# Accounting Principles for Tax Purposes

Fifth Edition

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A CIP Catalogue record for this book is available from the British Library.



ISBN 978 1 78043 455 1

Typeset by Phoenix Photosetting, Chatham, Kent
Printed and bound in Great Britain by CPI Group (UK) Ltd, Croydon, CR0 4YY

*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** The picture changed with the introduction of accounting standards in the early 1970s. These introduced agreed accounting policies and practices for the first time. It is therefore much easier for the practitioner, taxpayer, HMRC or ultimately the courts, to identify what is generally accepted accounting practice, now commonly referred to as GAAP.

**1.5** 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) or in the development of accounting standards. It does help to know where we stand at present.

**1.6** A tax computation comprises two elements, the starting point, as discussed above, 'profit per the accounts' and then those adjustments necessary to arrive at taxable trading profit. In the words of the tax legislation, these are 'adjustment required or authorised by law in calculating profits for' income or corporation tax purposes. The balance then represents taxable trading profit. The computation also involves identifying any profits taxable other than as trading profits. The general principle outlined above and explained further in the remainder of this book is that, provided the accounts are prepared in accordance with GAAP, the accounting treatment is appropriate for tax, unless there is a specific tax rule which requires an alternative treatment. That tax rule may be derived from tax law (ie legislation) or from judge-made rules (ie case law). There are many examples to illustrate these general principles:

- Accounts include parking fines and costs of business entertainment but these are not allowable and are added back for tax purposes.
- The accounts include a charge for depreciation which is added back and replaced, where appropriate, by capital allowances. The question of what is capital and therefore eligible for capital allowances is determined both by legislation and case law.

**1.7** Given the general principles outlined above, HMRC may challenge the tax computation by arguing that the adjustments have not been made correctly, but they may also challenge the starting point, profit per the accounts. If the profit per the accounts is not in accordance with GAAP, tax is unlikely to be correct. That is the subject matter for this book: are the accounts prepared in accordance with GAAP? What does GAAP require in relation to a transaction or event, asset or liability, and what are the tax implications of a particular accounting treatment?

**1.8** The development of accounting and tax treatment of leased assets is a good illustration of the principles and practices involved in our subject. Leased assets were initially dealt with in *SSAP 21* and are now covered in *FRS 102, Section 20* 'Leases' and are dealt with in detail in **Chapter 17**.

**1.9** As will be seen, the accounting standard 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.

**1.10** In 1991, the Revenue decided (*SP 3/91*) that, in future, accounts prepared under these 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.

**1.11** 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.

**1.12** 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.

**1.13** 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 the 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.

**1.14** 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.

**1.15** 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.

**1.16** But, 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**.

**1.17** 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.

**1.18** Finally in this introduction, but by no means of least importance, the UK accounting standard setting process has been revised and it is the Financial Reporting Council (FRC) themselves who issue accounting standards. For accounting periods commencing on or after 1 January 2015, all existing accounting standards will be replaced.

**1.19** The impact on the contents of this book is mixed. Some accounting treatments do not change, and therefore neither does the tax. Some accounting treatments change dramatically, with consequent impacts on taxation. Yet other treatments change but have no tax consequences, because tax law overrides accounting treatment. The tax practitioner needs to be aware of these changes, and to be able to identify whether the change affects taxable profit or requires adjustment in the tax computation. Irrespective of whether the treatment changes, all of the references do and this has involved a major redrafting.

**1.20** This book has been organised into five 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. **Part IV** deals with accounting for specialised activities. Finally, **Part V** deals with some conceptual issues, relating to the current and prospective interweaving of notions of accounting and tax profits.