FINAL DETERMINATION - adjustment for cumulative depreciation - reduction by excess of debtors over creditors - amount of reduction of assessment determined - TMA 1970 s50(6)(a)

THE SPECIAL COMMISSIONERS

ANTONY PETER SILK

Appellant

- and -

MARTIN GRAHAM FLETCHER

(HM INSPECTOR OF TAXES)

Respondent

SPECIAL COMMISSIONER : DR A N BRICE

Sitting in London on 9 August 2000

Mr Howard Marshall Withers for the Appellant

The Respondent in person

FINAL DETERMINATION

The application

1. On 10 January 2000 Mr Antony Peter Silk (the Appellant) applied for a further hearing to determine the amount of the reduction of his self-assessment.

The facts relevant to the determination

The appeal

2. In his self-assessment return for the year ending on 5 April 1997 the Appellant claimed to deduct the sum of £59,429.00 in respect of finance charges. This was made up as:

1996 1995

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Bank charges £ 3,156.00 -

Bank interest £ 1,690.00 £ 9,297.00

Bank loan interest £ 3,196.00 £ 2,942.00

Frizell loan interest £17,961.00 £17,161.00

HP interest £ 755.00 £ 1,533.00

VAT interest etc £ 667,00 -

Leasing costs - £ 1,071.00

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£27,425.00 £32,004.00

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3. This claim was disallowed by the Respondent who wrote to the Appellant on 5 January 1999 and said that loans and overdrawn bank accounts at the balance sheet date totalled £218,268.00 of which £145,932.00 related to overdrawn capital account. This represented 66.8% of the loans. If 66.8% of the amount claimed for finance charges were disallowed the amount disallowed would be £39,698.00 which for one year (365/731) was £19,821.00. There was another disallowance of £351 which brought the total amount disallowed to £20,172.00.

4. It was against that amendment to the self assessment that the Appellant appealed.

The hearing of the appeal

5. The appeal was heard by the Special Commissioners on 7 June 1999 and the Decision was released on 30 June 1999. It is reported at [1999] STC (SCD) 220.

6. The issues in the appeal concerned the amount of interest deductible by the Appellant in computing the amount of his professional profits. In the appeal the Respondent argued that the capital account of the Appellant's business was substantially overdrawn and that, for many years, the Appellant's drawings from the business had exceeded the amount of the profits. That led to the conclusion that some of the Appellant's business loans were being used to fund the private expenditure of the Appellant from which it followed that some of the interest on those loans was not an allowable deduction as a result of section 74(1)(a) or (b) of the Income and Corporation Taxes Act 1988.

7. Specifically, the issues for determination in the appeal were:

(1) whether all the interest was deductible if the Appellant’s capital account were not overdrawn;

(2) whether the Appellant’s capital account should be adjusted by the addition of the sum of £107,319.00 which the Appellant claimed was the amount of the consideration which he had given for goodwill; and

(3) whether the Appellant’s capital account should be adjusted by the adding back of the amount of £55,276.00 in respect of cumulative depreciation (as argued by the Appellant) or whether that amount should be reduced by the excess of debtors over creditors (as argued by the Respondent).

The Decision

8. The decisions on the first two issues were:

(1) that, even if the Appellant’s capital account were not overdrawn, it did not necessarily follow that all the interest was deductible; it was still necessary to ask how much of the interest was expended for business purposes; and

(2) that the Appellant’s capital account should not be adjusted by the addition of the sum of £107,319.00 which was the amount which he claimed he had given as consideration for goodwill.

9. The reasons for the decision on the third issue were contained in paragraphs 58 to 62 of the Decision which read:

"58. The third issue in the appeal is whether the Appellant’s capital account should be adjusted by the adding back of the amount of £55,276.00 in respect of cumulative depreciation (as argued by the Appellant) or whether that amount should be reduced by the excess of debtors over creditors (as argued by the Respondent).

59. The Appellant argued that depreciation was a downward revaluation of assets and not a realised loss. He argued that his capital account should be adjusted by adding back the amount of cumulative depreciation from 1 January 1989 to 31 December 1996. At the hearing he accepted that the cumulative amount was £55,276.00.

60. The Respondent accepted that an adjustment might be made for cumulative depreciation but argued that it was just as relevant to consider the position of debtors and creditors. He accepted that one way of deciding how much of the interest on the loans had been paid for non-business purposes was to look at each withdrawal from the bank and determine how it was applied. That would be an accurate but a time-consuming approach. He agreed that the

method he had used had been simplistic, in that initially he had taken the proportion which the total loans bore to the overdrawn capital account and had disallowed that proportion of interest. Although he was prepared to add back an amount for cumulative depreciation there should also be a reduction for the excess of debtors over creditors. The reason was that if money had been earned but not received then it was not available for drawings: if drawings were made then they had to be borrowed and the interest on such borrowings was for a private purpose. Conversely, if drawings were funded by creditors then no interest was incurred and no adjustment was required. He therefore argued that the capital account should be adjusted not only for depreciation but also by the excess of debtors over creditors.

61 Again, these arguments have to be considered within the context of section 74(1) and the question to be asked is: how much of the loans were used for private purposes? It is clear that some of them were and the only question is determining the amount. The Respondent accepted that any method, other than analysing each withdrawal, would be simplistic but in my view the method proposed by the Respondent is likely to give a more accurate answer than that proposed by the Appellant.

62 The conclusion on the third issue is, therefore, that the Appellant's capital account should be increased by the amount of £55,276.00 for cumulative depreciation but also reduced by the excess of debtors over creditors."

10 The Decision (paragraph 63(3)) decided that the Appellant's capital account should be adjusted by the amount of £55,276.00 in respect of cumulative depreciation but that that amount should be reduced by the excess of debtors over creditors. The Decision directed (paragraph 64) that the amendment of self-assessment should be further amended to give an adjustment for cumulative depreciation reduced by the excess of debtors over creditors; the figures should be agreed by the parties but, in the absence of agreement, either party had liberty to apply.

11. For the sake of clarity I here record that the Decision meant that the following calculation had to be made:

Capital account

Add cumulative depreciation

Deduct (debtors less creditors)

The areas of agreement

12. The parties agreed the following figures:

Capital account: £145,932.00 DR

Accumulated depreciation: £ 55,276.00

Debtors £ 50,681.00

Creditors

As in accounts £20,295

PAYE and VAT £26,114

[Other amounts for creditors were disputed]

The areas of dispute

13. The dispute about the figures centred around three areas, namely:

(1) the meaning of "creditors" and the amount of creditors;

(2) whether the final adjustment to the calculation should be the deduction of the excess of creditors over debtors rather than debtors over creditors; and

(3) the amount of interest to be used in the final calculation.

Reasons for determination

14. I consider separately each of the areas of dispute.

(1) The meaning of "creditors"

15. The first area of dispute concerned the meaning of "creditors" and the amount of creditors.

16. For the Appellant Mr Withers first argued that the figure for creditors should be £67,351.00 made up as:

As in accounts £20,295.00

VAT and PAYE £26,114.00

Loan repayments due within 12 months

National Westminster £ 2,942.00

Frizell £18,000.00

£20,942.00 £20,942.00

£67,351.00

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17. Mr Withers drew attention to parts of Chapter 17 of a Manual of Auditing published by Messrs Coopers & Lybrand. Paragraph 61 referred to Schedule 1 to the Companies Act 1981 which required the amount of taxation and social security to be shown separately from the amount of other creditors. Mr Withers also referred to paragraph 48 of Schedule 4 of the Companies Act 1985. He argued that the amount for creditors should be increased by capital repayments on long term loans. The Respondent agreed that the amount of creditors should be increased by the amounts of PAYE and VAT.

18. As far as the repayments on the long term loans are concerned I have referred to Schedule 4 of the Companies Act 1985 which contains the provisions about the form and content of company accounts. Part III (paragraphs 35 to 58) contains provisions about the Notes to the Accounts. Paragraph 48 states the requirements in respect of each amount of "creditors" in the company’s balance sheet and paragraph 48(1) provides that there shall be stated in the notes to the accounts the aggregate amount of debts which fall due for payment after the end of five years. However, the Companies Act refers to companies and the Appellant is in business on his own account and so I have not found the provisions of paragraph 48 to be directly relevant in this determination.

19. In reaching a decision I have borne in mind that the question to be answered in the appeal (and in this determination) is how much of the loans were used for private purposes? Any method other than analysing each withdrawal will be to some extent inaccurate but an attempt has to be made. The long term loans referred to by the Appellant formed part of his overdrawn capital account and it is the interest on the loans which is to be disallowed. I can see no authority for treating repayments of the loans as creditors in this calculation.

20. Secondly, Mr Withers argued that the amount of creditors should be increased by the sum of £103,356.00 which was the Appellant’s valuation of his goodwill. He referred to Inland Revenue Statement of Practice IR131 and to Statement D - Statements relating to tax on Capital Gains. Paragraph D12 concerned partnerships and paragraph D12.3 described the procedure where partnership assets were divided in kind among the

partners. He argued that the asset of goodwill had crystallised when acquired by the Appellant. Even if an amount for goodwill did not appear on the balance sheet, and was not an asset, it was an amount which the business owed to the Appellant.

21. In paragraph 54 of the Decision the finding was made that none of the loans upon which interest was paid was used to acquire goodwill. The purpose of the present calculation is to decide how much of the loans were used to fund drawings. The underlying reality is that no sum was in fact paid by the Appellant for goodwill. Further, the Statement of Practice relates only to capital gains tax and not to income tax and so is not of direct relevance in this determination. In my view in the calculation the subject of this determination the amount of creditors should not be increased by any figure for goodwill.

22 I conclude that the amount for creditors in the final calculation should be:

As in the accounts £20,295.00

VAT and PAYE £26,114.00

£46,409.00

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(2) The nature of the final adjustment

23 The second area of dispute was whether the final adjustment to the calculation should be the deduction of the excess of creditors over debtors rather than debtors over creditors.

24. For the Appellant Mr Withers argued that it was the excess of creditors over debtors which should be used in the calculation. In 1989 the Appellant had purchased debtors and loans had been raised for that purpose. Accordingly, the borrowings to finance those debtors had given rise to a balance sheet asset. Debtors were part and parcel of the working capital of the practice. The Respondent argued that debtors were in fact clients who had not yet paid their fees. The fees were therefore not yet available to be withdrawn from the business.

25. At this hearing all I can do is to determine figures in the light of the original Decision. That Decision was quite clear and required the deduction of the excess of the debtors over the creditors. I cannot re-open that Decision at this stage but, even if I were able to do so, the Appellant has not persuaded me that I should. In paragraph 61 of the

Decision I adopted the arguments of the Respondent as set out in paragraph 60 and I have not changed my view.

(3) The amount of the interest

26. The third area of dispute concerned the amount of interest to be used in the final calculation. In his self-assessment return the Appellant claimed to deduct the sum of £59,429.00 as summarised in paragraph 2 above. The Respondent had disallowed 66.8% of that amount.

27 The Appellant argued that, in disallowing the finance charges in the original amendment of the self-assessment, the Respondent should not have included bank charges, HP interest etc but should only have included the amount of interest claimed which should have been £45,827.00 made up as:

1996 1995

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Bank interest £ 1,690.00 £ 2,877.00

Bank Loan interest £ 3,196.00 £ 2,942.00

Frizell Loan interest £17,961.00 £17,161.00

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£22,847.00 £22,980.00

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28. The original figures were not disputed at the hearing of the appeal and so it is now too late to seek to introduce an additional issue for argument. However, even if this new issue could have been introduced at this stage I would not have allowed the amendment proposed. To the extent that they funded private drawings rather than business credit, the bank charges and other amounts should be treated in the same way as the interest.

29. However, I note from the Respondent's calculations for the purposes of this hearing that he had reduced the total charges from £59,429.00 to £55,403.00. As this reduction was agreed by the Respondent I am prepared to accept it.

Determination of figures

30. I determine the figures in dispute as:

Capital account £145,932.00 DR

Add cumulative depreciation £ 55,276.00

Balance £ 90,656.00 DR

Deduct

Debtors £50,681.00

Less Creditors £46,409.00

£ 4,272.00 £ 94,928.00 DR

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31. The net amount overdrawn was therefore £94,928.00. Taking the other figures from paragraph 23 of the Decision, and the amount of finance charges as £55,403.00 as mentioned in paragraph 29 above, the adjustment is therefore:

94928/218268 x 55403 = £24,095.59

32. The disallowance for the 1997 return is 365/731 = £12,031.31. There is another disallowance of £351 which brings the total disallowed to £12,382.31.

33. Accordingly the total amount disallowed should be reduced from £20,172.00 to £12,382.31.

DR A N BRICE

SPECIAL COMMISSIONER

Date of Release: 18th October 2000

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