

Chapter 1

Introduction

1.1 ‘Profit per accounts’. Every tax practitioner must have reproduced this three-word phrase numerous times, but how well does he understand how that figure – which he has just extracted from the ‘accounts’ handed to him by his accounting colleagues – has been arrived at? This applies even to those practitioners with an accounting background, because the world of accounting standards, principles and practices has changed, and continues to change, so fast that anyone who departs from the mainline of accounting and financial reporting soon loses touch. This book sets out to explain what is meant by the word ‘profit’ and how it fits into the world of accounting and tax.

1.2 But why should this be of importance? Business profits are charged to income tax by *ITTOIA 2005, s 5*, and corporation tax by *CTA 2009, s 35*, which state that tax shall be charged in respect of the ‘profits of a trade’. *ITTOIA 2005, s 25* and *CTA 2009, s 46* both state that the profits of a trade must be calculated in accordance with generally accepted accounting practice. There are specific rules governing types of income or expense which are to be taxed or tax deductible, but nowhere in the statute is there to be found any definition of ‘full amount of profits’. Therein lies the problem.

1.3 In the early days of taxation, this absence of definition caused problems. Disputes arose and cases were taken to court. At that time, the accountancy profession was not yet fully organised and there was no regulatory framework to give assistance in interpreting the phrases ‘annual profits’ or ‘full amount of profits’. So, judges were left very much to their own devices. It was universally recognised that the phrases should mean the ‘profits of an enterprise as determined on proper commercial principles’. It was the task of the courts to discover what these principles were.

1.4 It is not necessary at this stage of the book to follow all the twists and turns in the history of judicial interpretation (Chapter 31 gives a more detailed tracing of the development of thinking in this regard). It does help to know where we stand at present. This may perhaps best be illustrated in relation to *SSAP 21* (which sets out the accounting rules for dealing with leased assets and is dealt with in detail in Chapter 17).

1.5 Introduction

1.5 As will be seen, *SSAP 21* provides that assets held on certain types of lease are treated as though owned by the lessee for the purpose of preparing accounts. In arriving at the measure of the lessee's trading profits, the lessee should not deduct the lease rentals payable, but there is a calculation to be made which results in them charging depreciation and a finance charge in their profit and loss account.

1.6 In 1991, the Revenue decided (*SP 3/91*) that, in future, accounts prepared under *SSAP 21* principles would be acceptable without adjustment for tax purposes. This was really quite revolutionary. Accounting rules derived from an accounting standard, which effectively elevated substance over form (by treating as 'owned' that which was legally only 'leased') and gave rise to a 'depreciation' charge, would be regarded as acceptable for tax purposes.

1.7 The matter went even further in 1992 and 1993 when two taxpayers decided to challenge the Inland Revenue. Two cases, with virtually identical facts, were heard before the courts simultaneously (*Threlfall v Jones*, *Gallagher v Jones* [1993] STC 537). The Inland Revenue argued that *SSAP 21* principles should apply and produced expert accountants as witnesses in support. The taxpayers sought to exclude *SSAP 21* and relied on certain very old cases (principally *Vallambrosa Rubber Co Ltd v Inland Revenue Commissioners* 1910 SC 519). Despite a slight setback in the High Court, the Inland Revenue won a comprehensive victory in the Court of Appeal. The cases did not proceed to the House of Lords.

1.8 In 1994, the case of *Johnston v Britannia Airways* [1994] STC 763 confirmed the trend. Discussions with the Inland Revenue resulted in the issue of a series of Questions and Answers (Tax 10/95) which confirmed the latest Revenue thinking.

1.9 This shift in policy then manifested itself in numerous ways. The codification of the true and fair view, and subsequent clarification of generally accepted accounting practice as being UK GAAP or, more recently, IFRS has been an important change. The new rules for the taxation of income from property, foreign exchange profits and losses and corporate loan relationships all closely follow accounting principles. *ITTOIA 2005, s 25* and *CTA 2009, s 46* state that the 'profits of a trade must be calculated in accordance with generally accepted accounting principles subject to any adjustment required or authorised by law'. Since 1998, further changes in HMRC (or Inland Revenue as it then was) include the appointment of financial reporting specialists to provide advice to tax inspectors on accountancy issues, and the creation of a 'gateway' between HMRC and the Financial Reporting Review Panel (FRRP). The legal gateway was formally enacted by the *Companies (Audit, Investigations and Community Enterprise) Act 2004* and a Memorandum of Understanding (MOU) between the Revenue and the FRRP, and allows HMRC to inform the FRRP when it detects irregularities in the accounts of companies submitted as part of the corporation tax self-assessment process.

1.10 In a nutshell, nearly 200 years of tax history can be summarised thus:

- business taxation is based on profits as determined on a proper commercial basis;
- early judicial decisions laid down principles;
- more recently, judges have placed greater reliance on accountancy rules and evidence; and
- the recent trend has been for HMRC to elevate accountancy rules and evidence to a pre-eminent position.

1.11 What this means is that it is crucial for tax practitioners to be completely comfortable with what their accounting colleagues are up to. This book sets out to help the reader understand the general principles underlying financial accounts. At appropriate points in each chapter, the particular tax relevance of the accountancy principle being described will be flagged.

1.12 But, finally, a word of warning. Just as the tax system is catching up with 'conventional' accounting, recent trends from accounting standard setters (in the UK and overseas) have progressed down new paths, in which economic substance is to be preferred to legal form, and where even the continuing relevance and retention of the profit and loss account is called into question. Also, in Europe there is currently a debate about adopting a common consolidated corporation tax base. This gives a whole new set of problems for the future – and these are addressed in Chapter 32.

1.13 Furthermore, in 2002, the European Union issued a Regulation *requiring* certain company financial statements, and *permitting* others, to be prepared in accordance with international accounting standards.

This book has been organised into three distinct parts. Part I deals with fundamental accounting concepts and the legal and accounting requirements for basic financial statements. In Part II, more detail is provided in relation to specific issues covered by accounting standards. In each of these, the discussion deals only with the accounts of an individual company. The complexities of consolidated accounts for groups of companies are left until Part III, where some more problematic areas are also introduced. Finally, Part IV deals with some conceptual issues, relating to the current and prospective interweaving of notions of accounting and tax profits.

<http://www.pbookshop.com>