The Wardle case: the commencement of a business or trade

Large Corporate | OMB



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We consider the importance for tax purposes of identifying the commencement of a business or trade, as highlighted by the *Wardle* case.

Key Points

What is the issue?

Identifying the commencement of a business or trade depends on the particular facts and circumstances and has a number of tax consequences. The *Wardle* case illustrates that trade can commence before the business is entitled to generate income.

What does it mean for me?

Identifying the correct date of commencement of a business or trade will assist in advising on tax compliance obligations, as well as available reliefs and claims and even jurisdiction of taxation.

What can I take away?

The *Wardle* case is a useful illustration of the principles involved in identifying when a trade has commenced. It may be helpful to consider how the principles could be applied in identifying the commencement of a trade or a property business, bearing in mind that in general trade principles are applied in determining taxable property business profits.

Identifying the commencement of a business or trade depends on the particular facts and circumstances and has a number of tax consequences. It is reasonable to expect that a business or trade commences when the entity begins operational activities. While this might not require sales to be made at that point, it would generally require some preparation for dealing with customers (though an activity which merely reviews customer possibilities or tries to justify going into trade is insufficient).

There have been a few recent cases in which the date of commencement of a trade or business has been considered. This article discusses the importance for tax purposes of identifying commencement, using the recent First-tier Tribunal decision in *Wardle v HMRC* [2024] UKFTT 543 (TC). This case held that the commencement of a trade of power generation from waste occurred before it was possible to make a sale.

Date of commencement and the tax implications

The first issue is to establish why the commencement of business or trade is an important issue for tax.

The commencement of business or trade is the start of an accounting period and triggers the obligation to register for tax (Corporation Tax Act (CTA) 2009 s 9 and Finance Act 1998 Sch 18 para 2). A business must be undertaking a qualifying activity (such as a trade or property business) before it can claim capital allowances and other reliefs, for example, land remediation relief (Capital Allowances Act 2001 s

11 and CTA 2009 s 1147).

For corporation tax, loan relationship debits that are incurred before a trade commences are treated as non-trade debits. However, an election can be made to treat them as trading debits on the first day of trading (CTA 2009 s 330) or undertaking a UK property business (CTA 2009 s 330ZA)). In a group context, these debits will only be available for group relief if the relevant companies are 'in business', as group relief is available by reference to an accounting period.

For corporation tax, the commencement of an investment business may mean that there are deductible management expenses available for group relief (CTA 2010 ss 99 and 188BB).

It is possible to claim pre-trading expenses as incurred on the first day of trade if they were incurred within seven years of that day (CTA 2009 s 61 and Income Tax (Trading and Other Income) Act 2005 s 57).

If a foreign business's activity in the UK amounts to a trade, it may have a UK permanent establishment and UK tax filing and payment obligations, notwithstanding that it owns no UK property as capital (CTA 2009 s 5), though the definition of a UK permanent establishment may be modified by the application of a double tax treaty. This is to be distinguished from preparing to trade.

Whether an activity is a business may determine where and how its income is taxed (as highlighted in the recent *GE Financial Investments* case [2024] EWCA Civ 797 at the Court of Appeal).

Whether an activity amounts to a trade can be important for determining whether certain reliefs are due; for example, a substantial shareholdings exemption (Taxation of Chargeable Gains Act (TCGA) 1992 Sch 7AC) or business asset disposal relief (TCGA 1992 ss 169H- 169SA and Sch 7ZA).

There may be an impact on associate company status if a company does not carry on a business activity (CTA 2010 s 18E(3) and *Jowett (Inspector of Taxes) v O'Neill and Brennan Construction Ltd* [1998] STC 482 Ch).

The *Wardle* case

The First-tier Tribunal decision in *Wardle* held that the waste to energy businesses met the trading requirement for what was, at the time, entrepreneurs' relief for the required two-year period. This was despite the fact that, at the start of the two year period before the sale, the plant to be used for the business had not passed its commissioning tests and was not at that time in a position to generate income from sales of electricity.

Assessing whether an activity amounts to a trade or business at a particular point in time is a fact-sensitive exercise. The *Wardle* case is a useful reminder of the factors to consider in relation to a trade, particularly on larger infrastructure projects where it may be some time before a sale is made.

It is helpful to summarise the facts and timeline in this case:

- In June 2015, a limited liability partnership was formed as a special purpose vehicle for the project. The external funders' investment committee approved funding in August 2015 and the limited liability partnership entered into unsecured loan arrangements with the funder.
- In August 2015, the limited liability partnership entered into a number of contracts for construction works.
- A power purchase agreement was signed in August 2015 and was subject to a number of conditions being met. A power purchase agreement usually refers to a long-term electricity supply agreement between two parties: a power producer and a customer. It can include conditions such as the amount of electricity to be supplied, the negotiated prices and penalties for non-compliance.
- In or around May 2016, the limited liability partnership issued the Commencement Notice under the operation and maintenance contract, at which point the contractor could commence work and invoicing for that work. At this time, the plant was due to be constructed in 2017 but this was delayed.
- By December 2017, the plant could import electricity under the power purchase agreement. However, on 28 February 2018, condition precedent 2.1(a) of the power purchase agreement was not satisfied and the plant was neither generating electricity nor receiving feedstock commercially.
- On 31 March 2018, the commissioning tests and trial runs were passed, with commissioning certified as complete by the installation contractor.

- In June 2019, electricity was generated commercially for the first time. Specifically, 808.409 MWh were exported to the Grid Company, representing revenue of £36,290.18.
- The limited liability partnership's Annual Report and Financial Statements for the period to 31 December 2019 ('2019 Accounts') record turnover of £173,528, a total loss of £11,177,548) and that the limited liability partnership had drawn down £89,240,773 under a loan arrangement.

An interest in the limited liability partnership was sold on 28 February 2020 and the question to be determined was whether the business had been trading for at least two years prior to that.

Assessing whether trade had commenced

The main basis used for assessing whether the trade had commenced were the tests commencement identified in the Special Commissioners' case of *Mansell v HMRC* [2006] UKSPC 551 (also mentioned in HMRC's Business Manual at BIM80505).

The *Mansell* case considered whether an individual had commenced a trade before he signed heads of terms for options over interests in land suitable for a motorway service station. This case was cited in the High Court case of *Tower MCashback* [2008] EWHC 2387 (Ch) as a useful demonstration of identifying when operational activities had begun. To reach that determination three factors had to be considered.

As applied in the case of *Wardle* for assessment by February 2018, these were:

1. Was there a specific concept of the type of activity to be carried on?

All parties were agreed that this was present – the construction and operation of a power plant burning wood waste where a third of the revenue would be derived from production and sale of electricity, and two-thirds from the sale of Renewable Obligation Certificates.

2. Has a trade been set up?

The acts of 'setting up' are not commencing or carrying on the trade. Setting up trade will include: setting up a business structure to undertake the essential

preliminaries; getting ready to face your customers; purchasing plant; and organising the decision-making structures, management and financing. Depending on the trade, more or less than this may be required before it is set up.

This is a fact-sensitive analysis and what is required to set up one business to the requisite level will vary (potentially greatly) from what is required to set up another.

In the case of *Wardle*, the First-tier Tribunal considered the trade to be sufficiently set up, despite not being 100% complete. This was based on a case where a gambling business was held to be set up, even though it did not have a gambling licence (*Hunt* [2019] UKFTT 515 (TC), and two cases concerning whether film businesses had been set up despite not yet having received approval from the department of culture, media and sport (*Halcyon Films LLP* [2008] UKSPC 696 and *Micro Fusion* [2008] UKSPC 695).

3. Was there operational activity?

HMRC had conceded that if the second step was satisfied then the power purchase agreement would satisfy the third step, as the power purchase agreement was operational activity, being dealings with a third party that were immediately and directly related to the supplies to be made, which it is hoped will give rise to expected profit and which involved the limited liability partnership putting money at risk. For the avoidance of doubt, the First-tier Tribunal agreed that the power purchase agreement constituted operational activity.

In conclusion

While the First-tier Tribunal did not comment on a specific date for commencement, it is clear that the findings in this case were that trade commenced more than a year before a sale was actually made.

While the *Wardle* case looks specifically at the date of commencement of trade, the date of commencement of a property business and an investment business are also of interest. You may have seen that the CIOT has made a pro-active submission attempting to get HMRC to give greater clarity about its views in this area (see tinyurl.com/4m73jwrr). While discussions on this are ongoing, it may be helpful to make reference to comments on business activity in two other recent cases.

In *Centrica Overseas Holdings Ltd* [2024] UKSC 25, the House of Lords commented that: ‘It is true that Parliament chose to calculate the profits of a property business in the same way as the profits of a trade and therefore incorporated a series of trading provisions by reference in [CTA 2009] s 210(2)’ (para 60).

The HMRC guidance at Property Income Manual PIM2505 gives HMRC’s view that a property rental business usually starts when letting first commences. New large rental premises often require significant planning, operational and finance activity before the first rent can be received. CTA 2009 s 207 identifies a UK property business as one which is carried on for generating income from land. It does not specify that the rental income has to be received before there is a business. Indeed, the *Wardle* case may indicate that such a business may have started some time before the first rental is received or before the first letting commences.

One might think that a company or limited liability partnership has to have a business purpose from its constitution. However, in the case of *GE Financial Investments*, it is worth bearing in mind the Court of Appeal comments on the earlier First-tier Tribunal finding that there was no business. It considered that the limited partnership in which the GE UK company had an interest:

> ‘…acted merely as a passive holding vehicle for some loan receivables. Their size makes no difference: the test is a qualitative one. The board of GEFI Inc, as the limited partnership’s general partner, did not make strategic decisions and in fact had “very little involvement”.’

Such an entity undertaking activity with significant assets can still be held to be ‘not in business’.

The date of commencement of business or trade can impact on many tax areas and may require detailed review to properly determine how tax applies in any situation.

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