

TaxZone Newthwire

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(1) Introduction

Before 1965 there were no specific rules or items of legislation that disallowed business entertainment expenses for tax purposes. As long as the expenditure was incurred wholly and exclusively for business purposes within what was section 74(1)(a), Taxes Act 1988, then the cost was tax-deductible from profits. Section 74 has been replaced, from 6 April 2005, by provisions within sections 32-55, Income Tax (Trading and Other Income) Act 2005.

In an old tax case that is effectively now overruled by more recent legislation a firm of solicitors were able to claim the costs of taking clients out to lunch (see *Bentleys, Stokes & Lowless v Beeson* [1952] 33 TC 491).

However, the culture of business entertainment was becoming so prevalent that the Inland Revenue perceived that the law was being abused. Consequently a specific section was introduced into the Taxes Acts for the purpose of disallowing business entertainment expenditure. However, like many other provisions, the law is not as straightforward as it might seem, as will be seen below.

(2) The legislation

The legislation concerning business entertainment was found at section 577, Taxes Act 1988. It contained ten sub-sections and sub-section (1) states:

‘No deduction shall be made in computing profits chargeable to tax for any expenses incurred in providing business entertainment’.

The subsection goes on to apply the disallowance to expenses of management.

Sub-section (3) extends the disallowance to sums granted to employees to be used for the entertainment of customers or clients. Sub-section (7) confirms that expenditure 'incidental' to the entertainment or hospitality comes also within the disallowance, and that a 'trade' includes a profession or vocation.

There is a small relaxation within subsection (8) in relation to small gifts, the cost of which do not exceed £50, and are not food, drink, tobacco or a token or voucher exchangeable for goods, and these are treated as allowable expenditure.

Subsection (9) exempts gifts made to charities, and subsection (10) the deduction of relevant expenses where the expenditure is in connection with the trade, i.e. a catering company, a restaurant or public house.

Once again, section 577 has been incorporated into ITTOIA 2005 from 6 April 2005, within sections 32-55.

(3) The definition

Subsection (5) of section 577 defines 'business entertainment' as 'entertainment (including hospitality of any kind) provided by a person, or by a member of his staff, in connection with a trade carried on by that person, but does not include anything provided by him for *bona fide* members of his staff unless its provision for them is incidental to its provision also for others'.

The Shorter Oxford Dictionary defines hospitality as 'the art or practice of being host to the reception and entertainment of guests with liberality and goodwill'. In the case of *Stokes and Lowless v Beeson* [1952] 33 TC 491 Mr Justice Roxburgh stated 'I cannot see much difference between entertainment and hospitality, and if hospitality arises then the relationship of host and guest follow as a matter of course'.

(4) HMRC material

The HMRC Business Income Manual contains a good deal of explanation about the allowability or not of business entertainment, and this is set out at BIM 45005 – BIM 45090. Some of this material will be discussed in detail later in this wire. Other HMRC pronouncements are as follows:

(a) Annual staff parties and functions

Section 264, ITEPA 2003 grants tax deductibility to the employer and tax exemption to the employee for an amount of up to £150 expended per employee the annual staff party or function. This sum is inclusive of VAT and the cost of transport to the function.

(b) Third party entertainment

Section 265, ITEPA 2003 exempts third party entertainment to an employee and his or her family, where the provider of the entertainment is not the employer or someone connected with him, and is not given in respect of services.

(c) Small gifts of vouchers and tokens

Employees and others are exempt from the benefits legislation in respect of gifts of vouchers or tokens capable only of being exchanged for goods, not provided by an employer or his associate, not procured by an employee or in recognition of services, and not exceeding a value of £250 for each tax year (section 270, ITEPA 2003).

(d) Small gifts from third parties

A similar exemption to that of section 270 is granted by section 324, ITEPA 2003 to small gifts of up to £250 a year granted to an employee or his or her family. An additional condition is that the gift must not be in cash, securities or the use of a service. The figure of £250 is inclusive of VAT.

(e) Benevolent gifts by traders

HMRC Extra-Statutory Concession B7 extends the concession granted by section 577(8) to charitable gifts by traders. Small gifts to local organisations such as educational, religious, recreational or benevolent bodies are exempted from disallowance. The exemption also extends to an ordinary annual subscription to a local trade association by a non-member.

(f) Donation of trading stock to charities

HMRC Interpretation 151 explains that trading stock given to charities will not come within the entertainment expenses disallowance of section 577, TA 1988. An example is surplus sandwiches given to charity by a catering trader. Accordingly the proceeds will be treated as 'nil'. There are special rules in section 84, TA 1988 in respect of trading stock given to 'designated educational establishments'.

(5) Tax cases

There are very few decided direct tax cases regarding entertainment expenses. The case mentioned earlier in this wire has been superseded by section 577. The main current case is:

Fleming v Associated Newspapers Ltd [1972] 48 TC 382

A claim by a newspaper publishing company failed to obtain a tax deduction for entertainment expenses incurred through its journalists to obtain material for publication from potential contributors. Section 577(10) referred to a trade of providing entertainment or hospitality, or to the provision of free samples.

However the definition of business entertainment has been tested in a number of VAT cases. Tolley's VAT Cases contains reports of almost 50 Tribunal or court cases on this subject. Perhaps the most important of these in relation to direct tax are:

Customs & Excise v Shaklee international and Another [1981] STC 776.

A pyramid selling organisation held regular courses for distributors. It was held that the VAT on the provision of food and accommodation was not reclaimable input tax.

Thorn EMI plc v Customs & Excise [1995] STC 674

A company manufacturing complex electronic equipment displayed its products at air shows. At these events it had exhibition stands and hospitality chalets. The Court of Appeal held that the expenditure should be apportioned for the purpose of establishing claimable input tax.

Celtic Football & Athletic Club v Customs & Excise [1983] STC 470

The cost of providing hotel accommodation for visiting teams during the European Cup was held by the court not to be business entertainment and the VAT on these costs was therefore deductible. Article 5, Input Tax Order applied, as in *Thorn* above. It has no equivalent in direct tax law.

(6) Disallowable expenditure

We now turn to the practical application of the law and principles set out above. In this respect the HMRC Business Income Manual is very helpful. Items that are definitely tax-disallowable in a trader's accounts include:

The provision of free or subsidised hospitality or entertainment to a customer, potential customer or any other person. The host/guest relationship is fundamental to the concept of business entertaining. (BIM 45010)

No apportionment of expenditure is permissible under section 577, TA 1988, whereas the VAT legislation permits this approach (see the *Thorn* case above). This treatment highlights the different purpose of the direct tax and VAT legislation. (BIM 45011)

Business entertainment includes entertainment and hospitality that is provided free of charge, but also subsidised entertainment and hospitality.

Example 1

A trader incurs expenditure of £1,000 on a social occasion for selected customers. Each customer pays a small amount to attend and the trader receives a total of £200. The net cost of £800 is business hospitality and is not allowed. (BIM 45012)

Incidental expenditure in connection with entertainment is also disallowed. This will include payments to a third party to organise the event, and travelling, motor expenses, train and taxi fares in connection with the event. (BIM 45020 and BIM 45025)

Payments for entertainment where there is no direct link between the expenditure incurred and any payment or value received. This was established in the *Associated Newspapers* case mentioned above. There is a vital difference between a hotel serving drinks, which would come within section 577(10) and journalists buying drinks for potential suppliers of copy. (BIM 45031)

Specific or round sum allowances made to employees for the purposes of business entertaining. (BIM 45040)

The provision of accommodation, as well as food and drink, is treated as disallowable when provided as entertainment or hospitality. However, see below for instances when such expenditure may be allowable. (BIM 45046)

Although sponsorship payments for sporting, cultural and other events may be allowable (see below), where the sponsor receives free tickets, private boxes or other benefits, a disallowance will be calculated based on the value of the benefits. Where the sponsor pays for additional events such as a dinner dance for a football club or a private reception for certain theatregoers, this is treated as entertainment expenditure and is disallowed. (BIM 45055)

As indicated above, payments to a third party (for example an events organiser) to provide hospitality on behalf of a business are entertainment expenditure, and are disallowable. (BIM 54060)

Business gifts are treated in the same way as business entertaining expenditure and are normally disallowable. Only in situations where they form part of a trading operation is the expenditure allowable. For instance where flowers are presented to a customer who has just purchased a car. (BIM 45065).

As indicated in section 577 there is an exception to this where gifts are presented that contain a conspicuous advertisement for the trader. The conditions are that the gift is not of food, drink or tobacco and is not a voucher or token exchangeable for cash, and that the total cost of gifts in the accounting period to that person does not exceed £50. Common examples of such gifts are diaries, pens and mouse mats. (BIM 45070)

(7) Allowable expenditure

Subscribers may be surprised to ascertain that there are numerous examples of situations where expenditure on entertainment, hospitality or subsistence is allowable. Some of these are as follows:

Where there is a contractual obligation for the recipient to provide value in return, hospitality payments will not be disallowed. An example is where hospitality is provided as part of a package of services for which payment is received. The *Celtic Football Club* VAT case referred to above is a further example of this approach. (BIM 45013)

The *quid pro quo* can be something of equivalent value given in return such as goods or services. This principle was established in the VAT case of *C & E v Kilroy Television Company Ltd* [1997] STC 901. Members of a studio audience were reimbursed train fares and given a buffet meal before the programme. The service provided by the studio audience was by participating in the programme. (BIM 45014)

Goods and services sold in the normal course of trade are not business entertainment. Examples of this principle are catering companies, hotels and restaurants. In the case of a restaurant this is extended to offers such as 'two meals for the price of one'. A pub may offer 'free' refreshments to a visiting darts team, and this may be regarded as a discount on the drinks purchased by the players – provided the hospitality is not out of proportion.

Similarly a residential training course will include a 'package' of services including meals and accommodation. All these services will have been paid for, so that there is no element of disallowable entertaining. On a lesser scale coffee provided at a hairdressers and drinks at a casino come into the same category. (BIM 45030)

The cost of goods or services given away as advertising promotion is an allowable cost. A sweet manufacturer might give away a free chocolate bar. Once again the gifts must be given away in the normal course of trade, and for the purpose of advertising.

Examples of this principle are free meals given to restaurant critics, a couturier giving away a dress to someone in the public eye, and a 'trial run' of hotel facilities given to a potential bulk buyer. (BIM 45032)

Staff entertaining is normally allowable, as long as it is wholly and exclusively for the purposes of the trade and is incidental to entertainment provided for customers.

However, there may be a 'benefits' charge on the member of staff. The legislation regarding allowable Christmas or other staff functions is referred to above. (BIM 45033)

Whether expenditure is incidental depends on the nature of the occasion. If the employee has lunch with the customer in the staff canteen the employee's lunch is allowable. If the employee takes the customer out to lunch, the whole cost is disallowed. A golf club subscription may be allowable, but will be a benefit to be shown on the employee's P11D. (BIM 45034)

The cost to a trader of ordinary subsistence for people directly involved in the trade is an allowable expense, even though such people may not be employees. There must be evidence of services provided and the food and drink must not be excessive. Examples include security people attending a rugby match (attendance is necessary for safety purposes) or jockeys at a race meeting (without whom they would be unable to conduct their business). (BIM 45045)

The treatment is extended to accommodation provided for outside tradespeople involved directly in the business. (BIM 45046)

The cost of food and accommodation provided for employees attending training courses for the trade is allowable. However, food and accommodation provided to other persons is treated as disallowable entertainment. If the course involves training for franchisees, the payment for the franchise is a payment for training and makes the food and accommodation allowable expenses. (BIM 45047)

Promotional events arranged for the purpose of publicising a trader's products are not in themselves business entertainment, but the costs of any food, drink or other hospitality provided is disallowable. (BIM 45050)

The cost of sponsoring sporting, cultural or other events for the purpose of business promotion are not disallowable under section 577. However, as indicated above, where tickets, private boxes etc are received in return some disallowance of the expenditure will be made. (BIM 45055)

Gifts carrying a conspicuous advertisement for the trader are allowable, provided that the gift is not food, drink or tobacco, nor is it a voucher exchangeable for cash; and the cost of the gift(s) during the relevant tax period does not exceed £50. (BIM 45070)

Free samples given to the public for the purpose of advertising those goods is not entertainment expenditure. (BIM 45071)

Gifts made to charities. Extra-Statutory Concession B7 extends this treatment to gifts made for certain cultural, religious, recreational or benevolent purposes, where the activities of the donee are not restricted to persons connected with the donor and the expenditure is small in relation to the business of the donor. Donations by Gift Aid are a subject beyond the scope of this wire. (BIM 45072)

Prizes for promotional and publicity purposes are normally allowable. This includes competitions open to the general public, including situations where prizes comprise the trader's own products. (BIM 45075) Prizes for customers and sales staff who achieve a particular level of sales are also exempted, provided certain conditions are fulfilled. (BIM 45080). It should be noted, however, that the prizes may be taxed on the recipient. (BIM 45090)

The issue of 'no purchase' scratch cards also comes within the small gifts exemption. Similar treatment is given to 'gifts' provided by the timeshare industry to individuals who attend presentations. (BIM 45085)

In the case of catalogue traders, prizes received by self-employed traders successful in draws are taxable. However, the many 'agents' who are not self-employed are in effect merely receiving a discount on their purchased goods, and are not taxable on any prizes. (BIM 45090)

(8) An illustration

Example 2

X Ltd is a book publisher. During the year it pays £40,000 to Y Ltd, an events organiser, to provide hospitality at some of its book launches. The actual cost of arranging these launches is £37,000.

X Ltd also pays £50,000 to Z Ltd, a public relations company. This is made up of £5,000 for a Christmas party for X Ltd's customers and £45,000 for publicising the company and its products. Z Ltd spends £3,000 on working lunches with journalists in connection with X Ltd's business.

The effect upon each company's tax computations is as follows:

X Ltd

£40,000 paid to Y Ltd for book launches.	Not allowable. Payment has been made for business entertainment.
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£5,000 paid to Z Ltd for Christmas party.	Not allowable. Payment has been made for business entertainment.
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£45,000 paid to Z Ltd for publicity.	Allowed in full. (The £3,000 has not been specifically reimbursed and is added back in Z Ltd's computation).
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Y Ltd

£37,000 expended on book launches. Allowed in full. Expenditure has been incurred by Y Ltd as agent for X Ltd and reimbursed in full. Not business entertaining expenditure in Y Ltd's hands.

Z Ltd

£4,500 expended on Christmas party. Allowed in full. Expenditure has been incurred by Z Ltd as agent for X Ltd and reimbursed in full. Not business entertaining expenditure in Y Ltd's hands.

£3,000 expended on lunches with journalists. Not allowable. Z Ltd has incurred expenditure as principal and not agent. The journalists do not pay for their lunch and the expenditure is not specifically reimbursed by X Ltd. The exclusion in section 577(10) does not apply.

(Reproduced from HMRC Business Income Manual BIM 45062)

(9) Any Answers

Entertaining or Advertising ?

Abdul Shohid, in his query of 17 January 2005, questioned the allowability of costs incurred in entertaining clients, employees and potential clients at a function celebrating the firm's 25th anniversary. A lengthy presentation was planned.

As regards VAT, John Price stressed that there had better be some serious advertising element for any VAT costs to be recovered at all. If this was achieved, much of the VAT on premises hire and other direct costs could be recovered.

For corporation tax purposes I fear that this expenditure would be treated as entertaining and hospitality, and would be disallowed in full.

Entertaining v Subsistence

What is the difference, asked Clarence Netto, on 22 October 2003? Is having lunch with a client after a morning meeting entertaining or subsistence?

All those who replied were unanimous that a business lunch was entertaining and not allowable. Peter Crowther and Roger Harding explained that subsistence was expenditure incurred when one was away on business and, for instance, stayed at a hotel.

Business entertaining

James, on 28 October 2004, queried the position where Company X provides fee paying services to Company Y, of which it is a 20% shareholder. Company X incurs entertaining expenses regarding customers of company Y and re-invoices these costs to company Y. Is it correct that the entertaining disallowance is reflected in the accounts of company Y? Hxj confirmed that this was the correct analysis.

Overall Planning Point

Practitioners with company and business clients should ensure that they are aware of the relevant legislation and practice regarding entertaining and hospitality expenses. They should be aware of easy resources to use when particularly complicated issues arise.

Ask a question

Readers with a current case should post their query in Any Answers.

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