

ACCOUNTANCY PRINCIPLES AND

CASE I PROFITS

by **Barrie Akin**

The Taxes Acts give no clue as to the relevance or otherwise of accountancy principles in arriving at profits for the purposes of Cases I and II of Schedule D. The nearest we get is the statement of the basis of assessment in Section 60 TA 1988 that

“... income tax shall be charged under Cases I and II of Schedule D on the full amount of the profits or gains of the year of assessment”.

Although the legislation is peppered with provisions treating the results of certain transactions as giving rise to a Case I profit and others as not being deductible in computing it, the legislation simply fails to give a starting point. Although Lord Halsbury was able to say in 1892 in Gresham Life Assurance Society v. Styles (3 TC 185, at 188):-

“The word ‘profits’ I think is to be understood in its natural and proper sense - in a sense which no commercial man would misunderstand”

the Courts have been troubled many times with disputes as to how trading profits should be calculated.

The purpose of this Article is to give a brief summary of what appears to be the current status of accounting principles as a determinant of Case I profit and to point out one or two trends which have manifested themselves over recent years.

The Current Position

The current position, following Gallagher v. Jones (66 TC 77) and Johnston v. Britannia Airways (67 TC 99) can be summarised as follows:-

- 1) Where accounting principles point unequivocally to a particular treatment of a transaction or state of affairs, that treatment will usually be followed in ascertaining trading profits.
- 2) Where conflicting accountancy principles are potentially applicable or where there is no generally accepted principle the Court will do its best to choose the most appropriate method of arriving at trading profit.
- 3) In all cases, the accounting treatment will be subject to statutory or judge made override where appropriate; i.e.

where taxation principles dictate a different treatment.

As for the most recent cases:-

Gallagher v. Jones

After a century or so of case law, the dominant trend that has emerged in recent years is that the Courts will place considerable emphasis on generally accepted accounting principles when they consider disputes as to the nature of trading profits. Accountancy principles are usually the starting point for arriving at trading profit (see, for example, Odeon Associated Theatres Ltd v. Jones (48 TC 257)).

This approach was illustrated in Gallagher v. Jones where the taxpayer's accounts deducted the full amount of 'front-loaded' rentals payable in the period under finance leases of canal boats, rather than the much smaller amount which would have been deducted in arriving at profits if the accounts had followed Statement of Standard Accounting Practice 21 ("SSAP 21"). The Special Commissioners accepted the unchallenged expert evidence of the accountancy advisor to the Board of Inland Revenue that the taxpayer's accounts gave a

completely misleading picture of the trading results of the business for the period in question. The profits had therefore to be recomputed using SSAP 21, which only permitted a deduction for the amounts (presumably, but not actually stated, the finance charge and notional depreciation) properly attributable to the period, having regard to the useful life of the asset. The taxpayer argued that SSAP 21 was overridden by the principle that actual expenditure properly incurred was deductible in the period in which it falls (see Vallambrosa Rubber Co. Ltd. v. Farmer 5 TC 529). In the Court of Appeal, Sir Thomas Bingham MR said

“... I find it hard to understand how any judge-made rule could override the application of a generally accepted rule of commercial accountancy 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.”

This dictum leaves plenty of scope for judges to depart from accountancy principles where appropriate, so the general current of opinion that accountancy principles took on greater importance with the judgment in Gallagher v. Jones may turn out to be an overstatement as accounting principles depart further from legal form.

Johnston v. Britannia Airways

The question of *conflicting* accountancy principles arose in Johnston v. Britannia Airways Limited where the taxpayer accrued the estimated cost of future engine overhauls. The taxpayer brought expert evidence as to the appropriateness of this accounting treatment when challenged by the Inland Revenue. At the hearing before the commissioners, the Revenue's expert put forward an alternative accounting method based upon the capitalisation of engine overhauls *after* they had been performed and their subsequent amortisation. As a result of this conflict of expert evidence, the Special Commissioners had to choose between accounting methods and they held that the accruals method used by the taxpayer was the more appropriate.

In the High Court, the Inland Revenue argued that the accruals method was inappropriate to the facts because it dealt with future expenses. By way of example, if the taxpayer had ceased trading before carrying out an overhaul, the accrual would, the Revenue argued, have been unnecessary. That argument would, if successful, have virtually destroyed the accruals concept for taxation purposes. It was not accepted.

The Revenue also argued that the accruals method was not, on the facts, sufficiently reliable, as in Southern Railway of Peru Limited v. Owen (36 TC 602).

In the High Court, Knox J treated the Special Commissioners' acceptance of the accruals method as a finding of fact, with which he clearly agreed and which he was not prepared to disturb following the well known principles in Edwards v. Bairstow (36 TC 207).

Johnston v. Britannia Airways is of interest because it shows that in the absence of any overriding legal rule, the potential conflict between possible accounting treatments is likely to be viewed as a question of fact for the Commissioners. To some extent, this is an innovation. In Duple Motor Bodies Limited v. Ostime (39 TC 537) the Commissioners chose one of two conflicting but apparently acceptable accounting treatments but, on appeal to the House of Lords, that treatment was rejected and the competing accounting treatment was adopted. The House substituted its own view as to which accounting principle was correct, treating the matter as one of "common sense" (per Lord Reid at page 571). The House seems to have considered itself quite free to do this, which

makes the issue appear to be one of law, rather than one of fact, which is usually a matter for the Commissioners. This apparent conflict between Johnston v. Britannia and Duple is possibly explained by the rather incomplete findings of fact made by the Commissioners in Duple, but Britannia certainly suggests a trend away from the judges' substituting their own views on accounting for those of the fact finding body.

This still leaves plenty of scope for disputes in the future. For example, the accruals concept often conflicts with the 'prudence' concept (both are in SSAP 2) and the "correct" application of these two concepts to any given set of facts is often a matter of fine judgment. The writer is aware of at least one case recently before the Special Commissioners (but not yet decided) where conflicting accountancy principles have played a significant part.

The third situation referred to in Gallagher v. Jones in which accountancy principles may be overridden is extremely broad. It covers the fairly straightforward situation where the accounting treatment is inappropriate having regard to the actual facts. An illustration of this would be where an equipment lease is accounted for as a finance lease within the meaning of SSAP 21, whereas the

facts plainly show it to be an operating lease. However, the override goes much further than this. It permits the court to apply a “legal” view of what constitutes “profit” for the generally accepted accounting view. A striking example, given the result in Gallagher v. Jones, is the taxation of finance lessors. SSAP 21 treats finance lessors as not being the owners of leased assets, but as providers of finance. Each payment of lease rental is treated as including an element of principal and an element of interest.

Accordingly only a portion of each rental is taken to the profit and loss account of the lessor. As is well known, tax law is assumed to take a totally different view, treating the entire rental income as income of the trade and hence forming part of profits. Even though the accounting treatment is generally accepted, it is generally assumed not to be appropriate for tax purposes. It is interesting to ask why this is the case. SSAP 21 takes a view of the distinction between capital and revenue which does considerable violence to the principles developed in case law. It treats most of the lease rental as a capital receipt. This feature (and the fact that SSAP 21 would not prevent a finance lessor from claiming capital allowances on the equipment) is arguably sufficient to bring the override into action. But SSAP 21 *was* regarded as appropriate for establishing the quantum of the deduction for finance lease rentals payable by

finance lessees in Gallagher v. Jones even though the lessee is treated by SSAP 21 as paying a mixture of financing charges and notional loan principal, rather than rent. This difficulty was not explored in the Courts in Gallagher v. Jones. In practice, of course, lessees will rely on Inland Revenue Statement of Practice 3/91 to secure a deduction for the depreciation charge in respect of the equipment, which generally relieves the capital element of the rentals.

Trends

It is clear that the law in this area is still developing. This is not surprising, given the enormous developments in accountancy theory over recent years. Lord Halsbury's words quoted at the beginning of this article have become increasingly less true, unless one replaces Lord Halsbury's "commercial man" with "chartered accountant".

There is also a clear trend for the Court to rely more heavily on accountancy evidence. Although this might seem at first to be a reasonable way of preventing the court from having to use its own common sense where the opinion of technical experts is available, there are risks. Accountancy is not a precise science. It involves the exercise of considerable skill and judgment to facts and situations

where there is frequently room for conflicting views. Rather than setting up an overriding principle of tax law to defeat the taxpayer's position, the Inland Revenue are now much more likely to dispute the accounting treatment adopted by the use of expert accounting evidence.

An illustration of the Revenue's recent thinking can be seen in the Revenue Interpretation issued in February 1997 on Employee Share Ownership Trusts, in which they accept that the timing of a trading deduction for contributions to a non statutory ESOT is governed by UITF 13, which may require the deduction to be taken to the contributor's profit and loss account before the expense is incurred. Specific reference is made to the recent cases as justification for this view.

A second trend which has emerged is for legislation to prescribe that "profits" for Case I purposes will follow some form of accounting treatment. The loan relationships legislation in the Finance Act 1996 taxes the profits and gains arising from the loan relationships of a company by reference to the credits and debits to be brought into account in accordance with "an authorised accounting method". Section 80 of that Act provides that, to the extent that a company is a party to a loan relationship for the

purposes of a trade carried on by it, the profits and gains arising from the relationship are to be brought into account in computing the profits and gains of the trade. Even though, superficially, this legislation appears to adopt accountancy principles in arriving at trading profit, it becomes rapidly clear that the authorised methods are tightly controlled; see s.85. To the extent that accountancy principles in general give a different result, or evolve over the years, they are always overridden by the precise words of the statutory provisions. This apparent adoption of accounting principles by statute is therefore somewhat misleading.

A third trend which comes out of recent legislation is the adoption of the accountancy based measure of profit where that gives a higher taxable profit than the use of “conventional” tax rules. This can be seen in the finance leasing legislation in Schedule 12 Finance Act 1997. This is not, however, evidence of a trend towards the adoption of accounting principles generally when taxing a leasing trade. It is if anything more indicative of the Revenue’s increasing interest in curbing what they consider to be a form of tax avoidance - where the trading profit for tax purposes is less than the trading profit disclosed in the taxpayer’s financial statements, including group accounts.

A potential danger with this method of legislation, quite apart from its complexity, is its unpredictable effect if accountancy principles change. There are already moves to abolish the distinction between finance and operating leases and for all leases to be capitalised.

The Future

Accountancy principles are not static. Nor are they drafted with legal precision. Nevertheless, we are likely to see greater reference to them as the determinant of taxable profit as the British taxation system slowly evolves away from the schedular system. This will not necessarily reduce the incidence of disputes between taxpayers and the Revenue on the correct measure of trading profit. It is, however, likely to shift the emphasis towards disputes between accountancy experts. Given the necessary flexibility of accountancy principles, this is likely to inject a further (and unwelcome) element of uncertainty into our system.