

INCOME FROM TRADE, BUSINESS OR SELF EMPLOYMENT

The profits of an individual who undertakes a trade or business personally (as opposed to through company or some other vehicle) is subject to special income tax rules. Tax law calls business activity the carrying on of a "trade".

What is a Trade?

Whether or not an activity is a "trade" is a question of interpretation. For example, a one off transaction may not be a "trade". It could involve a capital gain or it might simply be wholly exempt from taxation. There are a number of factors which will determine whether there is a "trade". The so called "badges of trade" are certain circumstances which may point to the existence of a trade. There is no decisive test. If goods or services are provided regularly with a commercial motive this will generally indicate that there is a trade.

The type of asset bought and sold is relevant. An asset acquired for investment for private use which is capital in nature would not generally be subject to income tax on its sale. Goods bought as stock are usually subject to income tax on the profits from their sale.

In order to be considered as an investment or capital asset and not as trade "stock", the asset must be income producing or held for aesthetic reason. When an individual acquired a million rolls of toilet paper and resold them it was held to be a trade rather than an investment. Length of ownership can be relevant but is not a conclusive.

The frequency and number of similar transactions by the same person is relevant. However a single transaction can be deemed to be a trading as in the toilet roll example above. Supplementary work such as making the items more marketable or improving it would be an indication of a trade. The intention of making a profit makes it more likely a transaction will be viewed as a trade.

The nature of the asset does not matter in the question as to whether or not trade is involved. The sale and purchase of land or shares can be a trading activity under certain circumstances. The position is much the same as under Irish Taxation Law.

Ascertaining Trade Income for Tax

The starting point is the 12 month financial accounts for the business ending in the tax year. The taxable profits are based on the profits in this accounting period. These accounts must then be adjusted so as to add back deductions which tax law does not allow and subtract make certain deductions allowed by tax law, but not reflected in accounting practice.

There are special rules in respect of opening years. In the first year profits are calculated from the date of commencement to the 5th April of that year. This is effectively the actual income for the period. If there is a 12 month period of account in the second year, then this period applies. Otherwise it is based on the first 12 months of trading. In year three rates the normal period i.e. 12 months ending on the accounting date applies. There is adjustment for any overlap. Overlap profits are those that are assessed in more than one tax year. It may be possible to relief overlap profits earlier by changing the accounting date.

There are equivalent rules in respect of the final years of a trade. They ensure that the profits not previously assessed are assessed at this point. The overlap profits from commencement are deducted.

If there is a change in accounting date may have certain tax advantages. However it is necessary to notify HMRC on or before the 31st January of the following tax year as to the changes concerned. The new account period must not exceed 18 months. If the period between the old accounting and the new accounting date is longer than 18 months two separate accounts will have to be prepared. There must not have been a change in the accounting date in the last five years.

Adjusting the Profits for Tax

There is certain deal of freedom within accounting rules. There may be elements of subjectivity in the way certain transactions and positions are shown in financial accounts. For policy reasons, certain types of deductions are not available or are limited or treated differently in the tax computation, in order to protect the tax base. For this reason the financial accounts must be adjusted to ascertain the taxable profits.

Any expenditure which isn't wholly and exclusively for the purpose of the business is not deductible. A self employed trader isn't able to eat lunch at home and claim the extra cost as a tax deduction. This is not wholly and exclusively for the purpose of the trade. Where expenditure has been partly incurred for a business, a proportionate amount may be allowed e.g. use of car.

Appropriation from accounts such as business owner's salary, interest on capital drawings are not allowed as deductions. These in effect represent appropriation of the income itself. Salaries in excess of certain amounts paid to family members are not fully deductible.

Income included in accounts that is not taxable trading income should be deducted e.g. capital receipts on sale of assets. Other forms of miscellaneous income such as savings and dividend income and exempt income will appear in financial accounts this will need to be deducted by way of adjustment. These categories of income and gains are taxed under different tax headings, but they are not part of the trading income calculation.

Expenditure on capital is not allowed as an expense. Capital profits and capital losses must be taken out of the financial accounts. Questions can arise as to the difference between revenue expenditure and capital expenditure in the context of repair. Repair to assets will be revenue expenditure, but an improvement will not be. The initial cost of repairs for making assets usable is usually not deductible. It is deductible if the asset could be put into use before the repairs are carried out.

There are restrictions on sums paid for car leasing. Rental charges are pro-rated downwards in respect of motor cars which would have cost more than £12,000.00 when new.

Provisions for future costs are allowable provided they are calculated in accordance with U.K. GAAP (accounting practice rules) and their estimation is sufficiently accurate. They are certain expenditure items which are specifically allowed or not allowed by tax law. Advice should be taken in relation to specific items.

Capital expenditure is dealt with under a separate system. Depreciation in financial accounts is added back. So called "Capital Allowance" rules only apply. See our separate note on capital allowances. Many types of capital expenditure do not qualify for capital allowance, e.g. purchase cost of offices. Other types of allowances are allowed, at different times and differing amounts to the deductions in financial accounts.

This Guide is intended as an overview and broad outline of the matters covered in it. Its purpose is to inform and raise awareness. We are happy to offer specific legal advice on particular circumstances.

This Guide should not be relied on as a substitute for comprehensive legal advice with reference to the particular circumstances.

While we have taken due care in the preparation of this publication, we do not accept legal liability as a result of any reliance placed on anything in this Guide. The reader should rely only on specific legal or taxation advice.