

MARS AND SECAN: THERE ILLUSION AND HERE TRUTH; THE COMPUTATION OF PROFIT

by David Goldberg

A trader, in his first year of trade, spends 100 on buying trading stock which, at all times, has a market value of at least 100. Assuming that there are no other transactions in the year, does he:

- (a) have a loss of 100;
- (b) have a profit of something; or
- (c) have neither a profit nor a loss.

The answer is obviously (c). There are no prizes for guessing or even for knowing that. But it raises a critical question: what is the logic that leads to this conclusion?

There are two possible answers:

- (1) the trader has an outgoing of 100 (the amount he spent on acquiring stock) which he deducts as an expense of his trade, and also has a receipt of 100, which is the value of his trading stock at the year-end (the value here being taken as cost or lower market value)¹; or
- (2) the trader has nothing to deduct as an expense in the computation of profit and nothing to bring in as a receipt in the year but, instead, the cost of unsold stock is “carried over” to be deducted in later periods, when sales occur.

Traditionally, the correct answer was thought to be (1). However, accountants have recently started to think differently about how they draw accounts; and they now say that it is answer (2) which is correct.

On the simple example put at the beginning of this article, (2) is certainly a plausible answer to the critical question. In some ways, it may even be the more attractive of the two possible answers. After all, there have been no actual sales of anything: the only thing that has happened is that cash has been turned into trading stock. Why go to the bother of drawing up a profit and loss account? If there is no expense and no receipt there is nothing to bring in to the account. The result is $0 - 0 = 0$. Nothing. In commercial terms, however, something has happened: cash has become trading stock. In the trader’s books, entries will have to be made to reflect the use of cash to buy assets and, in circumstances less simple than those being considered, changes may occur in the balance sheet. When the example becomes more complicated, answer (2) – which leads to the conclusion that the cost of unsold stock is not deducted in computing profits – may seem a little less plausible than it does at first glance; and it may seem even less plausible if some stock is sold by the year end and some retained.

Nonetheless, the House of Lords in *Small v Mars UK Ltd* and *HMRC v William Grant* [2007] STC 680 (“*Mars*”) has unanimously accepted that answer (2) is correct; and the decision has been greeted with widespread approval by most commentators (including – see the article by Barrie Akin “Depreciation and Trading Stock – Confusion Unconfounded” in *GITC Review* Volume VII No 1 – one of my colleagues here). That decision raises a large and important issue. Can profits be computed without deducting all the expenses laid out in the year in question and including in those expenses, the cost of both sold and unsold stake? The answer to this question is important: many tax provisions impose consequences where there has been a deduction and do not impose consequences where there has not been a deduction; the question is of high significance in, for example, F (No 2) A 2005 sections 24 and 25, which set out the arbitrage rules in “deduction cases”. If analysis shows that the answer to that question is No – so that answer (1), that there are outgoings matched by receipts, is the only sustainable answer to the critical question, it may be dangerous to rely too heavily on the House of Lords’ decision in *Mars*, to argue, in other cases, that no deduction has been made for current year expenditure or liabilities. It is part of the normal judicial process that past decisions need to be reviewed and adjusted to meet changing conditions, but the judicial committee of the House of Lords, as presently constituted or led, has a history of deciding cases quickly and then adjusting them, fairly soon, to meet a better understanding of present, rather than changed, conditions. A view different to that expressed in *Mars* may, accordingly, come into vogue sooner rather than later, and the possibility of that happening certainly cannot be ruled out.

It is as well to start the analysis at the beginning.

The Beginning

The correct approach to the computation of profits for tax purposes is well stated by Pennycuik V.C. in *Odeon Associated Theatres Ltd v Jones* 48 TC 257 at 272:

First, one must ascertain the profits of the trade in accordance with ordinary principles of commercial accountancy. That, of course, involves the bringing in as items of expenditure such items as would be treated as proper items of expenditure in a revenue account made up in accordance with the ordinary principles of commercial accountancy. Secondly, one must adjust this account by reference to the express prohibitions contained in the relevant Statute...

This is now the statutory rule. F.A. 1998 s.42 provides:

...the profits of a trade must be computed in accordance with generally accepted accounting practice subject to any adjustment required or authorised by law in computing profits for [tax]

purposes.

This means that the principles of accounting practice are of very great importance in determining profits. There are, however, four limitations on the role of accountants:

- (i) whatever the principles of generally accepted accounting practice are, they yield to a contrary rule of law. Thus, for example, if there is a rule of law that capital must not be mixed with income, that rule overrides a generally accepted accounting practice which treats capital and income as the same;
- (ii) the question “What is the generally accepted accounting practice?” is determined on the evidence: what accountants say about the practice is not conclusive; the court determines the correct practice by reference to the evidence heard in court;
- (iii) although accountants describe what they do, it is for the Court to understand what they do. In Court, an accountant is just a witness of fact. If a witness describes a spherical orange object as a tangerine, the Court has a duty (where relevant) to examine the totality of the characteristics of the object and decide, if appropriate, that it is in fact a mandarin. Thus, if an accountant says he is excluding something from a profit and loss account, it is open to the Court to examine the totality of what the accountant is doing and to decide, as a matter of analysis (which may be legal analysis), that he has not described what he does accurately.
- (iv) the obligation on a trader, now imposed by FA 1998 s.42, is to *compute* profits in accordance with generally accepted accountancy practice. It is not to adjust commercial accounts to arrive at a taxable profit. It may sometimes be easier to arrive at a correct computation by going back to first principles and so build up a computation, bottom up as it were, rather than to adjust the profit and loss account to create a taxable profit from the top down.

What accountants say they do is, accordingly, of very great importance in the computation of profits, but it is not determinative. What is determinative is what they actually do, so long as it accords with generally accepted accounting practice and is not contradicted by any rule of law

The next step in the analysis is to consider how these principles apply to a trader who holds stock-in-trade or work in progress² at a year-end.

The Traditional Analysis

Once upon a time, a long long time ago, most accounts used to be drawn on

a Mr Micawber cash basis. Until quite recently, barristers were still able to do that; and it seemed to be a system of accounting which had some things to commend it. Nonetheless, accountants became concerned that a cash-based account did not produce a fair picture of profit or loss: in particular, if a trader spent money on buying unsold stock, it did not seem right to treat that as an unmatched outgoing, deductible in full in the year; after all, the trader had spent the money in acquiring an asset which he still had, so the money spent was not, as it were, wasted. It was necessary for some notice to be taken of the use to which money spent was put, so what are called earnings based accounts became the vogue. Earnings based accounts require notice to be taken of stock in trade.

The way in which accounts of this sort work was explained, with characteristic elegance and lucidity, by Rowlatt J in *IRC v Naval Colliery Ltd* 12 TC 1017 at p.1027 where he said:

Now, one starts, of course, with the principle that has often been laid down in many other cases – it was cited from *Whimster's* case, a Scotch case – that the profits for Income Tax purposes are the receipts of the business less the expenditure incurred in earning those receipts. It is quite true and accurate to say, as Mr Maugham says, that “receipts and expenditure require a little explanation. Receipts include debts due and they also include, at any rate in the case of a trader, goods in stock.”³

The principles in play can be very clearly seen in the following passage from the judgment of Nolan LJ (as he then was) in *Gallagher v Jones* [1994] Ch 107 at pp.135/6:

The effect of [accountancy] practice, said Mr Glick, is to disallow the deduction of the trader's expenditure on the unsold stock, or so much of it as is represented by the market value, if lower, and carry it forward to be set against the price for which the stock is ultimately sold. That is certainly one way of describing the effect of the practice, and comes close to the language of Lord Reid in *Duple Motor Bodies Ltd v Inland Revenue Commissioners* 39 TC 539 at p.571, where speaking of stock-in-trade and work in progress, he said:

“So the question is not what expenditure it is proper to leave in the account as attributable to goods sold during the year, but what expenditure it is proper, in effect, to exclude from the account by setting against it a figure representing stock-in-trade and work in progress.”

That is how he described the effect of the practice, but it is I think clear from the earlier part of his speech, at pp.569-571, that as a

matter of legal analysis he regarded the practice as involving the deduction of the whole of the expenses incurred during the period but the crediting against them of a closing figure for unsold stock and for work in progress as a notional receipt.⁴

The idea that the computation of taxable profit was made by deducting all expenses of the year (whether incurred on stock or not) and then treating the cost or lower market value of unsold stock as a receipt was, accordingly, sanctioned by judicial decisions and appeared to be accepted by accountants. Indeed, until comparatively recently, accountants thought of unsold stock at the year-end as being “sold” (at cost or lower market value) by the trader to himself, the sale being, as it were, from one period to another. This way of thinking not only explained why the cost or lower market value of unsold stock came in as a receipt of the year being closed, but it also explained the function of the stock as an asset in the next year, a function which, as will be seen, is essential to the computation of profit in that next year. Of course the “sale” of stock from one year to the next was not an actual sale: it was just a way of explaining the things accountants were doing in drawing up accounts of profit and loss. Nobody was saying that there was actually a sale of stock, but everybody (including accountants) seemed happy to explain things that way.

The New Analysis

However, accountants have, recently, begun to think differently about what they are doing; and, now, they do not think of the computation as involving a deduction of all the expenses of a trade but, instead, as involving a deduction only of the expenses relating to sales in the year and the “carrying over” or “exclusion” of the expenses related to unsold stock from one year to another. So accountants are certainly explaining what they are doing differently from the way in which they used to explain it. Indeed, some of them have been a bit sniffy about the old explanation, calling it “sweet-shop accounting”. Nonetheless, the question which arises is whether, although they now describe what they are doing as “carrying over” the expense of unsold stock from one year to another, they are really doing anything fundamentally different from what they have always been doing. In this connection, it is well to remember that, for something over 80 years now, accountants have been telling courts what they do in computing profits and that courts, having heard the explanation, have said that, no matter how the accountants describe it, upon analysis – legal analysis as Nolan LJ put it in *Gallagher v Jones* – the cost of unsold stock is deducted in full in the year and matched with a receipt. Does what accountants now say they are doing change the analysis? Are they truly excluding part of the expenses of the year (those related to unsold stock) from the computation of profit?

Mars

It is important to bear in mind that, while *Mars* concentrates on questions related to depreciation, the depreciation in issue was treated as part of the cost of

stock. Accordingly, the case is not limited to depreciation, but, rather, raises much more basic issues: how is expenditure of the year to be treated? Is it all deducted? More particularly, the question in the case was whether the cost of unsold stock at the year-end is deducted in the year or not. That is exactly the question which has been considered and answered in cases like *Duple Motor Bodies* which was referred to, on this express point, in *Gallagher v Jones* (see above). Nonetheless, whether because the House was concentrating on the question of depreciation rather than the real issue about the function of stock, or for some other reason, the House did not adopt the traditional analysis set out above but thought that the way accounts are now drawn did change the analysis. Thus Lord Hoffmann, having reviewed Standard Statement of Accounting Practice (“SSAP”) 9 and 12 and Financial Reporting Standard (“FRS”) 15 concluded (in paragraph 8 of his speech) that:

The costs of stocks which remain unsold at year-end are not deducted for the purpose of computing the profit in that year, but are carried forward to be matched against the revenue from their sales in future years.

He supported this conclusion (at paragraph 12 of his speech) by pointing out that the “cost of sales” figure, actually deducted from the figure for turnover in the taxpayer’s profit and loss account to compute profit, did not include the cost of unsold stock. (Lord Hoffmann refers only to depreciation on unsold stock not being included as a deduction, but what he says must apply equally to the other costs of unsold stock.) Lord Hope delivered a speech to much the same effect, and both Lord Hoffman (at paragraph 15 of his speech) and Lord Hope (at paragraph 38 of his speech) held that accounting principles had moved on since the principles reflected in *Gallagher v Jones* had been expounded.

Have accounting principles truly moved on?

There is no doubt that the presentation of the profit and loss account never now shows a deduction for costs of unsold stock and a receipt for the value of that stock. However, the question which still needs to be answered is not just about stock. It is: “can profits of a period be computed without account being taken of all the expenses of the year?” No matter how profits are computed, the profit and loss account must, of course, show a figure for the cost of sold stock. It is important to understand how this figure is arrived at. It does not appear in the profit and loss account by magic: it has to come from somewhere. The question: “how is the cost of sold stock arrived at?” is at the heart of the analysis. No proper answer to the issue which arose in *Mars* can be given unless an answer to that question is provided.

The cost of stock is an amalgam of many things: it includes not only the cost of raw materials, but also the costs of the staff who have worked on it and so on. The accounting standards in issue in *Mars* show that, nowadays, the capital cost of machinery used in making stock is, to the extent of any relevant depreciation,

included in the cost of that stock and the recognition that that should be so is, no doubt, a significant accounting advance. However, no matter how accurate or advanced accounting techniques are, it is impossible, especially where the stock is, like Mars bars, fungible, to say with exactitude that this piece of stock cost x and that y : the cost of stock sold and of stock unsold is a part of the total relevant expenditure in the year; some form of apportionment of total expenditure in the year has to be made between sold and unsold stock. Once it is seen that an apportionment of expenditure has to be made, it becomes apparent that, in some way or another, all the expenses of a year are relevant in computing profit. It now becomes necessary to see in what way they are relevant and how opening and closing stock function in relation to expenses. In discovering the cost of stock for the year, it becomes necessary to know what the cost of opening stock at the beginning of the year was: that is because the cost incurred on stock in the year is always the aggregate of the cost or lower market value of the opening stock plus the actual expenditure in the year on acquiring stock. The necessity of taking opening stock into account in this way is unchanged and unchanging: it arose as soon as earnings based accounting was invented and has continued to exist ever since then.

It is worth noting (because Lord Hoffmann says at paragraph 16 of his speech in *Mars* that, while stock is an asset in the balance sheet, it is a cost in the profit and loss account) that, in this context, the cost of opening stock is representative of an asset held at the beginning of the period and so, in a sense at least, functions as an asset, even though it is the cost of the asset which is relevant. And, no matter whether stock functions as an asset or as a cost in a profit and loss account, there is no doubt at all that the cost of opening stock for a year must be brought into account in some way or another as an expense of the year; and, as it would be impossible to incur an expense as it were from nowhere, it is necessary to explain where the expense came from. The old explanation was that it was a “purchase” from the previous year, matched by a “receipt” in the earlier period. The new explanation is that it is an expense carried over from the prior period when it was, presumably, not, on the new theory, an expense at all or was an expense, but one not relevant to the computation of profit when incurred. It might just be that questions of plausibility begin to arise at this stage of the analysis. Nonetheless, the question remains whether closing stock is relevant and, if so, in what way. By this stage of the analysis, it is, as has been mentioned, apparent that, in some way or another, all of the expenses of a period must be taken into account, including those on sold stock and those on unsold stock. They are – must be – in the first place taken into account as a cost. Is that cost then “cancelled” to the extent of the unsold stock? To answer that, we need to see what the function of unsold stock is in the computation and it is useful to do that by reference to an example.

In his first year of trade, a manufacturer of widgets incurs costs (including the cost of the necessary raw materials) of 300 in manufacturing widgets. He is rather good at the manufacturing process, so that he intends to manufacture and

does actually manufacture 300 widgets, none of which he has sold by the year-end. It is easy to see that each widget cost 1 to make and, having been made, is still owned by the manufacturer; and it may be assumed that each widget has a market value of 3. There is no need, really, to draw a profit and loss account: it can be seen that there is no profit and no loss. Year 2 is rather more complicated. The year is uneven; costs rise and fall and rise again in a wholly unpredictable way which cannot be attributed exactly on a widget by widget basis and there are labour problems. Furthermore, the manufacturing process has become a little sloppier than it was: the manufacturer had hoped to make another 300 widgets and had bought the materials to do that, but some of them broke in the process and some of them were not really good enough to be called proper widgets. Some of them were good enough when made, but stopped being good enough before the year-end so that, although he had hoped to make 300 widgets, he does not actually know, until he takes stock, how many widgets he made in the year. What he does know is that he had an opening stock of 300 widgets which had cost him 300 to make and that he has spent 400 in Year 2 manufacturing widgets. He also knows that he sold 310 widgets in Year 2 for 930, and he needs to work out his cost of sales to find his profit. His total cost of manufacture is 700 over two years. On a simple FIFO basis, he would say 300 of the 310 widgets sold (the 300 widgets made in Year 1 and in stock at the end of that year) cost 1 each to make (he knows this because the results in Year 1 make it easy to know, though it will be appreciated that this is unusual) and so his profit on 300 widgets was 620 (cost 1 each, sale price 3 each (930/310)). But how much did the other 10 cost? It can be seen that the other 10 cost a proportion of 400, but what proportion? The answer to that question can only be found by seeing how many widgets are left in stock at the end of Year 2. If there are, say, 190 widgets in stock at the end of Year 2 and 10 of the 310 widgets sold in Year 2 must have been made in Year 2, it is now possible to say that the 400 spent in Year 2 was incurred on manufacturing 200 widgets, so that each widget manufactured in Year 2 cost 2 to make. But none of this can be done without taking account of all of the cost of manufacturing widgets in Year 2, the opening stock of 300, the sale of 310 widgets and the closing stock of 190: the closing stock is an essential element in calculating the cost of the sold widgets and the costs of manufacture during the year.

So it is now possible to see that the total expenditure incurred in the year, the opening and the closing stock are all essential elements in the computation of profit. There is no doubt that accounting methods have advanced and that the way of attributing costs to stock is now much more sophisticated than it used to be. However, despite all the accounting advances, it remains impossible to work out the cost of sold stock without taking into account the cost of opening stock in the year. Accordingly, the cost of opening stock (which, of course, represents unsold stock of the previous period) must always be deducted in arriving at the figures for sold stock in some form or another: it is just not possible to work out the cost of sold stock without taking into account, as a cost of running the business, the cost or lower market value of opening stock. And it is equally impossible to work out the cost of sales without taking account, in some way or another, of the

expenditure incurred in the year and of closing stock. It follows from all this that, somewhere or other – it may not now be in the profit and loss account, but somewhere or other – there must be a calculation of cost of sales which will include the cost of opening stock plus additions during the year together creating the expenditure in the year and the value (taken as cost or lower market value) of closing stock.

The evidence given by the accountants in the *Mars* case appears to have been remarkably coy about how the apportionment of costs between sold and unsold stock was made: there was a great deal of evidence about how the cost of stock was to be calculated, but not very much about how the apportionment of costs between sold and unsold stock was to be made: there was certainly no evidence that the apportionment did not take account of opening and closing stock and it seems inevitable and, indeed implicit in the accountants' evidence to the Special Commissioners in *Mars*⁵ that it must do so. Once it is seen that the apportionment must take account of opening and closing stock, it becomes equally inevitable that the cost of unsold stock has to be deducted at some point in the computation. Even if it does not now appear in the profit and loss account there must somewhere – perhaps now in a memorandum account – be a computation of the cost of sales which, as the examples above show, must include opening stock and closing stock.

Now all this can get really quite confusing and it may help to look at the matter in the form of an equation. In the equations which follows P stands for profit, R stands for receipts for the year in question (excluding the value of stock) and CAS stands for cost of all stock, that is the total expenditure incurred on stock in the year which includes both the cost of stock held at the beginning of the year and the cost of stock acquired during the year. CAS may be divided into CSS, which is the cost of stock sold during the year and CUS, which is the cost of stock unsold at the year-end, which forms the opening stock of the next year: indeed, not only may CAS be divided into these two component parts, but it must be, because some division of total expenditure for the year is needed to find the cost of sold stock. Using these symbols, the traditional analysis can be represented by the equation: $P = R + CUS - CAS$. The equation clearly shows the cost of unsold stock (“+ CUS”) as an addition to the receipts of the business and the deduction of all the expenses of running the business (“- CAS”).

The new analysis can be represented by the equation: $P = R - CSS$. Here, it looks as if only the cost of sold stock has been deducted. However, before concluding that there has been no deduction for unsold stock, it is necessary to see how the value of CSS has been arrived at: that is done and, as the example of Year 2 above shows, can only be done by an operation which can be represented by the formula $CAS - CUS$, which can, of course, be expanded to $(CSS + CUS) - CUS$. When it is recognised that the value for CSS must be arrived at in the way just explained, the equations $P = R + CUS - CAS$ and $P = R - CSS$ set out above can be written out more fully, breaking CAS down into its constituent parts of CUS and CSS.

On this basis, the equation for the traditional analysis is: $P = (R + CUS) - (CSS + CUS)$; and the modern analysis can be set out as $P = R - ((CSS + CUS) - CUS)$. Of course, the working out of “ $((CSS + CUS) - CUS)$ ” in the equation for the modern analysis is not seen in the profit and loss account: only the result of that formula is carried to the profit and loss account, but the formula still has to be worked out, so that the equation set out above for the new method accurately represents in full what is happening, while the formula $P = R - CSS$ only represents part of what is happening, because it does not explain how CSS is arrived at. When the fuller form of the equations above is analysed, it can be seen that, in both of them, the cost of unsold stock is both a receipt and a deduction exactly as Nolan LJ said it was in *Gallagher v Jones*: in the traditional analysis, the cost of unsold stock is a receipt in the part of the equation “ $(R + CUS)$ ” and it is a deduction in the part of the formula “ $-(CSS + CUS)$ ”. In the new method, CUS is deducted in the element of the formula “ $- ((CSS + CUS)$ and it is an addition in the “ $- CUS)$ ” part of the formula. In other words, both equations are the same.

It follows that, although accountants are now saying that they are doing something different, they are, in fact, at least so far as stock is concerned, doing the same thing as they have always done. Since that is so, accounting methods have not changed in any material way since (as Nolan LJ said in *Gallagher v Jones*) it was decided, in *Duple Motor Bodies v Ostime*, that, in computing profits, the cost of opening stock was a deduction and the cost or lower market value of closing stock was a receipt. In *Commissioner of Inland Revenue v Secan* 74 TC 1, Lord Millett understood this. First, he distinguished between presentation and computation and so emphasised the need, not emphasised in *Mars*, to compute profits for tax purposes rather than to adjust the commercial accounts. Secondly, he recognised that the cost of stock is always deducted in full in a year, even if some of it is unsold, and that the cost or lower market value of stock unsold at the year-end is a receipt. In other words, Lord Millett, in *Secan*, adopted the traditional analysis, which was, of course, an entirely conventional and judicially approved approach. The House of Lords in *Mars* accepted (inevitably) the result of *Secan*, but criticised the reasoning, suggesting that Lord Millett was, in effect, trying to ride two diverging horses at once.

The argument of the taxpayers in *Secan* was that there was a conflict between the tax system in force, which required all expenditure on stock to be deducted in the year in which it was laid out, and the accounting system, which did not deduct expenditure on stock until the stock was sold. It was agreed on all sides (and so was not in issue) that the tax system required deductions to be made as money was laid out for stock. The result was that the actual decision in *Secan* could only be arrived at by an analysis of accounting standards which showed that the cost of unsold stock is deducted year by year, so that there was no conflict between those standards and the tax system. That was the analysis which Lord Millett very clearly used. The criticism of the reasoning in *Secan* made in *Mars* accordingly fails to recognise both that the accountants’ current description of

what they do in computing profits is, in fact, a description, in new words, of what they have always done and, also, that the reasoning in *Secan* is entirely logical and correct, once it is seen that opening and closing stock do, indeed, function, respectively, as a cost and as a receipt of the year. In so far as the decision in *Mars* is based on the assertion that the cost of unsold stock is not deducted in computing profits, it represents a departure from authority which can be criticised: as demonstrated above, there has been no change (other than one of presentation, not computation) of accounting principles which justifies the decision.

So the question which then arises is whether the decision in *Mars* can be supported on some other basis from that given by the House of Lords. The answer is that it can be for one of two reasons, one of which is unattractive and the other of which is plainly right. The first possible way of supporting the *Mars* decision is to say that the interpretation of accounting practice relating to unsold stock consistently adopted by the Courts for the last 80 or so years was wrong. The argument here is that since the cost of unsold stock comes in (as part of the expenditure of the year) and is taken out again as a receipt, the deduction and the receipt cancel each other out and are to be disregarded: on that view, the cost of unsold stock is “excluded from the computation”. That has always been a possible view of the matter. It is, however, not the view which Courts have adopted and there does not seem to be any reason why the Courts should depart from their traditional views here. Moreover, the view that the cost of unsold stock is excluded from the computation, while it may have some superficial attraction, does not seem to be an accurate representation of the way in which profit is computed. As Rowlatt J, in the quotation from him set out above, said many years ago: profit is computed by taking the receipts and deducting from them the expenditure of the year. The amount of expenditure “excluded” from the deductions of the year, because it is represented by unsold stock at the year-end, cannot be determined until the actual expenditure for the year has been determined and the closing stock has been ascertained. Thus it is not a specific identified part of the general expenditure which is excluded from the deductions but, rather, an amount of the general expenditure which happens to be represented, at year-end, by the closing stock.

There is, thus, no doubt that, even expenditure represented by unsold stock is expended in the year and then matched up with the closing stock: but expenditure on closing stock is not matched as it occurs but is only matched up with closing stock after the year-end when that stock is known to be in hand. The necessity to match a part of the general outgoings up with the value of closing stock suggests both a deduction and a receipt. Indeed, that analysis seems a more accurate representation of what the accountant is doing than an exclusion. What is happening does not truly involve an exclusion, but a taking into account of expense and value. The difference is not just semantic or a matter of the mechanics of computation. An accurate account requires all expenditure to be taken into account; and if expenditure is to be taken into account it can, at least in the first place, only be taken into account as a deduction. If some of the

expenditure is to be left out of account as not being a deduction, it can only be because something has been set against it – and the thing set against it can only be a receipt. So the end result is the exclusion of a part of the deduction; the only way of explaining the exclusion is to say that there has been a deduction and a receipt, just as every lawyer, up until *Mars*, has always thought. The first reason for supporting the *Mars* decision is, accordingly, unattractive and cannot be sustained.

The second reason for supporting it is, however, undoubtedly right. As was said long long ago, income tax is a tax on income; and corporation tax, so far as it relates to income, is also a tax on income. Accountants are now drawing accounts which mix up capital and income. That may be good accounting. It is bad law. There can be no doubt that, in making a computation of income for tax purposes, capital elements must be excluded. That means that depreciation of capital assets has to be excluded from the deductions when they are made; and it must also be excluded from the receipts, or else an element of capital will be taxed, contrary to fundamental principles of our tax law. It may, accordingly, be concluded that the result in *Mars* and in *William Grant* is correct. But the reasoning is, sadly, wrong. Whether this really matters or not remains to be seen.

¹ Modern accounting methods may now require trading stock to be brought into the computation at market value. That raises new problems of computation, especially in the light of FA 1998 s.42. But this accounting requirement is really very recent and, in this paper, the assumption is made that the relevant rule is that cost or lower market value is brought into account. Whether this is an accounting rule or a rule of law may be open to debate, but the better view is that it is a rule of law.

² In what follows, references to stock include references to work in progress.

³ Emphasis added. See also, to the same effect, *Whimster & Co v IRC* 12 TC 813 esp at 823 and 826; *Osborne v Steel Barrel Co Ltd* 24 TC 293 at 307; *Patrick v Broadstone Mills Ltd* 35 TC 44 at 68.

⁴ Emphasis added

⁵ [2004] STC (SCD) 253 at 268 §§67 to 72.