DUFTON KELLNER
CHARTERED ACCOUNTANTS

SPRING 2016

Claiming Tax Relief For Pre-Trading Expenditure

When setting up a business there is generally a certain amount of preparatory work that needs to be undertaken before the business is ready to start trading. For example, it may be necessary to acquire and kit out premises, recruit staff, buy stationery and other offices supplies, install computer software, advertise etc. In getting the business ready to trade, costs will be incurred.

Understandably, the business will be keen to obtain tax relief for those expenses wherever possible.

Seven-year rule

For both income tax (sole traders and unincorporated businesses) and corporation tax purposes, relief is available for business expenditure incurred prior to the start of trading ('pre-trading expenditure'), but only if the expenditure was incurred within a period of seven years prior to the commencement of the trade. Relief is available to the extent that the expenditure is not allowable as a deduction in computing profits, but would have been deductible had it been incurred after the trade had commenced.

Revenue not capital

Relief against is only available for pre-trading expenditure to the extent that it is revenue expenditure rather than capital expenditure.

'Wholly and exclusively' rule

Expenditure that is incurred before the start of trade must pass the 'wholly and exclusively' test to qualify for deductibility in the same way as expenditure incurred once trading has started. Thus pre-trading expenditure is only deductible if it is incurred wholly and exclusively for the purposes of the trade. No relief is available for pre-trading expenditure that does not pass this test.

Treated as incurred on day 1

For the purposes of giving relief, qualifying pre-trading expenditure is treated as if it had been incurred on the first day of trading, and in that way is deducted in computing the profits of the first accounting period.

Pre-commencement capital expenditure

As noted above, relief for pre-trading expenses against profits is only available for revenue expenditure. However, where the expenditure is of a capital nature and of a type that would qualify for capital allowances, such as expenditure on plant and machinery, the expenditure is treated for capital allowances purposes as if it were incurred on the first day of trading. In this way, relief is given by means of capital allowances. Where the capital expenditure is of a type that qualifies for the annual investment allowance, relief may be given in full against the profits of the first accounting period.

Stock

A business which sells goods will need to acquire stock before it is able to start trading. However, the advance purchase of stock does not qualify for relief against profits as pre-trading expenditure. Instead, the cost of stock will be deducted in computing profits (as part of the cost of sales) once trade has begun.

Example: Preparing to trade

Albert starts trading as a painter and decorator on 1 October 2015. In preparation for the commencement of the trade, he bought a van in September 2015 for £5,000 and in the period from 1 June 2015 to 30 September 2015 he spent £1,000 on equipment. He also spent £500 on marketing in August 2015, publicising his new business to obtain customers.

Albert is able to obtain relief for the marketing costs in computing his profits for the period from 1 October 2015 to 5 April 2016. The marketing costs are treated as if they were incurred on 1 October 2015. While Albert cannot deduct the cost of the van and the equipment as this is capital expenditure rather than revenue expenditure, he can claim capital allowances instead. He is treated for capital allowances purposes as if he had incurred the expenditure on 1 October 2015.

Practical Tip :

When setting up a business, keep a record of all set up costs and don't forget to claim relief for pre-trading expenditure against profits of the first accounting period. Similarly, capital allowances can be claimed as if the capital expenditure was incurred on the first day of trading.

IN THIS ISSUE

Dufton Kellner Limited
Barnston House,
Beacon Lane,
Heswall,
Wirral
CH60 0EE

Email:post@duftonkellner.co.uk • Tel: 0151 342 6405 • www.duftonkellner.co.uk

IHT And Property Values: Get It Right – Or Else!

Some areas of tax compliance are much more difficult to get right (and therefore more of a risk in terms of making errors) than others. Valuing assets such as land and property for inheritance tax (IHT) purposes (e.g. on death) is one such area.

Land valuations

One of the difficulties with land (and many other valuations) for IHT purposes is a lack of clear guidance on what constitutes 'market value'. This term is simply defined in the legislation as '…the price the property might reasonably be expected to fetch if sold in the open market at that time; but that price shall not be assumed to be reduced on the ground that the whole property is to be placed on the market at one and the same time' (IHTA 1984, s 160).

According to HM Revenue and Customs (HMRC), inadequate valuation of land (and buildings) is one of the biggest risks in IHT compliance. HMRC enquiries into land valuations produce large amounts of additional IHT and interest. What can be done to reduce the possibility of problems with HMRC?

Call the professionals!

HMRC guidance in its 'Inheritance Tax Toolkit' states that for assets with a material value, taxpayers 'are strongly advised to instruct a qualified independent valuer to make sure the valuation is made for the purposes of the relevant legislation, and for houses, land and buildings, it meets Royal Institution of Chartered Surveyors (RICS) or equivalent standards.'

However, in HMRC's view it is not enough simply to seek a professional valuation. HMRC also state: 'In the absence of proper instructions the valuer will not understand the context nor have all the necessary details on which to make a proper valuation.'

HMRC expects the person seeking the professional valuation to explain the context and draw attention to the definition of market value in IHTA 1984, s 160 (see above), and provide the valuer with all the relevant details concerning the land and property, including copies of any agreements (e.g. leases), or full details where only an oral agreement exists.

The 'high risk' nature of a land valuation increases the possibility of challenge, particularly where HMRC suspects that the valuation may be too low *(see Hatton v HMRC [2010] UKUT 195 (LC))*. However, this will not necessarily result in an increased value being attributed *(see Chadwick and another v HMRC [2010] UKUT 82 (LC))*.

Penalties? Not necessarily…

HMRC review under-valuations to look for cases where penalties should be charged. However, in Cairns v Revenue & Customs [2009] UKFTT 00008 (TC), a professional executor who submitted an IHT account on a deceased individual's death containing a property valuation that later turned out to be too low successfully appealed against penalties sought by HMRC.

In that case, HMRC argued that Mr Cairns should have obtained another professional valuation or revisited the valuation already obtained, and that there had been a wilful default. However, the tribunal held that '…the mere failure to obtain another valuation when it has not been established that a second valuation would have led to a different figure being inserted in the statutory form does not constitute negligent delivery of an incorrect account.'

Practical Tip :

HMRC's Inheritance Tax & Trusts Newsletter (August 2009) featured a report on its Annual Probate Section Conference, which indicated that if instructions for the valuation of a property were given on the correct basis, any uplift in value subsequently agreed was 'unlikely' to attract a penalty. The 'correct basis' was defined as: '… a hypothetical sale in the open market under normal market conditions and marketed properly with no discounts for a quick sale or for the time of year etc.'

The suggestion was made that in order to be confident that 'reasonable care' had been demonstrated, three valuations from different estate agents would be preferable, or a professional (i.e. Royal Institute of Chartered Surveyors) valuation if a definitive valuation was necessary. However, whether a person has exercised reasonable care will depend on what actual steps were taken in each case.

Is It Really Too Late To Claim Back Overpaid Tax?

The tax system is full of time limits, so taxpayers and their advisers need to be constantly on their guard. For example, the normal time limit for claiming income tax or capital gains tax (CGT) relief is four years after the end of the tax year to which the claim relates (TMA 1970, s 43(1)).

Similarly, as a general rule HM Revenue and Customs (HMRC) is restricted to a four-year time limit for making income tax or CGT assessments (TMA 1970, s 34(1)).

Taxpayers will sometimes need to submit tax returns for earlier tax years. It might seem odd that HMRC could seek to reject tax returns on the grounds of them being submitted too late. However, could this happen if (for example) the taxpayer has overpaid tax for the year to which the return relates?

Tax returns and tax overpayments

In *The Queen (oao Higgs) v Revenue & Customs* [2015] UKUT 0092 (TCC), the taxpayer made self-assessment payments on account for 2006/07 of £46,317. He filed his tax return for 2006/07 on 2 November 2011, which showed a tax liability of £18,830, resulting in an overpayment of £27,487.

However, HMRC considered that the tax return was time-barred. This was on the basis that the time limit for filing the return was four years, and this limitation period (in TMA 1970, s 34(1)) expired on 5 April 2011. The taxpayer sought judicial review, as HMRC's decision meant that his payments on account were conclusive, and the tax overpayment was irrecoverable.

The Upper Tribunal held that the four-year time limit in s 34(1) has no application to self-assessment returns. The reference in s 34(1) to 'an assessment' did not include the taxpayer's self-assessment. Thus the four-year time limit in that legislation did not apply, and the tribunal ordered HMRC to process the taxpayer's tax return, including his self-assessment for 2006/07.

Helpful, but…

The decision of the Upper Tribunal in Higgs is obviously good news for those taxpayers who may otherwise have been unable to reclaim tax overpayments from more than four tax years ago. However, it should be noted that the tribunal's decision only apparently relates to self-assessment returns, and not (for example) overpayments arising from claims made outside the return, for which the four-year time limit in TMA 1970, s 43(1) is the general rule.

Furthermore, there is anecdotal evidence that HMRC will not consider 'late' self-assessment returns in respect of tax years for which a determination has been issued to the taxpayer (under TMA 1970, s 28C). Such a determination is generally treated as a self-assessment, and is automatically replaced if the taxpayer submits an actual self-assessment within the time limit stipulated in s 28C.

In addition, the Higgs decision will presumably not allow taxpayers to make 'late' amended returns, as there is a separate statutory time limit for making amendments, i.e. within twelve months from the 'filing date' in respect of the return (TMA 1970, s 9ZA).

Game, set and match?

How far back in tax years could taxpayers go in filing self-assessment returns in order to reclaim overpaid tax or payments on account? Self-assessment was introduced in 1996/97, so it appears that returns could be submitted going back that far.

However, in Higgs the taxpayer's return was submitted in response to an HMRC notice to file the return (under TMA 1970, s 8). Thus the decision in that case would not appear to cover 'unsolicited' tax returns submitted in the absence of a tax return filing notice.

Practical Tip:

It is not known at the time of writing whether HMRC will appeal the Higgs decision. However, taxpayers who have not submitted tax returns showing potential tax overpayments because the returns were assumed to be 'too late' should review their tax affairs, and consider filing the returns as a precaution against any future adverse change in the law.

Personal Tax

Claim Fixed Rate Deductions

To save some of the work incurred in keeping details of expenses, individuals carrying on a trade as a self-employed sole trader or in partnership with other individuals can instead claim fixed rate deductions.

Fixed rate deductions are available in respect of vehicle deductions, business use of home and in relation to business premises which are also used as a home.

Businesses can choose to claim the fixed rate deductions to save work. Alternatively, they can keep records of actual expenditure and make the necessary apportionments between home and business use. Where records are kept businesses have the option of claiming a deduction for either the actual expense or, where this gives a more favourable result, claiming the fixed rate deduction.

Case Study:

Lucy works from home running a small business making soft toys. She works 30 hours a week.

To save paperwork, she claims a fixed rate deduction of £26 per month (the rate applicable where hours worked at home in a month are 101 or more) for use of her home for business purposes.

Property Tax

Car Expenses

The cost of running a vehicle used in a letting business can be claimed against rental income. Unless the vehicle is used solely for business purposes, the costs must be apportioned between private and business use.

There are two alternative methods of calculation:

- Note the recorded mileage on 6 April each year giving the total mileage over the full tax year. Record the mileage of every business-related trip made in the tax year, which will give the proportion of running costs to claim.
- A business with annual turnover of less than the VAT registration limit (£82,000 for the tax year 2015/16) can claim 45p for the first 10,000 business miles incurred and 25p for any additional miles.

Whichever method is used, once used, it cannot be changed until the vehicle itself is changed.

Case Study:

James travels 12,000 miles on business attending to his portfolio of properties. The total recorded mileage (including private journeys) for the year is 15,000. Total cost of running the car is £3,750 per year.

Method 1:
£3,750 x 12,000/15,000 = £3,000

Method 2:
(10,000 x 45p) + (2,000 x 25p) = £5,000
Method 2 will produce the most tax-efficient amount to claim.

Business Tax

Keep All Business Profits For Yourself

An individual who is in business as a sole trader gets to keep all the profits made by his or her business. By contrast, profits made by a partnership are shared between the partners in accordance with the profit sharing ratio. Any profits made by a limited company belong to the company and can be paid out to the directors/shareholders in the form of a salary, bonus or dividend (as appropriate) or retained in the company.

A sole trader is uniquely placed to enjoy all the benefits of his or her business success.

Case Study:

Lucy is in business as a sole trader. She has a successful year and makes a profit of £100,000, which is treated as her income.

Her sisters, Katie and Emily, are in partnership, sharing profits equally. The partnership also makes a profit of £100,000. This is due mainly to a contract negotiated by Emily. However, the profits must be shared in accordance with the profit sharing ratio and Katie and Emily each have profits of £50,000.

In each case the profits are taxed as the income of the individual concerned.

Email:post@duftonkellner.co.uk • Tel: 0151 342 6405 • www.duftonkellner.co.uk