TAXATION
Published on *Taxation* (http://www.taxation.co.uk/taxation)

Is it appropriate to appropriate?

Posted: 09 July 2008
Authors: PETE MILLER [1]
Issue: Vol 162, Issue 4166 [2]
Categories: Analysis [3], Features [4], CGT [5]

Related articles:
Sharkey v Wernher: Has Time Moved On? [6]

PETE MILLER explains some of the problems that may arise with the new rules on appropriations of stock into or out of a business

KEY POINTS

- The new legislation relates only to trading stock and work in progress
- Difficulty in working out market value
- Interaction with the capital gains tax rules
- Statement of Practice A32 will no longer exist
- Keep detailed records of stock taken for personal use

One of the surprises in this year's Budget was the note (BN19) 'Trading stock', which told us about new legislation intended 'to put on a statutory basis a long established rule which has effect where goods are appropriated into or from trading stock other than by way of trade.

In such circumstances, the profits of the trade for tax purposes should be adjusted to replace the cost of the stock or the actual proceeds with their market value'. The draft legislation is in clause 34 and Sch 15 to the Finance Bill.

Keith Gordon has already explained the background and expressed his fervent hope that the measure would not be enacted (see The Sharkey bites back [7]).

In this article I will cover the passage of the legislation through Parliament and explain the detail of the new rules. We will then look at some of the problems that may arise in practice, due to the way the new rules have been enacted.

Sharkey v Wernher

The 'long established rule' mentioned in BN19 is the rule that arose from the 1955 decision in *Sharkey v Wernher* 36 TC 275. This case, and whether it remains good law, has been discussed many times, including in this journal (see *Sharkey v Wernher*: Has Time Moved On? [8] by Simon Sweetman, and Sharkey Revisited [9] by Keith Gordon).

In brief, Lady Zia Wernher had a stud farm that was taxed as a trade and a horse-racing activity that was treated as a hobby. When she transferred some horses from the stud farm business to the horse-racing hobby, the House of Lords held that she should bring into her accounts the amount that those horses would have been sold for on the open market, had she sold them as the stock in trade of the stud farm.

The legislation

What does the new legislation actually say? Put simply, it says that any appropriations of assets into trading stock or vice versa, or any disposals or acquisitions of trading stock 'otherwise than in the course of trade' are to be brought into account at the price it 'would have realised if sold in the open market at the time' of the transaction. If transactions 'otherwise than in the course of trade' are subject to transfer pricing legislation, the latter takes priority.

Trading stock is defined as anything 'which is sold in the ordinary course of trade, or which would be so sold if it were mature or its manufacture, preparation or construction were complete'. It includes 'all land or other property'. Specifically excluded are:

- materials used in the manufacture, preparation or construction of any such thing,
- any services performed in the ordinary course of the trade, or
- any article produced, or any material used, in the performance of any such services.

So the new rules apply only to the disposition of trading stock and work in progress and not to the provision of services or to the disposition or raw materials or consumables.

For income tax, these provisions are inserted as ITTOIA 2005, ss 172A to 172E. For corporation tax, they appear to be left as FA 2008, Sch 15 but will presumably be incorporated into the corporation tax rewrite.

It is clear that the intention is to ensure that non-trading transactions involving trading stock are to be treated as occurring at market value, whatever price (if any) is actually paid.

Why now?

The reason we were given in BN19 for enacting this decision more than 50 years after the decision in *Sharkey v Wernher* is the doubt caused by FA 1998, s 42.

This tells us that the starting point for determining business profits is the accounts figure, subject to 'any adjustment required or authorised by law in computing profits for those purposes' (s 42(1)).

But it was not clear whether the judicial decision in *Sharkey v Wernher* amounted to an 'adjustment required or authorised by law'. So the new legislation is intended to put the matter beyond doubt.

One of the points raised in Keith Gordon's recent article was why this measure had been brought forward now, after it had been rejected for inclusion in the rewrite project when ITTOIA was enacted. In the debate on Sch 15, the minister, Kitty Ussher, explained:

> 'The hon gentleman [Mark Hoban, MP for Fareham] asked why we abandoned our plans to legislate on the market value principle as part of the tax law rewrite project in 2000. We intended to do so, but some respondents felt that as the rule was not previously contained in law, to include it in a law rewrite was inappropriate. That is a

> grey area, but we thought it best to err on the side of caution, so the relevant provisions are excluded from the tax law rewrite bill. However, including such a thing in the Finance Bill enables us to debate the matter properly and get the issues on record. I hope that we have achieved that.'

Other observers have suggested that the decision in *HMRC v William Grant/Small v Mars UK Ltd* [2007] STC 680 was another driver for these new rules. In those joined cases, the House of Lords reasserted the primacy of correct accounts as the starting point for determining taxable profits.

Furthermore, correct accounts did not require appropriations into or out of trading stock to be dealt with at market value.

Unfortunately, as we shall see, a proper debate was not really achieved and the legislation as enacted leaves plenty to argue about in the future.

Restriction to trading stock

The first question is why the provision is restricted only to trading stock and work in progress. Sharkey v Wernher concerned trading stock, as we have seen.

But in the context of a manufacturing trade, it is hard to see why raw materials acquired for the purposes of the trade should not be treated in the same way.

So, if a chocolatier buys sugar for use in making chocolates, and takes a couple of bags of sugar home for personal use, why is that to be treated differently from the situation where he takes home a batch of chocolate for his wife?

The sugar is clearly a raw material and excluded from the definition of trading stock, it being material used in the manufacture or preparation of trading stock.

But the chocolates are trading stock by virtue of being the goods that a chocolatier sells in the normal course of his trade, so their expropriation from stock would require an adjustment under this new legislation. Certainly, this was the view taken when I was training as an inspector: raw materials were treated as trading stock in this context.

By analogy with *Sharkey v Wernher*, this would be as if the adjustment is made if mature horses are taken into the racing stables but not if the transfer is of immature foals which are too young to race.

What is market value?

This problem area has been discussed in previous articles. But it is worth highlighting again. In a Readers' Forum reply (Variable value [10]), a restaurateur asked about adjustments in respect of a bottle of wine taken from stock to drink at home.

HMRC were apparently contending that the market value adjustment should be on the basis of the list price on the wine list. Keith Gordon agreed that a better answer would be the retail price at a supermarket or local wine store (that is, if *Sharkey v Wernher* was still good law in the first place).

In other words, market value can only be applied to the item concerned and not to the wider context of the trade carried on in these circumstances.

To use the words of the new legislation, one would expect the open market to be one where you buy wine per se, not a market restricted to restaurant wine lists.

In his latest article, Keith Gordon refers to a shopkeeper who sells fresh bread. If he takes an unsold loaf out of the shop at the end of the day, what is the market value?

It might be the price he gave it first thing that morning, and one might expect the average HMRC officer to contend for that price. It might be the discounted price for which the loaf could be sold towards the end of the day. Or it might be nothing, if the unsold bread was normally just thrown away.

This point would apply to all perishable goods and my early experience was that many small traders would take old stock home for personal use rather than throw it away. On that basis, there should be no tax adjustment under either Sharkey v Wernher or the new legislation.

So far, we have not seen any HMRC guidance on how the issues of market value will be resolved. Many of us see this as an area ripe for major disputes in the future.

In this context, I am reminded that the new approach heralded by the Varney Report is that all new legislation is to be accompanied by detailed guidance from HMRC. I look forward to seeing the guidance for these rules.

Trade discontinuing

I have previously expressed some concern about the interaction between this new legislation and the provisions for the disposal of trading stock on cessation of trade. I think, on reflection, my concerns may be unfounded.

Although the interaction is not made explicit in the legislation, TA 1988, s 100 and ITA 2007, s 173 are both headed 'Valuation of trading stock at discontinuance'.

Similarly, by an amendment in this year's Finance Bill, Chapter 12 of ITA is entitled 'Trade profits: valuation of stock and work in progress on cessation of trade'.

Although the titles and headers are not strictly part of the legislation, it is nevertheless reasonable to infer that the intention of Parliament is for the new rules to apply to a continuing trade and for the existing rules to apply for valuation on cessation, unaffected by the new provisions.

Even if the legislation is not explicit, it seems likely that the courts would interpret the interactions this way.

Capital gains issues

TCGA 1992, s 161(1) provides that an appropriation of a capital asset into trading stock crystallises the chargeable gain, as if the asset had been disposed of on the open market at that time.

Section 161(3), however, allows an election whereby no gain arises under s 161(1) and the asset becomes trading stock at market value less the accrued gain (which effectively brings the asset into stock at cost plus indexation).

Section 173 extends the rule for groups of companies, to allow a transferee trading company to elect that a capital asset transferred from another group company be brought into trading stock at market value less the accrued gain.

The new provisions do not mention these capital gains rules at all. When amendments were proposed, to ensure that s 161(3) elections would take priority, Kitty Ussher said:

> 'The amendments seek to clarify how the market value rules introduced by clause 34 and Sch 15 intend to interact with similar rules for capital gains tax. They appear to be based on a concern that the legislation will override and affect the capital gains rules set out in TCGA 1992, ss 161 and 173. I am sure that the hon gentleman will be relieved to know that that concern is unfounded. The schedule will have absolutely no impact on the operation of the capital gains legislation, and ss 161 and 173… will continue to apply in the same way as they do currently. Had our intention been to override those sections…, we would have explicitly amended or repealed them. We have not done so because that is not our intention.'

This is all very well as a clear statement of intent (or of non-intent), but is it sufficient? On the one hand we have the new legislation telling a trader that the appropriation of assets into stock must be treated as having been acquired at market value, for tax purposes.

On the other hand, we have a rule that says the value to be brought into the trading accounts is market value less the chargeable gain on the asset.

In addition, we have a clear statement from the sponsoring minister that the new rules are absolutely not intended to have any impact on the capital gains rules.

Consider what might happen in practice.

An antiques dealer has a desk that he bought some years ago for £1,000. It is now worth £2,500 and he wants to sell it in his shop. As the trader is an individual, no indexation is due, so the inherent gain is £1,500. If he makes a s 161(3) election, the effect is to override s 161(1), so that there is no capital gain. The market value of the desk for the purposes of computing trading profits is reduced to £1,000.

But ITTOIA 2005, new s 172C tells us that the asset must come into trading stock at market value on the date of appropriation, i.e. £2,500. If we take this as a given, and the trader sells the desk for market value, then the trading profit is nil and the capital gain has also fallen out of account.

One might suggest that TCGA 1992, s 161(3) should override ITTOIA 2005, new s 172C (or its corporation tax equivalent), but s 161(3) is arguably not an income tax provision and, in any case, income tax provisions usually have precedence over capital gains provisions.

Broad view

Statement of Practice A32 was also mentioned in both Keith Gordon's 1 May 2008 article and in the parliamentary debate. It specifically states that inspectors should 'take a reasonably broad view' of the *Sharkey v Wernher* principle. Also, the principle is stated not to apply in three specific circumstances:

> a) 'services rendered to the trader personally or to his household …
> b) 'the value of meals provided for the proprietors of hotels, boarding houses, restaurants, etc. and members of their families …
> c) 'expenditure incurred by a trader on the construction of an asset which is to be used as a fixed asset in the trade.'

At least one and maybe two of these are potentially caught by the new legislation. In the context of the new rules, (a) is clearly outside the scope as services are excluded from the scope; (c) which might apply, for example, where a construction trader builds his own office block, might not be caught if one takes the view that a self-built asset does not constitute an appropriation from stock.

But (b) looks like it will be clearly caught by the new legislation. In any case, the explicit nature of the new provisions are such that it may be difficult for HMRC officers to 'take a reasonably broad view', as no discretion is apparently permitted.

In debate, Kitty Ussher confirmed that the statement of practice would no longer be needed and would be removed once the new rules were in place. But she also said:

> 'The Statement of Practice A32, as it is properly called, is part of HMRC's published guidance. That sets out how HMRC applies the market value rule in *Sharkey v Wernher* in practice. Once the rule is legislated in the Bill, as we propose to do today, there will be no need for a separate statement of practice, but there will be no practical effect on businesses, which will continue to operate the rule in the same way as they have always done.'

Does this help? Most commentators seem to believe that the statement of practice is a form of extra-statutory concession, 'the guidance softened or provided exemptions to the status quo' (from the Commons debate). If this is so, then its loss leaves businesses exposed to tax charges that they would not have previously suffered.

If the minister is correct, the statement of practice is HMRC's view of the extent of the *Sharkey v Wernher* principle, so that the enactment of that principle should not lead to any change in interpretation or of HMRC practice.

Only time will tell, but many of us suspect that the new legislation will be applied in ways that *Sharkey v Wernher* never was.

Practical measures

Keith Gordon (in his 2003 article) postulated a trader who buys 101 articles at the cash and carry, 100 for the shop and one for personal use. As a trainee inspector, this was one of the scenarios I was taught to challenge under *Sharkey v Wernher* principles. Sometimes it might just be simpler to separate business and personal purchases, even if all that means is to pay for them separately.

In terms of record keeping, I suggest that it is important only to put the business stock through the books. This might require a note saying that the invoice relates to 101 items, of which 100 are for the business, so that the actual financial book entry only refers to the 100 items of stock.

If the entire invoice is entered, with a reversal for the single item for personal use, an over-zealous inspector might contend that the book entry put all 101 items into stock and that the reversal was an appropriation for personal use.

In many cases stock is indeed taken from the business for personal use, so it is important to keep detailed records of what was taken and what the selling price was. As an inspector, I found that most small traders would happily admit to taking stock but usually they had no idea how much.

If you keep a comprehensive record of what you take, it will be much easier to make any adjustments required and much harder for HMRC to impeach the records of the business in this respect. If stock that is reaching its sell by date is taken, record that too, along with any records you might have of the selling price of that stock over its last few days on the shelf.

That way, you might be able to avoid a tax adjustment completely or even claim a loss on the basis that the selling price of old stock would have been less than cost.

This is an area where some HMRC guidance would be helpful. But it is also the area where traders can, with careful record keeping, help themselves to avoid problems with HMRC.

Complicating matters

What ever else it does, this new legislation is likely to make the operation of the UK's tax code that bit more difficult. Apart from the unanswered questions raised in this article, I suspect that more issues will come to light as people start to operate the new regime.

The sad thing is that it could all have been avoided so easily by proper consultation. Time and again we have said we will engage with HMRC and the Treasury to help draw up new legislation. Frequently this happens. But all too often there is inadequate or no consultation, as here, and the result is confusion.

I hope that the minister was right, when she said that the new legislation 'is simply a translation from guidance into legislation'. Will HMRC follow her lead?

Pete Miller is national tax technical director with Tenon and can be contacted by telephone on 0116 249 5190; or email pete.miller@tenongroup.com [11].

For more *Taxation*, visit our blog [12]

Sections - corporation tax

Share this page [13]

Halsbury House, 35 Chancery Lane, London WC2A 1EL
Customer Services 0845 370 1234

Source URL: http://www.taxation.co.uk/taxation/articles/2008/07/09/5631/it-appropriate-appropriate

Links:
[1] http://www.taxation.co.uk/taxation/articlesbyauthor/PETE%2BMILLER
[2] http://www.taxation.co.uk/taxation/issuearticles
[3] http://www.taxation.co.uk/taxation/category/content-type/features/analysis
[4] http://www.taxation.co.uk/taxation/category/content-type/features
[5] http://www.taxation.co.uk/taxation/category/taxation-financial/taxation/cgt
[6] http://www.taxation.co.uk/taxation/articles/2001/10/04/1360/sharkey-v-wernher-has-time-moved
[7] http://www.taxation.co.uk/Articles/2008/04/30/53111/The+Sharkey+bites+back.htm
[8] http://www.taxation.co.uk/Articles/2001/10/04/7867/Sharkey+v+Wernher+Has+Time+Moved+On.htm
[9] http://www.taxation.co.uk/Articles/2003/07/24/30886/Sharkey+Revisited.htm
[10] http://www.taxation.co.uk/Articles/2006/11/02/51255/Variable+value.htm
[11] mailto:pete.miller@tenongroup.com
[12] http://taxation-magazine.blogspot.com/

[13] http://www.taxation.co.uk/taxation/forward?path=node/5631