**INCOME TAX**

**LECTURE 5 – TAXATION OF TRADING PROFITS**

**SLIDE 1**

Hello my name is Sarah Brooks. This online lecture relates to the subject area of taxation and is the fifth online lecture relating to income tax.

**SLIDE 2 – OUTCOMES**

In this fifth online lecture I am going to be concentrating on the trading profits of a Business, how they are calculated for Income Tax purposes and which of those trading profits are subject to income tax in any given tax year.

**SLIDE 3 – PART 2 – TRADING PROFITS**

You will recall from listening to the first online lecture on Income Tax that trading profits are a source of taxable income under Part 2 of the Income Tax and Trading and Other Income Act. Part 2 sets out how Businesses trading in profits are calculated. Once you have that trading profit figure this is then taken out and inserted into the individual’s total income tax calculation when calculating that individual’s overall income tax liability. Part 2 sets out that trading profits are calculated as follows. First of all, you work out what the businesses chargeable receipts are, then you deduct any deductible expenditure and then finally you deduct any capital allowances. The final figure then is the businesses trading profit.

**SLIDE 4 – CHARGEABLE RECEIPTS – DEDUCTIBLE EXPENDITURE**

The first step then is to calculate the businesses chargeable receipts. Chargeable receipts then is any income that the business receives from carrying out their trading activity, for example selling of their stock. In order for something to be a chargeable receipt though it has to be something of an income nature. In other words it has to have an element of recurrence to it. Secondly then we can deduct from those chargeable receipts any deductible expenditure. In order for something to be deductible expenditure it has to be expenditure of an income nature, in other words it is expenditure that has an element of recurrence to it and also that expenditure has to be incurred wholly and exclusively for the purpose of the business. Some key examples of deductible expenditure then are money that a business might spend on rent, stationery, salaries or utility bills. These are clearly expenditure of an income nature. You pay your rent monthly, you pay your salaries weekly etc. etc. and they are also incurred wholly and exclusively for the purpose of carrying on that business.

**SLIDE 5 – CALCULATING TRADING PROFITS EXAMPLE**

Now it is your turn again to have a go at calculating trading profits. Let’s assume that Jo runs a successful business as a florist and her accountant calculates that she has a turnover of £35,000 in the current tax year. During that year Jo has spent money on the following: £12,000 on salaries, £1,000 on gas and electricity, £500 on flower wrapping, £200 on cards and £12,000 on the purchase of a new van. Have a go at calculating Jo’s trading profits on that information. I suggest that at this point you pause the online lecture and then restart it once you have completed the calculation.

**SLIDE 6 – CALCULATING TRADING PROFITS EXAMPLE**

Hopefully you calculated Jo’s trading profit to be £21,300. Her chargeable receipts were £35,000 and from that we can deduct the deductible expenditure that she spent on salaries, gas and electricity, flower wrapping and cards. In total then her deductible expenditure was £13,700 and taking that away from her chargeable receipts gives her a trading profit of £21,300. Hopefully you have realised that Jo couldn’t deduct the amount she spent on the new van as deductible expenditure. Because it is not of an income nature there isn’t an element of recurrence to that expenditure. Purchasing a van is an one-off payment and therefore an item of capital and isn’t classed as deductible expenditure.

**SLIDE 7 – CAPITAL ALLOWANCES**

The third stage in calculating the businesses trading profits then is to deduct any capital allowances. Now we know from the example with Jo and the purchase of her van that normally items of capital are not deducted from trading profits as they are not of an income nature. However, the Capital Allowances Act does allow a trader to deduct a certain percentage of their expenditure on certain capital items in order to reduce their trading profits and therefore their overall income tax liability.

It is important to note then that the Act only allows traders to deduct a certain percentage of their expenditure on plant and machinery.

**SLIDE 8 – CAPITAL ALLOWANCES (CONTINUED)**

In terms of capital allowances, every business has an AIA. This allows a business to deduct 100% of the cost of new plant and machinery up to 1 million pounds from their trading profits. Should a business spend in excess of 1 million pounds on new plant and machinery, they can only deduct up to 18% of the cost of the excess from their trading profits.

**SLIDE 9 – CAPITAL ALLOWANCES (CONTINUED)**

How do these capital allowances work in practice? Let’s assume that A has profits of 5 million pounds and he purchases machinery for 1.5 million pounds. Remember A has an annual investment allowance of 1 million pounds. This means he can deduct 100% of the first 1 million pounds he spends on that machinery from his trading profits. He can also deduct 18% of the remaining half a million pounds that he spent on that machinery from his trading profits. As a result, A can deduct 1 million and £90,000 from his trading profits for that year reducing them down to £3,910.000. As far as the next accounting year is concerned A’s accounts will show that his machinery is worth £410,000 that is the 1.5 million pounds that he originally paid for the machinery less what it has been written down by.

**SLIDE 10 – CAPITAL ALLOWANCES (CONTINUED)**

Let’s assume that in the following tax year A has trading profits that currently stand at 6 million pounds. A still owns the machinery but because it is the second year he has owned it, he can only deduct 18% of the written down value of the machinery from his trading profits. We know that the written down value of the machinery is now £410,000 so A can only deduct 18% of that. In other words, £73,800 reducing A’s trading profits down to £5,926,200.

**SLIDE 11 – BALANCING CHARGES**

What happens then when a business sells one of its capital assets for more than it’s written down value? Well basically they are taxed on any profits that they make from that sale. There is an example here on the screen.

**SLIDE 12 – TAXATION OF BUSINESSES**

We now know how to calculate businesses trading profits but how do we know which of those profits the business is taxed on in any given tax year. Firstly, it is worth noting then that businesses have what we call accounting years and these are very often different to the tax year which we know runs from the 6th April to the 5th April.

Businesses then are taxed on the profits that they make in their accounting year that ends in the current tax year and this is what is known as the current year basis.

**SLIDE 13 – CURRENT YEAR BASIS – EXERCISE**

Remember that businesses are taxed on the profits that they make in their accounting year that ends in the current tax year.

If business A’s accounting year runs from the 1st January to the 31st December what profits will they be taxed on in this tax year? I suggest that you pause the on-line lecture at this point and then restart it when you think you have an answer.

**SLIDE 14 – CURRENT YEAR BASIS – ANSWER**

Hopefully you have worked out that business A will be taxed on the profits that it makes between the 1st January this year and the 31st December this year. Remember the tax year runs from the 6th April to the 5th April and a business is taxed on the profits that it makes in its accounting year that ends between the 6th April and the 5th April. There is an example on the slide for you.