that, where practicable, the company should only be required to disclose these amounts so that they can be taxed as personal income, though this would still require some apportionment between business and personal expense. A further concern for the legislator is similarly the boundary between the company and the shareholder. For the latter, there is no value in the company unless some economic benefit can be extracted from it. The individual taxpayer will always be interested in receiving value free of personal tax, particularly in the case of a closely held company. It is submitted, however, that, where practicable, such matters should be taxed at the shareholder level (where the benefit is enjoyed) so as to limit the need for anti-avoidance provisions to the accounts at the company level.

3.23 The jurisdictional boundaries of the tax system always provide opportunities for tax avoidance, so provisions preventing this will inevitably create differences from the accounting profits. Transfer-pricing provisions where transactions between connected persons are not at arm's length are fundamental to the necessary protection of the revenue. Others will also need to be retained, such as those dealing with entities leaving the tax jurisdiction. The overall impact of moving more to an accounts-based system, however, should be that, for the reasons explained above, fewer anti-avoidance provisions are required.

3.24 Appendix B contains a list of statutory provisions that can result in accounting profit differing from taxable profit. It has been compiled from a single trawl through tax legislation and in those circumstances is not to be treated as exhaustive. It is hoped, however, that it will be sufficiently comprehensive to provide a reasonable picture of

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[17] S. 74(1) (a)–(c).
[18] TA 1988 s. 577.
[19] TA 1988 s. 578 (a) and CAA 2001 ss. 74–79.

what tax law is now doing in relation to the profit computation. Some suggestions as to how this list might be affected by the principles involved in a move to an accounts-based system appear throughout this paper. We have also suggested in Appendix A a general analysis in terms of which readers might form their own judgements as to both the rationales and the effects of the differences. It is also hoped (as further explained in Chapter 8) that the detailed statutory provisions might also be reviewed with a critical eye by government to see which might be discarded or simplified following a move to a more accounts-based system.

CHAPTER 4

SOURCES OF INCOME AND THE SCHEDULAR SYSTEM

4.1 In many respects, the computational distinctions between the sources have now been removed:

(a) a company's Schedule A profit is (save as expressly provided) to be computed in the same way as the profits of a trade;
(b) Schedules B and C have been abolished;
(c) Case III of Schedule D still allows (for example) certain income to be taxed on an arising rather than an accruals basis, but perhaps the most important area subject to Case III concerns profits of an investment company from loan relationships, which are now determined on an accounting basis, in a similar way to Case I or Case II profits from loan relationships;
(d) Case IV has been abolished for companies;
(e) Case V profits and Case VI profits are (save for certain specific applications of Case VI) computed in a similar way to Case I and Case II profits; and
(f) the former Schedule E and Schedule F are not normally applicable to companies;

but the underlying problems noted below still exist.

4.2 The original rationale for the schedular system was that income taxable under the different schedules would be assessed by different inspectors, it being considered inappropriate that an individual Revenue official should have knowledge of the total income of a gentleman! We now need to look elsewhere, however, for any defence of the schedular system. The only justification for its retention would be if it were an effective way of capturing all those transactions that go to make up an entity's profits. One of the consequences of the source doctrine, however, is that a transaction that cannot be attributed to a source as legally defined in the schedules is excluded from the tax base. By contrast, accounting will account for all transactions, even if some of them may not appear on the face of the profit and loss account.

4.3 Differences may in fact arise on account of the schedular system in two respects: either transactions fall completely outside the bounds of the individual sources as legislatively defined, or they may be excluded or modified by computational provisions specific to particular sources. Accounting measures will refer to the activities of a business, regardless of whether the business is involved in letting property, trading or investing. Until recently, such measures have been a reference point only for taxable income from a particular source – a trade, and even then each trade has technically been a separate source.

4.4 One of the most significant exclusions from the schedules was what is referred to as 'capital' as opposed to 'income' profits. This statutory omission, together with the judicial decisions as to what constituted a capital receipt, meant that until the advent of

the capital gains tax, these profits escaped the tax net completely, creating substantial opportunities for tax avoidance. The very existence of such avoidance, and the retaliatory legislation, was sure evidence that the tax base was inadequately defined. Whilst there was a catch-all provision for income in the form of Schedule D Case VI, its force was emasculated by the judicial requirement that any transaction brought within its scope had to be *eiusdem generis* with transactions taxed under the other schedules and cases. This reinforced the significance of the income/capital divide. Further, the judicial understanding of the source doctrine meant that to be taxable, income had to be seen as flowing from, in the sense of being separated from, the source. So long as the fruit was picked from the tree, this would be income, but should the tree be sold with the fruit on it, the whole was capital. This approach not only reflected the income/capital divide but also reinforced the view that income should be realised before it was taxed.

4.5 Although capital gains tax has now been introduced, and might be viewed as another schedule, it still does not always result in a comprehensive tax base. The tax includes many exemptions which, whilst understandable in the context of a tax on individuals, are arguably not appropriate for a tax on business entities. Such exemptions themselves create opportunities for tax avoidance.

4.6 If accounting output were to be used as the starting point for taxing all transactions, the capital/income divide, as we know it, would be removed, and much anti-avoidance legislation would become redundant.

4.7 The schedular system has also been used to facilitate the conferring of certain tax advantages on trading compared with investment companies. As discussed in Chapter 5, the reasons for this do not always appear compelling. It would appear, however, that even if it were desired to maintain these differences, it would not be necessary to retain the schedular system.

4.8 A further possible reason for maintaining the schedular system is to restrict the ability to set losses against profits of another case or schedule. As appears to be accepted in the second consultation paper, there is a strong argument, however, that these rules operate unfairly.

4.9 In Chapter 2, it was argued that using accounting profit as the basis for measuring the profits of a business (as opposed to those from a particular source) would provide the most comprehensive measure of profit, and that this was desirable on neutrality and equity grounds. It follows that the measure of profit in a period should automatically reflect any losses in that period.

4.10 The rationale for loss relief is that, without it, the tax would act as a disincentive to risk-taking in an uncertain environment. Positive returns would be reduced by the tax rate, but negative ones would not, thus reducing the net after-tax expected returns by more than the tax rate and also increasing the standard deviation (a measure of risk) of the expected rate of return. Thus the set-off of all losses in a period against any profits of the same period ensures that the tax system does not create this disincentive. It also

means that issues of when losses are incurred become less important, even more so if the carry-forward of losses is similarly unrestricted.

4.11 In the accounts, the loss for a period will automatically be set against any profits brought forward, and any accumulated losses brought forward will be set against subsequent profits. For tax purposes, the latter treatment seems entirely logical and in accord with the rationale for giving relief in the first place. However, the set-off of losses against the taxed profits of prior periods needs further justification. In part, the carry-back provisions stem from the old preceding-year basis of assessment and are accordingly now irrelevant. Further, noting that tax may be equated with a distribution, we observe that dividends are not repaid by shareholders when a company subsequently makes losses. On the other hand, a practical justification for carry-back is that tax on profits of one year may become due for payment in the year when the company is incurring a loss, with consequent cash-flow pressures.

4.12 The existing, highly complicated, loss relief rules (helpfully set out in tabular form in the second consultation paper) cannot be justified on grounds of principle. Why, for example, should a company that has a Case III loss on a loan relationship and a Case I trading profit in the same accounting period be better off than a company that is prohibited from utilising the Case III loss against a Case I profit in the subsequent accounting period? Both companies may have exactly the same aggregate profit or loss after the two-year period.

4.13 We have argued for a comprehensive measure of income devoid of the restrictions imposed by the schedular system and by the traditional capital/income divide. However, we recognise that there will have to be limits on loss utilisation to protect tax revenues. There is a very limited case for the carry-back of losses, particularly if unrealised revaluation gains are excluded from the tax base. Save for group relief and certain reliefs on reconstructions, loss relief will still need to be restricted to the tax unit incurring the losses, so anti-avoidance legislation preventing the sale of tax losses will remain. Existing unrelieved losses clearly cannot be carried forward on a comprehensive basis without significantly reducing tax revenues. A pragmatic solution, if comprehensive loss relief is given in future, might be to limit loss relief brought forward as previously, but perhaps with a time limit on its availability.

CHAPTER 5

INVESTMENT COMPANIES AND THE DEDUCTIBILITY OF EXPENSES

5.1 There are many differences between the tax treatment of trading and investment companies. It is mentioned in the second consultation paper that some differences have been justified historically on the grounds that trading activity needs greater support because of its inherently riskier nature and because of its direct contribution to productivity and economic output. The paper then acknowledges that this argument does not necessarily justify the different tax treatment, as assets held by investment companies may be used for production by trading companies, and investment companies provide capital for productive businesses. One might go further and say that this distinction is a left-over from the days when it was considered that investment income was properly the subject of a higher rate of personal income tax than earned income, and as such reflects an outdated view of economic activity which to a large extent can no longer be sustained.

5.2 Thus, and consistent with an accounts-based approach to tax, it is considered that most of the tax differences between investment and trading companies should be eliminated. The government is actively reviewing the rule that expenses of management can only be deducted from investment income by an investment company, and also looking at extending the substantial shareholding exemption to disposals by investment companies and extending roll-over relief. It is hoped that, in due course, the review will be extended to such matters as company reconstructions, demerger legislation, loss relief, etc., whilst recognising that the revenue needs to be protected against certain avoidance possibilities for closely held investment companies.

5.3 It is proposed to focus in the remainder of this chapter on the expenses rule, however. Although the immediate Revenue concerns are with the requirement to be an investment company in order to deduct expenses of management, and the timing of tax relief for these, the fundamental issues of principle go beyond this.

5.4 The general rule limiting what can be deducted in computing the profits of a trade is the wholly and exclusively rule of ICTA 1988 s. 74 (1) (a). The expenditure does not have to be necessary and can be incurred simply on account of commercial judgement. However, it does have to relate to the particular trade in question, so that expenditure relating to the business as a whole of a company that has activities other than the trade would not be deductible. Restrictions on the meaning of expenses of management also mean that relief is sometimes not available for genuine business expenses.

5.5 It is considered appropriate, therefore, that in due course (probably at such time as the schedular system is abolished – see Chapter 8), a general rule should be introduced restricting relief by reference to business as opposed to source-specific expenditure.

5.6 An appropriate formulation of the rule for business might be based on that used in FA 2002 sch. 26 para. 24 (and the corresponding provisions in the loan relationships and

derivative contracts rules). This is that where the purposes of incurring expenditure include a purpose not 'amongst the business or other commercial purposes of the company', it would be unallowable. The point of this broader definition would be to get away from the narrow constraint of trade and the distinction between that and other activities.[20] However, there would undoubtedly be a need to introduce some jurisdictional limitation to prevent deduction of expenditure by a UK company in relation to an investment in an overseas company not taxed in the UK.

5.7 At the same time, the general anti-avoidance provision as used in that paragraph could also be applied. A tax avoidance purpose would only be treated as a business or other commercial purpose of the company where it is not the main, or one of the main, purposes for the transaction, thus incorporating avoidance principles in the general rule.

5.8 The question of provisions for future expenses should also be considered. These are recognised for accounting purposes and for tax purposes provided there is sufficient certainty as to their calculation. To follow accounting in this respect would accord with case law as to provisions. Statute, however, denies a deduction for a general provision for bad debts; there seems no good reason to retain this prohibition against one of the most common of all provisions in accounts. It is accepted, on the other hand, that there are instances where tax will recognise only payments rather than amounts provided in accounts under the accrual basis as being a proper charge to the accounting period in question. In part, these will reflect avoidance provisions where taxation of the recipient is required as a precondition for deductibility of the accrual, whilst on other occasions, as with pensions, there are policy issues driving the tax treatment.

5.9 Capital expenditure is also not in general deductible under current tax law.[21] This was originally founded on the rules necessary for the introduction of a temporary tax where the burden of the tax should not be determined by the vagaries of the timing of lumpy expenditure. Accounting practice did not then generally charge depreciation. Today, however, accounting for discrete periods within what is in reality a business continuum is at the heart of accounting practice. Expenditure is recognised for accounting purposes in measuring profit when there remain no future economic benefits attributable to it – that is, when it does not represent an asset. Where the expenditure does represent an asset, it is 'capitalised' (a notion recognised, for example, in the FA 2002 legislation on intangible fixed assets), and the question for accounting is when it ceases to be an asset and becomes a charge in computing profit.

5.10 By contrast, expenditure categorised as 'capital' on the basis of years of tax precedent cannot normally be deducted in computing taxable profit. It can only attract capital allowances, and then only if it comes within specific statutory definitions which have no regard as to whether or how the accounts in fact depreciate the asset. To disallow expenditure incurred wholly for a business purpose simply because it does not fit neatly into legislative categories, or judicial interpretations of those categories, can have no

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[20] See also the use of the term 'business' in conjunction with trade in F(No.2)A 1992 ss. 40B, 40D, 41 and 42 with reference to films.
[21] TA 1988 s. 74 (1) (f).

justification in a modern tax system. It obviously causes distortions and inequities and leads to attempts to bypass the difficulties by, for example, leasing assets, with the lessee charging the rental and the lessor arguing that the asset is used in the trade of leasing.

5.11 It would be consistent with relying on accounting as the starting point for computing taxable income now to repeal the capital expenditure restriction. The test for recognition would then simply be whether the expense is for a business purpose. Indeed, to do otherwise provides the sort of boundary problem that bedevils the schedular system and creates incentives for avoidance.

5.12 The question of depreciating assets is also considered in the discussion of capital assets in Chapter 6.

CHAPTER 6

CAPITAL ASSETS

6.1 In this chapter, we consider the tax treatment of what are referred to as capital assets. This is not limited to what accountants refer to as fixed assets but extends to all assets not used in the business as stock-in-trade. It covers assets held for use in the business as well as those held for investment purposes. The discussion includes both gains realised on disposal and gains included in the accounts following a revaluation, as well as further consideration of the expensing of the costs of acquiring capital assets.

6.2 As with income provisions, so the capital gains provisions have their own computational rules which are not always consistent with accounting computations. The Rubicon has already been crossed in relation to such matters as intangible fixed property, loan relationships and derivative contracts. This is because it has apparently been decided (correctly in our view) that the large number of capital gains rules that apply to other capital assets are unnecessary and even unhelpful to determine the taxable profit attributable to these assets, even if they had been 'capital' under the old regime. In due course, it should be possible to deal in a similar way with all other capital assets.

6.3 Roll-over relief has been provided for on the disposal of intangible fixed assets, notwithstanding that they have ceased to be regarded as 'capital' assets for tax purposes. The tax policy for conferring roll-over relief on the acquisition of replacement assets needed for use in the business is supported, and it is merely noted that it can be provided by appropriate definition of the assets without needing to maintain the 'capital/revenue' distinction.

6.4 Accounting practice will ensure that expenditure resulting in an asset is capitalised and not expensed. It will then be a matter for separate discussion as to whether accounting depreciation should replace the tax depreciation given by capital allowances.

6.5 This is a multifaceted question. Ideally, we seek a measure of economic depreciation particular to each entity. An accounts measure of depreciation will accord more closely to this than a fixed set of rates applied to all taxpayers identically. However, an immediate concern is that taxpayers would seek to accelerate their accounting depreciation in order to effectively increase their tax relief. The taxing authority would thus have to police the application of the appropriate accounting standard in order to ensure that it had been complied with faithfully, thus increasing enforcement costs. However, as noted above, this need not involve a loss of tax to the exchequer if distributable profit is determined by the accounting depreciation.

6.6 A further consideration is that government may, as a matter of policy, wish to accelerate depreciation allowances in order to encourage investment either generally, in particular sectors of the economy or in specified types of assets. The same incentive might be given (at rates to reflect the timing advantage of accelerated tax reliefs) either

by means of a tax credit or by old-style investment allowances where the allowance does not affect the written-down value. In both cases, the incentive can be given without changing the accounting computations, but consideration would need to be given to whether this form of incentive offended EU rules on state aid.

6.7 However, adjustments consequential upon other tax decisions may be unavoidable. If it is decided not to include gains arising from revaluations in the tax base, particularly in respect of assets held for use in the business, then accounting depreciation, which will be based upon the revaluation, will have to be adjusted. Similarly, if roll-over relief is given, the base cost for depreciation will be reduced, again requiring an adjustment to the accounting measures while the asset is held and also on disposal. The legislation for intangible fixed property has managed to deal with these matters, however, and it should be possible to have a general provision in that mould dealing with adjustments where the accounting base differs from the tax base.

6.8 Adjustment would also follow if depreciation were not recognised for tax purposes for particular types of asset. Commercial property is one such type of asset identified in the second consultative document. It is difficult to see the justification for discriminating against these buildings, however, particularly when the service industries are such an important part of the economy. Perhaps what clouds the issue is that the land on which the buildings sit generally increases in value but is not taxed until disposal. However, exactly the same point applies in respect of industrial buildings.

6.9 It is suggested that a distinction should be made between investment properties and others, however. This is not a distinction that is made under IAS, which treats investment properties as any other asset for the purposes of depreciation, though the buildings and land are regarded as separable assets. This issue is intimately involved with the question of taxing revaluation gains on capital assets, which was discussed in Chapter 3. The distinction between an investment property and one used in business by an owner is that typically the former can be sold on to another investor without any consequential costs other than direct disposal costs. By contrast, an owner-user could suffer, for example, the costs associated with ceasing to trade.

6.10 The other consideration is that property markets are not developed to the same extent as financial markets. This is why the IAS has not made it obligatory to revalue investment properties at fair value, though disclosure is required. We have already noted that accounting now accepts a lower threshold of certainty than is appropriate for taxation, so, given that evidence of property values is considered inadequate for accounting, it is unlikely that it will suffice for tax purposes. Nevertheless, it would seem inappropriate to allow depreciation but totally ignore value changes where capital appreciation is one of the main reasons for holding the asset. A possible solution would be to adopt the accounting definition of investment property, and to allow depreciation where the fair value does not exceed the carrying cost. Where this is not the case, there would be no allowance for depreciation, but there would still be no charge on unrealised gains.

6.11 If accounting depreciation is to be adopted for tax purposes, there is a transitional issue to be resolved. Assets held at commencement day could continue to attract capital allowances until disposal, but this could involve a long transitional period operating two systems. Alternatively, to bring the tax-written-down value into line with the accounting book value, they could attract a balancing charge or allowance, with accounting depreciation applying from commencement day. Given that accounts depreciation is usually at a slower rate than tax depreciation, accounts carrying values will usually be higher than tax values, so to revalue to accounts book values would involve a balancing charge. This charge could be recovered at the same rate as the accounts depreciation was applied.

6.12 There would still remain the question of those assets that do not currently attract allowances but that are depreciated in the accounts. Not to grant allowances to these latter assets could simply force companies to sell and reacquire them (depending on market value), so these too should attract relief for accounting depreciation from commencement day. The prior disallowance for tax purposes would be reflected (where it is the case) on disposal because the accounts computation on disposal would automatically reflect the accounting depreciation before commencement day.

6.13 One difference that it is proposed to remove is the indexation relief that is given for tax purposes on capital assets but which is not now used for accounting purposes. However, this reflects an inadequacy of accounting measurement rather than a misconceived relief in the tax system. While it is correct to say that the relief is discriminatory in that it does not apply to traded assets, it would be the case that, having removed the capital/income divide, such relief could be extended and apply not just to the full range of assets but also to liabilities. Probably the issue is of relatively low importance in a period of sustained low inflation, and in the interests of simplicity and a balanced overall package as between the Revenue and taxpayers, the abolition of the relief should be accepted. There should, however, be provision for the introduction (perhaps by regulation) of a properly structured relief should inflation rise above a specified level.

6.14 Removal of indexation would be effective from commencement day. In itself, it would not require adjustment to accounting computations on a disposal, but would simply be a relief specific to each disposal and subject to the limitation that it could not turn an accounting gain into a loss.

6.15 The discussion above indicates quite clearly that in taxing capital assets there are likely to be differences between taxable and accounting profits. This does not mean that substantial alignment with accounting is not possible. What it would often require is that the tax calculation of profit is that which would apply to a transaction stripped of any intermediate revaluations or disposals to which roll-over relief applied. As such, the adjustments may require a minimal set of statutory rules, which to a large extent have already been worked out in the intangible fixed property legislation.

CHAPTER 7

RESPONSE TO THE SECOND CONSULTATIVE DOCUMENT

7.1 In these detailed responses to the questions asked in the second consultative document, no attempt is made to answer those questions related to administrative or compliance costs, nor questions related to particular businesses, where there are others much better placed to supply the answers.

7.2 In relation to questions 1–5, the full pooling of all revenue losses is much to be preferred to the option of partial pooling of trading and property income. The latter should only be adopted if essential to protect the exchequer or (which would seem unlikely) if some advantage is perceived in moving by stages to full pooling.

7.3 In relation to questions 6–11, the detailed proposals for loss relief on full pooling seem very sensible. If the schedular system is abolished, pre-commencement losses, and subsequent losses carried forward on a reconstruction, could be dealt with on a streaming basis as currently provided within ICTA 1988 s. 343 (8)–(10). The change of ownership rules would deny the carry-forward of losses arising under the new system if there were a major change in the nature or conduct of the business or if the activities of the business became negligible.

7.4 In relation to questions 22–28, the tax differences between trading and investment companies are largely unsustainable. There should be a new, generalised, business expenses rule.

7.5 In relation to questions 29–31, the substantial shareholding rule should be extended as far as possible to investment companies, with appropriate anti-avoidance rules for personal investment companies.

7.6 In relation to question 38, the accounts should be used as much as possible to determine capital profits (save in relation to unrealised gains).

7.7 In relation to questions 39–41, commercial depreciation should be used as much as possible for land and buildings, subject to some limitation for investment properties. The proposed roll-over relief is accepted.

7.8 In relation to questions 42–47, substantial issues arise in relation to plant and machinery allowances, both in relation to their incentive effect and in relation to the costs to the exchequer. It is suggested, however, that the advantages of an accounts-based system are sufficiently strong to place the burden on the person supporting the current capital allowances system to justify their retention.

7.9 In relation to question 50, the full pooling of ‘capital’ losses (i.e. losses on assets currently treated as capital) with ‘income’ gains and losses is to be preferred. The need to

restrict the utilisation of 'capital' losses with a view to protecting the exchequer is less pressing if unrealised gains and losses are outside the tax base.

7.10 In relation to questions 52–54, a fast transition is to be preferred.

7.11 In relation to questions 55 and 56, the government's position is accepted, i.e. that 'capital' gains of CFCs should be included on an accounting basis, subject to review of the detailed implications.

7.12 In relation to questions 61 and 62, we see no case for departing from the accounting treatment of leases. However, if there are tax incentives given, in addition to accounting depreciation, these could be given to lessees, even though it is recognised that the growth of the leasing industry occurred in part because companies were unable to use their first-year tax allowances.

CHAPTER 8

LEGISLATIVE CHANGES AND CONCLUSION

8.1 The long-term aim should be to have a new Corporation Tax Act which defines the tax base in terms of accounting profit of the company, rather than of particular sources. Departures from that would be set out in statute. Income tax and capital gains tax legislation would cease to apply to companies, and much of the legislation that currently seeks to bring tax into line with accounting would be redundant. There would be a common set of anti-avoidance provisions ranging from the general, based upon the business expense rule, to the more specific applying to such matters as transactions with connected persons, transactions with members of a group, transferee companies leaving a group, unpaid debts, and other tax avoidance possibilities that still remained. Loss relief rules would be minimal, with restrictions on set-off being limited to what are perceived as avoidance opportunities.

8.2 As a first step, it may be desirable to provide that section 42 applies not only to Case I and Case II of Schedule D and to Schedule A, but also to all other sources of taxable income. If it were desired to preserve the status quo in relation to certain matters not currently taxable on such an accounting basis (for example, Case III discounts not arising under loan relationships), further express exceptions would be made for these. Section 42 should itself be amended so as to make amendments to the accounting profit subject only to statute.

8.3 The old loss rules for companies would be abolished, and new rules introduced for full pooling, i.e. revenue losses under all the schedules could be aggregated and set against current profits of any description (whether income or capital), pending the switch to full accounting profits. Any resulting net loss could be carried back one year to set against profits of any description in that year (but not carried back in this way before the effective date for the change in law), and, subject to this, any net loss could be carried forward to set against profits of any description in a subsequent year. Losses brought forward under the old rules could only be set against profits of the same source, if that is what the old rules required. New loss rules (similar to ICTA 1988 s. 768 and s. 343 for trading losses) should be introduced for changes of ownership and reconstructions for all sources of profits.

8.4 Capital expenses ('tax nothings' under current legislation) should be allowed, as per the accounting treatment, by immediately repealing the capital expenditure provisions of ICTA 1988 s. 74.

8.5 The indexation allowance should be abolished.

8.6 Subject to review of the detailed impact, the CFC legislation should be applied to capital gains.

8.7 Steps should be taken to reduce the tax differences between investment and trading companies.

8.8 Specific consideration should be given to whether the existing complex rules for reorganisations and the exchange of shares and other securities might be simplified, and the extent of any need for departure from the accounting treatment of such transactions.

8.9 A further review should be carried out of capital allowances, to decide the extent to which an accounts-based solution should also be substituted for this system, and to consider how best to maintain the option of tax incentives whilst basing depreciation on the accounts measure.

8.10 When the present review has been completed, a Revenue team could commence redrafting for a new Corporation Tax Act which would be introduced in, say, about five years' time, when all the above matters had been dealt with. (Such a time frame might also have advantages in terms of the timetable for completing the third Income Tax Bill at some time in 2006.) After that five-year period, all the schedules and cases would be collapsed into one head of charge, as would the rules for taxing capital gains. Charges on income would fall to be dealt with in this 'one bucket'. Losses that had arisen under the old rules which are still being brought forward would be streamed against subsequent profits attributable to the activities that produced the loss. Although the new Act would look very different from previous legislation (it should be very much simpler), the substantive effect at that time would be limited since earlier changes to legislation to enable this collapse to occur would already have been digested and have become familiar. At this time, however, it might be appropriate to introduce a new general rule for the deduction of business expenses.

8.11 The opportunity should be taken to introduce other changes during the transitional period or in the new Corporation Tax Act which would simplify and rationalise the rules (i.e. the approach should not be limited to making existing law more clear as in the tax rewrite project). Existing legislation of the kind set out in Appendix B should be examined to see if it is still required or might be simplified in the light of an accounts-based system. Further consideration might also be given to other legislation: a particular example of this might be the group relief rules in ICTA 1988 schedule 18 (where the concept of fluctuating rights of equity holders inherent in securities held, or which could come about under option arrangements, could be much more succinctly addressed than is currently the case in paras 4–5F). A further candidate for review might be the rules in TCGA 1992 schedule 7A for pre-entry capital losses of bought-in companies, particularly where the scope for utilising such losses had been reduced by new rules taxing what were capital gains as income.

8.12 As the second consultation paper recognises, there would be much work to do merely to abolish all the current schedules, let alone put into effect the other suggestions made above. It is submitted, however, that this effort would be well worth it, because in a few years' time, the result would be a system of corporation tax that had indeed removed many economic distortions and reduced the scope for avoidance.

APPENDIX A

ANALYSING THE STATUTORY DIFFERENCES BETWEEN TAX AND ACCOUNTING PROFITS

It is possible to consider the statutory differences in Appendix B in terms of both their cause and their effect. The effects, as noted in 3.3, can be seen in either recognition or timing differences.

The causes of the differences may be analysed as follows:

1. **Policy:** This might range from the disallowance of illegal expenditure, or the exclusion of government grants, both of which are recognition differences, to accelerated capital allowances, giving a timing effect. It would also include specific GAAP overrides, such as pension or share-based payment provisions.

2. **The capital/income divide:** This usually takes the form of provisions originally enacted as anti-avoidance legislation and without which there would be a recognition difference. The effect therefore generally becomes one of timing, although the disallowance of capital expenditure can result in there being no recognition of the expenditure under any head of charge.

3. **The schedular system:** The boundaries set by the schedules may result in recognition differences either, for example, through receipts not entering the tax base or through business expenses being disallowed as not being directly attributable to a specific source of income. That it is sources of income rather than businesses that are taxed may also lead to specific commencement/cessation provisions and either recognition or timing differences.

4. **Losses:** Whilst for accounting purposes one period will dovetail into the next by setting losses brought forward against current profits, or current losses against profits brought forward, for tax purposes each accounting period is a closed assessment period. Rules on loss utilisation may give both recognition differences, in that some losses may never be relieved, and timing differences.

5. **The personal tax system:** The corporation tax borrows heavily from the personal income tax and the personal capital gains tax. Differences of recognition arise from provisions that are aimed at distinguishing between personal consumption and business expense, and which are probably not appropriate to incorporated businesses, or from exemptions, debts and chattels, for example, from the capital gains tax. Timing differences might arise where, for example, receipts are spread over a number of years as a way of relieving the effect of progressive tax rates in the personal income tax.

6. **Structural:** The chosen structure of the corporation tax may result in provisions that generally have recognition effects. Thus the choice of the individual company as opposed to a group of companies necessitates specific group provisions which will have recognition effects for the single company, though possibly only a timing effect for the group. Similarly, although the corporation tax is formally a tax on the company, it is in fact a tax on the profits attributable to equity shareholders. The consequential provisions defending the boundary between dividends (not deductible) and interest (deductible) can result in recognition differences. There are also further provisions, usually anti-avoidance, concerned with the relationship between the shareholder and the company which will result in recognition differences.

7. **Anti-avoidance provisions:** These may result in either recognition or timing differences and may relate to any of the above categories.

8. **Historic:** Some provisions would appear to have no current rationale, but have remained in the statute in spite of developments in accounting and case law. An example would be the disallowance of general provisions for bad debts, this giving rise to a timing difference.

9. **Transitional or consequential provisions:** Although not included in Appendix B, transitional provisions will usually involve recognition differences, but could (see, for example, our proposal for moving to accounts-based depreciation) involve timing differences. Consequential provisions are those that arise as a direct consequence of the introduction of provisions under any of the heads above and may give rise to either category of difference.

Many differences might be considered to arise under more than one head. In analysing the rationale for the differences noted in Appendix B, the reader is invited to consider how many could be removed by more closely aligning with the accounts without infringing policy objectives. Differences attributable to the corporate tax structure would inevitably remain, but many of those attributable to the capital/income divide and the reliance on the personal tax system and its schedular system could surely be removed.

APPENDIX B

STATUTORY DIFFERENCES BETWEEN ACCOUNTING PROFITS AND TAX PROFITS FOR COMPANIES

Contents:

I ADJUSTMENTS TO THE SCHEDULE A COMPUTATION

II ADJUSTMENTS TO THE SCHEDULE D CASES I AND II COMPUTATION

III FURTHER PROVISIONS RELATING TO THE INCOME AND CHARGEABLE GAINS OF COMPANIES

IV 'SCHEDULE E'

V DISTRIBUTIONS RECEIVED AND PAID

VI LOSSES

VII CLOSE COMPANIES

VIII SETTLEMENTS

IX ANTI-AVOIDANCE PROVISIONS

X DOUBLE TAXATION RELIEF

XI LOAN RELATIONSHIPS

XII DERIVATIVE CONTRACTS

XIII INTANGIBLE FIXED ASSETS

XIV THE TAXATION OF CHARGEABLE GAINS ACT 1992

XV CAPITAL ALLOWANCES ACT 2001

Note:

This appendix excludes references to non-resident companies, charities, insurance companies, pension funds, Lloyds underwriters, oil companies, certain government or crown agencies and statutory bodies, and certain other special classes of companies mentioned in part XII of ICTA 1988 (friendly societies, trade unions and employers' associations, unit trust schemes, industrial and provident societies, credit unions, housing associations, EEIGs, local authorities etc.). It does not apply to trust property held by corporate trustees, or to investment trusts or venture capital trusts. Transitional and commencement rules in relation to new legislation are also excluded.

I ADJUSTMENTS TO THE SCHEDULE A COMPUTATION

(Section references to ICTA 1988)

(Statutory provisions mentioned in section 21A which also apply for the purposes of Schedule D Case I are not repeated in this Part I)

1. Section 30

$^{1}/_{21}$ of capital expenditure on sea walls is deductible against Schedule A profits in each year over a 21-year period.

This operates as a form of capital allowance, and tax write-off need not conform with accounts treatment.

2. Section 34

(a) A proportion of premium on grant of short lease is taxed in the account period received as rent.

This need not conform with accounts treatment, as all the proportion treated as rent may not be recognised at that time as accounting profit.

(b) Obligation on tenant to improve premises on grant of short lease is deemed to be a premium.

It is very unlikely that accounts treatment would reflect tax treatment.

(c) Sum paid in lieu of rent under terms of lease, or for surrender of lease, or for waiver of lease, is treated as a premium.

This need not conform with accounts treatment.

3. Section 35

A proportion of the profit on an assignment of a short lease originally granted at an undervalue is treated as rent.

This need not conform with accounts treatment.

4. Section 36

When land is sold with a right to a reconveyance at a lower price, a proportion of the excess is taxed as rent ‘up front’.

This need not conform with accounts treatment.

5. Section 37

When there has been a charge to tax under section 34 or 35 on the grant of a lease or the assignment of an interest in land, there is some relief from a subsequent charge under section 34 or 35 on a subsequent grant of lease or assignment.

This need not conform with accounts treatment.

6. Section 40

This section provides for apportionments to be made on the sale of land of rents and other amounts payable to or by the owner of the interest in land for the purposes of the Schedule A computation.

This could in some circumstances differ from the accounts treatment, e.g. where land is sold for a loss, but Schedule A income still needs to be recognised.

7. Section 43

Proceeds of sale of rents in defined circumstances are taxed as a Schedule A receipt.

This need not conform with accounts treatment (in which any gain may be reduced to reflect impairment of the asset).

II ADJUSTMENTS TO THE SCHEDULE D CASES I AND II COMPUTATION

(Section references to ICTA 1988 unless otherwise stated)

1. Section 72(2)

Where an apportionment of income to different account periods is necessary, this is to be done in proportion to the number of days in those periods.

Accounts treatment could perhaps be different if a different method of apportionment were thought appropriate.

2. Section 74a

No deduction is allowed for disbursements or expenses not being money wholly and exclusively laid out for the purposes of the trade.

Accounts would show the expense.

3. Section 74b

Certain expenses, including for private or domestic purposes, are not deductible for tax purposes.

Accounts would show the expense.

4. Section 74c

This restricts any deduction for rent paid for dwelling house, part of which is used for the trade.

This is included for completeness but is unlikely to be relevant for companies.

5. Section 74d

No deduction is allowed for expenditure on repairs to premises beyond that required for the purposes of the trade.

Accounts would show the expense.

6. Section 74e

There is no deduction for any loss not connected with or arising out of the trade.

Accounts would show the expense.

7. Section 74f

There is no deduction for capital expenditure.

Accounts would show the expense.

8. Section 74g

There is no deduction for capital expenditure on the improvement of premises.

This is mentioned for completeness although such expenditure would normally be capitalised (and not expensed) in the accounts.

9. Section 74h

There is no deduction for notional interest on capital.

This is mentioned for completeness although the notional interest may not be charged in the accounts.

10. Section 74j

There is no deduction for a general provision against bad debts (with a similar rule for debts that represent loan relationships – see Part XI below).

The accounts may contain such a provision.

11. Section 74k

There is no deduction for 'average loss beyond the actual amount of loss after adjustment'.

This provision is understood to relate to losses from aviation or maritime activities, where the loss is not covered by insurance.

12. Section 74l

There is no deduction for any sum recoverable under an insurance or contract of indemnity.

It is possible that accounts may not show the corresponding receivable in some circumstances, e.g. where a decision had been made not to pursue an indemnity claim.

13. Section 74m

There is no deduction for any annuity or other annual payment (not being interest) payable out of profits.

The accounts would reflect such payments, but tax relief is given (if at all) as a charge on income under section 337A (see Part III below).

(Sections 74n, 74o and 74p are not relevant for companies.)

(NB There are many statutory provisions that override or restrict the application of section 74 in specified circumstances. Where this occurs, the accounts profits are more likely to equal the tax profits. These provisions are not set out in this appendix.)

14. Section 85

Payments to trustees of approved profit-sharing schemes are deductible only if certain conditions are satisfied.

Accounts would reflect all such payments.

15. Section 85A

Payments to establish employee share ownership trust are deductible only if certain conditions are satisfied.

Accounts would reflect all such payments.

16. Section 87

Part of premium on grant of short lease, which is taxable on landlord, is deductible as a trading expense.

Accounts depreciation is unlikely to be calculated in the same way.

17. Section 90

An additional payment to a redundant employee which would not be deductible under basic principles by reason of discontinuance of the trade is treated as deductible, but only up to three times the statutory payment.

Accounts would show all the payment without any cap.

18. Section 91

This confers a deduction which may be calculated on a formula basis for all or part of certain capital expenditure incurred in a cemetery business.

It is unlikely that accounts treatment would match tax treatment.

19. Section 91A

This confers a deduction for a restoration payment for site used for waste disposal.

It would appear that such a payment might be capitalised in the accounts.

20. Section 91B

This confers a deduction for a preparation payment for site used for waste disposal according to a formula.

Accounts need not apply the same formula.

21. Section 91BA

This confers a deduction for a successor to a waste disposal site for a proportion of a site preparation payment incurred by the predecessor which the predecessor would have deducted if there had been no transfer.

Accounts need not apply the same formula (see section 91B above).

22. Section 91C

This restricts relief for certain expenditure on mineral exploration and access.

Accounts would show the entire expense.

23. Section 92

This provides a tax exemption for regional development grants.

Accounts would show the receipt, although perhaps as reduction of capital cost.

24. Section 94

The release of a debt gives rise to a taxable receipt for a trader who has previously deducted the expense incurred, unless there has been a relevant arrangement or compromise made pursuant to company or insolvency law.

Accounts would show the release regardless of any arrangement or compromise.

25. Sections 96 and 97 and schedule 5

A farmer or market gardener may elect to average two years' profit where one of the year's profit is less than 70 per cent of the other year's profit (with marginal relief where the one year's profit is less than 75 per cent of the other year's profit).

The accounts would not reflect this averaging.

There are also special rules for computing the profits of a farming or similar trade where there is an election for the 'herd basis'.

Accounts would be unlikely to follow this treatment.

26. Section 99

Costs attributable to trees on purchase of woodlands are disregarded in tax computation of a dealer in land, together with a similar sum on the sale of woodlands with those trees (see also section 65 FA1988 in Part III below).

Accounts treatment will differ.

27. Sections 100–102

These contain special rules for the valuation of trading stock and work in progress on discontinuance.

Accounts need not follow these rules.

28. Sections 103–106

These provide special rules for receipts after discontinuance.

Accounts need not follow these rules.

29. Section 116

There are restrictions on the ability of a company partner to offset partnership profits against other losses, and vice versa, where arrangements are made for payments or other benefits in respect of those profits or losses.

Accounts treatment would not reflect such restrictions.

30. Section 118

This restricts the ability of a limited company partner to utilise losses from a limited trading partnership to set against other profits.

Accounts treatment would not reflect such a restriction.

31. Sections 118ZA–ZB

These are a similar restriction to that provided by section 118 for a company partner in limited liability partnership.

Accounts treatment would not reflect such a restriction.

32. Section 118ZB

Losses of a limited liability partner, which are not relieved by virtue of sections 118ZA–ZB, are treated as a loss of the succeeding accounting period.

Accounts would not reflect this.

33. Section 121

Sums disbursed by company letting rights to work minerals are deductible if disbursed wholly, exclusively and necessarily as expenses of management or supervision of those minerals.

Accounts would show expense even if not wholly, exclusively and necessarily incurred.

34. Section 122

Mineral royalties receipts are reduced by half for tax purposes.

Accounts would reflect full amount of such royalties.

35. Section 125

There is no tax relief for annual payments made in respect of non-taxable consideration.

Accounts would reflect such annual payments.

36. Section 337

The commencement and discontinuance rules apply when a company begins or ceases to carry on a trade, whether or not the trade is in fact commenced or discontinued.

This section extends the potential application of sections 100–106, which are addressed above.

37. Section 343

Tax losses and capital allowances position of a predecessor company can be inherited by a related successor company on the transfer of a trade.

Accounts of the successor company may not reflect, for example, losses incurred by the predecessor company.

38. Section 473

A conversion of securities (as defined by the capital gains tax rules) held by a dealer in those securities is not treated as giving rise to a disposal.

The accounts treatment may differ where the gain or loss is nevertheless recognised in the accounts (or vice versa, where a disposal is recognised for tax purposes but not for accounts purposes), because the accounting rules differ from the capital gains tax rules.

39. Section 40A–B FA 1992

Expenditure on the master version of a qualifying film is treated as revenue in nature and allocated to accounting periods on a just and reasonable basis.

This treatment may differ from the accounts treatment.

40. Section 41 FA 1992

Relief is available for preliminary expenditure on a film, but subject to a cap for relief under this section of 20 per cent of budgeted total expenditure on the film.

To the extent that the cap applies for tax purposes so as to deny relief, the accounts treatment will differ.

41. Section 42 FA 1992

Relief is available for production or acquisition costs of a film, subject to a cap for each accounts period of one-third of total expenditure.

To the extent that the cap applies for tax purposes so as to deny relief in an accounting period, the accounts treatment will differ.

42. Sections 92–94A FA 1993

These sections contain the rules for ascertaining the sterling equivalent of foreign currency profit for corporation tax purposes where the accounts are drawn up in whole or in part in a foreign currency.

It should be noted that the rules may vary for the underlying subject matter, e.g. where there is a capital gain.

43. Schedule 12 FA 1997

Part I of this schedule sets out rules for charging a finance lessor on the true income return from the lease, having regard to the substance of all the relevant arrangements including the payment of a lump sum (which is not rent under the lease) to the lessor or a person connected with him.

Under part II of this schedule, a finance lessor is to be taxed by reference to accountancy earnings if that exceeds the normal rent provided for in the lease.

Finance leasing is a major topic in any consideration of the relationship between accounting and taxable profits, and a full description of the issues is not attempted. Suffice to say that, although these provisions do much to align accountancy and tax treatment, differences remain. For example, the lessor may be taxed under part I on more than the lessor receives (as reflected in the lessor's accounts), while a person connected with the lessor who receives a lump sum may be taxed on less than that person receives (as reflected in that person's accounts).

44. Section 42 FA 1998

The profits of a trade or vocation are to be computed in accordance with GAAP, subject to any adjustment required or authorised by law.

The reference to 'law' rather than 'statute' appears to leave the court residual discretion to adjust the accounts profits for tax purposes, even where there is no express statutory adjustment. In the case of Gallagher v Jones, it was said that 'no judge-made rule could override the application of a generally accepted rule of commercial accounting which (a) applied to the situation in question, (b) was not one of two or more rules applicable to the situation in question, and (c) was not shown to be inconsistent with the true facts or otherwise inapt to determine the true profits or losses of the business'. In such circumstances, therefore, it would appear that a 'judge-made rule' could prevail.

The ‘rule in Sharkey v Wernher’ (stock to be brought into account at market value for tax purposes when appropriated for private use) is a possible example of such a rule. (It is to be given statutory effect in the next Income Tax Bill.)

45. Section 54 FA 1999

Reverse premiums on the grant of a lease are taxed as income, with special rules where the arrangements are not at arm’s length.

Although the basic rule brings tax into line with accounts (since before section 54 FA 1999 the reverse premium would not have been liable to tax), the specific rules for non-arm’s-length arrangements could result in a difference between accounts and taxable profits.

46. Section 63 FA 1999

Where a contract has been entered into by a club to secure the services of a footballer or other player before the introduction of specified financial reporting standards, nothing in those standards shall affect the manner in which a fee payable under the contract is taken into account in computing the club’s taxable profits.

The accounts profit may differ, therefore, if the standards are applied to the pre-existing contract.

47. Section 69 FA 2000

An SME may deduct 150 per cent of its qualifying R&D expenditure in computing the profits of its trade.

The accounts expense would not be uplifted in this way.

48. Section 82 FA 2000

This section and schedule 22 FA 2000 introduce a completely new system for calculating the profits of a shipping company (determined by reference to the net tonnage of qualifying ships operated by the company), if the company so elects.

The accounts profits of the company would not then apply to determine taxable profits.

49. Section 70 FA 2001

This section and schedule 22 FA 2001 provide that a deduction of 150 per cent of qualifying land remediation expenditure is available in computing the profits of a trade or a Schedule A business.

The accounts would not reflect the enhanced expenditure.

50. Section 53 FA 2002

This section and schedule 12 FA 2002 enable large companies to claim relief for 125 per cent of qualifying R&D expenditure.

The accounts would not reflect the enhanced expenditure.

51. Section 54 FA 2002

This section and schedules 13–14 FA 2002 enable companies to claim relief for 150 per cent of expenditure on vaccine research (with a further possible 50 per cent enhancement for expenditure by SMEs).

The accounts would not reflect the enhanced expenditure.

52. Section 64 and schedule 22 FA 2002

Rules are provided for the calculation of taxable profits where there is a change in generally accepted accounting practice which gives rise to a prior-period adjustment or an official change in view as to the operation of tax adjustments to a prior accounting period.

These rules may not be reflected in the same way in the accounts.

III FURTHER PROVISIONS RELATING TO THE INCOME AND CHARGEABLE GAINS OF COMPANIES

(Section references to ICTA 1988 unless otherwise stated)

1. Section 75

This confers tax relief for expenses of management disbursed by an investment company.

Such a company will not obtain tax relief for expenses that are not expenses of management for the purposes of this section, although such expenses would be reflected in the accounts. Further, the timing of the tax relief may differ from the accounts.

2. Section 337A

There is no deduction for dividends or other distributions (which for tax purposes include certain interest payments etc. – see Part V below), or any deduction for income from any source for any charges on income, subject to express provision to the contrary. Nor is there any deduction for interest save as provided for in the loan relationship legislation, nor any deduction in respect of losses from intangible fixed assets save as provided for by Finance Act 2002.

Charges on income can be deducted from total profits, but only on a payment basis, and only if they satisfy the conditions mentioned within the definition in section 338A (e.g. annuities or other annual payments must be paid in return for valuable and sufficient consideration, not charged to capital etc., or e.g. donations to charity must not be subject to a condition for repayment or result in certain benefits for the company or a connected person). Interest and losses from intangible fixed assets are deductible only if the relevant conditions in relevant legislation are satisfied (see Parts XI and XIII respectively below).

Accounts will show the expense, whether or not these respective conditions are satisfied, and on an accruals basis.

3. Section 342

Interest on tax repaid in the final accounting period of a company, which does not exceed £2,000, is exempt.

Accounts will reflect such income.

4. Section 468Q

This section provides the rules for calculating the taxable part of a distribution received from an authorised unit trust.

The accounts will reflect all the distribution received.

5. Section 469

The income of a unit trust that is not an authorised unit trust or an umbrella scheme is treated as the income of the trustees and not income of the unit holder for tax purposes.

This may result in differences from the accounts treatment for a company having an interest in the trust.

6. Section 469A

Any common investment fund established under section 42 of the Administration of Justice Act 1942 is treated as an authorised unit trust for tax purposes.

This may result in differences from the accounts treatment for a company with an interest in the fund.

7. Sections 524–525

A capital sum received on sale of a patent (acquired before 1 April 2002) is treated as received over a six-year period (subject to acceleration if there is a winding-up of the company).

The accounts will show the capital sum received in the year of sale.

8. Section 526

A non-trader can deduct expenses in connection with the maintenance of a patent (acquired before 1 April 2002) if those expenses would have been deductible had the person been a trader, and any excess expenses can be carried forward and treated as incurred in subsequent accounting periods under section 528.

Accounts will reflect the expense, but there may be circumstances in which the expense would not be deductible for tax purposes (i.e. if it would not have been deductible even if the person were a trader) or is deductible in a subsequent accounting period under section 528.

9. Section 527

Tax on receipt of a royalty for a patent (acquired before 1 April 2002) in respect of a period of two years or more is not to exceed the tax that would have been payable had the royalty been received in a number of yearly instalments (corresponding to the length of use of the patent), up to a maximum of six instalments, ending on the actual date of the receipt.

The accounts profits will reflect the actual receivables (although strictly the tax adjustment is not to the accounts profits but to the tax payable on those profits).

10. Sections 539–554

These sections deal with the taxation of gains arising in connection with life insurance policies, contracts for life annuities, and capital redemption policies.

The gains as defined for tax purposes may differ from the accounts profits.

11. Section 573

An investment company that realises a loss (under the capital gains rules) on the disposal of shares in a qualifying trading company may elect to deduct the loss against other income of that accounting period or (if it was then an investment company) the preceding accounting period.

Although the principal effect of this section is to deem a capital loss to be a revenue loss for tax purposes, there may still be a difference arising from the accounts profits where, for example, the capital gains rules define the amount of the loss to be different from the amount calculated for accounts purposes, or where there is a carry-back of the tax loss.

12. Section 577

No tax deduction is available for business entertainment expenses or certain gifts.

The accounts would reflect such expenses or gifts.

13. Section 577A

No tax deduction is available for a payment the making of which constitutes a criminal offence.

The accounts would reflect such expenditure.

14. Section 578

Housing grants made pursuant to statute are exempt from tax.

The accounts would reflect any such grant received (although it may be capitalised in the accounts).

15. Section 578A

The tax deduction for the costs of hiring a car the retail price of which exceeds £12,000 is restricted.

The full hiring charge would be reflected in the accounts.

16. Section 579

A tax deduction is available for a statutory redundancy payment, which if made after the discontinuance of a trade or other business is deemed to be made on the last day that such trade or business is carried on.

The timing of the tax deduction may not therefore match the accounts deduction, particularly if no reserve (or an insufficient reserve) is made in the accounts for the year of termination for a later payment.

17. Section 582

Where 'funding bonds' (defined to include bonds, stocks, shares etc.) are issued in respect of a liability to pay interest, the issue of the funding bonds is treated as if it were a payment of that interest equal to the value of the funding bonds when issued.

The accounts may not, for example, recognise the value of the funding bonds at the time of issue, in which case the tax profits would be different.

18. Section 584

On the making of a claim, overseas source income that cannot be remitted to the UK (because of foreign laws or executive action, or the impossibility of obtaining foreign currency) is exempt from tax in the UK until such time as it can be remitted.

It is possible that the accounts may nevertheless recognise the income as it arises or when it is earned.

19. Section 586

No deduction is, in general, available for war risk premiums (which entitle the person to any indemnification for war damage).

The accounts would reflect such premiums.

20. Section 587

No deduction is, in general, available for any payments to provide benefits in respect of the death or injury of an employee caused by war, or payments made by way of premium for an insurance policy in respect of such death or injury.

The accounts would reflect such payments.

(Section 587A – extra return on the issue of new securities – is largely redundant for corporation tax purposes, since it only applies for such purposes where the new securities were issued before 1 April 1996.)

21. Section 587B

A deduction is available equal to the market value of certain qualifying investments (shares, securities, real property etc.) given to charity.

The accounts may only show the elimination of the historic cost of the investment that is donated.

22. Section 817

No deduction is allowed in the computation of profits or gains for tax purposes save as expressly enumerated in the Tax Acts.

The scope of this section is unclear, but where it applies, the accounts profit will differ from the tax profit.

(The converse of this section is that a receipt is not taxable unless within one of the schedules in tax legislation. Thus, for example, a gift may not be taxable if not a receipt of a trade, or a capital receipt may not be taxable if it does not arise from a disposal or deemed disposal of an asset.)

23. Section 827

No deduction is available for tax penalties (including those payable under the VAT legislation).

The accounts would reflect such penalties.

24. Section 65 FA 1988

Profits or gains from the occupation of commercial woodlands are not, in general, liable to tax.

The accounts would reflect such profits.

25. Sections 43–44 FA 1989

There is no tax relief for a trader or for an investment company in an accounting period for emoluments not paid within nine months after the end of that accounting period (even though they may be reserved for in the accounts).

The accounts profit would be reduced by any such reserve.

26. Section 76 FA 1989

There is no tax relief for an expense of providing benefits under a non-approved retirement benefits scheme where the benefits are not those in respect of which a person is, on receipt, liable to income tax.

The accounts would reflect any such expense.

27. Section 102 FA 1989

A payment made by one company in a group for the benefit of a transferred tax refund originally due to another member of the group is not tax-deductible or taxable (as the case may be).

The accounts would probably reflect such a payment as a tax payment or a refund of tax, so that arguably no difference between accounts profit (before tax) or taxable profit arises as a consequence of this provision.

28. Section 592 (with section 112 FA 1993)

Tax relief for an employer's contributions to an exempt pension fund is given on a payments basis only.

This would differ from the accounts where the accounts are prepared on an accruals basis.

29. Section 154 FA 1996

Exemption is available from tax on certain gains arising in respect of FOTRA securities.

The accounts would reflect such gains.

30. Section 20 F(No.2)A 1997

Losses cannot be set against surplus franked investment income for tax purposes.

The loss may, however, be offset in the accounts (such that, for example, no loss is carried forward to the next year).

31. Human Rights Act 1998

It is possible that the imposition of corporation tax on a profit shown in the accounts of a company could be held to be in breach of the Human Rights Act 1998, with the consequence that taxable profits would differ from accounts profits.

32. Section 63 FA 2000

This section and schedules 15–16 set out the rules for the corporate venturing scheme, whereby a company can reduce its liability to corporation tax by an amount equal to 20 per cent of the amount subscribed for shares in another company, provided a number of conditions are satisfied.

Strictly, however, there is no adjustment to the amount of the subscribing company's profit for tax purposes, only an adjustment to the amount of corporation tax payable.

33. Section 143 FA 2000

This section enables regulations to be made for providing incentives to use electronic communication, such that anything received by way of incentive under such regulations shall not be taxable.

The accounts would reflect the incentive payment.

34. Section 57 FA 2002

This section and schedules 16–17 set out the rules for community investment tax relief, whereby a company can reduce its liability to corporation tax by an amount equal to 5 per cent of its qualifying investment.

Strictly, however, there is no difference in the amount of the investing company's taxable profits, only in the amount of corporation tax payable on those profits.

35. Section 141 and schedule 23 FA 2003

A deduction is available when a company awards shares or an option to acquire shares to a person by reason of his employment, when the shares are acquired, of an amount equal to the market value of the shares less any amount paid for the shares (including any amount paid for an option).

This need not reflect the accounts treatment.

36. Section 143 and schedule 24 FA 2003

A payment to a third party as an employee benefit contribution is only deductible in that accounts period if it is used before nine months of the end of that period to provide a taxable benefit to the employee or to meet expenses of the third party that would have been tax-deductible if incurred by the employer.

These rules are irrelevant for the accounts.

IV 'SCHEDULE E'

Tax on the emoluments of an office or employment (the former Schedule E) is not generally relevant to companies. Although companies may be liable to tax on directors' fees, for example, ESC A37 does not mention any particular schedule for charging this.

V DISTRIBUTIONS RECEIVED AND PAID

(Section references to ICTA 1988)

1. Section 208

There is, in general, no liability to tax on dividends or other distributions received, and no deduction for dividends or other distributions paid.

Accounts would reflect such income, and may also deduct for the purposes of computing net profits interest expenses etc., which are treated as distributions for tax purposes.

2. Section 209

Interest paid that depends on the results of a company's business, or that is excessive, or that is paid in respect of convertible securities or securities linked to shares, and certain other amounts may be distributions for tax purposes.

The accounts would reflect such items as a deduction in computing profits and not (as for dividends) an appropriation of profits.

(It would not appear that sections 210–211 (bonus issues and repayment of share capital), sections 213–218 (exempt distributions paid or received not reflected in P&L) or section 219 (purchase by unquoted trading company of its share capital not treated as a distribution) result in any difference between tax and account profits for the company having the relevant share capital. This is because any payments made by the company would either represent a repayment of capital or an appropriation of profit, rather than a payment that is deducted in computing profit.)

VI LOSSES

(Section references to ICTA 1988)

1. Section 392A

Schedule A losses can be set against total profits of the same accounting period, but any excess is carried forward and treated as a Schedule A loss of the succeeding accounting period.

The accounts would not reflect the loss as incurred in that succeeding accounting period.

2. Section 392B

Losses of an overseas property business can only be carried forward to set against future profits of that business.

The accounts result will differ if, for example, there is a loss of £X from the overseas property business in year one, but a Case I profit of £X in that same year. (The overall accounts result will be nil, but there will still be a taxable profit.)

3. Section 393

Case I losses can be set against profits of the trade in future accounting periods.

The accounts result will differ where losses are carried forward to the extent that that year's profit will be reduced for tax purposes.

4. Section 393A

Case I losses can be set against profits of any description for the same accounting period, and, if the company was then trading, against profits of any description for the preceding accounting period.

The accounts result will differ if, for example, Case I losses are carried back to the preceding year.

5. Section 395

A lessor cannot set tax losses arising under a leasing contract against other profits under section 393A if there are arrangements for a successor company to carry on the leasing activities.

The accounts result will differ if, for example, such losses cannot be set against other current-year profits for tax purposes.

6. Section 396

Subject to section 398 (losses on transactions in deposits), Case VI losses can be set against other Case VI profits of the same accounting period, or carried forward to set against future Case VI profits.

The accounts result will differ if, for example, there are Case VI losses of £X for year one and Case I profits of £X in that year.

7. Section 397

A Case I loss arising from farming or market gardening cannot be set, in certain circumstances, against other profits under section 393A if there has been such a Case I loss in each of the preceding five years.

The accounts result will differ if, for example, a Case I loss cannot be set against other current-year profits.

8. Section 399

Case V or VI losses on commodity or financial futures or qualifying options cannot be set against other Case V or VI profits.

The accounts result will differ if, for example, a Case V or VI loss cannot be set against other current-year Case V or VI profits.

9. Section 400

Where government investment in a company (e.g. a loan to the company or shares subscribed in the company) is written off, tax losses of the company may be reduced.

The accounts result may differ if, for example, the write-off of government investment is not taxable, or where the write-off is reflected in the accounts in a given accounting period but the reduction in tax losses is effective in a different accounting period.

10. Section 401

Expenses incurred for the purposes of a trade incurred within seven years of the commencement of a trade are deemed to be incurred on the day the trade commences.

The accounts will differ as to the timing of the expense if incurred within the seven-year period, or in respect of the amount of the expense if incurred before the seven-year period (in which case no tax relief is available).

11. Sections 402–413

These sections contain the rules for group relief, which enable the tax losses of one company to be surrendered in whole or in part against the taxable profits of another company for the corresponding accounting period.

The accounts of both the surrendering and claimant companies will show a different profit or loss from the taxable profit or allowable loss in these circumstances.

VII CLOSE COMPANIES

(Section references to ICTA 1988)

1. Section 418

Certain expenses incurred by a close company, which provide a benefit for a participator or an associate of a participator, are treated as a distribution by the close company (and cannot therefore be deducted for tax purposes).

The accounts will reflect any such expense.

2. Section 419

A close company that makes a loan to a participator is, in general, required to pay an amount of tax equal to 25 per cent of the amount of the loan (which is refunded when the loan is repaid).

The obligation to make this payment will not be reflected in the accounts (although, strictly speaking, the tax liability does not result from an adjustment to the company's taxable profits).

VIII SETTLEMENTS

(Section references to ICTA 1988)

1. Section 660A

Income of a settlement in which a settlor retains an interest is, in general, deemed to be the income of the settlor for tax purposes.

The accounts (of either a company settlor or a company that receives income under the settlement) would not reflect this deeming provision.

2. Section 677 and section 687A

A capital sum paid directly or indirectly to the settlor normally results in an income tax charge on the settlor on an amount equal to the income of the settlement (up to the amount of the capital sum), but section 687A provides that no tax is due where the payment is due by a discretionary trust to a company.

The accounts would reflect the receipt of a capital sum by a company settlor (which would not give rise to a tax liability in the absence of section 677), but the company settlor would not be liable to tax in respect of the payment by reason of section 687A.

IX ANTI-AVOIDANCE PROVISIONS

(Section references to ICTA 1988 unless otherwise stated)

1. Section 703

Where a person realises a tax advantage in prescribed circumstances as a consequence of a transaction in securities (without being able to show that obtaining a tax advantage was not a main object of the transaction), the person is liable to counteraction by the Revenue. This counteraction may take the form, for example, of a recomputation of the person's profits for tax purposes.

The accounts would show a figure of profit before any such recomputation.

2. Section 730

Where the owner of securities sells the right to receive interest in respect of the securities without selling the securities themselves, that person is deemed to receive the subsequent interest payments for tax purposes.

The accounts would not reflect such interest payments.

3. Section 730A

Where an owner of securities sells them under arrangements where the owner may be bound to repurchase them, the difference between the sale and purchase price is treated as a payment of interest to or from the owner (as the case may be), made at the time of the repurchase, and the repurchase price is deemed to be equal to the original sale price.

Although the accounts may show the same resulting net income or expense, it is possible that, for example, the deemed interest is treated as a distribution for tax purposes (and hence is not tax-deductible) or that a tax liability arises on an accrual of the deemed interest before the repurchase occurs.

4. Sections 731–734

The broad effect of these sections is that where a person buys securities, receives 'interest' (defined to include dividends) paid on those securities and then on-sells within defined time limits, the person is liable to tax (if not otherwise liable to tax) on the appropriate proportion of the 'interest' received.

The accounts would not reflect such tax treatment.

5. Section 736

Where a dealing company owns a holding of at least 10 per cent of a class of securities issued by a UK-resident company, and the value of that holding is materially reduced by one or more distributions, the reduction in value is added to the carrying value of the holding, and to the proceeds of sale, to determine the tax liability of the dealing company.

The accounts may not reflect this treatment.

6. Sections 736A, 736B and 737A and section 97 FA 1996

These sections contain complex rules for manufactured dividend and interest payments, deemed manufactured payments in stock lending arrangements and deemed manufactured payments on the sale and repurchase of securities.

It is possible that the accounts profit may differ from the tax profit on the application of these rules.

7. Sections 747–756

These sections (and related schedules) contain the controlled foreign companies rules whereby, broadly speaking, the chargeable profits of subsidiaries that are resident in low-tax jurisdictions may be imputed to a UK-resident parent company.

The (non-consolidated) accounts of the parent company would not reflect these profits.

8. Sections 757–764

These sections contain rules for treating the gain realised on a disposal of a material interest in a non-qualifying offshore fund as an income gain rather than a capital gain.

Although the basic rule (converting a capital into a revenue gain) would not produce a difference from the accounts profit, the detailed rules for computing the offshore income gain in schedule 28, and the balance of any gain treated as a capital gain under section 763, could produce such a difference.

9. Section 768

Trading losses cease to be available for carry-forward following a change of ownership where there is a major change in the trade or the activities of the trade become negligible within three years of that change of ownership.

Aggregate taxable profits may therefore exceed aggregate accounts profits at the time that brought-forward accounts losses have been offset by subsequent accounts profits.

10. Section 768A

Trading losses arising after a change in ownership in the circumstances referred to under section 768 cannot be carried back against profits arising before the change in ownership.

Aggregate taxable profits may therefore exceed aggregate accounts profits at the time that accounts profits have been reduced by subsequent accounts losses.

11. Section 768B

Losses of an investment company (whether excess expenses of management or charges on income) cease to be available for carry-forward following a change of ownership

where there is a significant increase in the capital of the company, or a major change in the business of the company, or the activities of the business become negligible within three years of the change of ownership.

Aggregate accounts profits may therefore exceed aggregate taxable profits at the time that brought-forward accounts losses have been offset by subsequent accounts profits.

12. Section 768C

Following a change of ownership of an investment company, where losses are not prevented from being carried forward under section 768B, there is nevertheless an apportionment to be made to determine which losses may be used to set against a gain accruing on the disposal by the investment company of a capital asset within three years of the change of ownership that was acquired from another company in the group after the change of ownership.

Any such restriction on the utilisation of losses would result in a difference between the aggregate accounts profits and the aggregate tax profits over all the periods concerned.

13. Section 768D

This section contains similar restrictions for a company that has Schedule A losses from using those losses to set against profits after a change of ownership.

Such a restriction on the utilisation of losses would result in a difference between the aggregate accounts profits and the aggregate tax profits over all the periods concerned.

14. Section 768E

This section contains similar restrictions for a company that has a non-trading loss on intangible fixed assets from using such loss to set against profits after the change of ownership.

Such a restriction on the utilisation of losses would result in a difference between the aggregate accounts profits and the aggregate tax profits over all the periods concerned.

15. Section 770A

This section and schedule 28AA contain the transfer-pricing rules whereby, broadly speaking, an arm's-length price may be substituted for the price actually paid on a transaction between related companies, where the effect of the price actually paid is to reduce UK taxable profits.

The accounts would reflect the price actually paid.

16. Section 774

Where a dealing company obtains a tax deduction for the depreciation in the value of a right subsisting against an associated company (being a non-dealing company), or for a payment made to that associated company, but the non-dealing company is not otherwise

liable to tax, the non-dealing company is deemed to have a taxable receipt equal to the amount deducted by the dealing company.

The accounts of the non-dealing company may not, for example, reflect a benefit corresponding to the depreciation of the right against it, so that its tax profits would differ from its accounts profits.

17. Section 779

Tax relief for rent paid following a sale and lease-back of land is not to exceed the commercial rent for the land.

The accounts would reflect the actual rent paid.

18. Section 780

Where a lessee receives a capital sum on the surrender or assignment of a long lease and then takes a new lease of the land for a period not exceeding 15 years, a part of the capital sum (determined by a formula) is taxed as income on the lessee.

It is unlikely that the accounts would recognise a gain equal to the aggregate of the amount to be taxed as income under this section and the further amount to be taxed as capital gain.

19. Section 781

Where a tax deduction is granted to a trader (for example) for a payment under a lease of an asset (of any description), and that person subsequently obtains a capital sum in respect of the lessee's interest in the lease, that person receiving the capital sum is charged to tax on an amount equal to that for which the tax deduction was allowed.

The accounts treatment of the transactions may not have the same net effect as the tax treatment.

20. Section 782

Where a trader uses an asset for the trade, and the asset is subsequently leased to the trader, a tax deduction is not available for the rent in so far as it exceeds a commercial rent.

The accounts would reflect all the rent paid.

21. Section 786

Where a person assigns, surrenders, waives etc. income arising from any property (without a sale or transfer of that property), he is still charged to tax on that income.

The accounts would not reflect such income.

22. Section 787

Where interest is paid under a scheme or arrangement the sole or main benefit of which is the obtaining of a reduction in tax liability, no relief is given for that interest payment.

The accounts would reflect the interest paid.

23. Furniss v Dawson and related cases

It is possible that the accounts profit of a company may differ from the taxable profit by reason of the application of these cases. It should be noted, however, that it has been held by the House of Lords (in the case of Westmoreland Investments Ltd v MacNiven) that these cases serve as rules of statutory construction since the court is not itself able to make tax law (and do not therefore constitute new tax law which could affect the level of taxable profit).

X DOUBLE TAXATION RELIEF

These provisions define the extent of any credit for foreign tax paid against UK tax without, in general, adjusting for tax purposes the amount of pre-tax profit as shown in the accounts. An exception to this is where an election is made against credit for foreign tax, in which case the foreign tax is treated as an expense, which may be deductible in the UK tax computation. This would reduce the profit for UK tax purposes but not the pre-tax accounts profit (which would not reflect foreign tax).

XI LOAN RELATIONSHIPS

(Section references to FA 1996 unless otherwise stated)

1. Section 84

Profits and losses from loan relationships for tax purposes include those carried to or sustained by any reserve in accordance with GAAP (other than share premium account).

These amounts would not be reflected in P&L.

2. Section 84A

Certain exchange gains and losses taken to the balance sheet are not subject to the loan relationship rules (and could, therefore, be dealt with under the capital gains rules or, in relation to liabilities, be ignored for tax purposes).

These rules may result in differences from the accounts treatment.

3. Section 87

Loan relationships between connected persons are required to be accounted for under an accruals method of accounting for tax purposes.

If the actual accounts are prepared on a mark-to-market basis, the tax profits may differ from the accounting profits.

4. Section 88A

Where the object, or one of the main objects, of a company becoming a party to a creditor relationship is the obtaining of a tax advantage, and the terms of the loan are amended so as to materially affect its fair value, only the mark-to-market basis of accounting is available for tax purposes.

If the actual accounts are prepared on an accruals basis, the tax profits may differ from the accounting profits.

5. Section 92

Where a convertible loan satisfies certain conditions, the only amounts to be brought into account under the loan relationship rules in respect of a creditor relationship are those amounts relating to interest and exchange gains and losses.

The accounts may reflect changes in value in the loan relationship which reflect the value of the conversion rights.

6. Section 92A

Where a loan relationship creditor is or may be entitled to acquire shares in the debtor company or any other company by virtue of that relationship, the debtor company is not

entitled to deduct certain costs of making such shares available under the loan relationships provisions.

These costs may be reflected in the accounts.

7. Section 93

Where the value of a loan is linked to the value of a chargeable asset, and certain conditions are satisfied, the only amounts to be brought into account under the loan relationship rules in respect of the creditor relationship are those relating to interest.

The accounts may reflect changes in value of the loan relationship which reflect the value of the chargeable asset.

8. Section 93B

When a loan relationship ceases to fall within section 93, the creditor company is treated as having a held-over gain or loss determined by reference to the value of the loan at that time.

Any resulting increase in value may, for example, be taxed in a later accounting period than that in which the increase is reflected in the accounts.

9. Section 94

Non-trading debits or credits arising in respect of an index-linked gilt-edged security are adjusted to eliminate changes in value due to changes in the retail price index.

Such tax adjustments would not be reflected in the accounts.

10. Section 95

Where a company exchanges a gilt-edged security for strips of that security, the company is treated for tax purposes as if the gilt-edged security had been redeemed at market value and the proceeds applied in purchasing the strips, the cost price of each strip being calculated pro rata to its market value.

The accounts treatment may not correspond to this tax treatment.

11. Section 96

The loan relationship rules apply to two specified gilts only in relation to interest.

The accounts would reflect any other gains or losses in respect of the gilts.

12. Section 100

Only the interest and exchange gain or loss element of a debt that is not a money debt is dealt with under the loan relationship rules.

The accounts treatment may differ from the tax treatment in respect of the other elements of the debt.

13. Schedule 8

This schedule and section 83 contain the rules for set-off of non-trading loan relationship losses for tax purposes, including, for example, the rule that such a loss can be carried back one year to set against profits on non-trading loan relationships in the earlier year.

The accounts of the company would not reflect the loss in the earlier year.

14. Para. 2 schedule 9

No deduction is available for an accrual of interest due to a connected person, or a participator in a close company (and certain other persons), if the corresponding credit is not brought into account under the loan relationship rules, and the interest is not paid within 12 months of the end of the period in which it is accrued.

The accounts would reflect the accrual.

15. Para. 3 schedule 9

The amounts to be brought into account in respect of a loan relationship under an accruals basis of accounting for an accounting period shall be determined, where the amount or timing of any subsequent amount due under the loan relationship depends on the exercise of an option, on the assumption that the option will be exercised to the best advantage (apart from tax) of the person concerned.

It is likely that, as a consequence, the accounts profits would match the tax profits, but it may still be that a difference would result.

16. Para. 5 schedule 9

No general provision for bad debts under loan relationships is deductible, and amounts released are not brought into account under a creditor relationship where there has been a relevant arrangement or compromise (as defined in section 74 ICTA 1988) or where the parties are connected.

All these matters could result in the accounts profit differing from the taxable profit.

17. Paras 6–6C schedule 9

No tax relief is, in general, given for a provision against a bad debt due from a connected company.

The accounts would reflect such a provision.

18. Para. 7 schedule 9

No credit is normally required to be brought into account for tax purposes on the write-off of a loan relationship that is a government investment in a company.

The accounts would reflect such a write-off.

19. Paras 8–9 schedule 9

Relief available for a write-off of overseas sovereign debt is restricted to the percentage specified in Treasury regulations.

The accounts may write off a higher percentage.

20. Para. 10 schedule 9

Any loss referable to a period when a loan relationship was not subject to UK taxation is not allowed for UK tax purposes.

This provision may override an accruals accounts treatment.

21. Para. 11 schedule 9

The credits or debits arising on a disposal of rights under a loan relationship that is not on arm's-length terms shall be determined as if the parties were independent persons, unless both parties are in the same group and subject to corporation tax.

The accounts will reflect the actual credits or debits.

22. Para. 11A schedule 9

Where a company is a debtor under a loan relationship, and either the interest is treated as a distribution or the profits and losses fall by virtue of schedule 28AA to be computed as if the loan had not been made, any exchange gains or losses arising out of the loan relationship are left out of account for tax purposes.

These exchange gains or losses would be reflected in the accounts.

23. Para. 12 schedule 9

Where rights under a loan relationship are transferred from one company in a group to another, the transferee company 'stands in the shoes' of the transferor company, such that debits or credits for the transferee company are those that would have been made for the transferor company had no transfer been made.

The accounts will reflect the actual position, e.g. the actual payment made in consideration of the transfer.

24. Para. 13 schedule 9

Debits, and credits in respect of exchange gains, from a loan relationship are not to be recognised for tax purposes to the extent that they are attributable to an unallowable purpose (broadly speaking, a tax avoidance purpose).

The accounts would reflect such debits and credits.

25. Para. 14 schedule 9

Debits or credits in respect of exchange gains in respect of a loan relationship brought into account in determining the value of a fixed capital asset or project shall be brought into account for tax purposes in the same way that debits or credits are brought into account for determining the company's profit or loss.

The debits or credits referred to would not be reflected in the P&L account of the company.

26. Para. 15 schedule 9

The transfer of rights under a loan relationship under a stock lending or repo transaction is not taxed under the loan relationship rules.

The accounts may, however, reflect the terms of the transfer.

27. Para. 17 schedule 9

Where a discounted security issued by a company is held by a connected company, the issuing company only obtains tax relief for the discount when the security is redeemed, if credits representing the full amount of the discount are not brought into account for the purposes of the loan relationship rules by the creditor company.

The accounts of the debtor company may nevertheless reflect the discount as it accrues.

28. Para. 18 schedule 9

Where a close company has issued a discounted security, which is held by a participator in the company (or certain related persons), the company only obtains tax relief for the discount when the security is redeemed.

The accounts of the company may nevertheless reflect the discount as it accrues.

XII DERIVATIVE CONTRACTS

(References are to schedule 26 FA 2002)

1. Para. 4

Schedule 26 broadly provides that profits derived from derivative contracts are to be charged to tax as income in accordance with the accountancy treatment of such profits. Para. 4 excludes derivative contracts relating to land, tangible movable property, intangible fixed assets, shares, rights in a unit trust scheme, and certain loan relationships from these provisions. (Paras 5–8 state that these provisions nevertheless apply to certain trading contracts, certain contracts producing a guaranteed return, and certain insurance contracts.)

To the extent that para. 4 applies, the accounting-based rules in schedule 26 will not apply, so the accounts treatment may not reflect the tax treatment.

2. Para. 16

Certain exchange gains and losses arising from derivative contracts (mentioned in para. 16(3)) are brought into account (if at all) in accordance with regulations.

The debits or credits brought into account for tax purposes may differ from the debits or credits shown in the accounts of the company as a consequence.

3. Para. 22

This paragraph prevents tax relief for general provisions against bad debts on derivative contracts, and provides that no credit is to be brought into account (for a company using an authorised accruals method of accounting) where a liability under a derivative contract is released as part of a relevant arrangement or compromise.

These matters would be reflected in the accounts.

4. Para. 23

Debits, and credits due to exchange gains, from a derivative contract are not recognised for tax purposes to the extent that they are attributable to an unallowable purpose.

The accounts would reflect such debits and credits.

5. Para. 25

Debits or credits in respect of a derivative contract brought into account in determining the value of a fixed capital asset or project shall be brought into account for tax purposes in the same way that debits or credits are brought into account for determining the company's profit or loss.

The debits or credits may not be reflected in the P&L account of the company.

6. Para. 26

Where as the result of the expiry of an option there is a transfer of value from one company to a connected company and the latter company is not charged to tax under the derivative legislation, the former company is required to bring an appropriate credit into account for tax purposes.

The accounts of the former company would not reflect such a credit.

7. Para. 27

Where the profits and losses of a company are to be computed as if the company had not entered into a derivative contract as a consequence of the transfer-pricing rules, the debits and credits arising under the contract are also ignored for the purposes of the derivative legislation.

Such debits or credits would be reflected in the accounts.

8. Para. 28

Where one company in a group replaces another company in the group as a party to a derivative contract, the successor company (unless the predecessor uses mark to market in its accounts) normally ‘stands in the shoes’ of the predecessor company, such that the debits or credits for the successor company are those that would have been made for the predecessor company had no transfer been made.

The accounts will reflect the actual position, e.g. the actual payment made in consideration of the transfer.

9. Para. 31

Where a company and a non-resident person are parties to a derivative contract, the company shall not bring into account for tax purposes any debits that represent notional interest provided for in that contract.

The accounts would reflect such debits.

XIII INTANGIBLE FIXED ASSETS

(References are to schedule 29 FA 2002)

1. Para. 9

Although tax depreciation of an intangible fixed asset normally follows accounts depreciation, the tax depreciation is reduced if for some reason the original cost of the asset for tax purposes is less than the original accounts cost.

The accounts depreciation will therefore differ.

2. Paras 10–11

A company can elect to depreciate the asset at a fixed rate of 4 per cent per annum for tax purposes instead of taking the accounts depreciation for tax purposes.

The accounts depreciation will therefore differ.

3. Para. 12

Where there is an accounting reversal of a previous accounting gain, a debit arises for tax purposes which may differ from the accounting debit if the earlier tax credit differed from the accounting gain for some reason.

The accounts profit will therefore differ.

4. Para. 15

Where there is an accounting revaluation of an asset, there may be no credit for tax purposes if there has not previously been a debit in respect of the asset for tax purposes. The tax credit may also differ if for some reason the tax value of the asset at that time differs from the accounting value.

5. Para. 17

Where there is an accounting reversal of a previous accounting loss, a credit arises for tax purposes which may differ from the accounting credit if the earlier tax debit differed from the accounting loss for some reason.

The accounts profit will therefore differ.

6. Para. 20

On the realisation of an asset that has been written down for tax purposes, the tax credit or debit will differ from the accounting debit or credit if the tax-written-down value of the asset differs from the accounts value of the asset.

7. Para. 21

On the realisation of an asset that has not been written down for tax purposes, the tax credit or debit may differ from the accounting debit or credit if for some reason the cost of the asset recognised for tax purposes differs from the accounting cost.

8. Para. 22

On a part realisation of an asset, the tax-written-down value, or the cost for tax purposes of the part that is realised, is determined on a pro rata basis.

The tax credit or debit may differ from the accounting debit or credit for one of the reasons mentioned in para. 20 or para. 21.

9. Para. 24

The proceeds of realisation are defined as those recognised for accounts purposes, subject to any adjustment required for tax purposes.

This provision does not in itself create a difference between accounts profit and tax profit but makes it clear that other rules of tax law may apply to create such a difference.

10. Para. 26

Similarly, abortive expenditure on a proposed realisation is defined as that recognised for accounts purposes, subject to any adjustment required for tax purposes.

This provision does not in itself create a difference between accounts profit and tax profit but makes it clear that other rules of tax law may apply to create such a difference.

11. Paras 30–35

These paragraphs determine which case or schedule applies to debits or credits brought into account under the fixed intangible assets legislation (and, in particular, Part VI of this appendix applies accordingly so as to restrict the utilisation of losses in certain circumstances). Para. 35 provides that a non-trading loss under the fixed intangible assets legislation can be set against total profits of the current year, with any excess being carried forward to be treated as a non-trading loss of the next year.

The accounts profit may differ from the tax profit as a result of these rules (where, for example, the utilisation of losses is restricted).

12. Paras 37–45

These paragraphs provide for roll-over relief on the realisation of intangible fixed assets and the reinvestment of the proceeds in other intangible fixed assets. Under para. 56, this relief is available where the realisation and reinvestment are effected by different companies in a group, and under para. 57, an acquisition of a group company can be treated as the acquisition of intangible fixed assets owned by that company for roll-over purposes.

The accounts profit will differ from the tax profit on the realisation of both the first asset and the second asset as a consequence.

13. Para. 55

Where an intangible fixed asset is transferred from one member of a group to another member of the group, the successor company 'stands in the shoes' of the predecessor company so that the tax credits or debits applicable to the successor company in respect of the intangible fixed asset are the same as they would have been for the predecessor company had no transfer taken place.

The accounts profit may differ from the tax profit as a consequence, and in particular the accounts of both companies would reflect the actual price paid for the transfer of the asset.

14. Para. 58

Where a company acquires an intangible fixed asset from another member of the group and then leaves the group, it is (subject to rules for mergers and other special circumstances) deemed to realise the asset for a consideration equal to its market value.

The accounts of the company would not reflect this deemed realisation.

15. Para. 66

Where a realisation gain is deemed to accrue under para. 58, an election may be made to the effect that all or part of the gain is deemed to accrue to another company in the group.

The accounts of both companies would not reflect this tax treatment.

16. Para. 71

A payment for the benefit of roll-over relief under para. 56 or para. 57 or for the transfer of a degrouping charge under para. 66 is ignored for tax purposes.

The accounts would reflect such a payment, although it may be treated in the accounts as a payment or repayment of tax.

17. Paras 72–83

The intangible fixed asset legislation provides for tax credits or debits which (subject to specified exceptions) reflect accounting debits and credits, but paras 72–83 exclude or limit the application of this legislation to certain assets. To the extent that other rules (in particular, the capital gains rules for chargeable assets) apply as a result, the accounts-based treatment of the intangible fixed asset legislation will not apply, and tax profits may differ from accounts profits. Excluded assets include assets representing rights over land or tangible movable property, financial assets, shares, intangible fixed assets held for tax purposes, and certain royalties and rights representing R&D expenditure.

18. Paras 84–91

These paragraphs provide for the postponement of a charge to tax on the transfer of a business or trade (or part of a business or trade) that involves the transfer of an intangible fixed asset, under a scheme of reconstruction or under certain cross-border arrangements.

The accounts will reflect any actual consideration paid under these arrangements, but the actual consideration may be ignored for tax purposes.

19. Para. 92

Where there is a transfer of an intangible fixed asset from a company to a related party, it is treated for tax purposes as being for a consideration equal to market value.

This consideration may be different from the actual consideration paid, which will be reflected in the accounts.

20. Para. 94

Where payment of a royalty to a related party is not made within 12 months after the end of the period in respect of which the debit is accrued, and a corresponding credit is not brought into account under the intangible fixed asset legislation by the related party, the royalty is only brought into account for tax purposes when it is paid.

The accounts will not reflect this treatment.

21. Para. 103

Regional development grants made under part 2 of the Industrial Development Act 1982 and recognised in the P&L account are disregarded for the purposes of the intangible fixed asset legislation, and where the grant is treated as reducing the cost of an intangible fixed asset in the accounts, it is added back for the purpose (for example) of computing a gain on a subsequent realisation of the asset.

The accounts would reflect the grant received.

22. Para. 104

Regulations may be made under this paragraph in relation to the finance leasing of an intangible fixed asset, and may provide, for example, for the deemed realisation of the asset when the asset becomes subject to the lease.

The accounts may not reflect this treatment.

23. Para. 106

Where the accounting value of an asset acquired by a company is nil, but it is deemed to be acquired for market value for tax purposes, the intangible fixed asset legislation applies as if the accounts had reflected the market value acquisition cost.

24. Para. 107

Fungible assets are treated for the purposes of the intangible fixed asset legislation as a single asset, growing or diminishing as assets are acquired or realised.

The accounts may employ a different system for identifying assets realised with assets acquired.

25. Para. 111

Tax avoidance arrangements are disregarded in determining whether debits are to be brought into account for tax purposes for the writing-down of assets, or the amount of such debits, and in determining whether credits are to be brought into account for tax purposes on the realisation of assets, or the amount of such credits.

The accounts will not reflect this treatment.

26. Paras 113–114

These paragraphs reflect the general rules that emoluments accrued but not paid within nine months of the end of an accounting period, and pension contributions accrued but not paid before the end of an accounting period, are deductible only when paid.

The accounts profit will therefore differ from the tax profit when these paragraphs apply.

27. Para. 115

This paragraph prevents tax relief for general provisions for bad debts, and states that no gain is to be recognised for tax purposes when a liability is released as part of a relevant arrangement or compromise.

These matters would be reflected in the accounts.

28. Para. 116

This paragraph contains assumptions for the purpose of computing the chargeable profits of a controlled foreign company in relation to intangible fixed assets.

Such chargeable profits are imputed to a UK company and would not be reflected in the accounts of that company.

XIV THE TAXATION OF CHARGEABLE GAINS ACT 1992

(Section references to TCGA 1992 unless otherwise stated)

1. Section 1

Companies are liable to corporation tax on chargeable gains accruing on the disposal of assets.

The tax principles for determining whether there has been a ‘disposal’ (or, indeed, a ‘deemed disposal’) may differ from the circumstances in which ‘derecognition’ of an asset is required for accounting purposes.

Not all gains are chargeable gains for tax purposes (see section 15 below).

The accounts profits may differ from tax profits as a consequence of these two points.

2. Section 8

Chargeable gains are computed for an accounts period after deduction of allowable losses arising in that accounts period or brought forward from earlier accounts periods.

The tax gains will differ from accounts gains for the period to the extent that brought-forward losses are utilised.

3. Section 13

A proportion of a gain accruing to a non-resident company (which would be close if it were UK-resident) is attributed to a UK resident (including a company) that is a participator in the overseas company, the proportion corresponding to the extent of the participator’s interest in the overseas company.

The accounts of the UK-resident company would not reflect this proportion of the gain.

4. Section 15

Only chargeable gains (and not all gains) are charged to tax (see section 1 above).

The accounts would reflect all gains.

5. Section 16

Similarly, only allowable losses (normally arising in such circumstances where a gain would have been a chargeable gain) are deductible for tax purposes.

The accounts would reflect all losses.

6. Sections 17–18

An acquisition or disposal of an asset is deemed to be made for a consideration equal to market value in specified circumstances where the transaction is not a bargain at arm's length, or made for a consideration that cannot be valued, or in connection with an employment. By section 18, a transaction between connected persons is deemed not to be a bargain at arm's length for this purpose.

The accounts will reflect the actual consideration paid, if different.

7. Sections 19–20

Where assets are disposed of in linked transactions to a connected person, and the aggregate value of the separate assets is less than the value of the assets taken together, the appropriate proportion of the value of the assets taken together may be substituted as the consideration for each single disposal for capital gains purposes.

The accounts would reflect the actual consideration paid.

8. Section 21

All forms of property, including foreign currency, are assets for capital gains purposes.

The accounts rules may differ from tax rules in relation to different forms of property.

The section also defines part disposal to include, for example, where an interest in or right over the asset is created by the disposal.

The accounts may not reflect a part disposal in these circumstances.

9. Sections 22–23

There is a disposal where a capital sum is derived from an asset, save where the capital sum is applied (or nearly all applied) in restoring the asset.

The accounts may not reflect this treatment, where, for example, compensation money is (save for a part that is not regarded as small for tax purposes) applied in restoring an asset.

10. Section 24

There is a disposal where an asset is lost or destroyed, or where it becomes of negligible value.

This may not reflect the accounts treatment, in relation to timing for example. The deemed disposal may occur for tax purposes at the time of the negligible value claim, or the claim may specify the time of the deemed disposal to be up to two years earlier for tax purposes. The accounts may not reflect this timing.

11. Section 27

There is a deemed entire disposal on acquisition of an asset for capital gains purposes at the commencement of a hire-purchase contract.

The accounts of the hirer may not recognise the gain attributable to an entire disposal at that time.

12. Section 28

A disposal takes place for capital gains purposes at the time of entering into an unconditional contract, or when a conditional contract becomes unconditional.

The accounts may reflect a disposal at a different time (e.g. on completion).

13. Section 29

A disposal occurs for capital gains purposes where a person exercises control of a company such that value flows out of shares or other rights over the company that he holds and passes into other shares or rights over the company.

Such a transaction may not be recognised for accounts purposes.

14. Sections 30–34

These sections contain rules for increasing the consideration for tax purposes on a disposal where steps have been taken to reduce the value of the asset before the disposal, including in particular the case where the value of a shareholding in an associated company has been reduced by the payment of a dividend paid out of specified profits.

The accounts would reflect the actual consideration received.

15. Section 35

The base cost for capital gains purposes of an asset held on 31 March 1982 is (subject to several exceptions) its market value on that date.

The accounts would not reflect this rebased value.

16. Section 36 and schedule 4

Where, broadly speaking, a gain on an asset held on 31 March 1982 that is disposed of before 6 April 1988 is rolled over or held over on the acquisition of a replacement asset, the gain on the disposal of the replacement asset is reduced by half for capital gains purposes.

The accounts would not reflect these tax rules.

17. Section 37

While consideration chargeable to tax as income is not normally charged to tax in the capital gains computation, this does not prevent the capitalised value of a rent charge or other rights to income over a period from being taken into account in the capital gains computation.

The accounts would not reflect this potential for a double charge, nor recognise the distinction between income receipts (against which none of the capital gains base cost is deductible in the tax computation) and capital receipts.

18. Section 38

The deductible costs of an asset for capital gains purposes are the expenditure wholly and exclusively laid out for the asset, enhancement expenditure reflected in the state of the asset at the time of the disposal, and certain defined incidental costs of the disposal.

The accounts may reflect acquisition costs that are not wholly and exclusively laid out for tax purposes, enhancement expenditure not reflected in the state of the asset at the time of disposal, and costs associated with the disposal that do not satisfy the definition of incidental costs for tax purposes. Further, the carrying value in the accounts may have been depreciated or revalued upwards, resulting in a different accounts profit or loss on the disposal.

19. Section 42

On a part disposal of an asset, the proportion of the base cost of the asset that can be deducted in the capital gains computation is calculated by reference to the consideration for the part disposal and the market value of the property that remains undisposed of.

The accounts may reflect some other reasonable basis of apportionment of the base cost.

20. Section 43

Where assets have been merged, divided, changed their nature, or rights over assets have been created or extinguished, an ‘appropriate’ proportion of the original base cost is to be attributable to each new asset.

The Inland Revenue may not accept that an apportionment reflected in the accounts is ‘appropriate’ for this purpose.

21. Section 45

No chargeable gain arises (save in certain specified circumstances) on the disposal of a wasting asset that is tangible movable property.

The accounts would reflect any gain or loss realised on the disposal.

22. Section 46

The base cost of a wasting asset that is not tangible movable property, and not eligible for capital allowances as mentioned in section 47, is reduced over the predictable life of the asset on a straight-line basis.

The accounts depreciation may be calculated on a different basis, and, further, no tax relief would be available for such depreciation (whether or not on a straight-line basis).

23. Section 48

Consideration due after the time of disposal is brought into the capital gains computation without any discount, and (subject to later recalculation if necessary) without any regard to the risk of the consideration being irrecoverable or to the right to receive it being subject to a contingency.

The accounts may reflect a discount in respect of all these factors.

24. Section 49

In the first instance, certain contingent liabilities (including, for example, contingent warranty claims) are ignored in the capital gains computation.

The accounts may provide for such contingent liabilities.

25. Section 50

Expenditure that is met directly or indirectly by the Crown or other government public or local authority is left out of account in computing the base cost of an asset.

The accounts would normally reflect the same overall result, but the grant may, for example, be treated as deferred income and recognised over the useful life of the asset, so that timing differences will result in the accounts treatment compared with the tax treatment.

26. Section 51

Gambling winnings are not chargeable for capital gains purposes.

The accounts would reflect any such winnings.

27. Sections 53–56 (with other sections in the TCGA setting out detailed rules)

An indexation allowance on the base cost of capital assets is available to companies, which may reduce the gain for tax purposes on a disposal of such assets.

The accounts would not reflect the indexation allowance.

28. Section 70

A transfer of an asset into settlement is treated as a disposal of the entire property, even though the transferor may have a beneficial interest in the settled property.

The accounts may not reflect an entire disposal in such circumstances.

29. Section 71

Where a person becomes absolutely entitled as against the trustees to an asset that has been settled property, the asset is deemed to be disposed of and reacquired at market value for capital gains purposes.

The accounts of a company that so becomes entitled to settled property may not reflect a carrying value of the property equal to its market value at that time.

30. Section 76

No chargeable gain accrues, in general, on the disposal of an interest arising under a settlement if the trustees are UK-resident.

The accounts would reflect any such gain. (Although a deemed gain may arise to the trustees in such circumstances under schedule 4A, and the trustees would have a statutory right of recovery of tax paid against the person making the disposal, the gain is not itself attributed to the beneficiary.)

31. Section 77

Gains accruing to the trustees of a UK settlement in which the settlor retains an interest are treated as accruing to the settlor.

The accounts of the settlor would not reflect such gains.

32. Section 85

On the disposal of an interest in a settlement where the trustees are not UK-resident, where the interest was acquired whilst the trustees were UK-resident or liable to UK tax, the base cost of the interest is determined by reference to its market value when the trustees ceased to be UK-resident or liable to UK tax (as the case may be).

The accounts would not reflect this base cost.

33. Section 85A and schedule 4C

Where a gain is deemed to arise to non-resident trustees who make a transfer of value linked to borrowing by virtue of schedule 4B, that gain can be attributed to a beneficiary who receives a capital payment from the trust.

The accounts of the beneficiary may not reflect these tax rules for calculating the gain.

34. Sections 104–109

Several rules apply to identify shares disposed of with shares acquired (in order to calculate the base cost of the shares disposed of), depending on when shares have been acquired by the company disposing of them, and whether an acquisition was before, after, at the same time as or within a specified time of the disposal.

The accounts policy for identification of shares disposed of with shares acquired may differ, so that the accounts gain on a part disposal out of a share pool would then differ from the tax gain.

35. Section 116

On a reorganisation that involves, for example, the exchange of shares not qualifying for the substantial shareholding exemption for a qualifying corporate bond, any gain that would have accrued had the shares been sold for market value is held over and is deemed to accrue on a subsequent disposal of the qualifying corporate bond.

The accounts may not reflect this treatment.

36. Section 122

A shareholder who receives a capital distribution from a company is, in general, deemed to have received it in consideration of disposing of an interest in the shares, save that if the amount received is ‘small’ it is deducted from the base cost of the shares.

The accounts of the shareholder may not reflect this treatment.

37. Section 123

Where a person becomes entitled in respect of shares to a provisional allotment of shares or debentures and then disposes of that right, section 122 applies as if the consideration for the disposal were a capital distribution received by him.

The accounts of the shareholder may not reflect this treatment.

38. Section 125

Where a close company transfers an asset for less than market value, the difference (subject to section 239) is apportioned to the shareholders of the company so as to reduce the base cost of their shares in the company (save that any amount so apportioned to another close company is apportioned to its own shareholders).

The accounts of a corporate shareholder (which is not a close company) may not reflect any such reduction in the carrying value of the shares.

39. Sections 126–131

A reorganisation of share capital (as defined in section 126), in which a new holding of shares and/or debentures is substituted for the original holding, does not involve a disposal, but the new holding is treated as the same asset as the old holding. If the new

holding consists of more than one class of shares or debentures, the original base cost is apportioned amongst the new holding pro rata to market value at the time of a subsequent disposal out of the new holding. If, however, any part of the new holding is quoted, the apportionment is made pro rata to market value when such part was first quoted.

The accounts may not reflect these rules.

40. Sections 132–134

Sections 127–131 apply with any necessary adaptation to a conversion of securities, with special rules for any premium (including any 'small' premium) received on such conversion or received on any 'euroconversion' of securities.

The accounts may not reflect these rules.

41. Section 135

On an exchange of shares or debentures in company A for shares or debentures in company B, no gain is recognised provided company B then holds more than 25 per cent of the ordinary shares of company A, or company B has made a general offer for company A, and provided also (where the holder holds 5 per cent or more of a class of shares or debentures in company A) the transaction is bona fide commercial.

The accounts of a corporate shareholder/debenture holder may not reflect these rules.

42. Section 136

On a scheme of reconstruction (for the purposes of the section), no gain is recognised on the issue of shares or debentures in company B pro rata to the relevant holdings in company A, provided (where the holder holds 5 per cent or more of a class of shares or debentures in company A) the transaction is bona fide commercial.

The accounts of a corporate shareholder/debenture holder may not reflect these rules.

43. Section 138A

Subject to an election to the contrary, section 135 applies on the exchange of shares or debentures for an 'earn-out right' (as defined in the section) and a subsequent issue of shares or debentures in pursuance of the right is treated as a conversion of securities.

The accounts of a corporate shareholder/debenture holder may not reflect these rules.

44. Section 139

Where a scheme of reconstruction involves the transfer of the whole or part of a business to another company within the charge to tax in respect of the assets (and which provides no consideration for the transfer to the first company), no gain is, in general, recognised by the first company provided the transaction is bona fide commercial. The successor company acquires the capital assets of the business having the same tax base cost as the predecessor company.

The accounts of the two companies concerned may not reflect these rules.

45. Section 140

On a claim by a UK-resident company carrying on a trade outside the UK through a branch or agency, which transfers the whole or part of the trade to a non-resident company in consideration of the issue of shares or debentures of the transferee company (where the transferor company then holds at least 25 per cent of the ordinary shares of the transferee company), no net gain is deemed to accrue to the transferor company. Such a gain is deemed to accrue on a subsequent disposal of those shares or securities, or if the transferee company disposes of the business it acquired within a six-year period.

The accounts of the transferor company may not reflect these rules.

46. Section 140C

Where a claim is made by a company incorporated in an EU member state and resident in the UK, which transfers the whole or part of a trade carried on outside the UK through a branch or agency in a different member state to another company incorporated in a member state that is resident in a member state outside the UK in consideration for the issue of securities in the transferee company, the transaction is deemed to result in a single net chargeable gain for the transferor company. This section facilitates the obtaining of credit for foreign tax which would have been payable but for the merger directive against UK tax on the gain. It does not apply if the transaction is not bona fide commercial.

Although this section may not in itself result in a net tax gain being different from a net accounting gain, the section does not apply if the transaction is not bona fide commercial. It is also to be read in conjunction with section 140, and a claim under section 140 precludes a claim under section 140C.

47. Section 144

The grant of a put or a call option is treated in the first instance as the grant of new asset (normally having no deductible base cost for the grantor), but on a subsequent exercise of the option the total capital gain or loss is calculated on the basis of subsuming the exercise with the original grant of the option into one transaction.

The accounts of the grantor may not reflect these rules.

48. Section 147

Where a quoted option to subscribe for shares is dealt in within three months of a reorganisation etc. to which sections 126–140 apply, the option is treated for the purposes of those sections as the shares that could be acquired by exercising the option.

The accounts may not reflect this treatment on a reorganisation etc.

49. Section 148

Where a person has granted a traded option and closes it out by acquiring a traded option of the same description, any disposal involved in closing out the first option is ignored for the purpose of corporation tax on chargeable gains, and the incidental costs of granting the first option are increased by the consideration given for the second option.

The accounts may not reflect these rules.

50. Sections 152–158

Where the consideration for the disposal of certain business assets used in a trade (or certain other activities) is reinvested in other such assets within a prescribed period, the consideration received may be deemed reduced for tax purposes by such amount as eliminates any gain on the disposal, and the acquisition cost of the replacement assets is reduced by a like amount.

The accounts would reflect the actual consideration received and paid.

51. Section 161

A capital asset that is appropriated to trading stock is deemed (subject to an election under subsection (3)) to be disposed of for a consideration equal to its market value for capital gains purposes.

The accounts may not reflect this treatment.

52. Section 171

On the transfer of an asset from one company in a capital gains group to another company in the group, the transfer is deemed to be for such a consideration that no gain or loss accrues to the transferor company.

The individual company accounts would reflect the actual consideration paid.

53. Section 171A

If a company disposes of an asset to another company not in the same group, an election may be made to treat the transaction for tax purposes as if the first company had transferred the asset to another company in the same group and then that company had transferred the asset to the real acquiring company. In this way, any chargeable gain or loss is deemed to accrue to the second company in the group rather than the first company in the group. Any payment made between the group companies in connection with the election is ignored for tax purposes.

The accounts would not reflect any such deemed transfer, but would reflect any payment made between the companies (although such payment may be shown as if it were a payment or repayment of tax).

54. Section 173

Where one company in a group has an asset that does not form part of its trading stock and disposes of it to another company in the group which acquires it as trading stock, the second company is deemed for the purposes of section 161 to have acquired it otherwise than as trading stock, and then to have appropriated it to trading stock. Where a company holding an asset as trading stock transfers it to another group company which does not hold it as trading stock, the first company is deemed for the purposes of section 161 as having appropriated the asset out of trading stock immediately before the transfer.

The accounts may not reflect the application of section 161 in this way.

55. Section 174

Where rebasing of an asset to its 31 March 1982 value is not for some reason to apply, schedule 2 applies in relation to assets held on 6 April 1965 as if all members of a group of companies that have owned the asset were the same person.

The accounts would not need to have regard to these rules.

56. Section 175

Roll-over relief can be available where a specified business asset is disposed of by one member of a group of companies and a replacement asset is acquired by another member of the group.

The accounts of the two companies concerned would not reflect this tax treatment.

57. Section 176

Any allowable loss accruing on the disposal of shares or securities in a company shall be restricted to such as is just and reasonable having regard to any depreciatory transactions that have taken place between companies in the same group.

The accounts would reflect the actual loss.

58. Section 177

Any allowable loss on the disposal of a holding of at least 10 per cent of a class of shares shall be restricted to such as is just and reasonable where a distribution in respect of the holding has materially reduced its value.

The accounts would reflect the actual loss.

59. Section 177A

Schedule 7A applies so as to restrict the ability of a company to set a capital loss brought forward against a gain on the disposal of an asset that had been transferred to it within a group from a company that was not part of that group at the time that the loss accrued.

The accounts losses brought forward will be reduced by any subsequent accounts gain.

60. Section 177B

Schedule 7B applies so as to restrict the ability of a company to set a capital loss on the disposal of an asset that had been transferred to it within a group against a gain on the disposal of an asset before the company joined the group.

The accounts losses will be reduced by any accounts gain on the earlier disposal.

61. Section 179

Where a company that has acquired a capital asset from another company within the group leaves the group within six years after the time of acquisition, it is, in general, deemed for capital gains purposes to have disposed of the asset for a consideration equal to the market value of the asset at the time of the intra-group transfer.

No such deemed disposal would be reflected in the accounts of the company.

62. Section 179A

An election can be made such that any gain or loss deemed to accrue to a company under section 179 can itself be deemed to accrue to any other member of the original group of companies.

The accounts of that other company would not reflect any such gain or loss.

63. Section 179B

Roll-over relief can be available to a company that is deemed to realise a gain under section 179 or section 179A.

The accounts would not reflect such roll-over relief.

64. Section 185

A UK-resident company that ceases to be resident in the UK is, in general, deemed to have disposed of its assets for capital gains purposes for a consideration equal to market value at that time.

The accounts would not reflect such a deemed disposal.

65. Section 192A and schedule 7AC

Exemption is available for a gain accruing on the disposal by a trading company or a member of a trading group of shares forming all or part of a holding of at least 10 per cent of the ordinary shares in a company which is itself a trading company or the holding company of a trading group.

The accounts would reflect any gain accruing on such a disposal.

66. Section 210

A gain on a policy of assurance or a contract for a deferred annuity on the life of any person is not a chargeable gain unless actual consideration has been given for the policy (ignoring amounts due under the policy).

The accounts would reflect any such gain.

67. Sections 227–236

Roll-over relief is available on the sale of shares to a qualifying employee share ownership trust provided certain conditions are satisfied and the seller reinvests the sale proceeds in other chargeable assets. A gain can subsequently be deemed to accrue, however, if the trustees (for example) transfer the shares otherwise than to a qualifying beneficiary.

The accounts of the seller would not reflect this roll-over relief, or any gain on a subsequent chargeable event.

68. Section 236A and schedule 7C

Roll-over relief is also available on the sale of shares to an approved employee share ownership plan provided certain conditions are satisfied and the seller reinvests the sale proceeds in chargeable assets.

The accounts of the seller would not reflect this roll-over relief.

69. Section 237

No chargeable gain accrues on the disposal of the right to certain annuity payments or annual payments.

The accounts would reflect any such gain.

70. Section 240 and schedule 8

Special rules apply in relation to leases of land, in particular to determining the proportion of the original acquisition cost that is deductible on the disposal of a lease having a duration of less than 50 years.

The accounts need not reflect these rules.

71. Section 242

On the disposal (for not more than £20,000) of a part of a holding of land whose value does not exceed 20 per cent of the value of the entire holding, the transferor may claim to be deemed not to have made a disposal, and for the consideration received to be treated as reducing the base cost of the remaining land.

The accounts may not reflect this treatment.

72. Section 243

A similar relief (without the £20,000 limit) is available on the part disposal of land to a local authority with compulsory purchase powers, provided certain conditions are satisfied.

The accounts may not reflect this treatment.

73. Sections 245–248

There are detailed capital gains rules that apply on a disposal of land to an authority having compulsory purchase powers.

These rules may not be reflected in the accounts.

74. Section 250

Consideration for the disposal of trees on woodlands by the occupier, and consideration attributable to trees on a disposal of woodland, are not brought into the capital gains computation.

The accounts would reflect such gains.

75. Section 251

No chargeable gain (or allowable loss) in general accrues on the disposal of a debt that is not subject to the loan relationships provisions of FA 1996.

The accounts would reflect such gain or loss.

76. Section 257

On a disposal of an asset not at arm's length to a charity, for a consideration that is less than the base cost of the asset, the disposal is deemed to be for such a consideration that no gain or loss accrues on the disposal.

The accounts would reflect any actual consideration received.

77. Section 258

No chargeable gain accrues on the disposal of an asset with respect to which an inheritance tax undertaking has been given.

The accounts would reflect any actual gain.

78. Section 259

On a disposal of an interest in land not at arm's length to a relevant housing association for a consideration that is less than the base cost of the interest in land, the disposal is deemed to be for such a consideration that no gain or loss accrues on the disposal.

The accounts would reflect any actual consideration received.

79. Section 262

No chargeable gain accrues on the disposal of an asset that is tangible movable property if the consideration does not exceed £6,000 (with marginal relief if the consideration exceeds £6,000 by less than a defined amount).

The accounts would reflect any such gain.

80. Section 263

No chargeable gain accrues on the disposal of a passenger road vehicle.

The accounts would reflect any such gain.

81. Sections 263A and 263B

Sale and repurchase arrangements, and stock lending arrangements, are ignored for capital gains purposes to the extent laid out in these sections, provided certain conditions are satisfied.

The accounts treatment may differ if, for example, no accounts gain is recognised even though not all the tax conditions for ignoring the disposal are satisfied.

82. Section 267

An agreement for the sharing of transmission facilities by national broadcasting companies does not give rise to a chargeable gain provided certain conditions are satisfied.

The accounts would reflect any actual consideration received for a disposal.

83. Section 268

A disposal of a decoration awarded for valour that was acquired otherwise than for money's worth does not give rise to a chargeable gain.

It is conceivable that this could apply to a company that had, for example, been gifted such a decoration. The accounts would reflect the actual consideration for the disposal.

84. Section 271

This section provides for a number of exemptions of limited scope relating to such matters as specified disposals relating to pension funds etc.

85. Section 278

Subject to section 277 (credit for foreign tax), foreign tax paid can be deducted in the computation of the capital gain arising on a disposal.

The accounts pre-tax profit would not be reduced by the foreign tax.

86. Section 279

Chargeable gains on the disposal of assets situated outside the UK are reduced by any amounts that cannot be remitted to the UK for causes specified in the section.

The accounts may not, for example, reflect certain amounts due but not received, even though the tax requirements of section 279 are not satisfied.

87. Section 284A

If the benefit of a concession is repudiated in a later accounts period, the chargeable gain deferred by the concession is deemed to arise in that later accounts period.

The accounts would recognise any gain in the earlier accounts period.

88. Marren v Ingles

On a disposal of an asset in consideration of a right to further unascertainable consideration in the future, a gain or loss may accrue on the disposal of the asset and also on the disposal of the right. Under section 162 FA 2003, it may be possible to treat a loss arising on the disposal of the right as occurring at the time of the earlier disposal (if that produced a gain).

The accounts may not reflect these rules.

XV CAPITAL ALLOWANCES ACT 2001

Numerous provisions are contained in this Act that confer 'tax depreciation' at a rate (which depends on the class of asset concerned) likely to be in excess of the accounts depreciation for the asset, and provide for clawback of tax on a disposal of the asset for a consideration in excess of tax-written-down value. These rules are not, however, described in detail.