COMMERCIALITY – COMBINED BUSINESSES AND SMOKE SCREEN

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Recently HMRC has paid a lot of attention to the sideways offset of losses (ITA 2007 s 64 and s 72) and, in so doing, the question of commerciality is raised. Particular attention has been focused on, for example, Stud farms, hobby farming and racehorse trainers who also combine their main trade with a farming operation.

Rather than have tax losses disallowed, some businesses (either consciously or by default) have merged profitable businesses with unprofitable businesses that they do not want to relinquish. The proprietors want to achieve the tax relief. The overall benefit of sideways tax loss relief is the loss offset against total income which is achieved indirectly or (please excuse the pun) through the side door.

Sponsorship

It can be argued that ‘sponsorship’ by a profitable business or a non profitable business are effectively this type of merging and smoke screen, that is putting in monies from profitable business into a non profitable business so that commerciality can be achieved. An example of such sponsorship is shown in the 1996 Special Commissioners case *Executive Network (Consultants) Ltd v O’Connor* SpC 56. In this case a company made payments to a riding school business (owned by the wife of the controlling shareholder) and claimed deduction for tax of these payments on the basis that they were sponsorship payments. The payments were disallowed for corporation tax purposes on the basis that they could not be proved to be wholly and exclusively for the purpose of a company’s trade.

In looking at *Executive Network* the Special Commissioners did consider the fact that ‘personal benefit played a part in the decision to make the sponsorship payments’. The payment by the company was strongly influenced by the deficit position of the wife’s business. More direct approaches to offsetting losses can be taken where the unprofitable legal entity was actually used by another family member to incorporate another business activity. The overall result is a shared net profit from the two businesses using tax losses which would probably not pass the commerciality test as utilised incorrectly.

Offset of Losses - Training

HMRC do try and review in detail business accounts which include a number of activities, one of which, for example, is loss making and is being propped up by the other profitable activities. A clear example of a profit being offset against an un-commercial loss is farming and the racehorse trainer (where the farmer is often just training his own horses).

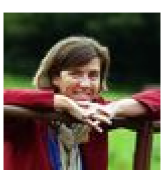
Practical Steps to protect correct tax loss claims

The practical steps to consider are:

1) Carry out a good “fact find” when taking on a client in the first instance and continue to understand the nature of the activity and whether more than one trade exists within the business.

2) Identify the activities contained within one set of books and records delivered into the accountant’s office.

3) Produce enterprise accounts where there are separate trades or activities, especially when there is a worry that there is a propping up of a loss making operation.



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