

INCOME TAX - Schedule D – change to current year basis - transitional provisions - change of accounting period - amount of overlap profit - calculation of the amount of the profits of the basis period for the year 1997-98 which arose after the end of the basis period for 1996-97 and before 6 April 1997 - basis period for 1997-98 agreed to consist of the twenty-three months from 1 May 1996 to 31 March 1998 - dispute about the method of calculation of the profits arising before 6 April 1997 - whether this should be time-apportioned over the full twenty-three months as argued by the Appellant - no - whether this should be time-apportioned over the twelve-month period of the accounts from 1 May 1996 to 30 April 1997 as argued by the Inland Revenue - yes – appeal dismissed - TA 1988 s63A; FA 1994 Sch 20 para 2(4) Catchwords: use right arrow to move to starting point after this box

## **THE SPECIAL COMMISSIONERS**

**A M LYONS Appellant**

**- and -**

**A J KELLY**

**(H M INSPECTOR OF TAXES)**

**Respondent**

SPECIAL COMMISSIONER : DR NUALA BRICE

Sitting in public in London on 24 July 2002

Andrew Hithchmough of Counsel, instructed by Messrs Baker Tilly Chartered Accountants, for the Appellant

The Respondent in person

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## **DECISION**

### **The appeal**

1. Mr A M Lyons (the Appellant) appeals against a decision of the Respondent dated 25 July 2001. The decision amended the Appellant's 1997/98 return by decreasing the amount of transitional relief. The transitional relief claimed by the Appellant was £710,523 with £10,605 carried forward. The Respondent was of the view that the correct figure of transitional relief should be £626,986 with £9,358 carried forward.

### **The legislation**

2. Schedule 20 of the Finance Act 1994 (the 1994 Act) contains the transitional provisions relating to the changes for facilitating self-assessment. Paragraphs 1, 2 and 3 of Schedule 20 contain provisions about assessment under Cases I and II of Schedule D. The relevant parts of paragraph 2 provide:

**"2(1) Subject to paragraph 3(2) and (4) below, this paragraph applies in the case of a trade, profession or vocation set up and commenced before 6th April 1994 and continuing after 5th April 1997.**

**(4) Section 63A of the Taxes Act 1988 shall have effect as if the amount of the profits or gains of the basis period for the year 1997-98 which arise after the end of-**

**(a) the basis period for the year 1996-97; or**

**(b) in the case of a trade or profession carried on in partnership with other persons, the basis period for the partnership for that year;**

**and (in either case) before 6 April 1997 were an overlap profit for the purposes of that section."**

### **The issue**

3. The issue in the appeal concerned the method of time apportionment to be adopted in calculating, for the purposes of paragraph 2(4), the amount of profits of the basis period for the year 1997-98 which arose before 6 April 1997.

4. It was agreed that the amount of profits for the basis period for the year 1997-98 consisted of the profits in the accounts prepared for the period from 1 May 1996 to 30 April 1997 and also, following a change in accounting date, of the profits in the accounts prepared for the eleven month period from 1 May 1997 to 31 March 1998. It was also agreed that there were 340 days from 30 April 1996 to 5 April 1997; 365 days from 1 May 1996 to 30 April 1997; and 700 days from 1 May 1996 to 31 March 1998.

5. The Appellant argued that, in calculating the amount of profits which arose before 6 April 1997, it was necessary to time-apportion the profits for the full twenty-three month period from 1 May 1996 to 31 March 1998 so that the fraction was 340/700 applied to the profits for the twenty-three month period. The Inland Revenue argued that, as accounts were available for the twelve months ending on 30 April 1997, it was that period which should be time-apportioned so that the fraction was 340/365 but applied to the profits for the twelve months ending on 30 April 1997.

6. Thus the issue for determination in the appeal was whether, in calculating the amount of profits which arose before 6 April 1997, the time apportionment was of the twenty-three months, the resulting fraction to be applied to the profits of the twenty-three months (as argued by the Appellant) or of the twelve months, the resulting fraction to be applied to the profits of the twelve months (as argued by the Inland Revenue).

### **The facts**

7. The following facts were agreed

8. The Appellant is an architect and a partner in the firm of Messrs Lyons, Sleeman & Hoare (the partnership) which carries on business at an address in Hook, Hampshire. The partnership has seven partners of which the Appellant is one.

9. The partnership prepared accounts for the period of twelve months from 1 May 1995 to 30 April 1996 and also for the period of twelve months from 1 May 1996 to 30 April 1997.

10. The partnership then changed its accounting date to 31 March and so the next set of accounts were prepared for the eleven month period from 1 May 1997 to 31 March 1998.

11. Thus both sets of accounts ended in the year ending on 5 April 1998.

12. Profits and capital allowances were agreed to be:

*12 months to 30 April 1997*

Profits £1,661,189

Capital allowances £47,982

Profits for allocation £1,613,207

*11 months to 31 March 1998*

Profits £1,953,475

Capital allowances £51,154

Profits for allocation £1,902,321

13. It was agreed that the basis period for the year of assessment 1997/98 was the 23 month period from 1 May 1996 to 31 March 1998. Accordingly, the partnership profits to be allocated between the partners for the year of assessment 1997/98 were £3,515,528. The total amount of the profits before capital allowances was £3,614,664.

14. The Appellant's share of the partnership profits for 1997/98 was £1,446,908.

15. Each of the partners is entitled to transitional relief under paragraph 2(4) of Schedule 20 of the Finance Act 1994.

16. There is an open appeal from each partner relating to the amount of the transitional relief available to him for 1997/98 and to carry forward thereafter. I was informed that the outcome of this appeal would determine the appeals of the other partners.

17. In October 1998 the Inland Revenue published a Revenue Interpretation (IR 193) on the use of apportionment in the calculation of transitional overlap profit.

### **The arguments of the Appellant**

18. It was the Appellant's case that the period which should be apportioned was the full twenty-three months from 1 May 1996 to 31 March 1998 and that the profits which should be apportioned were the profits for those twenty-three months. For the Appellant Mr Hitchmough argued that this method of apportionment was in accordance with the scheme of the legislation. Paragraph 2(4) of Schedule 20 was dealing with the amount of profits or gains of the basis period for 1997/98 and so it was that basis period which should be time apportioned and the resulting fraction applied to the profits of that twenty-three month period. He also argued that the whole of paragraph 2(4) (including paragraph 2(4)(a)) referred to basis periods and not to accounting periods and so it was the basis period which should be apportioned.

19. At the hearing an example was produced showing that, if the Appellant's argument were adopted, then the relief would be calculated as  $340/700 \times \text{£}3,614,664$  where: the 340 was the number of days from the end of the basis period for 1996/97 (namely 30 April 1996) to 5 April 1997; the 700 was the number of days in the agreed basis period for 1997/98 included in the two sets of accounts running from 1 May 1996 to 30 April 1997 and from 1 May 1997 to 31 March 1998; and  $\text{£}3,614,664$  was the aggregated agreed profits for the accounting periods of twelve months to 30 April 1997 and eleven months to 31 March 1998. The results of the Appellant's calculation would be that the amount of  $\text{£}1,755,693$  would be allocated among the partners. The Appellant's relief would be  $\text{£}711,982$  for 1997/98 with  $\text{£}10,627$  to be carried forward. [These figures are slightly different from those in the decision letter but no point was taken on the difference at the hearing.]

### **The arguments of the Respondent**

20. It was the Respondent's case that the period which should be apportioned was the twelve months ending on 30 April 1997 and that the profits which should be apportioned were the profits for those twelve months. The Respondent argued that an apportionment of the profits of the twelve months ending on 30 April 1997 would give the best estimate of the profits which arose before 6 April 1997. She cited *Marshall Hus & Partners Limited v Bolton* (1980) 55 TC 539 at 549 and argued that her method produced a more accurate and fair method of apportionment, and was closer to the true profit for the period, especially as the second part of the Appellant's twenty-three month period did not begin until after 6 April 1997. It was also relevant that the Appellant's calculation of profits for the 340 days to 6 April 1997 ( $\text{£}1,755,693$ ) was higher than the actual profits for the 365 days to 30 April 1997 ( $\text{£}1,661,189$ ). The Respondent also argued that her method was in accordance with the statutory provisions as the object of the change from the preceding year basis of assessment to the current year basis was to ensure that tax was paid on actual profits. As a result of the changes, the basis period for 1997/98 was the twenty-three months from 1 May 1996 to 31 March 1998 and paragraph 2(4) of Schedule 20 was designed to reduce the amount of those profits to an amount for twelve months. The Respondent also argued that the method she proposed was in accordance with section 72 of the Income and Corporation Taxes Act 1988 (the 1988 Act) which referred to "any period for which the accounts have been made up". Finally, the Respondent argued that, if profits remained even over time, then the Appellant's method of apportionment and her own would give the same result. However, where, as in this appeal, profits were rising (from  $\text{£}1,661,189$  for the twelve months ending on 30 April 1997 to  $\text{£}1,953,475$  for the eleven months ending on 31 March 1998) the Appellant's method would always give a higher figure for the relief and where profits were falling then the Appellant's method would always give a lower figure for the relief whereas her method would always give a consistent result.

21. At the hearing an example was produced showing that, if the Respondent's argument were adopted, then the relief would be calculated as  $340/365 \times \text{£}1,161,189$  where: the 340 was the number of days from the end of the basis period for 1996/97 (namely 30 April 1996) to 5 April 1997; the 365 was the number of days for which accounts were prepared from 1 May 1996 to 30 April 1997; and  $\text{£}1,661,189$  was the agreed profits for the accounting period of twelve months to 30 April 1997. The results of the Respondent's calculation would be that the amount of  $\text{£}1,547,409$  would be allocated among the partners and the Appellant's relief would be  $\text{£}627,517$  for 1997/98 with  $\text{£}9,366$  carried forward. [These figures are slightly different from those in the decision letter but no point was taken on the difference at the hearing.]

### **The arguments of the Appellant in reply**

22. In reply Mr Hitchmough argued that the purpose of paragraph 2(4) was to modify section 63A which only applied if there had been a change of accounting date with a period exceeding twelve months. Section 63A(5) referred to computations for two successive years of assessment. Section 62(2)(b) defined the basis period so that in this appeal it was twenty-three months. It was not correct to say that the application of the Appellant's formula gave a greater relief than the profit as what paragraph 2(4) did was to provide an amount of overlap profit which then became ingredient (A) in the formula in section 63A. He argued that *Marshall Hus* was not authority for the view that an apportionment had to yield the best measure of profit and relied upon the fact that there was clear authority in paragraph 2(4) for apportioning the profits of the basis period and not the profits of part of that period.

### **Reasons for decision**

23. In considering the arguments of the parties I first consider the scheme of the legislation which was relied upon by both parties

24. Section 18(1)(a) of the 1988 Act provides that tax is to be charged under Schedule D on the annual profits or gains arising or accruing from any trade, profession or vocation.

25. Chapter II of the 1988 Act (sections 60 – 69) contained the provisions about the basis of assessment for income tax and sections 60 to 63 related to Cases I and II of Schedule D. In order to facilitate the change to self-assessment, sections 60 to 63 of the 1988 Act were amended by sections 200 to 205 of the Finance Act 1994 (the 1994 Act) which inserted new sections 60, 61, 62A, 63 and 63A into the 1988 Act. The effect of these changes was to replace the preceding year basis of assessment for Cases I and II of Schedule D by the current year basis of assessment. As a result of section 218 of the 1994 Act the new provisions apply with effect from the year 1996/97 to trades, professions and vocations set up and commenced before 6 April 1994, subject to the transitional provisions in Schedule 20 of the 1994 Act.

26. Leaving the transitional provisions to one side, section 60 now provides that assessment is, in principle, on the current year basis; section 61 deals with commencements; section 62 deals with a change of basis period (including an accounting change); section 63 deals with discontinuance; and section 63A deals with overlap profits and losses. The sections relevant to this appeal are sections 60, 62, and 63A.

27. The effect of section 60 is that, under the current year basis of assessment, the period of account ending in the year of assessment normally forms the basis of assessment for that year.

28. Section 62 applies where there is a change of accounting date in a year of assessment and if the conditions in section 62A are satisfied. It was not disputed that those conditions were satisfied in this appeal. Section 62(2)(b) provides that the basis period for the year of assessment is "the relevant period" if that is a period of more than twelve months. "The relevant period" is defined as the period beginning immediately after the end of the basis period for the preceding year and ending with the new date in the new year.

29. If the relevant period is more than twelve months a formula is necessary to calculate the overlap profit available for relief and this formula is found in section 63A. Section 63A provides that, where the basis period is given by section 62(2)(b), a deduction shall be made in computing the profits of that year of an amount equal to the formula in section 63A(2). The details of the formula are not relevant in this appeal but one element in the formula (element A) consists of "the aggregate of any overlap profits". Section 63A(5) is relevant in this appeal and it provides:

**"(5) In this section-**

**"overlap profit" means an amount of profits or gains which, by virtue of sections 60 and 62, is included in the computations for two successive years of assessment; and**

**"overlap period", in relation to an overlap profit, means the number of days in the period in which the overlap profit arose. "**

30. Schedule 20 of the 1994 Act contains the transitional provisions relating to the changes for facilitating self-assessment. Paragraphs 1, 2 and 3 of Schedule 20 contain provisions about assessment under Cases I and II of Schedule D. Paragraph 2(4) amends new section 63A of the 1988 Act by providing that the amount of profits of the basis period for 1997-98 which arise after the end of the basis period for 1996/97 and before 6 April 1997 are an overlap profit for the purposes of section 63A. These overlap profits then have to be inserted in the applicable formula in section 63A(2) as part of element A, "the aggregate of the overlap profits".

31. Paragraph 4 of Schedule 20 defines "overlap profit" for the purposes of the transitional period as the amount of profits for the basis period for the year 1997-98 which arose after the end of the basis period for the year 1996/97 and before 6 April 1997. It was agreed in this appeal that the amount of the profits for the basis period for the year 1997-98 was the amount of the profits for the twenty-three month period from 1 May 1996 to 31 March 1998. In identifying the basis period for the year 1996-97 one had to look at paragraph 1(2) of Schedule 20 which defined the basis period for the year 1996-97 as:

**"(a) where the accounting date falls within the year, the period of twelve months ending with that accounting date."**

32. As the accounting date which fell within the year 1996/97 was 30 April 1996 it followed that the period from 1 May 1995 to 30 April 1996 was the basis period for 1996/97. Accordingly the entire profit for the twenty-three month period from

1 May 1996 to 31 March 1998 arose after the end of the basis period for the year 1996-97.

33. In order to arrive at the amount of these profits which arose before 6 April 1997 some apportionment is necessary. The parties agreed that time-apportionment was appropriate relying upon section 72 of the 1988 Act. The relevant parts of section 72 provide:

**"72. Apportionments, etc for purposes of Cases I, II and VI**

**(1) Where in the case of any profits or gains chargeable under Case I, I or VI of Schedule D it is necessary in order to arrive for the purposes of income tax or corporation tax at the profits or gains or losses of any year of assessment, accounting period or other period, to divide and apportion to specific periods the profits or gains or losses for any period for which the accounts have been made up, or to aggregate any such profits, gains or losses or any apportioned parts thereof, it shall be lawful to make such a division and apportionment or aggregation.**

**(2) Any apportionment under this section shall be made in proportion to the number of days in the respective periods."**

34. Put shortly, what section 72 says is that, if it is necessary in order to arrive at the profits for any period to apportion to specific periods the profits of any period for which the accounts have been made up, one has to make an apportionment by reference to the number of days in the respective periods.

35. *Marshall Hus* concerned the application of the predecessor to section 72 as applicable to corporation tax. There a trader made up accounts for the period from 1 April 1968 to 24 December 1973 and contended that, in order to arrive at his profits for each of the six accounting periods the total profits should be apportioned on a time basis. The Inspector contended that the profit or loss for each of the six accounting periods should be ascertained by reference to the relevant transactions in each of the accounting periods. Goulding J held that apportionment in that case was not "necessary" within the meaning of the section as it was possible to reach a more accurate and a fairer estimate of profit or loss by other means.

36. It was accepted in this appeal that the apportionment was necessary to arrive at the profits for the period ending on 6 April 1997 and that the apportionment should be done on a time basis. The only dispute was as to the period to be apportioned.

37. I have not found the resolution of this point to be without difficulty. The Appellant's argument, (that, as the whole purpose of paragraph 2(4) is to apportion the profits of the twenty-three month period, that is the period which should be apportioned) is very attractive. However, on balance I prefer the arguments of the Respondent for two reasons. The first is the language of section 72 which mentions the apportionment of the profits "for any period for which the accounts have been made up". The accounts have been made up for the period ending on 30 April 1997 and so it follows that that is the period which should be apportioned. I accept that accounts have also been made up for the period ending on 31 March 1998 but section 72 does not refer to "the period or periods" for which accounts have been made up; just one period. I have considered whether, in the light of *Marshall Hus*, it could be said that in this appeal one should consider only the provisions of paragraph 2(4) and undertake the apportionment

in accordance with those provisions only. However, the difficulty is that in this appeal an apportionment is "necessary" (as agreed by the parties) and the only statutory basis for the apportionment is section 72. One has therefore to apply the words of section 72.

38. The second reason for preferring the arguments of the Respondent is that it produces a consistent result and avoids anomalies. As Goulding J said in *Marshall Hus at 548H*:

"Anomaly, of course, is never a safe argument by which to decide a Revenue dispute, but I am satisfied that if the contentions of Mr Thornhill, for the Company, were accepted great inequalities might be introduced between different taxpayers otherwise in a similar position. Unjustified windfalls might accrue, sometimes to the Crown and sometimes to the taxpayer ... Those considerations, (while, as I say, not in themselves decisive in any way) encourage me to think that I am right in the conclusion I have reached on the language of the Act alone, that Parliament did not intend the result for which the Company here argues."Chairman's name: use right arrow to move to starting point

39. In this appeal, if the contentions of the Appellant were accepted, inequalities (although not perhaps very great) would result. Where profits were rising over the period to be apportioned the taxpayer would get a greater amount of relief but where profits were falling the amount of relief would be reduced. It is relevant that the rising profits would occur in this appeal after 6 April 1997 and, conversely, if profits were falling, the fall would occur after 6 April 1997. The method of apportionment proposed by the Respondent would achieve not only a consistent result but also one which bears a truer relationship to the actual profits arising before 6 April 1997 and that, in turn, is consistent with the principle underlying the current year basis of assessment.

### **Decision**

40. My decision on the issue for determination in the appeal is that, in calculating the amount of profits which arose before 6 April 1997, the time apportionment should be of the twelve months ending on 30 April 1997 and the resulting fraction should be applied to the profits of those twelve months.

41. The appeal is, therefore, dismissed.

42. This is a decision in principle. Under Regulation 18(5)(b) of the Special Commissioners (Jurisdiction and Procedure) Regulations 1994 SI 1994 No 1811 I adjourn the making of the final determination until the figures have been agreed by the parties.

**DR NUALA BRICE**

**SPECIAL COMMISSIONER**