SECTION 42 FINANCE ACT 1998 – AN OPPORTUNITY MISSED?

by Barrie Akin

Section 42 Finance Act 1998 introduced for the first time into the computation of Case I and II profits a clear statutory requirement that

> "... the profits of a trade, profession or vocation must be computed on an accounting basis which gives a true and fair view subject to any adjustment required or authorised by law in computing profits ..."

At first sight, this provision seems to elevate the rôle of financial accounting beyond mere score-keeping: it appears as if the accounts will be the both the start and the end point in most cases. Coupled with dicta in relatively recent cases[1] it might appear that there is no longer any great difficulty here – that apart from the obvious statutory prohibitions on deduction, such as entertaining expenditure, and the obvious statutory reliefs, such as those for capital expenditure qualifying for capital allowances, the accounting treatment is now king. This article attempts to show that that is not the whole story.

How New?

It should not be forgotten that s. 42 did not effect a revolution. There are plenty of dicta from the middle of the last century to the effect that profits should be computed by taking properly produced accounts. In

Odeon Associated Theatres v. Jones,[2] Pennycuick V-C said:

> "In ascertaining the true profit of a trade the Court applies the correct principles of the prevailing system of commercial accountancy ..."

Which Accounts?

It goes (almost) without saying that the actual accounts of the taxpayer are not in any sense conclusive as to what the accounting profits should be for taxation purposes. Section 42's successors[3] require that profits should be calculated on an accounting basis which accords with generally accepted accounting practice ("GAAP"). If the accounts of the taxpayer do not do this, they cannot be set up as being determinative. This does not in fact represent much of a change from the previous position: see for example *Gallagher v. Jones,*[4] in which the taxpayer could not rely on accounts that were not GAAP compliant.

Explicit Exceptions

Even though the legislation requires profit to be computed in accordance with GAAP, it explicitly excepts from this requirement adjustments required or authorised by law. So depreciation continues to be disallowable and capital allowances continue to be deductible, whatever the accounts say. Again, this was nothing new.

But what about non-statutory adjustments – those that are generally considered to be purely judge-made? There is nothing in the words used to confine the exceptions to those explicit in statute[5]. Judicially developed exceptions must also continue to apply. However, the precise status of judge-made exceptions is, following *Gallagher v. Jones*[6] and *Herbert Smith v. Honour,*[7] somewhat unclear. See below.

Ascertaining the Correct Accounting Treatment

It is easy nowadays to assume that accountancy has become sufficiently complex for it to be regarded as a matter for expert evidence, leaving the ascertainment of the correct treatment under GAAP to expert evidence if necessary. The older authorities do not, however, support such a view. They make it abundantly clear that the judges did not, at least initially, regard accountancy as sufficiently esoteric to be the exclusive realm of experts. On the contrary, the judges appeared quite content to regard the ascertaining of trading profits as a straightforward matter on which they were free to pronounce. For example, in *Gresham Life Assurance v. Styles* (1892) 3 T.C. 185, Lord Halsbury said at 188 and 189

> " ... profits ... is to be understood in its natural and proper sense – in a sense which no commercial man would misunderstand ..."

> " ... profits ... must be ascertained on ordinary principles of commercial trading ..."

In 1914, Lord Parker of Waddington, when considering the lineal ancestor of the provisions which deal with the ascertainment of trading profits for the purpose of income tax[8] was able to say in *Usher's Wiltshire Brewery v. Bruce*[9]

> "The expression "balance of profits and gains" implies ... something in the nature of a credit and debit account, in which the receipts appear on the one side and the costs and expenditure necessary for earning these receipts appear on the other side ..."

These and similar dicta in the early cases suggest that the judges thought it perfectly possible to ascertain trading profits without any great difficulty. Given the unsophistication of accounting in the nineteenth century and the relative newness of the accounting profession[10], this is not surprising. None of the early cases appears to have admitted expert accountancy evidence or to have seen the rôle of the appellate Courts as a supervisory one.

This early (and somewhat amateurish) approach has largely died out. One clear development in the Courts' approach from the middle of the last century is the reception of expert accountancy evidence and the explicit recognition of its rôle. Departing from the earlier approach of regarding the ascertaining of profit as a matter of business common sense, the Courts were able to go a little further. And in *Odeon Associated Theatres v. Jones,*[11] Pennycuick V-C said:

> " ... the Court applies the correct principles of the prevailing system of commercial accountancy ... it has recourse to the evidence of accountants. That evidence is conclusive on the practice of accountants ... but the Court has to make a decision as to whether that practice corresponds to the correct principles of commercial accountancy." *[Emphasis added.]*

This does not, however, take matters very much further than the older cases. While recognising that accounting evidence is vital in arriving at trading profit, it nevertheless arrogates to the Court the ascertainment of the "correct principles of commercial accountancy."

This was not a maverick decision. The House of Lords said much the same thing in *Duple Motor Bodies v. Ostime,*[12] in which accountancy evidence showed that there were two possible methods of accounting for work in progress, both of which could be acceptable for accounting purposes. The company's preferred method yielded a lower accounting profit. The leading speech (Lord Reid) made it clear that the Court attached great weight to the views of the accounting profession, but that the Court must always have the last word.[13] In *BSC Footwear v. Ridgway*[14] the House of Lords considered the merits of rival accounting treatments. They did not regard the findings concerning accountancy practice as a matter solely for the commissioners.

Recent Times

Whether bound by precedent or not, the continued development of GAAP has forced the Courts to modify

their approach. In *Johnston v. Britannia Airways*[15] the Inspector sought to substitute his own accounting method for the company's method of recording the cost of engine overhauls. It was accepted that both the company's and the Inspector's methods were acceptable from an accounting point of view. The Special Commissioners accepted the company's method. Knox J regarded the whole question of accountancy evidence as being one of fact, overturnable only on *Edwards v. Bairstow*[16] principles. Whether the accounting method was otherwise unacceptable, for example because it violated taxation principles, was still a legitimate point for discussion, but Knox J made it clear, following *Gallagher v. Jones*[17] that

> "[t]he Court is slow to accept that accounts prepared in accordance with accepted principles of commercial accountancy are not adequate for tax purposes as a true statement of a taxpayer's profits for the relevant period. In particular, it is slow to find that there is a judge-made rule of law which prevents accounts prepared in accordance with the ordinary principles of commercial accountancy from complying with the requirements of the tax legislation."

This approach, commonsensical as it is, does not sit easily with the earlier dicta in the Lords to the effect that the Court always has the last word, but is amply justified in the light of the enormous development of accounting standards and their recognition in statute. For example, the Companies Act 1985[18] required accounts to state whether they had been prepared in accordance with applicable accounting standards and to give particulars

of any material departure from them. *Accounting standards* was defined by reference to the statements of standard accounting practice and Financial Reporting Standards issued by a prescribed body – the Accounting Standards Board.[19] All of this suggests that the Court would do well to keep away from the detailed mechanics of accounting, unless there are very good reasons for intervening. It also suggests that s. 42 or its successors could usefully have provided some guidance as to how far the judges can go in deciding whether or not a particular accounting treatment accords with GAAP.

The Status of Judge-Made Rules

It is clear from the decisions in *Gallagher v. Jones* and *Johnston v. Britannia Airways* (above) that judge-made rules requiring the departure from properly drawn accounts are no longer encouraged. The best known such rule is perhaps the rule that expenditure incurred in a particular year is deductible, even if it is designed to secure a future benefit.[20] However, in *Gallagher v. Jones*[21] the Court of Appeal, when faced with extremely large initial rental payments for boats that would be leased for many years, did not permit that rule to override what they considered to be the correct accounting treatment. Lord Bingham MR doubted that any general overriding principle was in fact being laid down by the Court of Session when it decided *Vallombrosa Rubber*. A bolder Court might have found that where that principle was inconsistent with the accruals concept, it should be overridden by the accounting treatment. In *Herbert Smith v. Honour,*[22] in

which the taxpayer sought relief for future rental losses booked in its accounts in accordance with the prudence principle, Lloyd J regarded any judge-made rule against the anticipation of losses as inconsistent with the accounting treatment and therefore inapplicable.

But the principle of judge made exceptions to accounting treatment may well have some life left. Consider the position of the person who leased the boats to the taxpayer in *Gallagher v. Jones*. His correct accounting treatment under GAAP for the finance leases granted to the taxpayer lessee[23] would have been to treat the boats as belonging to the lessee and to treat his own investment in the boats as a loan made to the lessee. He would then have spread the rentals received over the life of the finance lease, taking to profit and loss account only the interest element inherent in each rental payment. At the same time, the lessor would have claimed capital allowances on his entire capital outlay. It is perfectly clear that HMRC will not accept that only the element of rental income taken to profit and loss is taxable, whatever the accounts say.[24] If the point were litigated, the Court might well find that the accounting treatment could not override clear taxation principles, based on the proposition that in law what is being received is a rent for the use of a chattel, although the fact that the owner will probably be entitled to capital allowances on his entire expenditure would no doubt play a part in the Court's reasoning. The author finds this all rather uncomfortable. Where does the dividing line fall between following GAAP to ascertain trading profit and

deciding that GAAP gives an answer that is inconsistent with legal principle and must therefore be ignored?

A better approach might be to provide that there should only be statutory exceptions to the use of GAAP based accounts.

The Jumping-off Point

In truth, the requirement that profits be calculated in accordance with GAAP is little more than a jumping-off point. Subject to limited exceptions for barristers in early years of practice, the legislation does little more than abolish the cash basis of accounting for traders. It does not prevent the taxpayer and the Revenue from arguing as to just how GAAP compliant a particular accounting treatment is or whether a compliant accounting treatment is overridden in any particular case. In *HMRC v. William Grant & Son Distillers Ltd*[25] there was no dispute as to the correct accounting treatment, but the Court had considerable difficulty in arriving at its proper taxation effect. The GAAP compliant accounts simply formed the jumping-off point for the main issue – was depreciation to be added back on the basis that it had already been deducted?

It was only when the case reached the House of Lords that it was made clear that the answer was in the negative. The majority in the Court of Session made extremely heavy weather of the accounting evidence and lost sight of the difference between the mechanics of bookkeeping and the function of accounts. See VII GITCR 1 for further details.

Missed Opportunities

The ascertainment of trading profit can never be a conflict-free zone. Disputes can and will arise over the appropriate treatment of transactions under GAAP. However, when those disputes arise, it is unfortunate that there is still high authority to the effect that the Court has a free hand in deciding upon the correct accounting treatment, when it is clear that the most appropriate approach is to rely on expert evidence.

Equally, the older authorities lead to a further consequence: that the Court can choose among competing valid accounting methods. Even if Knox J took a more modern approach in *Britannia Airways*, he would, on the authorities, have been justified in choosing the expert evidence he thought most compelling, rather than exercising a supervisory jurisdiction on *Edwards v. Bairstow* principles, or regarding the taxpayer as having the right to choose between competing methods – an approach specifically rejected in *Ostime*.

In general, where two competing accounting treatments are equally acceptable for GAAP purposes, there should be no reason to deny the taxpayer a free choice as to which to accept. Neither the Court nor HMRC should have any say in the matter, but the authorities say otherwise. It is, in the author's view, high time that the position was clarified.

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[1] *Gallagher v. Jones* (1993) 66 T.C. 77 and *Johnstone v. Britannia Airways* (1994) 67 T.C. 99

[2] (1969) 48 T.C. 257
[3] The history of the legislation following the enactment of s. 42 is a little convoluted. The section was (eventually) rewritten to s. 25 ITTOIA 2005 (income tax) and s. 46 CTA 2009 (corporation tax) in the following form:

> "The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits..."

[4] (1994) 66 T.C. 77
[5] The contrary was not asserted in *HMRC v. William Grant & Sons Distillers Ltd* (2007) 78 T.C. 442
[6] (1994) 66 T.C. 77
[7] (1999) 72 T.C. 130 at 166
[8] Section 100 of the Property and Income Tax Act 1842 –see now s. 25 ITTOIA 2005 and s. 46 CTA 2009
[9] 6 T.C. 399 at 429
[10] The ICAEW was awarded its royal charter as late as 1880
[11] (1969) 48 T.C. 257
[12] (1961) 39 T.C. 537
[13] See *ibidem* at 570, 571. Note also that the Company's decision to choose one of the two possible methods was held not to be relevant to which method was "correct".
[14] (1971) 47 T.C. 495
[15] (1994) 67 T.C. 99
[16] 36 T.C. 207
[17] (1994) 66 T.C. 77
[18] Paragraph 36A of Schedule 4, inserted by the Companies Act 1989
[19] See s. 256 Companies Act 1985 and (now) SI 2005/697
[20] *Vallombrosa Rubber v. Farmer* 5 T.C. 537
[21] 66 T.C. 77 at 112 to 113
[22] (1999) 72 T.C. 130 at 166
[23] This was all long before Chapter 10A of ITTOIA 2005 (Long Funding Leases) which in any event does not govern the taxation of all finance leases.

[24] HMRC Finance Leasing Manual, paragraph 21.25; Business Leasing Manual 33015. Again, the position would be different for a finance lease that fell within the Long Funding Lease provisions.
[25] 78 T.C. 442