The Personal Tax Planning Review

GREAT EXPECTATIONS: RESTRICTIONS ON THE CARRY BACK OF LOSSES UNDER SECTION 381 ICTA 1988

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Introduction

Prior to 1960 those who made losses in their trade, profession or vocation (hereafter "trading losses") could set those losses against their other income without restriction. The Revenue could only refuse a claim on the basis that the activity did not amount to a trade, profession or vocation. The Finance Act 1960 introduced the restriction now found in section 384 ICTA, blocking relief under section 380 unless the activity was being carried on "on a commercial basis and with a view to the realisation of profits". Although the Revenue had initially persuaded the Chancellor to use an objective test of "a reasonable expectation of profits", he changed his mind in the interval between the Budget and publication of the Finance Bill, preferring a subjective test of an intention to make a profit. As a result, the provisions did not strike their intended target, "hobby farmers", and this required the introduction of special restrictions in 1967 (now in section 397).

It was not until 1978, when what is now section 381 was introduced, that more severe restrictions were applied, albeit only to losses carried back under that section. The purpose of this article is to examine the nature of these restrictions and some of the problems faced when attempting to apply them in practice. In doing so, aspects of sections 384 and 397 will also be examined, particularly where they contrast with section 381.

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The General Framework

Section 381(4) debars relief "in any period unless the trade was carried on throughout that period on a commercial basis and in such a way that profits in the trade ... could reasonably be expected to be realised in that period or within a reasonable time thereafter". This identifies three prerequisites for relief. The taxpayer must show that he was:

(1) carrying on a trade;

(2) on a commercial basis; and

(3) doing so in such a way that profits could reasonably be expected in:

  (a) the period which actually produced a loss, or

  (b) in a reasonable time after that period.

These preconditions are analysed below and, as points (1) and (2) also apply to section 380, the relevant commentary is equally applicable.

Carrying on a trade

The Revenue's first line of attack against a claim for relief in respect of trading losses is to argue that there was no trade, adventure or concern in the nature of trade being carried on. This involves the application of principles derived from the well-known case law in this area to the particular facts in question, and Inspectors are instructed to apply a consistent approach irrespective of whether there is a profit or a loss.[2] Where the taxpayer claims the existence of a trade, the instructions require a critical examination if an attempt to obtain relief for a hobby, investment losses or capital expenses is suspected. Inspectors are warned to look out for cases in which the taxpayer makes an isolated profit in a particular year in order to support his assertion that he is trading since "(t)he profit may be no more than a mere flash in the pan or even a contrived event".[3]

Transactions undertaken *solely* to obtain a tax advantage are not trading transactions

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2 Inspector's Manual, paragraph 123 (b).

3 *Idem.*

even if they have the outward characteristics of trading.[4]

Difficulties may also be experienced where an asset is acquired as a capital asset, perhaps by gift or inheritance, and the taxpayer claims that, before sale, it was appropriated to trading stock. The Revenue may argue that the taxpayer never altered his intention in relation to the asset, but merely took such actions as were necessary to dispose of it in the most profitable manner - or, as the case may be, in the manner which minimises losses. The mere assertion by the taxpayer that his intention was to trade will not be conclusive. However, if, on an objective view of the facts, his acts are consistent both with realising a capital asset to its best advantage, and also with trading in that asset, the motive for the transaction would be a very material factor when weighing the total effect of all the circumstances.[5]

Commercial basis

In the Revenue's opinion, blocking loss relief on the grounds that there was no actual trading was inappropriate to deal with hobby farmers. When it was introduced in 1960, what is now section 384 added the requirement that the trade must be carried on on a commercial basis and with a view to profits. The Revenue had suggested this form of words to the Royal Commission on the Taxation of Profits and Income which adopted this test and recommended its use to restrict relief for hobby losses. However, before implementation, the Revenue shifted their stance, wanting instead to restrict relief to cases where there was a "reasonable expectation of profits". This modification was prompted by concern that Appeal Commissioners would be easily persuaded that loss-making activities were nevertheless entered into with a view to profits. However, the Chancellor preferred the safety of the tried and tested wording drawn from provisions introduced in 1915 to give relief for commercial woodlands which had posed no difficulties in its application.[6] The uncontroversial nature of these words is shown by the fact that until recently no courts had considered the expression despite its wide use in tax legislation.

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4 *Ensign Tankers (Leasing) Ltd v Stokes* 64 TC 617.

5 *Kirkham v Williams* 64 TC 253.

6 Hansard, Finance Bill Committee, 24th May 1960, The Chancellor of the Exchequer at Column 251.

The matter was considered in *Wannell v Rothwell* [7] in which Walker J, having been shown no authority in which the court considered the expression, suggested that the best guide is to view "commercial" as the antithesis of "uncommercial".

> "The distinction is between the serious trader who, whatever his shortcomings in skill, experience or capital, is seriously interested in profit, and the amateur or dilettante."[8]

He illustrated two categories of trade conducted in an uncommercial way. Firstly, where the terms of trade were uncommercial, instancing the hobby market gardening enterprise where prices do not realistically reflect overheads and variable costs. Secondly, where the trade was uncommercial in other respects, instancing the hobby art gallery or antique shop where opening hours are unpredictable, depending simply on the owner's convenience. Thus the test seems to require examination of the precise way in which the trade is carried on. This involves investigating both the activities of the taxpayer and the way in which he organises those activities. However, the question still remains - what will show that a person is a "serious trader" and has a "serious interest in profit"? *Wannell* is only marginally helpful in this respect as it did not discuss the question but merely upheld the Special Commissioner's view that the taxpayer was not even carrying on a trade. However, it does show that a lack of commercial organisation, for example, office accommodation, equipment and staff, *may* be a factor to be considered in determining whether a trade is carried on on a commercial basis. Wannell's admission of some casualness and lack of self-discipline in the manner in which he carried on his activities resulted in his failure to show that he was trading, let alone that he was doing so on a commercial basis.

As Walker J pointed out, in determining whether a trade is carried on on a commercial basis "there will ..... be many difficult borderline cases ... and such borderline cases could as well occur in Bond Street as at a car boot sale". By what criterion then are such borderline cases to be decided? This decision cannot be based on the taxpayer's own opinion as this will inevitably be in his favour. Rather, this requires an objective test to which the standards of the reasonable man are to be applied. Given that this is a commercial matter, the reasonable man would be interpreted as the ordinary competent businessman. The question is therefore whether the taxpayer has, in order to attempt to make profits, adopted a course of action which such a businessman would have adopted in those circumstances. It is important to note that there is no requirement to consider the *probability* of making

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7 [1996] STC 450.

8 *Ibid*, at 461

profits - it is sufficient if there is merely some chance of making a profit. All the facts and circumstances would have to be taken into account and, although no particular factor would be determinative, it is suggested that the following would be relevant to commerciality:

- carrying on the activity in a way which is substantially similar to the way such activities are carried on by other businesses
- the time and effort expended by the taxpayer in carrying on the activity
- the relationship between prices charged and the fixed and variable costs of the enterprise
- the use of separate business accommodation, equipment and staff
- advertising and promotion of the business
- the maintenance of complete and accurate books and records

These tests are reflected in the Inland Revenue manuals. For example, in considering historic houses, the Inspector is instructed to consider how much of the property is set aside as a showplace, the number of days it is open to the public and the amount of effort invested in the attraction and reception of visitors, such as adequate advertising and publicity, the provision of a ticket office, car parks, refreshments, guides and guide books.[9] In the case of market gardening, he is advised to test commerciality by reference to the area of land so used and the total sales as compared to the cost of labour and other expenses.[10] In the case of furnished holiday lettings, any lettings to friends or relatives at zero or nominal rents are not accepted as commercial.[11]

Profits

In order for relief to be available under section 381, there must be a reasonable expectation of profits. Although there is no direct case law on the meaning of profits

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9 Inspector's Manual, paragraph 2425.

10 *Ibid* paragraph 2871.

11 Property Income Manual, paragraph 4100.

in this context, the Special Commissioner's decision in *Brown v Richardson*[12] is persuasive on the point. In this case the taxpayer had borrowed money to buy property which he had then let out as furnished holiday lettings. As a result of interest paid, the expenses relating to the letting exceeded the income received. However, Counsel for the taxpayer contended that interest paid was not deductible in computing the profits under Case VI of Schedule D and that, if the interest payments were disregarded, the taxpayer had actually realised profits. The Crown replied that it would be contradictory to treat a project as profitable by ignoring interest when in fact it was unprofitable because of that interest, and then to take it into account in claiming relief for losses. The Special Commissioner agreed with the latter view and held that profits meant commercial profits as distinct from taxable profits under a particular Schedule or Case. It would seem that by analogy the profits referred to in section 381(4) are commercial profits as measured under generally accepted accounting principles and not the tax-adjusted figure where this is different. As a certain amount of flexibility is sometimes available in measuring profit for accounting purposes, it may be possible to ensure that a profit is achieved. However, if this is done by ignoring accepted accounting principles, the Revenue would be justified in "rewriting" the profit figure to reflect those principles.[13]

The way the trade is carried on

The section requires that the trade was carried on in such a way that profits could reasonably be expected. The reference to "in such a way" clearly requires that the *actual* way in which the trade was carried on is considered rather than a hypothetical way in which the trade could have been carried on. Detailed evidence of the actual way in which the trade was carried on will therefore be required by the Revenue if they wish to resist a claim.

The way in which a trade is carried on may change over time and the question of which period is to be considered has to be determined. The legislation clearly states that relief will not be given in respect of a loss sustained in any period "unless the trade was carried on *throughout* that period ... in such a way that profits ... could reasonably be expected". The period which is to be considered is therefore the period in which the loss was made. The taxpayer may have changed the way in which trading was carried on during the period in which the loss was incurred. Despite the use of the word "throughout", if the test for relief is met for part of the period, Revenue practice is to allow the losses for that part of the period, even if the

12 [1997] STC (SCD) 233.

13 *Gallagher v Jones* [1993] STC 537.

test is failed for the remainder of the period.[14] Thus if a claim fails, the taxpayer can learn his lesson and change the method of trading to help ensure that relief will not be refused in the next period.

Reasonable expectation

It is not enough that the taxpayer has carried on the trade on a commercial basis, he must also be able to show a *reasonable expectation* of profit. Having determined the way in which the taxpayer carried out his trading activities during the period in which there was in fact a loss, one must then consider whether his activities evidenced a reasonable expectation of profit in that period or within a reasonable time thereafter. The fact that the trade was conducted in a commercial manner is not of itself enough to meet the reasonable expectation test, otherwise the latter would be otiose. Although a trader may subjectively intend to make a profit, and do all within his power to achieve this, viewed objectively he may lack the skill, experience, capital or other relevant attribute which would have enabled him to do so in the period of loss. The test does not require certainty of profit, because businesses are always subject to risks and unforeseen and fortuitous circumstances to a greater or lesser degree. The most a trader can do is to follow best business practice to maximise the probability of making profits. But the question remains as to what level of probability justifies a reasonable expectation.

The only UK tax case in which the question of expectation seems to have been considered is *Crown Bedding Co Ltd v CIR*[15] in which the issue was whether the main benefit which might have been expected to accrue from a transaction was avoidance or reduction of liability to tax. The Master of the Rolls had the following to say on expectation.

> "The question of probability or possibility is a matter really which can be considered as resembling a scale. At the top of the scale is certainty. At the bottom of the scale is improbability so extreme that no sensible person could ever take it into account. But, subject to that, the precise point on the scale which you can say that a thing is probable rather than possible and the precise point at which you can say that a probability falls to the level of a mere possibility depends on the view taken by a hypothetical observer. It seems to me that it is quite impossible to put on the word 'expected' the

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14 Inspector's Manual paragraph 3507.

15 (1946) 34 TC 107.

> sense that a hypothetical observer must have had that degree of confidence in the future as to expect that the benefit would materialise."[16]

The question therefore resolves into whether a hypothetical observer, the "reasonable man", would consider the probability of profit so low that he would not take it into account.

Thus a fair, objective and unemotional view is required, as otherwise a trader who is hopelessly out of touch with reality would be able to subsidise his eccentricity at the expense of other taxpayers. However, risk and reward usually go together so that, while there may only be a small potential for making a very substantial profit, this may still be a realistic outcome rather than an extreme improbability.

Having determined that the question of reasonable expectation is to be judged by the reasonable man, the question then arises as to what characteristics should be attributed to this hypothetical objective observer who is to examine the actual way in which the trade was being carried on. Although the original concept of the reasonable man was the hypothetical ordinary man on the Clapham omnibus, it is subject to some modification. Where a person has a particular commercial skill or knowledge, the reasonable man would be based on a typical member of that trade or profession, showing the ordinary competence one would expect.[17] In Scotland, it has been stated that the reasonable man is presumed to be free both from over-apprehension and over-confidence.[18] Thus the standard used is that of the reasonable *man in the position of the taxpayer*, taking account of all relevant characteristics and the actual way in which the trade is carried on. It may be useful therefore to obtain evidence from independent sources of the expectation of profit and normal best practice as it applies in that class of business.

The type of factors which should be taken into account will vary according to the precise activity being carried on and no one factor will be decisive. In *Wannell v Rothwell*[19] the Revenue argued that, because of the haphazard, casual and intermittent nature of the taxpayer's activities, profits could not reasonably be expected. However, although there is no specific mention of these matters in the

16 *Ibid*, at 117.

17 *Hunter v Hanley* [1955] SC 200. In England, see *Maynard v West Midlands Reginal Health Authority* [1984] 1 WLR 634.

18 *Muir v Glasgow Corporation* [1943] SC at page 10.

19 [1996] STC 450.

Special Commissioner's decision or in the Court's judgment, the Judge said "it is implicit in what [the Special Commissioner] said about the taxpayer's experience and method of operating that he had a *reasonable prospect* of achieving profits".[20] Clearly, therefore, relevant experience may be an important factor to take into account. In the absence of any other cases it is suggested that some other factors to take into account are as follows:

- The degree of preparation for the activity by study of the accepted business, economic and/or scientific practices and consultation with those who are expert in such matters.
- The success of the taxpayer in previous business ventures.
- The time taken in that class of business to progress beyond the initial or start-up stage where losses are normally sustained.
- The degree to which losses relate to unforeseen or fortuitous circumstances beyond the control of the taxpayer such as drought, disease, fire, theft, a downturn in the economy or an increase in interest rates.
- Any changes in the method of operating which show the likelihood of improved profitability.

A reasonable time

It is not sufficient that there is a reasonable expectation of profit. That expectation must be realisable within a reasonable time. The reasonable man with knowledge of this particular type of activity must not merely be able to say that the activity will probably make a profit at some future indeterminate time. A reasonable time is that which the hypothetical observer would consider reasonable in the circumstances of the particular type of business. The Inspector's instructions reflect this: "a reasonable time should be interpreted by reference to the particular circumstances, especially the nature of the business undertaken. In general, it would be a fairly short period of say a year or so."[21] However, the case of *Walls v Livesey*[22] indicates that a reasonable time may well exceed four years: "... one deduces that

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20 *Ibid,* at 461.

21 Inspector's Manual paragraph 3507.

22 [1995] STC (SCD) 12.

at least four years of losses may be anticipated. That is inherent in the section. To that one adds a reasonable time thereafter."[23] The Revenue's view is:

> "... that relief is available so long as profits may be expected not later than a reasonable time after the end of the four year period for which claims under that section are possible. A reasonable time depends on the facts and nature of the loss making activity. In the context of furnished lettings it should normally be within five years of commencement."[24]

The Revenue often ask whether profit forecasts were prepared before the activity began but this is not a determinative factor. Many business are set up and continue without ever making profit forecasts. Such forecasts are usually forced upon new businesses by banks as an assurance prior to borrowing and, in any event, are often little more than speculations. They are unlikely to be accurate unless receipts and expenses can be reasonably predicted, as in the case of commercial lettings. What is a reasonable time would depend more upon the period taken to build up a client base, know-how, a track record and goodwill rather than the existence of a speculative forecast of when profits will arise.

Conclusion

Section 381 was introduced to assist new entrepreneurs through their initial loss-making stage by enabling them to obtain a refund of tax paid. Such entrepreneurs may often undertake risky ventures with the prospect of considerable rewards, for example the *bona fide* inventor. The fundamental question is whether the potential for abuse of the section by those who are really undertaking hobbies or recreational activities outweighs the discouragement of the true entrepreneur. In the USA, the Bill introducing an equivalent restriction on loss relief contained a "reasonable expectation of profit" test but this was rejected in favour of a test which debars relief unless the activity is engaged in for profit. It was thought that the reasonable expectation test was too severe and might discourage valuable economic activities.

However, it appears that adherence to an objective assessment of the reasonable expectation of profits within a reasonable period should provide sufficient check on spurious claims, while still affording relief to the genuine claimant. This element of objectivity must clearly be modified to a degree in order to import factors such

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23 *Ibid*, paragraph 8b at p.16

24 Revenue Interpretation, RI 175.

as the taxpayer's business environment into the equation, but any broader use of subjective considerations moves the test too far towards asking the taxpayer himself whether *he* thought he had a reasonable expectation of profit. This would render section 381(4) ineffective as every answer would be in the affirmative. Expectations, great or small, are inherently so self-referential that any test based on expectation must be transposed to an impersonal dimension.