MINISTRY OF FINANCE

INCOME TAX OFFICE

INCOME TAX ACT 2010

GUIDANCE NOTES

CLASSES OF EXPENDITURE ALLOWED AS DEDUCTIONS

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What legislation?

The guidance being provided is for paragraph 2(1) of Schedule 3 – Rules for ascertaining profits or gains (Part I) of the Income Tax Act ("the Act").

These notes explain our interpretation of the Act and the way the Income Tax Office applies the law in practice. They are not a substitute for the Act and do not, in any way, affect a taxpayer's right to argue a different interpretation by way of appeal to an independent tribunal.

Based on the outcome of any such appeal referred to above, this Office may wish to either amend our interpretation as set out in these notes or to propose legislative amendments to the Act as deemed necessary. Any changes to the guidance provided in these notes will be issued publicly by this Office.

How does the legislation work?

The allowability of deductions will be determined on a matter of degree and fact from either statute, the opinion of the Commissioner of Income Tax or persuasive case law. In computing the profits or gains of any person under the Act, paragraph 1 of schedule 3 makes reference to profits or gains computed in accordance with either Generally Accepted Accounting Practice ("GAAP") or other accounting standards appropriately modified for the purposes of this Act.

The Act actually operates in a negative way, by simply stating those deductions that are not allowable rather than attempting to specify what shall be allowable. This means that a deduction will ***not*** be allowable if either of the following conditions hold true:

- it falls within the scope of any deductions expressly prohibited by the Act, or
- it is not a proper deduction in computing the gains and profits according to typical accounting practice as noted above.

What does 'wholly and exclusively' mean?

Paragraph 2 of schedule 3 states that *"….a deduction in computing the profits or gains of any basis period shall only be allowed in respect of any disbursement or expense, which is money wholly, and exclusively laid out or expended for the purposes of the production of the income of the trade, business, profession or vocation, except-".*

Our interpretation of this statement is two-fold. Firstly the deduction must be a valid business expense, which has been incurred solely for use in the trade, business, profession or vocation. Secondly once the purpose of the expense is established, then we will ascertain whether the incurring of that expense contributed in any way to the production of the income of the trade, business, profession or vocation.

What are the principles governing the deductibility of expenses?

There are three primary principles, which govern the basis on which deductions are allowable for the purposes of the Act. These are as follows:

- Any deduction, which is expressly prohibited by the Act, is not allowed in computing profits or gains.

- If the deduction is not in accordance with typical accounting practice (as prescribed in paragraph 1 of schedule 3 of the Act) it is not allowed in computing profits or gains.

- Any deduction, which although not expressly prohibited by either the Act or typical accounting practice (as prescribed in paragraph 1 of schedule 3 of the Act), is proved not to contribute in any way to the production of the income of the trade, business, profession or vocation is not allowed in computing the profits or gains.

What deductions are specifically prohibited under the Act?

The Act specifically prohibits certain types of expenditure from being claimed as deductions in computing assessable gains and profits. Nevertheless, some of the expenditure prohibited below and in particular certain types of capital expenditure may be eligible for capital allowances in accordance with the provisions of part 2 of schedule 3 of the Act.

Each deduction specifically prohibited has been reproduced below (including legislative references) with the corresponding guidance.

Paragraph 2(1)(a)

"the rent of the whole or any part of any dwelling-house or domestic offices, except any such part as is used for the purposes of the production of the income of the trade or profession and where any such part is so used, the sum so deducted shall not, unless in any particular case it appears that having regard to all the circumstances some greater sum ought to be deducted, exceed two-thirds of the rent bona fide paid for that dwelling house or those offices;"

The legislation disallows the rental cost of any private dwelling or domestic offices.

In the event that a proportion of the private dwelling or domestic offices are used in the production of the income of the trade, business or vocation then a deduction may be claimed up to a maximum of ⅔ of the total rental cost referred to above.

Any claim will be considered on the relevant facts and degree and a suitable apportionment basis (for example - utilisation of floor area) may be used in arriving at the allowable deduction.

Paragraph 2(1)(b)

"any sum expended for repairs of premises occupied, or for the supply, repairs or alterations of any implements, utensils or articles employed, for the purposes of the trade, business, profession or vocation, beyond the sum actually expended for those purposes;"

‘Repairs’ mean the restoration of an asset by replacing individual component parts of the whole asset. The cost of repair is normally revenue expenditure, which is an allowable expense.

No significant improvement of the asset beyond its original condition can result or there will no longer be a repair. The cost of replacing the asset or undertaking a significant improvement to the asset as a whole constitutes capital expenditure, and therefore not an allowable expense. It is important to identify on what asset the work has been carried out on. The question as to the nature and type of the asset, and therefore the application of the ‘entirety principle’ is one of fact and degree based on the facts of the particular case, in order to distinguish whether the costs that have been incurred are either revenue or capital.

Please refer to our guidance under paragraph 2(1)(d) in which various factors are explained that may be used in determining whether the expenditure incurred is of a capital nature.

Scenarios on which further guidance may be required include the following:

1. <u>Relief</u>

   The taxpayer may be able to obtain relief for capital expenditure on the replacement of entire assets via capital allowances.

   If the taxpayer repairs the asset, that is restores it to what it originally had been, then that would normally be an allowable expense. However, the mere fact that the taxpayer has had to deal with a maintenance problem does not mean that the expenditure is automatically allowable. The decision whether or not the costs are allowable, is based on the nature and extent of the work carried out.

2. Tangible assets with limited economic life

   There may be instances where a tangible asset may have a limited economic life. As a general rule of thumb it is reasonable to accept that if the asset's economic life is less than one year then the expenditure incurred on it is of a revenue nature.

   However the permanence or durability of the asset in question is important in deciding whether the expenditure is of a capital nature. Determining this however is largely a matter of degree.

3. An alteration or improvement is not a repair

   If instead of repairing the asset the taxpayer has the asset altered, improved or upgraded, that is, makes it better than it had been at the start, then all the cost of the work is capital expenditure. In these instances no revenue deduction can be allowed for any part of the expenditure.

4. Small amounts of improvement may be incidental and allowable

   Whether the taxpayer has had the asset repaired or improved is a question of fact and degree. An improvement element may be sufficiently small to count as incidental to the repair. In the absence of other capital indications, the entire cost can then be regarded as revenue expenditure.

5. Notional repairs

   If the asset had not been improved, then the business would ultimately have had to have the asset repaired. The cost of these repairs would have been allowable.

   The business does not get relief for the repairs it would have had to pay for, the 'notional repairs'. The business did not have the asset repaired and taxation depends on what actually happened. The business chose to have the asset improved and this is capital expenditure, and therefore not an allowable expense.

6. Changing technology

Problems can arise with older assets as to what is the dividing line between a repair and an improvement.

The fact that the method chosen is normally the cheapest and most effective is neutral to the tax treatment, since it does not deprive the expenditure of its capital character. Replacing an object may actually be cheaper and more effective than patching and mending.

A repair or replacement of a part of the asset using modern materials may look like an improvement because of the greater durability, superior qualities, etc of the new material. If the new materials are broadly equivalent to the old materials then the cost is normally an allowable expense.

IT equipment is of particular relevance within changing technology given the relatively short time span within which items of this nature may become technologically obsolescent. IT equipment, which is sensitive to technological obsolescence, may be treated as a tangible asset with a limited economic life, by considering the specific circumstances and to what degree the principles of permanence and durability may apply.

7. What is a repair: effect of change of ownership

A repair, which restores a worn or dilapidated asset, is normally an allowable expense.

If an asset is acquired second hand, then it is quite possible that it will need to be repaired. These repairs do not arise from use in the current business.

The fact the taxpayer had repairs carried out just after the asset had been acquired does not mean that the cost of the repair is disallowable.

The fact that the repairs were needed when the asset was acquired does not mean that the cost of the repair is disallowable.

The cost of the repair will be a capital expense if it is effectively part of the cost of acquiring the asset.

Whether the cost of the repairs is part of the cost of the asset is a question of fact. It is important to establish the condition of the asset and how the price was arrived at.

The following guidance can be used in instances where a repair may be considered part of the cost of acquiring the asset.

- the asset could not be used in the business without being repaired; or
- the asset could only be used in the short term and its long term use was dependent upon the repairs being carried out; or
- the purchase price of the asset was substantially reduced because the asset needed repairing.

The following guidance can be used when the expense is purely just a repair and therefore allowable as a deduction.

- the repairs are just part of the routine normal maintenance cycles; or
- the price paid was not affected by the condition of the asset; or
- the price was adjusted, but only to reflect where the asset was in the routine maintenance cycle; or
- the asset could be used in the longer term in the business without being repaired.

8. <u>Assets on which capital allowances given</u>

   The replacement of a component part of an asset (part of an 'entirety') is a revenue repair provided that replacement merely maintains the asset in its original form. The fact that capital allowances have been given on the asset as a whole does not prevent a revenue deduction being made for a repair to that asset.

Paragraph 2(1)(c)

"any loss not connected with or arising out of the trade, business, profession or vocation;"

Losses referred to here include those arising on activities, which do not represent the taxpayer's principal trade, business, profession or vocation, and therefore cannot be allowable as a deduction in computing assessable profits or gains.

Paragraph 2(1)(d)

"any capital withdrawn from, or any sum employed or intended to be employed as capital in the trade or profession, but so that this paragraph shall not be treated as disallowing the deduction of any interest;"

The determination of what is and what is not capital expenditure requires a balanced judgement of the relevant facts applicable at the time the expenditure was incurred.

Given that capital is not defined in the Act, this guidance is based on the wide range of tax cases and definitions established in UK tax law. It is important to note that rulings based on established tax cases need to be applied in a similar context – since applying a particular test in very different circumstances can lead to incorrect results.

The classification between capital or revenue is determined not only by the nature of the item involved, but also by the circumstances of the underlying transaction.

Although there is no comprehensive guide in this respect, a number of broad factors may help to determine whether a payment is of a capital or revenue nature. These factors are derived from established tax cases and may be useful only in the proper context. Other than the factor based on specific legislative provisions, you should not rely on any other shown below when your circumstances are different to the original context on which the guidance was based.

1. <u>Specific legislative provisions</u>

   The existence of a provision in the applicable tax legislation or in general law governing or providing for a payment to be treated as either a capital or a revenue payment, will render all the other factors considered below irrelevant since the nature of the payment is prescribed in law.

2. <u>Determination if expenditure is capital is primarily a question of law.</u>

   Accountancy treatment may be informative in these instances but is not determinative. What matters is the effect of the expenditure in question. Accountancy does not determine the effect but may be informative as to what was the effect of the expenditure. The fact that expenditure has been charged to non-current assets in a set of accounts may lend support to an argument that the expenditure is capital for tax purposes, provided such treatment is consistent with correct accounting principles. Although both the Act and accountancy principles are not fully aligned on the treatment of capital expenditure, tax legislation takes precedence.

3. <u>'Perpetual' payments are unlikely to be capital.</u>

   Expenditure of a recurring nature on the acquisition of assets, which are fixed capital, remains capital in nature. There is a difference between payment of a defined lump sum by means of a series of recurrent payments or instalments and payments that go on in perpetuity. Although the former may represent instalments of a capital sum, and therefore be classified as capital expenditure, the latter is classified as revenue expenditure.

4. The question between capital or revenue is answered by the effect of the expenditure and not the purpose.

   It is generally accepted that capital expenditure will usually produce an enduring result (either a benefit or advantage). It does however not follow that because expenditure is advantageous to a business it must therefore be of a capital nature, since it is most unlikely that a trader will knowingly incur expenditure that is detrimental to their business. Therefore determining that the expenditure was advantageous does not conclude the classification of the expenditure into either capital or revenue. The important point is therefore the nature of the advantage obtained from the expenditure in question.

   The term 'enduring' does not mean everlasting and the interpretation provided is a matter of fact and degree based on the particular applicable circumstances or context.

5. Generally capital expenditure will result in the acquisition, disposal or modification of an identifiable capital asset, either tangible or intangible, and where expenditure is abortive, the same result applies as would have applied if the expenditure had achieved its objective.

   The effect of the expenditure should be established and what was obtained or would have been obtained if the expenditure had not been abortive. If the effect is to acquire, dispose of or modify a capital asset then the expenditure is capital, irrespective that the expenditure is not reflected in the balance sheet.

   Most repairs are found to involve the replacement of defective parts of an asset, but the replacement of old parts with new ones does not in itself make the expenditure capital. The concept of the 'entirety' is used, in conjunction with the consideration of fact and degree, to distinguish revenue repairs from capital expenditure. If the entirety is replaced then the expenditure is capital, and as such not an allowable expense. If less than the entirety is replaced then the expenditure is likely a repair, and therefore an allowable expense.

6. <u>The nature of the asset concerned in the transaction</u>

   If it is not part of the company's trade, business, profession or vocation to deal in the class of asset in question then the expenditure is likely to be capital.

Paragraph 2(1)(e)

"any capital employed in improvements of premises occupied for the purpose of the trade or profession which generates the income;"

Detailed guidance on the capital/revenue divide as regards expenditure is provided in *2(1)(d)* above.

Paragraph 2(1)(f)

"any interest which might have been made if any such sums under subparagraphs 2(d) or 2(e) had been laid out at interest;"

Any interest, which is capitalised and classified as capital expenditure in accordance with accountancy practice, will not be allowed as a deduction in computing profits or gains under this Act.

Paragraph 2(1)(g)

"any debts except –

- ***(i)*** ***a bad debt;***
- ***(ii)*** ***a debt or part of debt released by the creditor wholly and exclusively for the purposes of his trade, business, profession or vocation as part of a relevant arrangement or compromise which became bad or were released during the period for which the profit or gain is being ascertained; and***
- ***(iii)*** ***doubtful debts to the extent that they are respectively estimated to be bad during the said period, notwithstanding that such bad or doubtful debts were due and payable prior to the commencement of the said period;"***

'Relevant arrangement or compromise' means an obligation under any other applicable local legislation.

A deduction for a bad or doubtful debt is to be made in arriving at the profits of the year in which the debt becomes bad or doubtful. This deduction in respect of bad or doubtful debts should be based on a separate valuation of each individual debt.

A general reserve, which is one calculated as a percentage of total debts or sales, is not allowed as a deduction if it has been made without regard to the circumstances of the particular individual debtors.

Where a deduction for a bad or doubtful debt has been claimed and this debt is subsequently recovered, the actual debt recovered or the amount in excess of its written-down value is brought into charge in the year in which it was recovered.

Paragraph 2(1)(h)

"any average loss beyond the actual amount of loss after adjustment;"

This applies where there is either no insurance or the insurance is for less than the full value or is 'free from average'. The latter applies to instances where a 'general average loss' may arise following which an adjustment may be required. A 'general average loss' is one where all the insurers share the cost of damage or loss, not just the insurer of the things actually damaged or lost.

Parties that have **not** suffered a loss under these circumstances may claim an allowable deduction in respect of the adjusted average contribution, which is to be paid by each insuring party.

Parties that have suffered a loss under these circumstances are entitled to claim an allowable deduction of the net amount after this has been reduced by the adjusted average contribution made.

Paragraph 2(1)(i)

"any sum recoverable under an insurance or contract of indemnity;"

No deduction is allowed for **expenditure** that is recovered under an insurance contract or contract of indemnity.

The tax treatment applicable to receipts from insurance recoveries follows the 'quid pro quo' principle as follows.

Loss of gains or profits from a trade, business, profession or vocation are trading receipts even if the compensation received exceeds the original amount forming the subject of the claim. The time at which any recoveries should be recognised within trading income will be based on generally accepted accounting practice.

Any recovery arising in connection with a capital asset is a capital receipt and therefore not liable to tax. Any allowable expenditure incurred in either repairing, renewing or replacing the asset should be reduced by the recoverable amount.

Paragraph 2(1)(j)

"any interest paid or payable to a person not resident in Gibraltar if and so far as it is interest at more than a reasonable commercial rate;"

Does not allow a deduction for any interest paid to a non-resident person in the event that this interest is paid at a rate greater than a reasonable commercial rate (i.e. a non-arms length transaction)

The facts and degree of any individual case~~s~~ would need to be determined.

Paragraph 2(1)(k)

"depreciation of any assets;"

Although the depreciation of a non-current asset constitutes a proper deduction against profits under GAAP, it is not an allowable deduction in computing profits or gains for tax purposes on the basis that it is of a capital nature.

Paragraph 2(1)(l)

"any interest which is paid or payable upon any money borrowed other than for the purposes of the trade or profession which generates the income or acquiring the capital employed in acquiring the trade or profession which generates the income;"

Interest costs incurred wholly and exclusively in the production of the income are allowable as a deduction in computing the profits or gains under the Act. Furthermore any interest incurred on acquiring capital employed is considered not to be capital in nature and therefore allowable in computing the profits or gains under the Act.

Paragraph 2(1)(m)

"any taxation charged under –

(i) this Act; or

(ii) any tax in respect of which relief may be given under section 37;"

Any tax charged under this Act shall not be allowed as a deduction in computing the assessable profits or gains. Tax in this context includes any surcharges or penalties levied in accordance with the provisions of this Act together with, where applicable, any foreign tax that has been paid which is subject to a claim for unilateral relief.

Any deduction in respect of tax charged on any benefits received by an employee, which is paid by an employer on behalf of that employee, in accordance with the provisions of paragraph 74(1) of schedule 7, is not an allowable deduction for the purposes of this Act.

Paragraph 2(1)(n)

"contributions made to a provident, pension or other fund for the benefit of employees where such fund has not been approved by the Commissioner for the purposes of this paragraph;"

In order to claim an allowable deduction in computing assessable profits and gains for the purpose of this Act, the contributions claimed must have been made to a provident, pension or other fund approved by the Commissioner of Income Tax.

Paragraph 2(1)(o)

The rules covering this specific deduction are the subject of a separate set of guidance notes issued by the Income Tax Office on Business Entertainment Expenditure.

Paragraph 2(1)(p)

(i) ***"head office expenses or expenses incurred by any branch for the common purpose of the company and its branches or for the purposes of the head office or another branch exclusively (all for the purposes of (ii) referred to as 'head office expenses') in excess of 5% of the gross income of the person.***

(ii) ***For the purposes of (i) above head office expenses shall mean a deduction claimed by a branch of a person in respect of expenditure which is incurred in common between the branch in Gibraltar, the person and other branches of the person and is shared on an apportionment basis either between the person and the branches of the person."***

This sub-section only allows a maximum claim in respect of head office expenses equivalent to 5% of the gross income of the person.

For the purposes of this sub-section gross income means the turnover or equivalent income derived from the principal trading activity, as computed in accordance with any standards, convention or statutory regulation applicable to that particular trade, business, profession or vocation.

Structures not involving branches will face a similar restriction in accordance with the anti-avoidance provisions of the Act.

When are deductions apportioned on a pro-rata basis?

Section 2(2)(a) of schedule 3 of the Act requires those deductions allowed in accordance with the Act to be apportioned between both chargeable and non-chargeable income. The apportionment basis used to pro-rata the allowable deductions should be equivalent to the proportion that the chargeable income bears to the entire income, including any passive income.

For the purposes of the above, the term passive income includes bank interest, dividend income, or any other income that is derived from activities in which there is no material participation required to generate it.

Examples are included in Appendix 1 – Apportionment of deductions allowed.

Further help and advice

These notes are issued for guidance purposes and therefore any enquiries on these should be directed to this Office. Contact details are provided below.

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Appendix 1 - Apportionment of deductions allowed

Example 1 - Company with trading income and no passive income

No proportional apportionment of allowable deductions

	£	£
Trading income		
Chargeable to tax	140,000	
Non-chargeable to tax[1]	60,000	
		200,000
Expenses		
Allowable	(65,000)	
Not allowable	(5,000)	
		(70,000)
Profit for year		130,000

[1]Income not chargeable to tax since neither accrued in nor derived from Gibraltar.

Proportional apportionment of allowable deductions

	£	£
Trading income		
Chargeable to tax	140,000	
Non-chargeable to tax	60,000	
		200,000
Apportionment basis – 70% (140K/200K)		
Expenses		
Proportion allowed		
(70% of £65,000)		(45,500)
Profit for year		154,500

Example 2 - Company with trading and passive income

No proportional apportionment of allowable deductions

	£	£
Trading income		
Chargeable to tax	140,000	
Non-chargeable to tax[1]	60,000	
		200,000
Passive income[2]		50,000
Expenses		
Allowable	(65,000)	
Not allowable	(5,000)	
		(70,000)
Profit for year		180,000

[1]Income not chargeable to tax since neither accrued in nor derived from Gibraltar.

[2]Passive income consists of both bank interest and dividend income.

Proportional apportionment of allowable deductions

	£	£
Trading income		
Chargeable to tax	140,000	
Non-chargeable to tax	60,000	
		200,000
Apportionment basis – 56% (140K/250K)		
Passive income		50,000
Expenses		
Proportion allowed		
(56% of £65,000)		(36,400)
Profit for year		213,600